Marlborough Group

Q&A: Marlborough US Multi-Cap Income, a concentrated portfolio of high-quality US companies

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> ***"We believe the outlook for our portfolio companies remains bright."***
>
> Brad Weafer

Marlborough US Multi-Cap Income Co-Manager Brad Weafer shares his views on the outlook for US equities and explains why the fund's investment team are continuing to back tech giants and believe the US equity market remains the most attractive in the world.

How have US equities performed in 2019?

"To the end of November, the S&P 500 returned an impressive 27.6% year to date, in US dollar terms. This stands in stark contrast to the 1.1% estimated growth in earnings per share for the index. Improved expectations for a trade deal with China and a more accommodative US Federal Reserve policy reversed the negative sentiment that plagued markets in 2018.

"Market sentiment can be very fickle though and is notoriously hard to predict. We prefer instead to focus on the fundamentals of the concentrated group of high-quality companies we own. On average, the companies in our portfolio grew earnings per share by 10%. With overall earnings for the wider market barely growing, we are quite happy with that result."

Which companies in the portfolio performed well in 2019 and were there any that disappointed?

"We saw strength in a number of our large technology holdings including Microsoft, Mastercard, Equinix, and Apple. The global economy needs productivity enhancements to support growth in the coming years and decades, with population growth forecast to be lower relative to history and even negative in some regions. The US technology industry is a global leader and the fund and US markets are overweight this space. The companies we own have significant competitive advantages, durable business models and prodigious free cash flow. We expect sustained growth from this group of market leaders.

"Our most disappointing holdings were primarily healthcare companies including Gilead, UnitedHealth and Johnson & Johnson. Demographic trends support a robust outlook for healthcare demand, but drug pricing controls and healthcare policy have been a key topic of political debate, specifically from the Democratic Party presidential nominees. While there remains some risk, our positions are sized appropriately given potential policy changes and we are monitoring developments closely."

What do you look for in companies when you're considering investing and how is the fund currently positioned?

"We believe that our equity returns follow the profits of the underlying businesses when held for long periods of time. We strive to build portfolios of companies with attractive economics and reinvestment opportunities. Finding such unique opportunities requires hard work and patience. However, with thorough and independent research, it is possible to identify a select number of companies to invest in.

"These businesses share similar characteristics, including paying a growing dividend, a demonstrated history of stable and growing cash flow, high returns on invested capital, low leverage and competitive advantages that suggest sustainable profitability well into the future. In addition, we favour business models that are less reliant on economic expansion to support profitability and growth. Having said that, it's near impossible to completely avoid economic risk.

"Historically, sustained drawdowns in equity markets coincide with recessions and corporate profit declines. Today there are a number of signs that suggest the US is in the latter stages of an economic expansion that started over 10 years ago. Late-cycle economic growth is more vulnerable to recession and at risk from errors of policy, both monetary and fiscal. The additional uncertainty raised as a result of trade disputes and politics raises the potential for volatility.

"Trying to anticipate or time the outcomes of these uncertain world events promises to be a costly and very difficult exercise. However, we have taken steps to reduce areas of cyclical exposure in the portfolio by reducing our holdings in banks and companies operating in the oil and gas industry. In their place we have looked for opportunities where companies have independent avenues of growth, including selected areas of insurance and vehicle auctions."

What is the biggest issue facing US equities?

"The key issue facing US equity markets remains policy error, in particular the risk that the current trade dispute with China transmits into actual weakness for the US economy and harms corporate profits.

"Given the complexity of the issues and negotiations, it's difficult to predict what the outcome of these negotiations will be. What we can see though, is the negative impact on business confidence. The Conference Board Measure of CEO Confidence has declined dramatically in recent months and is experiencing new lows not seen since the last recession. In order to grow the economy and profits, businesses need to invest. Considering CEO confidence correlates with business investment, the decline in recent months is not encouraging.

"Thus far, weakness has primarily been observed in the manufacturing sector and has not had a material impact on the consumer economy, but we will be watching this closely."

What is the outlook for US equities?

"While estimates for earnings growth for the broader market suggest a pickup in 2020, US economic growth has been decelerating. To meet expectations and drive US markets higher, we need to see an improvement in the economic data we track. It is possible that resolution of the trade dispute, coupled with the potential for fiscal stimulus ahead of the presidential election could drive such an acceleration but the probability is falling by the day. Fortunately, we believe the outlook for our portfolio companies remains bright and we expect the businesses we own to grow ahead of the rate of the broader market as they did in 2019.

"We continue to believe the US is the best place to invest relative to other geographies. Growth in the working-age population and expected increases in productivity should drive higher economic and profit growth for US companies over the long term. When accounting for higher profitability, good shareholder governance practices and sector makeup, we see any valuation premium as reasonable. This creates a solid backdrop for our concentrated portfolio of high-quality companies to drive attractive returns for equity investors."

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