VT DE LISLE AMERICA FUND

Manager's Commentary

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A Look Back Over the Last 12 Months

The USD share class of the Fund has returned -1.29% over the last 12 months vs. -0.21% for the S&P 500 Index (USD TR). However, this does not tell the full story. Over the period we have seen a large discrepancy in performance of large/mega cap stocks vs small and mid caps; the Russell 2000 index is -17.13% (USD TR). We have also seen value outperform quality growth stocks. The value component of the S&P 500 returning 2.59% (USD TR). This is the wider context in which our Fund's portfolio, with its bias towards smaller cap, under-researched companies, should be judged.

The past 12 months have seen ever increasing storm clouds which are bad for small caps and good for large caps. Expectations of a post-pandemic recovery have downgraded due to a number of factors, including Covid variants, China slowdowns, inflation jumps and geo-political tensions. A year ago we were discussing the Great Outdoors and the desire for experiences. At the moment, it's about natural gas price differentials and food shortages. Guaranteed plodding growth is wonderfully reassuring during such a transition which is why plodding stocks like Coke, P&G and utilities like Cons Ed are up 15%+ over a year. All sub-market growers in the long term, all premium to the market now. This tells us the very high level of fear around which is also manifest in the investor sentiment statistics at 30-year lows in terms of pessimism.

At the moment, the P/Es of Coke, P&G and Apple are all between at 25.8 - 27.3x*. The answer to which of these are a buy should be none. As for Apple, they are the size of what the UK economy produces in a year. People think of them as FAANNMGs but don't realise that Apple was 16x the size of Netflix before Netflix share price fell by a quarter. It's 30x as big now. A 3.6% change in Apple is as important as the whole of Netflix. At this size Apple goes with the economy, so if they do 6% over the next 10 years they'll be doing well. They haven't done huge numbers in the last 10 – it was largely P/E expansion as bonds went up.

This analysis gives us the growth of the large caps in the last year: good for the plodders, counterbalanced by falls for high multiple growth as interest rates rose off the floor. Apple itself, a full 7% of the S&P 500, has done very well and has in fact risen by 23%, therefore doing much better than its peers. For instance, the NASDAQ 100, a proxy for high multiple growth, is down 4%. Putting it all together, the net result for the S&P 500 is zero. However, the 250 stocks which form the value component is +1%. They are better despite Coke etc, because value has been driven by the much discussed surge in energy and all matters in commodities. Exxon is +50%, the biggest component Berkshire is +15%.

Rising fear has sent investors towards recession resistant staples. The safest of all are perceived to be the electric utilities which don't seem to grow at all any more but nonetheless have had a tremendous year and are now at a market multiple.

The reason for having a bias towards smaller cap stocks is because they are an outperforming asset class (Fama, French 1990, O'Shaughnessy 2005 and others). The price you pay, is that they tend to underperform on perception of recession, as we've just seen. The ideal conditions for small cap stocks is coming out of a recession and with pricing flexibility, because they are price takers not price makers. That is why the best time for small caps in the last 100 years has been 1975 to 1983, coming out of the 1975 recession with inflation around. That is also why the recovery from the Great Financial Crash did not favour small caps but rather large-cap growth, exerting unregulated monopoly power in a disinflationary decade and was the place to be. People will look back at this unique 13 years when the largest stocks in the market outperformed. It's never happened before and it took the unprecedented combination of a unique bond bull market going to zero rates and a unique hole in monopoly legislation which didn't cover the internet at all to create it. It's very different now. Consider: coming out of 2009 it was the consumers in debt, having spectacularly bust in the housing/credit bubble. 12 years of QE to help their fragility. Now it's the government with US consumers in net credit for the first time (source: FT 27/04/22). Expect the consumer to be more robust next recession than the last one which is good for small (consumer discretionary and industrials are mainly small).

The stats suggest long-term investors should buy small cap stocks trading at attractive valuations. The best long-term asset class is at its biggest discount. However, some investors are still fearful of jumping in too early and having to wait many years until that mean reversion occurs. They want to catch that ecstatic moment of take-off. August 13th 1982, March 9th 2009, they do occur. What would it take for the next one? The catalyst is no recession. Or, better, a recession is announced later this year (it's already priced in) so this already feels like 1990 when small and the market took off as soon as recession hit.

Past performance is not a guide to future performance; the value of an investment and income from it can go down as well as up.

That moment of acknowledgement and realisation that we'll come out the other side would be the ideal inflection point. An alternative scenario is: falling inflation, falling bond yields and a resumption of the low growth pre-pandemic environment. If this occurred, given the historical low employment numbers, any normalisation of low consumer confidence will get people spending money. Our consumer cyclicals, which are on a 40 year low, P/Es would fly. And if war and fear pertain, our 30% in energy and primary producers acts as a bar-bell strategy. I feel that's a lot safer than hiding in large cap value/staples at record relative valuations and a premium to a market that we know does better.

*Source: https://www.gurufocus.com/, 04/05/2022

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