March 2020
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Thoughts on recent market volatility and portfolio positioning

A discussion with Artisan Partners Growth Team

Escalating COVID-19 concerns and Saudi Arabia's decision to cut oil prices and boost production have prompted a sharp selloff in global equity markets in recent weeks. The Artisan Partners Growth Team is monitoring both situations closely and believe the biggest relative performance risk from here is massive volatility. While there will likely be large up days for battered sectors, the fund manager expects a drift lower on balance until the true extent of the COVID-19 impact can be discounted into stock prices.

The fund manager's lack of direct exposure to the energy sector leaves its portfolios relatively well-positioned against the risk of a pricing war among the world's largest oil producers. Energy exposure was eliminated in 2019 and the team have since sought to build positions in renewable energy companies—most of which are utilities—with more attractive profit-cycle opportunities. Wind and solar economics have improved meaningfully over the last decade given technology improvements and capital-cost declines, and it is cheaper to add an incremental megawatt of electrical capacity via wind and solar today than it is via nuclear, coal and natural gas—notably, without government subsidies. This trend is in the early stages, and it is expected this pricing gap to widen over time, with these holdings—which have on average held up better than other holdings and broader benchmarks in recent weeks—well-positioned, in the team's view, to benefit from accelerating profit cycles.

Turning to COVID-19, the team believe the illness will be disruptive to supply chains and demand across the global economy in the short term—pressuring corporate profits for at least the first and second quarters of 2020. If the virus returns during the fall flu season, there could also be after-effects beyond the first half. While the impact's magnitude is impossible to predict, it is believed any spending decisions that can be delayed will be delayed and there will be job loss, particularly in the airline, hotel and rental-car sectors—all sectors with below-benchmark exposure today and which the team have historically shied away from given their cyclical nature and tendency to be driven by external factors.

Furthermore, any companies with a field sales force will struggle in the short-term since people are staying off airplanes. That said, it is believed that as in past public health emergencies (such as SARS in 2003 and H1N1 in 2009), this disruption will prove temporary.

The team is satisfied with the portfolios' overall quality, and have been encouraged by its relative resilience since the sell-off started in the second half of February. This can be attributed to a few factors: the focus on high-quality franchises with strong balance sheets and the below-benchmark exposure to some of the hardest-hit areas of the economy (travel, commodities, China, energy, financials).

Consistent with what was stated in various other periods of market volatility and how the team seeks to differentiate itself as active managers, the team has become significantly more active over the past month amid the heightened market volatility. The team has been drawing down cash positions, which had been elevated in recent quarters, and deploying capital into high-conviction holdings at opportunistic price points relative to growth expectations over the next two to three years. Furthermore, there have been no material changes to long-term earnings expectations or private market valuations for businesses in portfolios, and the team remain laser-focused on its investment process—putting capital behind strong franchises with visible profit-cycle drivers and healthy balance sheets and following trends that are more secular than cyclical in nature. With history as a guide, this market correction will likely be an opportunity for the kind of resilient franchise growth companies sought by the team.

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