Fluctuat nec mergitur*: where our portfolios stand "after the tide went out and in" in Q12020

*A latin expression (motto) describing Paris: "shaken by the waves, but does not sink"

Jean-Louis Scandella,
Equity Chief Investment Officer at Ostrum AM

Everywhere the number of victims of the Covid-19 is increasing, everywhere economies are now running with capacities reduced by one to two thirds, everywhere markets are , after a collapse and a rebound, down by 20 to 30% ...

At the end of a literally unprecedented first quarter, Ostrum AM equity strategies, which had significantly outperformed in the upside of 2019, are demonstrating resilience in the meltdown, showing positive relative outperformance compared to their reference index, ranging from 300 to 1000 basis points across the product range at the end of Q1 2020. This is the result of our disciplined stock selection process that focuses exclusively on companies that demonstrate quality of business models, management, balance sheets and secular growth with high visibility.

Admittedly, this relative outperformance is only a small consolation for our investors in a context of painful absolute losses. That said, we are convinced that our approach which made our past success in both rising and falling markets, will continue to deliver strong overperformance in the future. However, the health crisis has not peaked yet and the impact on economies, surely unprecedented, is still uncertain : -2% for world GDP in 2020?, -5% for European economies GDP? More than that, a systemic crisis can also not be ruled out. Consequently we have undertaken a systematic and realistic revision of our corporate growth scenarios and valuation in order to give an accurate picture of where our strategies stand at the end of Q1 2020 in terms of expected aggregated growth and upside potential.

As we have explained many times before, our approach to equity investing relies on a deep conviction: the price of a share is nothing , but the sum of the profits and dividends of the underlying corporate, looking out five years forward and bringing it to present value thanks to a discount rate reflecting both risk and cost of capital. Relying on this assumption, we have systematically reviewed the expected profits and dividends of each of the companies in which we are invested and systematically raised our discount rates to reflect the current increased risk environment.

For that matter, we have applied the following double scenario: (1) one third of the world economy is paralyzed for two months in 2020, because of confinement, with a subsequent gradual restart and (2) the decline in profits and dividends we'll see in our companies in 2020 should be close to the decline observed in the 2008 crisis. This general frame is finetuned on the basis of management statements of the companies we are invested in, even if many companies are currently very reluctant to give precise indications for the future.

The results of our analysis is that we have revised the 5 years growth projection of all companies held in our portfolio from +13% CAGR initially to +9%, observing a painful drop of -12% in 2020 earnings followed by a rebound of +19% in 2021 earnings. These first estimates will be refined in the coming weeks, relying on ongoing discussions we will have with company management. Should the average world confinement and subsequent paralysis of 1/3 of the economy be extended from two to three month, our estimates would need to be revised down further.

Considering these new forecasts and an increase in the equity risk premium by increasing the discount rate by 100 basis points, the potential upside of our aggregated portfolios is, after the collapse and subsequent rebound, reduced over the next 12 months from +35% initially to a mere +10% currently, followed by +9% per year for successive years until 2025. We identify the most attractive perspectives are for strategies exposed to European Small and Mid Caps, Consumer sectors and European companies that will continue to pay dividends. We believe these markets segments can potentially appreciate +19%, +20% and +21% respectively.

As our reduced scenario rules out the possibility of a strong rebound for the next 12 month and shows only modest upside potential compared to the current downside risk, we have decided to keep the steering wheel on cash (5 to 10% for all our strategies), that we initiated at the start of the crisis. We shall deploy cash to increase weights on our current holdings when we see our global scenario confirmed and largely accepted as such by the markets.

In a world where the bond markets are held at arm's length by central banks and government debts are being monetized, we remain convinced that stocks, like all real assets, and despite their volatility, are an intangible reserve of value, provided that the corporates they reflect are first of extreme quality and second leading on secular trends affecting their markets.

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