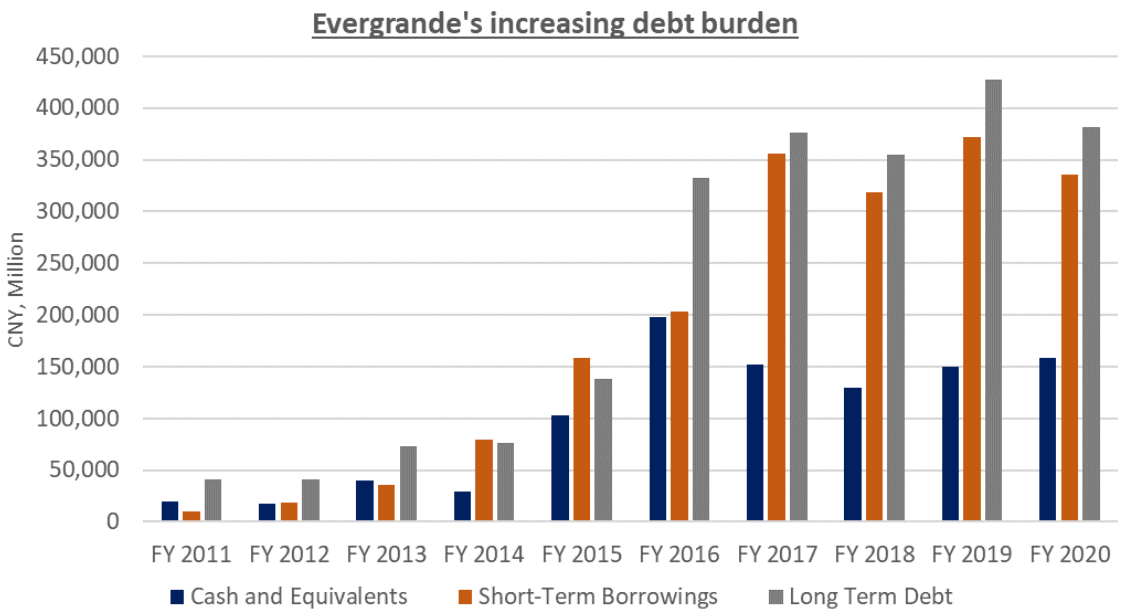
“Fear is incomplete knowledge” - Agatha Christie.

September proved true to form of being the worst month for equity returns, and this year the looming spectre of Evergrande’s debt issues helped to dampen the investor confidence that has driven returns so far this year. The whipsaw-like changes in sector returns that has been prevalent throughout the year, occurred again in force during the month as the US 10-year yield finally broke out of its trading range and energy prices also moved significantly higher.

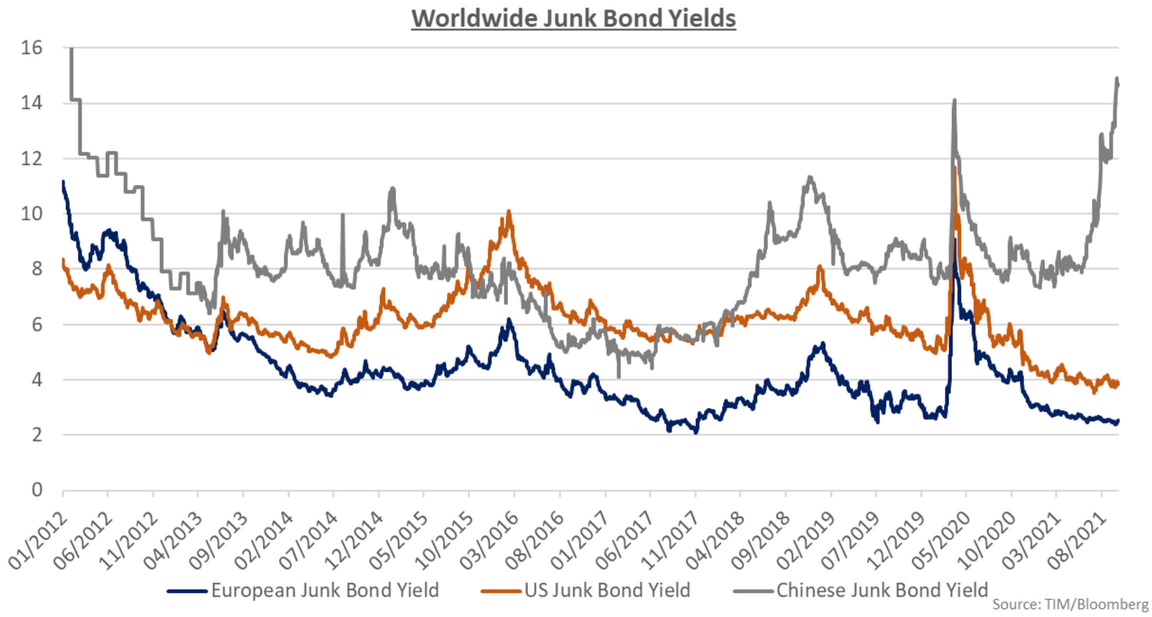
Evergrande is the world’s most indebted property company, and a possible default on some of its bond payments this month have been brewing for some time given the structural problems of its business model. The company has increasingly used short-term financing to build property that is sold before it is built. With $330bn of debt at the end of 2020, the company traded on a Net Debt/EBITDA ratio of 7.9x, and 46% of this debt is short-term in nature. Although these problems have been brewing for over a year, they escalated in August as the Chinese government moved to clamp down on property developers’ ability to accrue debt, limiting both debt/equity and liability/asset ratios and requiring the companies to hold cash equivalent to their short-term debt.



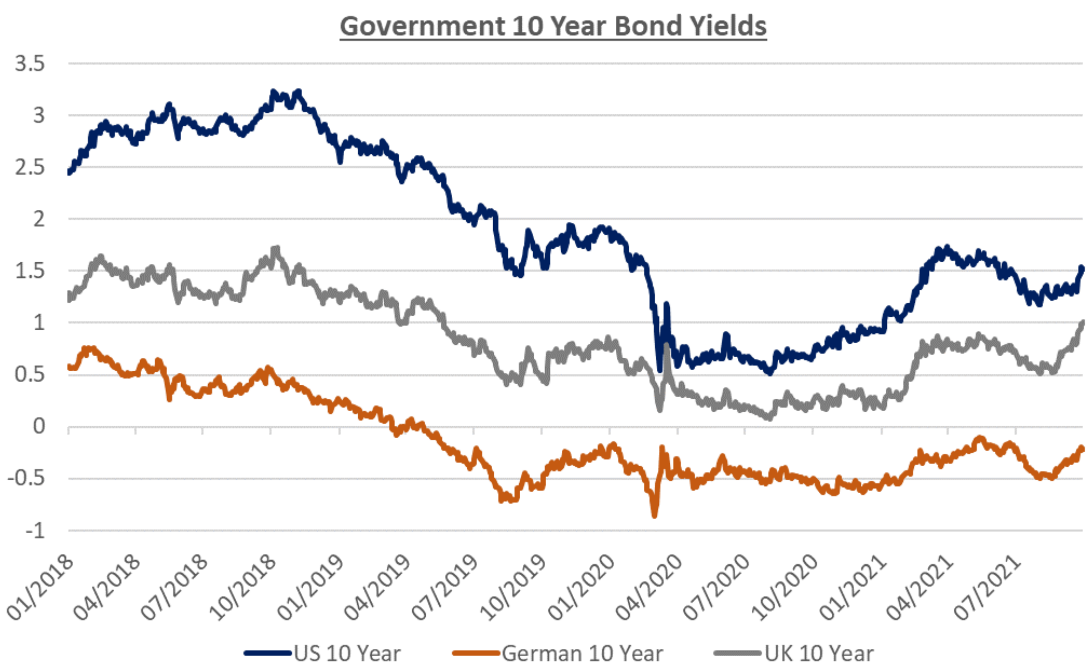
Source: TIM/Bloomberg

Fearing the contagion effects from a failure to pay its creditors, having failed to sell some of its property portfolio, the Chinese bank felt the need to inject short-term cash, which soothed the short-term concerns. For the Fund, the secondary effects were felt by our escalator & elevator holdings as China has been a significant source of growth over the past 10 years, and a scaling back on property development is likely to further temper an already cooling property market.

The initial concerns surrounding worldwide contagion, however, seem misplaced as most the major western banks with operations in China disclosed minimal exposure to Evergrande and most the debt appears to be held by Chinese banks and trust funds. Junk bond yields in the western world hardly moved in response to the crisis and remain at abnormally low levels.



While junk bonds continue to decline, more importantly to equity markets there are signs that global 10 years yields are starting to rise once again, after falling back over the summer. The oil price also appears to be breaking out of its long-term downward facing trading range. Typically, more cyclical equities tend to perform better in times of rising bond yields; banks and energy stocks being particular beneficiaries. The VT Tyndall Global Select Fund is a concentrated, bottom-up portfolio of quality holdings and does not chase short-term shifts in market sector shifts, and time has shown that maintaining true to a philosophy and process of investing in quality companies with robust investment cases, should outperform over the long-term versus any short-term gains that might be obtained by chasing short-term market movements.



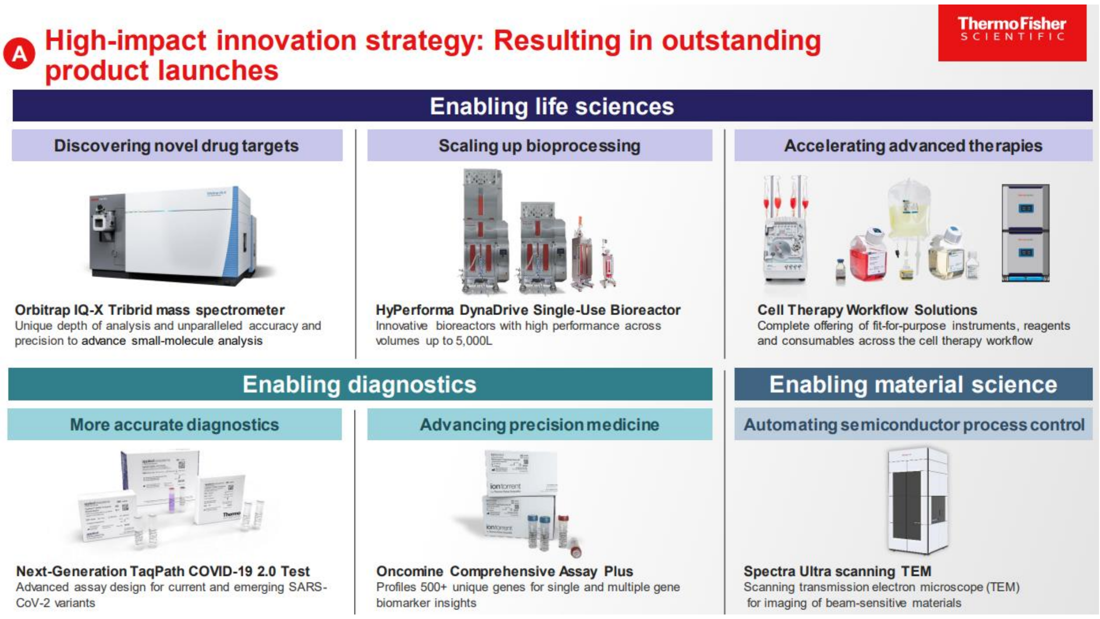
Source: TIM/Bloomberg

With the third quarter reporting season about to get underway, our focus will be upon the impact of rising costs and supply constraints. As Nike (see later in this letter) showed, even the largest and most efficient supply chains are struggling with bottlenecks and labour shortages, but much of is likely to prove to be transitory for quality companies with tight control over their suppliers. Of greater concern are those companies that are not able to pass through rising input costs to their customers, which we expect will become increasing evident in the coming months. While many companies can put through price increases, there may be a time lag until these changes come into effect, and thus margins may be weaker in the quarter just past, but these pressures should be recouped in the coming months; our holding in Sherwin Williams is a prime example as it is currently putting through its 4th price increase this year as it seeks to offset rising input costs. While those companies with strong market positions and differentiated products should be able to pass on costs, there are many who are price takers and despite order volumes picking up are likely to see margin pressures for the foreseeable future. The importance of analysing each company using Porter's 5 forces has seldom been more important, however, we also stress that to maintain customer loyalty, companies must also have a strong focus on consumer outcomes; it will be a fine balancing act that only the best-in-class management teams will be able to finesse.

Global equity markets struggled with the prospect of declining returns given the headwinds from inflation and bottlenecks in the supply system. The Technology sector fared poorly in the face of rising bond yields and the Medical Technology sector also fared poorly as investors looked to shift capital into the Energy and Financial sectors. The VT Tyndall Global Select Fund B Acc (GBP) fell 3.02%, reducing the year-to-date returns to 13.37%.

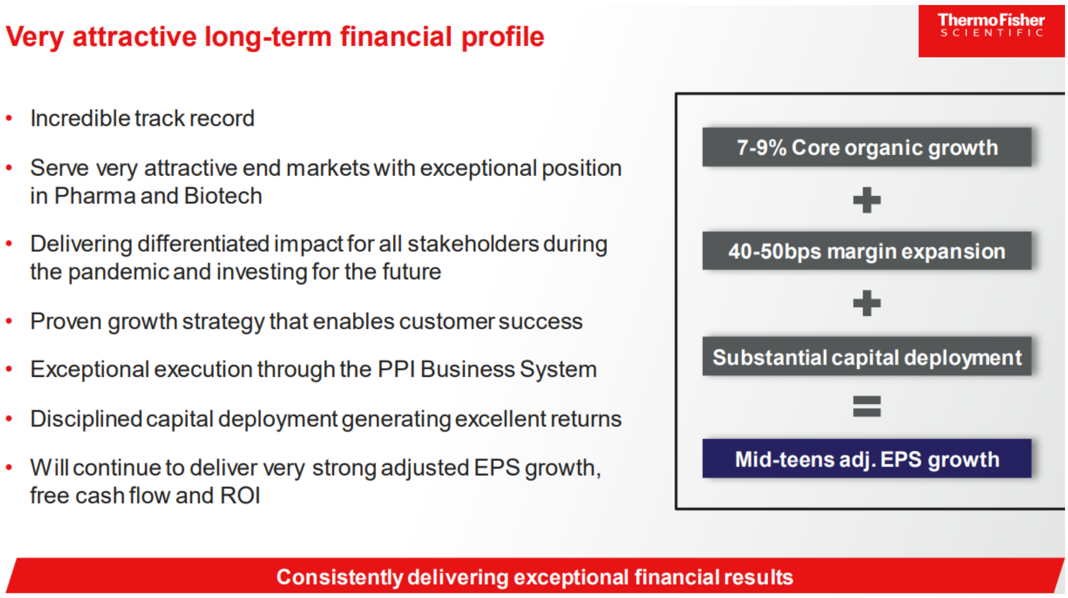
Fund Activity and News

Thermo-Fisher Scientific, the Fund's largest holding, held a capital markets day during the month where it laid out it 2022-2025 guidance. The shares have been held back this year by the management's cautious approach to guidance over COVID related sales given the $6bn of surplus revenue generated in 2020 and investors questioned whether 2021 will see similar benefits given that testing was expected to drop off as vaccines roll-out. The company let the market know that it expects to generate $4.9bn for COVID testing revenues in 2021 and, what we see as a conservative, $750m in 2022. Offsetting some of this decline vaccine and therapy revenues are expected to increase to $2bn from $1.8bn this year.



In addition to this guidance, the company announced that it is expected to close its acquisition of PPD this year, which would add $6bn of revenues to the top line, and the resulting group margin would be 5.5% ahead of analyst expectations. Given that PPD currently has high teens margins, and the rest of the company generates 27.1% operating margins, the EPS accretion from synergies and driving operational efficiencies in the consolidation is likely to be considerable and the +50bp per year that management expects could prove to also be conservative.

The company has a strong track record of financial performance, producing 12% CAGR revenue growth, 19% earnings per share growth and 19% free cash flow growth over the past 10 years and is well positioned to accelerate these impressive statistics through its strategic M&A and targeted R&D in some of the fastest growing segments within pharma and biotech markets. Economies of scale, prioritisation of economical efficiencies and synergies from its acquisitions should lead to increased operating margins, while leveraging its >$1bn R&D budget, the company is likely to take market share and grow top line revenues ahead of the market average, in what is already a high growth area.



The greatest detractor from performance this month was our holding in Nike. Over the last couple of months, we have highlighted the issues surrounding global supply chains ranging from European driver shortages, bottlenecks in US sea ports and, particularly for Nike and Adidas, the closure of factories in Vietnam due to COVID-19, where 51% of Nike's footwear is produced and 30% of their clothing. While it is encouraging that some of the factories have started to reopen, the company highlighted that it may take a few months to ramp up to prior capacity. These supply issues have gathered to become an almost perfect storm and preventing Nike from fulfilling the extremely strong demand for their products.

Matthew Friend, Nike's CFO highlighted this, commenting that in-transit times in North-America are currently almost twice that of pre-pandemic levels, he added that *"Consumer demand for Nike remains at an all-time high, and we are confident that our deep consumer connections and brand momentum will continue. However, we are not immune to the global supply chain headwinds that are challenging the manufacture and movement of product around the world. Previously, I had shared that we were planning for transit times to remain elevated for the balance of fiscal 2022. Unfortunately, the situation deteriorated even further in the first quarter with North America and EMEA seeing increases in transit times due primarily to port and rail congestion and labour shortages."*

In Nike's favour is its policy surrounding excess inventory. Unlike many of its peers the company holds back unsold inventory and does not put it on sale to clear out unsold items. Given the lower sales during the pandemic, the company has ranges that it can now sell to help bridge some of supply/demand imbalance caused by the factors above. The inventory policy is realised by the strength of gross margins despite sales volumes being below potential where the strength of the brand allows the company to maintain full pricing.

We see these issues as transitory, and as long-term investors we take heart that the underlying mega-trend in consumer leisure remains in place. Notably, the higher margin Direct-to-Consumer & digital sales grew by >25% in the quarter and new buying members increased by >70%, which should increase return on invested capital levels to above the already impressive 30%. We do not use stop losses in running the Fund, as if the long-term investment case remains intact then to do so would be counterintuitive, and value destructive, in fact market corrections should be times when one looks to put additional capital to work.

Global demand for Nike's products remains stronger than ever, and as this Fund Manager seeks to complete the London Marathon this weekend, he will undoubtedly be in the queue for yet another pair of trainers to replace his current pair of Nike ZoomX Vaporfly shoes though his Nike Direct account, doing his bit to help group margins!

Richard Scrope, Fund Manager, VT Global Select Fund, 30th September 2021
Data source (unless otherwise stated): Bloomberg.

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