Guarded Optimism, Sobering Reality, and Adapting

This article is excerpted from an Ossia Partners Fund letter by MOI Global instructor Curtis Jensen, portfolio manager at Robotti & Company Advisors, based in New York.

Despite glimmers of hope and more positive market sentiment, underlying economic and business trends remain grim, as measured by staggering unemployment figures (jobless claims topping 22 million in April), plummeting auto and retail sales, a swan dive in many commodity prices (oil prices at twodecade lows) and generally dour corporate earnings announcements.

The Covid-19 pandemic has brought us to the intersection of economics and epidemiology. These perspectives suggest a bumpy and long road ahead, one that runs through a potentially deep recessionary environment.

On the health front, much remains unknown about the virus, but it seems likely that "normalcy" will require broad testing, rigorous contact tracing, selective quarantines and a public willingness to continue modifying its behavior, including socially distancing when necessary. Vaccine trial results, if successful, and ultimately, broad availability, will take many months if not longer to develop. In New York the crisis has highlighted the tension that exists between the federal government and the rights and expectations of individual states, a tension that has strained the availability of critical supplies and funding. Getting corporations and Main Street businesses back on their feet requires massive relief funds, a healthy workforce and a confident customer base.

But human ingenuity and a wave of innovation and creativity have kicked in and should not be ignored: in the U.S., for example, apparel manufacturer Carhartt is making gowns and masks in its factories in Tennessee and Kentucky; Ford and GE have signed a Federal contract to manufacture ventilators; Apple and Duke University are using an arsenal of 3D printers to manufacture face shields for medical workers. Abroad perfume maker Christian Dior and French spirits giant Pernod Ricard are making hand sanitizer. Empty hotels have become quarantine shelters. Pharmaceutical and biotech companies are pushing hard to develop new therapies and diagnostic tools and some employers like Walmart, CVS and Kroger are hiring.

While much remains unknowable, I am guardedly optimistic about people's ability to adapt and to return to something more normal, even if it is not the world we knew two months ago.

The epidemiology community largely anticipates a second wave of the virus next fall or winter and it is hoped we are better prepared for it should it eventuate. As we ease back into our new existence with staggered work schedules, moderated travel and entertainment habits, new budgetary constraints and household savings patterns, it stands to reason that these changes – whether from individuals or corporations and governments – will likely flow back into our economic lives unevenly, some temporarily and some more permanently.

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OPF Response

With the above views in mind, I have been more focused than ever on resilience and staying power, both at the individual company level and at the portfolio level. This focus has manifested as follows:

- Considering those "changed behaviors" or forced changes that may persist for years versus more temporary setbacks and their impact on business economics.

- A "gentle" portfolio repositioning, with an added emphasis on identifying stocks that can be held for a long time i.e., companies whose underlying businesses may have more resilient business models and, accordingly, an ability to compound value in a post-Covid world. **Stock market values have reset, in many cases significantly (share prices down 40% – 50%), affording an unusual opportunity to consider businesses defined by greater resilience that heretofore were unattractive from a valuation perspective.**

- Crystallizing a loss in one holding while replacing it with a security whose valuation is similarly depressed but whose underlying business, while sharing similarities, may be superior (or more resilient) on a long-term basis. Generically, "sell Exxon to buy Chevron."

- Developing a bucket of six to eight smaller positions (~ 1% – 2%) where the return profiles appear outsized (e.g., 3x – 4x), but where the range of outcomes is wide and lower confidence levels demand a smaller position. In time, this bucket might include distressed debt.

As alluded to in the March letter, I have executed on a few new ideas in the past month or two and expect to discuss these in a mid-year letter when corporate Q2 results have been digested and, I hope, we are all a little further down the path to the new normal.

Investing and Uncertainty

Given the extraordinary uncertainty that engulfs investors, it might be instructive to consider British economist David Ricardo's experience at a similarly disquieting point in history:

> *David Ricardo made a fortune buying bonds from the British government four days in advance of the Battle of Waterloo. He was not a military analyst, and even if he were, he had no basis to compute the odds of Napoleon's defeat or victory, or hard-to-identify ambiguous outcomes. Thus, he was investing in the unknown and the unknowable. Still, he knew that competition was thin, that the seller was eager, and that his windfall pounds should Napoleon lose would be worth much more than the pounds he'd lose should Napoleon win.*[1]

Investing always involves varying degrees of uncertainty, and in a normal environment I would suggest that *time in the market is more important than timing the market.* But today's environment is anything but normal – in fact, it is unprecedented. One of OPF's original investors has notified me that he is adding funds May 1st and others have indicated an interest in adding as well. While I don't think this is a time to "bet the ranch," I do not believe it’s a time for shunning risk altogether. Corporate values are dynamic, though over short spans of time they do not change nearly as much as public stock prices would suggest.

Our work as analysts is to constantly assess the price and value dynamic; if anything, severe price declines in the portfolio have widened the gap to underlying corporate values. Hence, I am more on offense than defense, even knowing that public market values might decline in the months ahead. As alluded to in last month’s letter, currently weak periods such as today’s tend to have limited impact on the longer-term economic value of soundly financed, competitively positioned businesses whose ultimate corporate values are not dictated by the next year or two of earnings and cash flow, but those that follow in the decades ahead. Therefore, I am patiently and guardedly allocating OPF’s capital.

[1] *Investing in the Unknown and Unknowable, Richard Zeckhauser, Harvard University.*