Our Strategy in Today's Investment Environment

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The third quarter of 2018 saw a continuation of robust fundamentals in the U.S. but more fragile conditions in foreign markets. Foreign economies have been more affected as trade tensions have escalated and U.S. interest rates have risen. The dollar continued to rise during the quarter, as did U.S. bond yields which are at near fifteen-year record spreads versus those in Germany and Japan. U.S. equities ended the period up 10.6% for the year versus -1.4% for developed market equities and -7.7% for emerging market equities.

The divergences have indeed been stark. For example, U.S. growth stocks continued their surge, outperforming value stocks by 3% in the quarter and by 13% for the year-to-date—having already bested value stocks by 16% in 2017 and by nearly 163% since 2008. The posterchild was Amazon which through September this year gained 71% and added an astonishing $400 billion to its market capitalization. Popular Asian growth stocks Tencent and Alibaba by contrast declined 19.1% and 11.2%, respectively, during the quarter (and are down similarly for the year). The China A share market also continued its decline and is now down 19.7% for the year-to-date.

Almost immediately after the quarter ended, a global equity market sell-off ensued and while some of the divergences reversed somewhat (value outperformed growth and Amazon gave back a significant portion of its year-to-date gains), many did not, including foreign equity markets continuing to underperform U.S. equities. It was a vivid reminder of how quickly things can change and how important it is to have a rigorous investment discipline.

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Today's investment environment has a particular macro backdrop, as well as structural one. At the macro level, U.S. economic and earnings growth have been remarkably strong, aided in no small part by the corporate tax cut that took effect this year. At the same time, the escalation of trade tensions and higher interest rates have been much worse for foreign markets than for the United States, and they have added to the pressures that those markets already faced. The uncertainty around Brexit, for example, had already put a damper on businesses making long-term commitments to the U.K. and the rest of Europe. Additionally, China overcoming its domestic struggles was already dependent on sustained high rates of economic growth. These factors together have contributed to the U.S. being a less uncertain place to invest capital—at least in the short run. Market prices, moreover, are reflecting this state of affairs by according much lower valuation multiples to foreign equities. It looks very much like a get-what-you-pay-for environment in which geopolitics is increasingly becoming a source of fragility and creating propensity for dislocations.

Macro questions aside, the capital markets continue to evolve structurally in the way capital is invested and managed. Outperforming requires a crisper edge today given that individuals are trading less (for example, by favoring indexing) and are increasingly leaving it to the more sophisticated money to duke it out among themselves. At the same time, banks continue to remain on the sidelines in important areas of the capital markets (the result of regulatory constraints following the Global Financial Crisis). It is an important phenomenon that has fostered the growth of the private capital markets through alternative investment firms and platforms that engage in the likes of direct lending, restructuring, reinsurance and private equity.

Taken together, these conditions only reinforce what we are striving to do today. As always, the starting point is to seek attractive investments, and we have a specific playbook for doing so. It is anchored in a bottom-up search based on a thorough understanding of the fundamentals. In an uncertain world, there is little substitute for owning positions that are deeply researched and attractively priced relative to their fundamental value.

We have two primary means to seek these attractive investments. The first is to have close partnerships with managers who have broad mandates and who are highly skilled at sourcing and executing on a wide range of opportunities. These firms seek to look through near-term issues and develop a clear view of fundamental value over the medium term, and they will be of sufficient scale (typically a few billion dollars in AUM or more) to possess the resources and capabilities needed to execute on such a strategy. They also tend to do better in dislocated environments when sellers become needier. We believe that conditions project well for such firms given the way the macro environment seems to be evolving.

Our second approach is to search for inefficient areas of the capital markets where we can deploy capital with high-quality players dedicated to those areas. Inefficient markets are usually less crowded because one needs highly specialized capabilities to succeed in those areas and because the larger players cannot profitably deploy sufficient capital there. The skill sets required in niche markets are hard to come by, and we take great care in how we select and work with our partners in these spaces. These types of opportunities tend to be riskier individually, but they have much higher upside and play an important role in a well-diversified portfolio.

In everything we do, we seek to be very cognizant of our comparative advantage: where do we and where do we not possess investment edges, how can we develop new ones, and how soon must we abandon an approach where our edge is diminishing. Enduring advantages for us have always been our mandate to search far and wide for opportunities, as well as our network and the trust we are able to develop with high quality partners. With niche managers that tend to be smaller given their more limited scope and the size of their markets, we have increasingly been able to create value by driving terms and alignment. Where possible and sensible, we will also participate in coinvestments with our managers.

We also seek to be cognizant of the broad categories of investment risk we are taking and to maintain thoughtful diversification. While our conviction level is driven primarily by positives that are specific to a given investment rather than macro considerations, we are careful to aggregate the macro exposures that are embedded within and manage those risks from a top-down and from an overall perspective.

When we look top-down, we are not trying to time markets. In this, we do not possess a material edge (nor does anyone else that we know). Rather, our focus is on tail-risk management and maintenance of dry powder. In a dynamic world, vigilance to an evolving risk environment is essential if the goal is to protect on the downside, and our risk models provide an important means for seeking to do so. Equally importantly, possessing dry powder in dislocated environments and being close to our managers can be a very fruitful way to earn returns. Striving to achieve both is an important part of what we do.

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