LOMBARD ODIER
INVESTMENT MANAGERS

PrivilEdge – Delaware US Large Cap Value (M share class)

Newsletter

Active Strategy • Equities **31 January 2022**

MARKET HIGHLIGHTS

Stocks generally moved lower in January amid investor concerns about the prospect of tighter monetary conditions, rising interest rates, high inflation and the economic dislocations caused by the Omicron variant of Covid-19. For the month, the broad market S&P 500 ND Index declined 5.2% (source: FactSet Research Systems).

In its January statement, the Federal Open Market Committee (FOMC) announced that it anticipates ending monthly asset purchases in March 2022 and expects it to soon be appropriate to raise the target range for the federal funds rate. In his comments following the release of the FOMC statement, Federal Reserve (Fed) Chairman Jerome Powell said the FOMC is contemplating a steady hiking cycle (of interest rates) and that he believed the inflation outlook had deteriorated since December (sources: Cornerstone Macro, Federal Reserve Bank).

The US economy experienced strong growth in the fourth quarter (Q4) of 2021. Real gross domestic product (GDP) expanded 6.9% at a seasonally adjusted annual rate, according to the US Department of Commerce's initial estimate. About 70% of the increase was the result of inventory accumulation as companies moved to rebuild their inventories (sources: Bureau of Economic Analysis, Ned Davis Research).

Inflation pressures continued to build. The Personal Consumption Expenditures Price Index (PCE) was up 5.8% in December from a year earlier, while the Core Personal Consumption Expenditures Price Index (Core PCE), the Fed's preferred inflation gauge, which excludes food and energy prices, increased 4.9% (source: Bureau of Economic Analysis).

PERFORMANCE AND ATTRIBUTION

In January, the PrivilEdge – Delaware US Large Cap Value Fund decreased by 0.5%, ahead of the 2.7% decline of its benchmark, the Russell 1000 Value NR Index. At the portfolio level, stock selection drove relative returns.

Investments in the healthcare and industrials sectors made the largest contributions to relative performance. The Fund's healthcare stocks rose 3.5%, on average, compared with a decline of 4.7% for the sector in the benchmark. Pharmaceutical manufacturer Viatris led the group with a gain of 10.6%. The rebound in Viatris' shares can be attributed in part to oversold conditions following tax-loss selling that occurred towards the end of 2021 (Viatris was down 26% in 2021). The stock also appeared to benefit from speculation that Viatris and Indian biopharmaceutical company Biocon may be planning to combine their respective biosimilars units to form a new company in an attempt to unlock value. Additionally, Viatris announced a 9% increase to its quarterly dividend.

In the industrials sector, the Fund's holdings posted an average loss of 2.0% compared with a 5.5% drop for the sector in the benchmark. Aerospace and defence company Raytheon Technologies led the group, rising 4.8% during the month. The company reported quarterly results that were largely in line with expectations and offered guidance for the coming fiscal year that appeared to be conservative. Raytheon's management noted that targets for cost synergies were exceeded during the year and margins had improved across the business. Looking ahead, the portfolio managers believe Raytheon's defence business remains well positioned and that the company is poised to benefit from an eventual recovery in the commercial aerospace market.

Investments in the energy and information technology (IT) sectors caused the largest drags on relative returns. In energy, the Fund's single holding in exploration and production (E&P) company ConocoPhillips was the top contributor, up 22.8%, and outperformed the sector in the benchmark, which gained 18.7%. The Fund's underweight allocation in energy more than offset positive stock selection results. For the month, crude oil prices moved higher as supplies remained tight, while demand stayed reasonably strong, despite the near-term strain on economic activity caused by the Omicron variant. West Texas Intermediate (WTI) crude oil, a key domestic benchmark, rose 17.2% to 88.15 US dollars (USD) per barrel.

In the IT sector, the Fund's holdings were down 6.7%, on average, compared with a 7.2% decline for the sector in the benchmark. Despite positive results from stock selection, the Fund's overweight in IT resulted in negative attribution during the month. Mission-critical communication systems and analytics provider Motorola Solutions was the laggard in the group, down 14.6%. The sell-off in Motorola Solutions' shares appeared to be driven by profit-taking (the stock was up 61% in 2021), as there were no major company-specific developments during the month. Additionally, investors may have had concerns about the near-term effects of the Omicron variant on Motorola Solutions' private sector business and its supply chain.

Source: Delaware Investment Advisers.

TRANSACTIONS

There were no full-position sales or purchases in the Fund during the month.

OUTLOOK AND POSITIONING

In the first half of 2021, the Fund trailed the benchmark, gaining 11.4% compared with 16.7% for the Russell 1000 Value NR Index. This was not a big surprise to the team, given the stock market's outsized returns and the outperformance of lower-quality stocks, which tend to lead early in an economic recovery. The same can be said for the second half of 2020, as investors started pricing in the recovery in response to massive liquidity supplied by the Fed, trillions in fiscal policy support and, later in the year, the roll-out of the first Covid-19 vaccine. In the second half of 2020, the Fund gained 18.1% versus 22.3% for the benchmark.

Relative performance was better in the second half of 2021, as market conditions began to normalise, the Fed indicated its intention to begin tightening monetary policy, the benefits of fiscal stimulus began to fade and stock market valuation multiples appeared to plateau. In this environment, stocks of higher-quality companies (those with stronger balance sheets and more sustainable earnings and cash flows) generally fared better. During this period, the Fund gained 8.4% compared with 6.6% for the benchmark.

Over the three years ending 31 December 2021, the S&P 500 ND Index posted an annualised return of 25.4%, higher than any three-year period (on a rolling monthly basis) since March 2000, near the peak of the Internet bubble. This level of returns is unsustainable, in the portfolio managers' view, and given the changing market backdrop (slowing economic growth, tighter monetary conditions, decelerating corporate profits and currently high inflation), they believe a period of below-average returns is ahead. In response, the portfolio managers have been placing an even greater emphasis on quality and downside protection. The Fund trades at a discount to the Russell 1000 Value Index across a range of valuation measures and at an even larger discount to the broad market. In the team's opinion, its discounted valuation and the higher-quality profile of portfolio holdings position the Fund very well for the next five years.

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