WORLDWIDE
ASSET MANAGEMENT

How to Invest in a More Difficult Economic Environment

By C WorldWide Asset Management

History shows that high-quality companies typically perform well when global economic growth slows. Even recessions come to an end, and then it's good to be in a position that has a longer-term perspective.

From the outset, 2023 has been a challenging year with many crosscurrents. The future is difficult to predict; however, a mix of headwinds could tip both the US and the broader global economy into recession. The uncertainty stems from the following:

- The impact of runaway inflation
- Interest rates going up more than expected
- Russia's war in Ukraine

The message in early spring 2023 after the interest rate meetings at the Federal Reserve Bank and the European Central Bank is that the central bank's top priority is still to fight inflation. And the weapon of choice is higher interest rates. So, how can investors navigate this period of macroeconomic, geopolitical, and monetary turbulence together with a slowing economy? And what about afterwards?

"Our philosophy when exploring investment opportunities is to identify companies that can consistently grow earnings over many years."

Quality will perform

Our philosophy when exploring investment opportunities is to identify companies that can consistently grow earnings over many years. We believe that earnings growth is the key long-term driver of share prices. We invest in selected companies with long-term sustainable business models – companies that grow bigger over time. We call it the value of compounding. Like a snowball growing bigger as it rolls down the hill. Time works in favour of higher-quality earnings compounders; the opposite is true for lower-quality companies. For more information, please read our White Paper; The Anatomy of a Compounder.

In a scenario with weaker global economic growth as well as rising recessionary risks, we are convinced the right focus is to search for such quality companies. We think staying consistent and focusing on the long term is important. Our experience and history have shown that quality companies in many scenarios will grow earnings – even in a slow growth environment.

How to identify quality

Stated simply, quality shares are companies with:

- A stable business model – strong management teams with a disciplined focus on corporate governance
- Low debt
- High profitability
- Low-profit volatility
- High return on equity

At the same time, quality companies often have pricing power. Pricing power is particularly relevant in inflationary periods because it becomes an advantage to pass on the cost for more expensive raw materials to the customer.

To minimize the risk

Some investors might say that focusing on quality companies and taking a long-term view is a too defensive or even dull approach. Stability is simply not exciting enough. Many find it more appealing to chase short-term profits, follow the herd and market momentum trends or even go for a little excitement offered by the latest "high-fashion" stocks which, more often than not, are based on adventurous storytelling rather than the reality of real growth fundamentals. In other words, why not go for the rockets with more explosive characteristics as opposed to playing the long game? The answer is: to minimize the risk. We believe that patience is a virtue – and this is no different regarding successful investing.

In our view, using a traditional risk/reward framework remains the best approach. Avoiding extreme scenarios is key to prevent permanent loss of capital. Successful investors balance investment returns with investment risk. Searching for quality means concentrating on real fundamentals and of the proven ability to earn money today and in the years to come. As we usually say, successful investing is not a sprint – it's a marathon.

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Green dreams and red alerts

Of course, it's both thrilling and tempting to ride on the wings of possible current "winners" which is proving popular right now among certain investors. The "green transition" trend is a good example. In previous years, many newer companies appeared on the market with products or services addressing this popular trend.

Some flew into the sky like rockets on the stock exchanges. And many fell to the ground again.

The reasons are fairly simple: it is often difficult for many of the companies that are targeting the green transition to prove their ability to earn money and grow sustainably for a long period of time. This is because of their uncertain business models, highly competitive landscapes, and a market highly influenced by government policies and regulations.

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Many start-ups need to raise a lot of money with no proven track record of their ability to grow and provide positive returns. Even well-known companies operating in the green transition space with many years in the market have experienced problems with cash flow and profitability.

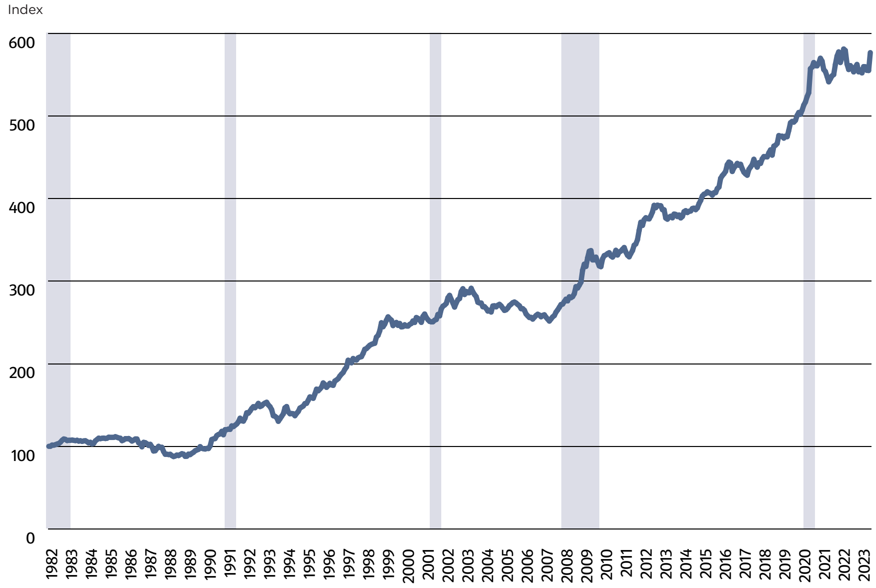
Having said that, the green transition is necessary. Wind turbines, solar cell systems, Power-to-X, hydrogen technology and any kind of alternative energy development to fight climate change will be a huge trend for the next decade. Enormous investments are truly needed. But where to invest is not an easy task.

Quality – the best way to navigate through recessions

As the world moves towards slow growth or a recession, we believe that long-term interest rates will stabilize and eventually

Figure 1

ACWI Quality relative performance



Source: Bloomberg, March 2023

fall as inflation moderates. Also, global debt levels in the world are so high that the world can not afford high interest rates over the long term.

The history of past recessions shows that quality companies typically outperform. The grey areas on the figure show periods when the economy is in a recession, and as can be seen in Figure 1, quality has outperformed during those periods.

The graph above also shows that quality companies struggled during 2022 due to the drag of rising interest rates hurting the relative valuation of quality companies as these are typically long-duration assets. Rising interest rates can hit companies with sustainable long-term earnings growth as the discounted value of future earnings decreases. But as mentioned, we don't expect that long-term rates will increase markedly from current levels, thereby gradually removing the valuation drag and enabling individual company performance to regain center-stage.

Our philosophy and approach to investing continues to be that time in the market is more important than timing the market. Therefore, identify quality companies, and be patient over the longer-term.

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C WORLDWIDE ASSET MANAGEMENT FONDSMAEGLERSELSKAB A/S
Dampfaergevej 26 · DK-2100 Copenhagen
Tel: +45 35 46 35 00 · Fax: +45 35 46 36 00 · VAT 78 42 05 10 · cworldwide.com
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