Hemenway Trust Company LLC

Fall 2019 Investment Report

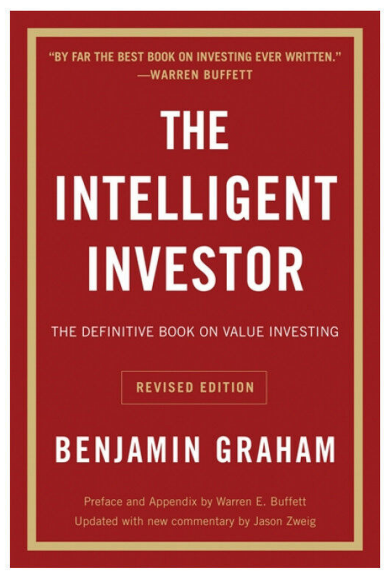
While the changing leaves of autumn signal a transition from one season to the next, little has changed in the markets over the last two quarters. In Q3, global equity markets were volatile, but posted muted gains as financial markets dealt with a continuation of the same issues we saw in Q2: trade, tariffs, Brexit, and slower corporate and consumer spending worldwide.

Again, similar to Q2, this has led to even lower bond yields – pushing down the 10-year treasury yield to 1.65%. While lower interest rates have helped boost valuations for more stable businesses, we've seen a near-term rationalization in the prices of many recently IPO'd stocks such as Uber, Lyft, SmileDirectClub, and Peloton. These are all companies with strong sales growth and loyal customers, but the pullback in their stock price (between 25-45%) shows that there are limits to where valuations can go for highly unprofitable businesses. The most glaring example has been WeWork, which – over a matter of weeks – went from a pre-IPO valuation of $47 billion to near-bankruptcy before it received an emergency cash infusion by SoftBank.

For more analysis on the various cross currents moving the markets, please see our Investment Reports for Spring 2019 and Summer 2019.

The Intelligent Investor

Before we turn our attention to new trends, let's take a step back into history.



In 1949, economist and professor, Benjamin Graham, wrote the book *The Intelligent Investor*. The book covers everything from the structure and history of markets, to diversification, inflation, stock selection, investment income, and most importantly valuation and patience. It has been updated several times over the decades, more recently with commentary by Graham's most famous student, Warren Buffet, and Jason Zweig.

The original book was written at an interesting time. The world was still recovering from WWII, the Dow Jones stock index still traded well below its 1929 high and bond yields were historically low (the 10-year treasury yielded <2.5%). Stock ownership by the public was limited (estimated <5% of the US population), the great mutual fund boom was years away and the concept of overseas investing was non-existent. Despite its age, the book provides important lessons about investing that are oftentimes forgotten, with painful outcomes. Below are just a couple of themes discussed in the book.

Investors vs. Speculators

Graham focuses on a critical distinction between market participants – Investors vs. Speculators. He writes that intelligent investing involves:

1. analysis of the fundamentals of a business;
2. a plan to limit severe loss; and
3. the pursuit of a reasonable return.

Speculation involves basing decisions solely on market price, hoping that someone will pay more than you at a later date. While there are a handful of successful speculators, we have seen there are many investors who fall prey to speculation.

The Margin of Safety

The chapter on Margin of Safety is probably the most well-known. It is also the title, and basis, for another famous investing book written by Seth Klarman, the founder of Baupost. The central thesis of the chapter is to minimize losses by buying assets below their intrinsic value. While this sounds simple, the intrinsic value on a business has many assumptions on the business (sales, earnings, pricing power, competition, etc.) and can vary on the investors' time horizon (one quarter or 10 years). We must also look at non-financial factors such as the company's impact on the environment or risks in governance structure (see our spotlight on Environmental, Social and Governance Investing). This margin of safety provides a cushion if there is a downturn in the market or there was another miscalculation in your assumptions.

Be Careful of Relying Too Heavily on the Largest Stocks

Top 10 Stocks in the S&P 500 in 2004 underperformed the broad market by 7% annualized

Top Holdings in S&P 500 in 2004	Mkt Cap $ Billions	15 Yr Return
General Electric	319	-0.028
Exxon	283	0.051
Microsoft	282	0.122
Pfizer	270	0.042
Citibank	240	-0.068
Walmart	240	0.068
BP	197	0.013
AIG	189	-0.131
Intel	184	0.075
Bank of America	168	-0.005
Weighted Average		**0.018**
S&P 500 Index		**0.09**
as of 9/30/19		

The margin of safety emphasizes the need to understand a business, where they are going, how they will allocate capital, and how they will return it to shareholders. For example as you'll see in the table to the right, blindly investing in the top 10 stocks in the S&P 500 in 2004 would have cost you 7% over 15 years. Currently, we are adjusting our positions on technology stocks because of the changing margins of safety, even though technology stocks continue to outperform. Conversely, we are adding to the healthcare sector, where we see wider margins of safety.

You can read *The Intelligent Investor* here: https://www.e-reading.life/bookreader.php/133361/The_Intelligent_Investor.pdf. We welcome your thoughts and questions about the book and would be happy to explain how we incorporate these long-term investing principles into your portfolio.

Environmental, Social and Governance Investing

As wealth managers, our primary objective is to design investment portfolios that meet each client's goals, while mitigating undue risks. We manage risks in a portfolio primarily through asset allocation and fundamental analysis (research and forecasting of a company's business model, sales, earnings, balance sheet) with an aim to uncover high quality businesses trading at reasonable valuations.

What is ESG and Impact Investing?

Our analysis also includes non-financial factors, commonly referred to as environmental, social and governance (ESG) factors, to help identify both risks and opportunities. ESG is often used interchangeably with the term impact investing; however, there is a distinction. Investors may consider ESG factors when evaluating decisions taken by company management that affect operational efficiency and the future strategic direction. Investors seeking to invest more thematically in companies that are proactively solving some of society's most pressing issues are considered to be implementing impact investing; these investors are typically, but not always looking at ESG factors.

Our Approach

ESG analysis has become an increasingly important part of our diligence process as a way to garner a more comprehensive understanding of the companies in which we invest, with a focus on factors including reputational risk, regulatory developments, or megatrends, such as climate change/price of carbon. This approach is supported by academic research which confirms that evaluating material non-financial factors contributes to performance and mitigation of risk. The level of emphasis that we give to this form of analysis depends on client interests and goals. In the past, client conversations were centered around divestment—this was due to the fact that, less than ten years ago, data relating to ESG factors was much less sophisticated than it is today. Much of the data available focused on exclusionary factors, such as controls and policies in place; examples include those to mitigate cluster munitions, bribery and corruption, or child labor. Today we have access to broader and more sophisticated data. While there is still no "one size fits all" answer, standards, guidelines, scores, stewardship codes, screens, and ratings are available and add tangible value to the investment decision-making process.

From a firm perspective, we added to our ESG research capabilities by investing in new analytical tools and an investment professional with an ESG background. We have always favored companies offering safe, reliable products with strong management teams and we find the additional steps we've taken are complementary to our traditional fundamental approach to investing.

Customizing Client Portfolios to Meet Individual Values and Priorities

A key difference in our approach to ESG/impact investing is that we structure each client's portfolio according to that client's values and priorities for environmental, social and governance concerns. In addition, for those clients for whom it is appropriate, we are available to discuss impact investments designed to support companies, often private, that are developing novel approaches and solutions to some of society's most challenging problems.

Contact Us

Thoughtful portfolio management is a hallmark of our approach and we would welcome the opportunity to speak with you about your interest in ESG investing.

www.hemtrust.com