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SECTOR WATCH

Profiting from the stay-at-home economy

U.S. equity funds that have skated through the recent pandemic-related volatility have invested in industries that should benefit from the Covid-19 pandemic

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Firms riding trends in online shopping, delivery, home entertainment and working remotely have performed well

THIS YEAR HAS PRESENTED more than the usual array of challenges for fund portfolio managers in the U.S. equities category. The extent and duration of the Covid-19 pandemic remain uncertain, and corporate earnings are showing a disheartening trend.

U.S. stock market leadership has been concentrated in companies that appear to be immune to and possible beneficiaries of the Covid-19 virus, such as firms active in online shopping, delivery, home entertainment and working remotely. Some health-care companies and financial services firms facilitating non-cash transactions have performed well.

Mutual funds that have emerged from the extreme market volatility of recent months in the best shape have significant holdings in these areas. Such funds were less affected by the short, sharp sell-off in markets in late February and March, and benefited from the subsequent strong recovery in stock prices as governments released a torrent of stimulus measures.

The outlook is murky as societies under lockdown reopen and are challenged by new rules surrounding social behaviour and psychological factors such as financial risk aversion and fear of getting sick. Although China began lifting lockdowns in March, consumption has been slow to return.

U.S. economic statistics for April showed a deepening slump as retail sales plunged by 22% year-over-year, with only online sales bucking the trend. The U.S. economy suffered a record 20.5 million job losses in April, and more than 40 million people had filed unemployment claims. The ripple effects could lead to a tsunami of business closures, given that consumer spending accounts for about 70% of the U.S. economy.

Although the post-March stock market rebound indicates many investors are looking ahead to the end of the pandemic, things could get worse. Fund portfolio managers are seeking holdings that can weather a prolonged, potentially severe downturn.

Vishal Patel, vice president and portfolio manager with Toronto-based **1832 Asset Management LP**, is lead portfolio manager of Scotia U.S. Equity Fund. He navigated the March stock market panic impressively. As of April 30, the fund had a respectable year-to-date return of 5.0%. The fund also has been a strong performer over longer periods, with a three-year average annual compounded return of 14.2%.

The Scotia fund holds a handful of U.S.-based global giants benefiting from the technology revolution and accompanying lifestyle changes — including online shopping and working from home. Among the fund's top 10 holdings are Microsoft Corp., NVIDIA Corp., Apple Inc., Facebook Inc. and Alphabet Inc. (parent of Google), as well as payment facilitators such as Visa Inc. and Mastercard Inc.

Patel seeks companies with a durable competitive advantage, a strong balance sheet and healthy cash flow. He does a lot of detective work regarding management teams and corporate cultures.

"We look for companies we can hold for the long term and benefit from their ability to compound growth," Patel says. "Quality companies with strong balance sheets will do well, irrespective of the coronavirus effects. [Those companies] can weather the storm, and may also be able to take advantage of the situation from a [mergers and acquisitions] perspective. They can afford to buy out competitors and achieve market-share gains."

Patel uses a four-step investment process:

First, he narrows the vast field of opportunities in the U.S. stock market to a manageable universe of about 120 names through quantitative computer screening. He refers to this step as the "Ironman" stage because it relies on machines.

The second step involves subjective decisions — what Patel calls the "art component." It includes a qualitative assessment, such as analyzing corporate management teams and their ability to allocate capital profitably. At this point, the "people" aspect is huge, Patel says, and a big part of his role is judging management. "It's not just the top executives," he says. "It's things like the culture of the company, succession planning and management tenure."

The third step is the important valuation stage, during which Patel determines the company's worth relative to its stock price.

Finally, after Patel finds about 60 candidates, he focuses the portfolio on 30, selecting a complementary mix and weighting companies appropriately.

"Quality growth is what we're looking for and we want compounders of wealth," Patel says.

Patel often lets his winners run. Turnover is low at about 20% a year, resulting in an average holding period of about five years.

"Big, healthy companies with the necessary management capability and balance-sheet flexibility can afford to spend on technology and infrastructure," he says. "'Hyper-scale' is important. During challenging times, the leaders shine."

Patel runs a diversified, "high-conviction" portfolio that includes defensive and cyclical companies. The Scotia fund's mandate is to be represented in seven of the 11 U.S. stock market sectors.

Technology is the Scotia fund's biggest sector, at about 29% of assets under management (AUM), followed by financials at 16%. The fund has no investments in the real estate sector, as Patel is uneasy about the leverage employed by real estate companies. In financials, he avoids banks, but Progressive Corp., a property and casualty insurance giant, is a top holding.

FOR THE PAST FEW YEARS, Grant Bowers, vice president and research analyst with **Franklin Advisors Inc.** in California, has been lead portfolio manager of Franklin U.S. Opportunities Fund. He has positioned the fund's portfolio to benefit from developments in e-commerce, fintech, digital media and health care.

Following the emergence of Covid-19, the Franklin fund performed well, as its overweighted positions in the technology and health-care sectors bolstered performance. The F series of the fund had a year-to-date gain of 8.4% and a three-year average annual compound return of 14.9% as of April 30.

"Technology has been our biggest sector and we continue to like it," Bowers says. "Society is undergoing a digital transformation and that is unlocking opportunities in such areas as cloud computing and video-conferencing as workforces discover the value of home offices. In fintech, we're seeing a rise in digital payments. These trends are poised to accelerate with more people working from home and shopping online."

The Franklin fund has almost 40% of its AUM held in tech companies, and another 16% in health care (the second-largest sector weighting). The two biggest holdings are Amazon.com Inc., which is riding a surge in online shopping, and Microsoft, a dominant player in cloud computing and video conferencing. Also high on Bowers' list, like Patel's, are Mastercard and Visa.

"Our quality bias and sector allocations have shone through as the market has struggled during the past few months," Bowers says.

In health care, key holdings include UnitedHealth Group Inc., a diversified health-care provider, and Intuitive Surgical Inc., a manufacturer of robot-assisted surgical equipment that enables microscopic surgery.

"Health care has been a favourite sector due to developments in genetic sequencing, advanced R&D and the leveraging of data analytics to produce better patient outcomes," Bowers says. "The aging population will need new and innovative treatments and cures."

The Franklin fund holds 60 to 90 names, with significant weightings in the top 20. He describes the smaller positions as "a bit of a tail," where seeds can be planted in emerging ideas that can potentially produce generous returns.

"We may invest earlier in some companies than many of our competitors [do]," he says. "The goal is to identify franchise businesses that can grow earnings and revenue and to hold them for a long time. We do deep analysis on every company, visit the operations, and talk with executives and their teams, as well as [their] competitors."

The Covid-19 crisis is supporting the Franklin fund's multi-year themes and fertilizing new ideas, Bowers says. For example, the pandemic has exposed weaknesses in supply chains, creating pressure for "re-shoring" manufacturing. Bowers sees opportunities in transportation, citing Union Pacific Railroad Co., which specializes in freight hauling.

Other themes related to the stay-at-home economy are online education and home exercise. The Franklin fund holds Peloton Interactive Inc., a maker of indoor exercise equipment and provider of online fitness classes. IE