iA Wealth

Market Commentary on the Impact of COVID-19

April 9, 2020

Speakers

Lee Rosenbaum
Vice-President & Portfolio Manager
Loomis, Sayles & Company, L.P.

The following is a summary of a conference call held on April 9, 2020.

Key takeaways

- Our technology and health care holdings are especially well positioned for post-crisis opportunities.
- We're also finding opportunities in financial technology, auto parts, housing and internet infrastructure oversight.
- The COVID-19 crisis will likely lead to a reassessment of potential supply chain vulnerabilities.

Summary

What is the big question you and your team have had to ask about the businesses you own that you didn't have to ask before the crisis?

- The companies in the portfolio were already in a very good position from the perspective of balance sheet strength.
- We're stress-testing our holdings for what we believe could be a 1–3 quarter period of significant economic weakness.
  - o We're doing this on the equity and fixed-income side, providing a 360-degree view of the capital structure.
- We normally account for a downside scenario in our modelling and forecasts, but factoring in a pandemic-type scenario is not something we would do as a baseline for our outlook.
  - o But this is what we're presented with, so we need to ask how companies, industries and regions are being impacted short term and how they will likely be impacted – and for how long – looking further out.
  - o The recovery cycle looks like it will be different in different parts of the world in terms of timing.
    - ▪ We've been long-time owners of HDFC Bank in India, and India may be one of the later-cycle countries.

The technology and health care sectors have held up well during the crisis. Your funds are overweight both sectors – do you see this as a short-term necessity or more of a longer-term trend?

- We were overweight both sectors coming into the crisis.
- Our technology companies are reducing costs, improving efficiency and supply chain structure – all things that independent of the COVID-19 crisis will likely have longer-term positive impacts.
- We also think our technology holdings are very well positioned for the environment we expect once we return to normalcy post-crisis.
- It's a similarly positive story for our health care holdings, which are very durable thanks to high percentages of recurring revenue.
- I think there is growing recognition that here in the U.S. we were not very well prepared for this pandemic.
  - o With that in mind, some of the companies we own

could benefit from actions taken post-crisis to better prepare ourselves for any future pandemics.

Is there an area of the market where you weren't invested leading up to the decline, but is now getting a second look?

- We came into the crisis with no energy holdings in our equity portfolios, and it's not an area we plan on giving a second look, mainly on free cash flow concerns.
- There are some 'bombed out' businesses that we're dusting off and giving a second look because we do think that in some cases they can generate free cash flow over time.
- In terms of sectors, the answer to the question is 'no,' but in terms of industries the answer is 'yes.'
  - We're looking at financial technology, auto parts businesses focused on value-conscious buyers, a housing-related business, and an opportunity in a company involved in the oversight of internet infrastructure.

Do you expect there to be any major winners or losers as a result of broad spending habit changes post-crisis?

- Businesses focused on travel are really ground zero in an environment like this.
- Any time we're looking at a company, regardless of industry, we need to be able to understand the downside scenario.
  - Our mantra is that if we don't understand a business' downside, then we can't accurately project its upside potential.
- We think Amazon and ecommerce-focused names were well positioned for changing shopping habits before COVID-19 and could see that position enhanced post-crisis.
- We've been long-term owners of a number of global consultancies (e.g., Accenture) that are now providing advice to C-suite managers in a range of industries on how to use technology to enhance their businesses and adapt to a very challenging environment.
  - We see potential for the larger consultancies to take market share from some of the smaller players.
- There are potential supply chain ramifications that we will be monitoring, specifically around the potential for rising nationalism as a consequence of the crisis.

You recently took a position in Peloton, which offers in-home exercise equipment and virtual, subscription-based workout classes. Was this a shorter-term, opportunistic trade given gym closures or more of a longer-term addition?

- Our due diligence on this company and its addition to the portfolio happened in 2019, prior to the COVID-19 crisis.
- We see a lot of opportunity in the boutique, in-home exercise market, but we do think there is an opportunity for Peloton to expand into other areas, such as yoga and strength training.
- We have a longer-term outlook on this company in terms of its position in the portfolio.
- In our view, there is an excellent value proposition for Peloton relative to a gym membership.
- The company has attractive customer acquisition costs and an interesting subscription model, which we believe will be key to driving long-term value creation.
- The COVID-19 crisis has generated a lot of discussion around Peloton, and this may help expedite what for us was a pre-existing view on the company's longer-term potential.

Do any of the health care companies in the portfolio have a role in efforts towards COVID-19 recovery?

- Every one of our health care holdings is in some way helping in the global fight against the pandemic.
- Becton Dickinson is the leading manufacturer of nasal swabs and kits for collecting and transporting clinical samples for COVID-19 testing.
  - The company's molecular diagnostic platform is being used in hundreds of labs across the globe.
  - The company has come out with a 15-minute serology test for COVID-19.
- We need to keep in mind that with the focus on responding to COVID-19, a lot of health care companies have had to put other priorities on hold, which could turn into a short-term headwind.
- Danaher, another long-term holding, also has a division that offers molecular diagnostics, which is being used in the company's 23,000 systems globally.
- IQVIA, a more recent holding, offers contract research and strong data analytics.

- o The company has developed what they're calling a trial matching tool, which allows individuals to be better matched with all of the different ongoing clinical trials from all of the global pharma and biotech companies.
- United Health Group, a very well-capitalized health insurer that has been in the portfolio for almost seven years.
  - o The company just put out a press release announcing the acceleration of payments for medical and behaviour care providers to the tune of $2 billion.
- Mettler Toledo, a manufacturer of all kinds of innovative weighing scales for health care applications, which are greater demand in this crisis.

Advisor Q&A

Do you expect the COVID-19 crisis to lead to a widespread re-evaluation of global supply chains? If so, what do you anticipate the impact will be on prices for consumers?

- This is something we're going to be looking at on a case-by-case basis.
- We think rising nationalism, which was already a major geopolitical trend, could accelerate the reassessment of supply chains in certain areas.
- Bringing things back on shore for certain companies could increase prices, but there are other positive effects (e.g., more employment in that domestic market).
- When there's too much outsourcing and you push the income statement and profit margins to the positive side too far, that can sometimes come with increased risk, through having such a wide-ranging supply chain.
  - o Particularly relevant to our view of how to evaluate a business, there's a case to be made that if a company vertically integrates, it might give up a bit of bottom-line net income, but this might bring with it an improved cost of capital because you're no longer bumping into some of these supply chain issues.

Definition of terms: Capital structure – Refers to how a company finances its operations; in other words, how debt and equity are allocated on the balance sheet. Downside – The actual or potential drop in an investment's price. Free cash flow – Refers to the cash a company generates after accounting for capital expenditures. Overweight – An overweight position means an investor or investment fund manager is allocating more to an asset class, sector, geographic region or other category than the benchmark weighting.

(20-0607) 04/20