DODGE & COX®

Podcast Transcript

How A Long-Term Value Investor Assesses Macro Factors Amid COVID-19

SEPTEMBER 2020

Scot Hoffman: Welcome to another edition of Dodge & Cox Investment Perspectives. I'm Scot Hoffman in Communications. Reflecting back on the last five months amid COVID-19, it has been an unprecedented period in the markets, for our industry, and for our firm, and we continue to work from home for the foreseeable future, as that continues to function very well. With much uncertainty still surrounding COVID-19 and with a number of questions from clients about the macro environment, we thought this would be a good time to take a step back. But before we do that, on behalf of Dodge & Cox our thoughts are with the millions of people and their families around the world who have suffered from the health and economic impacts of the virus. We will spend a few minutes discussing why and how macroeconomic research fits into our bottom-up research process at Dodge & Cox. Macro, among other areas, is one where we have built out expertise as we have globalized our investment research capabilities over the last several decades, and some of our clients may not be as familiar with where it fits into our investment process. To talk about this, I'm joined by Chairman and CIO Charles Pohl and CEO and President Dana Emery, both of whom are 37-year veterans of the firm. Charles is a member of our U.S., International, and Global Equity Investment Committees, and Dana is a member of our U.S. and Global Fixed Income Investment Committees. We are also joined by Macroeconomist and Global Fixed Income Investment Committee member Jose Ursua, who is an expert in analyzing the impact of pandemics. Welcome, Dana, Charles, and Jose.

Dana Emery: Thank you.

Charles Pohl: Thanks, Scot.

Jose Ursua: Glad to be here.

Scot Hoffman: Let's begin by setting some context. Charles, can you describe our Macro team's work and how it fits within our investment decision-making process as an active manager, who focuses on fundamental, bottom-up analysis of equity and debt securities?

Charles Pohl: Well, let me start by saying we haven't changed our investment process. Our primary focus is on fundamental, bottom-up analysis of companies and securities. But the key question is how does macro analysis help us in that effort? Over the last several decades, we have globalized and integrated our research process and expanded our capabilities across equity and fixed income. I'll spend a minute on equity and I'll turn it over to Dana to address fixed income. We've expanded the depth and breadth of our research skills and coverage. We call our analysts "global industry analysts" because they are truly covering companies on a global basis. To understand the opportunities and threats for Cisco, for example, you need to understand the business model of Huawei. That knowledge also translates into the value of new investment opportunities and vehicles; for example, the launch of

our international and global equity and global fixed income strategies. On top of that, you need to understand local economies and where they fit within the global economy. Take China, for example, where we have been building out a bench of native Mandarin speakers, who understand the culture and economic drivers that will impact the earnings and cash flow growth prospects of Chinese companies. That also gives us deeper insight into what is often the opaqueness of corporate governance.

Scot Hoffman: Dana, what would you add to that?

Dana Emery: Just adding to Charles' comments, beginning back in 2006 we started to build out our macro expertise in a more formal way at Dodge & Cox. We brought in academics and industry consultants to help us evaluate ways to assess FX risk in our international equity strategies, and we were worried about the U.S. dollar cycle. This work resulted in several successful FX hedging decisions for both our international and global equity strategies, and since then, we've gradually built out a dedicated team of in-house Macro Analysts, such as Jose, and added Research Associates to support them and many new data sources as they built out our proprietary models and dashboards to help us evaluate Macro exposures. They provide an important input to all of our strategies and especially our global fixed income strategy that was launched in 2014. In Macro analysis, we focus on three main areas: sovereign credit, rates, and FX. The Macro analysis provided by this group can be front and center to our decision-making as in sovereign and other government related credit decisions, rates positioning and FX positioning, both long and hedging decisions, in our fixed income as well as in our equity strategies. They are also a very important input to our bottom-up security selection in both equity and fixed income credits; for example, in the emerging markets. So macro can be both a driver and an important tool for our analysts as they evaluate bottom-up investment opportunities in equity and fixed income. This expertise also complements our deep analyst and trading team in structured products, derivatives, and other government-related securities.

Scot Hoffman: Jose, let's turn to you. You're a macroeconomist by training and, perhaps fortuitously, an expert in pandemics. How did you develop an interest in this field?

Jose Ursua: It started during grad school at Harvard, where I became interested in the area of intersection between macroeconomics and finance, in particular, in the study of rare disasters, which are infrequent events that happen with low probability but can have severe consequences. These matter from a macroeconomic standpoint because they shape key dynamics related to growth, inflation, investment, productivity, and other macro variables. And they affect asset prices too, including equities, debt securities, currencies, and commodities. So, after reconstructing historical macro data for many countries, Professor Robert Barro and I discovered that in addition to wars and financial crises, large macroeconomic contractions could also be associated with pandemics. And the best example of that was the Great Influenza Pandemic of 1918 through 1920. This research caught a lot of attention because we wrote it before the H1N1 pandemic of 2009 through 2010. And of course, COVID-19 and its associated macroeconomic disasters in 2020 have reignited interest in the field. From our perspective as investment managers, it has helped us inform the outlook ahead from a macro and financial standpoint.

Scot Hoffman: As you've reminded us, Jose, COVID-19 was a major shock that no one predicted, especially its severity or depth of disruption. What are the scenarios we are evaluating as you think about this uncertain environment and the macro picture?

Jose Ursua: We've followed some basic principles to construct three macro scenarios for our long-term investment horizon. These include 1) Distinguishing what we actually know from what we ignore, meaning basing our assessments on the data; 2) Being broadminded about the wide range of possible outcomes; 3) Having a focus on the long term, which matches our investment horizon; 4) Expressing views in probabilistic terms, not deterministically; and 5) Thinking dynamically, not statically, considering all the moving parts of the outlook. So we first sketched these three scenarios in March, and while we have refined them to take into account new data, the gist of them remains unchanged because they're multiyear horizons. In particular, we continue to focus on what we identified as the four main drivers of the outlook. First, the evolution of the virus; second, progress around lockdown policies; third, the behavior of financial markets; and fourth, policy decisions around support measures like monetary or fiscal. So at the center of the distribution of outcomes, we've played for a "baseline" scenario, which we think is most likely and is tracking as expected according to the data. This envisions a U-shaped recovery in the third quarter and fourth quarter of 2020, and strong 2021–2022 pick-ups in growth. The key drivers include the gradual fading of the virus by the winter, no re-imposition of generalized lockdowns, and continued monetary and fiscal support. Around that baseline, we've penciled in two additional scenarios. On the one hand, a strong scenario where the recovery happens faster, recessions in 2020 are shallower, and growth recovers to trend in 2021. On the other hand, we have also outlined a weak scenario, where the recovery is incomplete, delayed until 2022, recessions last longer, and longer-lasting depressions are likely and concerning. Overall, it's been important for us to discuss these views thoroughly among our fixed income and equity Analysts and Investment Committees, to make sure we've asked all the relevant questions, and that we're working together as a team considering or using a consistent set of assumptions.

Scot Hoffman: Thank you, Jose. Charles, I'd like to come back to you for a minute and link what Jose was talking about here to our equity portfolios. And we've talked about how the portfolios assume economic growth over the long term; we emphasized this at the end of last year in the context of the debate between value versus growth stocks. That is still very much the case, so what are the implications of the scenarios that Jose laid out and how are the Investment Committees really factoring these scenarios?

Charles Pohl: Well, we continue to believe that over the long term, looking out over our investment horizon, that we will see economic growth. But we're really investing in companies whose strong fundamentals are not reflected in the valuations. I'll make three points that illustrate why it is so important to look at valuations, using Financials, Energy, and Technology. First, let's look at Financials. Banks have been an important part of the solution for regulators and policymakers in this crisis and we're in a much stronger capital and liquidity position as we entered shelter in place. Having said that, the banks have performed poorly as rates moved to multidecade lows and GDP growth dropped off a cliff. Our analysts incorporate into their models our views that dividends will be suppressed and that earnings will be challenged over the next few years, as rates are likely to stay low for a prolonged period of time and credit costs are likely to rise as a result of the impact of shelter-at-home policies in the wake of COVID-19. We believe that valuations of our bank holdings incorporate significant pessimism about the future. However, we believe the long-term earnings power is considerable, and that over the long term they represent a significant investment opportunity. Second, low oil demand due to economic weakness has had a significant adverse impact on our Energy holdings. While the valuations of these companies reflect significant pessimism, in our opinion, they do not reflect the long-term investment opportunity. Capital spending in the Energy sector has been sharply curtailed to a point where supply is unlikely to keep up with demand as the economy continues to recover. We believe this could result in significantly higher oil prices and result in strong performance by our Energy holdings. Third, as we have discussed in many venues, the stock market in recent years has been driven by the high-growth technology companies, leaving most of the rest of the market behind. We think there are many opportunities for bottom-up fundamental security selectors with a valuation focus and a long time horizon like Dodge & Cox.

Scot Hoffman: We've seen significant policy responses from governments around the world. Dana, what do you see as the longer-term impact of these policy responses?

Dana Emery: Yes. First, let me give a little context about the policy responses and then I'll talk a bit about the potential consequences for markets. The Federal Reserve acted very quickly and decisively in the wake of the market and economic dislocations in March, as the shelter-at-home policies were implemented. They brought short-term rates to near zero. They reimplemented significant quantitative easing programs to help control long-term rates and ease financial conditions. They added security purchase programs to support the credit and structured products markets, in particular, and this all went a long way to calm the markets and mitigate the economic impact of the shelter-at-home policies. We believe that the Fed and the central banks around the world will continue to do whatever it takes to help mitigate the impact of COVID, and the policies that are implemented to combat it. This means that rates will likely stay low for a prolonged period. The Fed and other central banks will continue to build their balance sheets. The Fed also introduced recently an inflation averaging policy, meaning they would let inflation run above their 2% target and unemployment would run lower than in the past to jumpstart and sustain economic growth. On the fiscal side, governments around the world have approved large stimulus packages to support their citizens and companies navigate this very challenging period. Examples are above-the-line tax and spending measures, and below-the-line measures like loan and credit guarantees. And while there are benefits of these policies in the short term, over the long term there are significant costs, such as higher deficits and much larger debt stocks, which will likely impact economic growth for long periods as taxes are increased and spending is cut to help pay back the debt incurred. These views for slower economic growth and rates remaining low for longer, especially in the short end of the yield curve, are incorporated in our base and downside scenarios when evaluating investment opportunities in equity and fixed income and setting our overall portfolio structures. So taking the impact of the policy responses into account, we see considerable value in our ability to find attractive investments on a relative basis in our portfolios. We are confident in our current portfolios but we're cautious that the total returns are likely to be low in the broad markets on an historical basis, given the current valuations, and an overlay of significant economic and geopolitical uncertainty. In fixed income you have low starting rates and narrow credit yield premiums, and in equities, the traditional valuation metrics have risen above pre-COVID levels, metrics such as price-to-sales, price-to-book, price-to-earnings, and equity markets have recovered significantly.

Scot Hoffman: When we're talking about the macro environment, there are possible other large issues and risks that contribute to the uncertain economic picture. How are we thinking about these issues?

Charles Pohl: In addition to COVID-19, we've been paying close attention to other macro forces that can shape the investment outlook over our long time horizon. Jose, you've mapped out three horizons from a macro perspective.

Jose Ursua: That's right, Charles, mainly near, medium and long term. In the nearer term, developments around the U.S. elections in November, tensions around the U.S.-China relationship, ongoing Brexit negotiations, OPEC decisions, and geopolitical risks matter a lot. These can change policy decisions materially, and affect the recovery from COVID-19 in unexpected ways. In the medium-term, we are focusing on plausible paths for over-extended monetary and fiscal policies around the world, the thing I just described; on the monetary side, because aggregate demand and supply dynamics may shift the distributions of risks around inflation; and on the fiscal side, because the unraveling of debt build-ups has traditionally involved fiscal tightening through higher taxes. In the longer term, our analysts are actively evaluating possible behavioral changes post-COVID-19: shifts in supply chains and trade patterns, technological developments, environmental policies, risks from populism, and even demographics, which are topics you and I have discussed in the past, Charles.

Charles Pohl: Indeed. We think these macro considerations complement and enhance our bottom-up research, to strengthen as best as we can our investment decision-making.

Scot Hoffman: For our last question, given all these macro-crosscurrents that we've been discussing, what makes you optimistic about the positioning of our investment portfolios going forward? Let's start with you, Charles, and wrap up with a few comments from you, Dana.

Charles Pohl: We are obviously very concerned and sympathetic to the people affected by this horrible disease. But as a fiduciary, we continue to assess our current holdings and actively seek out new opportunities that come from the market dislocation. Keep in mind the pandemic of 1918— the worst in history— only lasted 18 months. COVID-19 won't last forever. It will either be brought under control with a vaccine or it will slowly fade away. We are already seeing many signs of economic growth returning. We have portfolios of securities, most of which are selling at modest valuations, and which we believe will benefit significantly from the economic recovery.

Dana Emery: I would add that we're confident in our investment process and in our focus on the long term. As a team, we've had significant experience navigating many challenging economic and market environments successfully, and this period is really no exception. And we believe we're well positioned for the long-term opportunities in a wide variety of scenarios across our portfolios. That gives us optimism about the relative long-term return opportunities. And we would end by just encouraging investors to stay focused on the long term and on achieving their long-term investment goals by staying invested.

Scot Hoffman: Thank you, Dana, Charles, and Jose for an excellent discussion, and thank you for listening. If you have any questions or comments, we encourage you to reach out to us.

Scot Hoffman: This podcast was posted in September 2020. Statements in this podcast represent the opinions of the speakers expressed at the time the podcast was recorded, are not a complete analysis of every material fact concerning any market, industry or investment, and may change based on market and other conditions without notice. The statements are not intended to forecast or guarantee future events or results for any product or service or serve as investment advice or a recommendation to buy, sell or hold any security. Any securities identified are subject to change without notice and do not represent a fund's entire holdings. This podcast should not be copied, distributed, published or reproduced in whole or in part without express permission of Dodge & Cox. Before investing in any Dodge & Cox Fund, you should carefully consider the Fund's investment objectives, risks and charges and expenses. To obtain a Fund's prospectus and summary prospectus, which contain this and other important information, or for current month and performance figures, visit dodgeandcox.com or call 1-800-621-3979. Please read the prospectus and summary prospectus carefully before investing.

Statements in this presentation represent the opinions of the speakers expressed at the time the presentation was recorded, and may change based on market and other conditions without notice. The statements are not intended to forecast or guarantee future events or results for any product or service, or serve as investment advice. Debt securities are subject to interest rate risk, credit risk, and prepayment and call risk, all of which could have adverse effects on the value of an investment. Investing in non-U.S. securities may entail risk due to foreign economic and political developments; this risk may be higher when investing in emerging markets.

The information provided is not a complete analysis of every material fact concerning any market, industry or investment. Data has been obtained from sources considered reliable, but Dodge & Cox makes no representations as to the completeness or accuracy of such information. The information provided is historical and does not predict future results or profitability. This is not a recommendation to buy, sell, or hold any security and is not indicative of Dodge & Cox's current or future trading activity. Any securities identified are subject to change without notice and do not represent a Fund's entire holdings.

Before investing in any Dodge & Cox Fund, you should carefully consider the Fund's investment objectives, risks, and charges and expenses. To obtain a Fund's prospectus and summary prospectus, which contain this and other important information, or for current month-end performance figures, visit dodgeandcox.com or call 800-621-3979. Please read the prospectus and summary prospectus carefully before investing.