Investing in Uncertain Times

Chris Sierakowski, CFA
Portfolio Manager

Andrew Xiao, PhD, CFA
Portfolio Manager

Laura Ostrander
Emerging Markets Macro Strategist

George Bicher
Asset Class CIO and Portfolio Manager

Shalabh Gupta
Global Pharmaceutical Analyst

Patrick Bernard
Assistant Director of Research
One quarter into 2020 and things are clearly not progressing as we had envisioned. It is always difficult during a crisis to see what will become obvious in hindsight but we believe we have the advantage of an investment approach that is built to look through market turmoil toward long-term fundamentals. At the same time, the current COVID-19 related disruption is creating risks and opportunities for our portfolio holdings, which our research analysts are evaluating. In this dynamic environment, our US Equity Portfolio Manager Chris Sierakowski shared his views on the market and how he’s thinking about his US Equity Select portfolio.
The global spread of the coronavirus has caused considerable economic and market disruption. As concerns about the virus’s impact increased, have you taken any portfolio action?

The speed at which markets have fallen is remarkable; it’s only a few weeks since the S&P 500 Index peaked at an all-time high on February 19. By the end of March, the index had declined -23.5% from the record after one of the sharpest drops in the history of the market.

In terms of portfolio activity, we sold a few of the stronger performers from last year, including Microsoft, ASML and Apple. Each of these names had gained over 75% in the trailing twelve months and had moved to valuation levels that looked relatively less attractive to us. One impact of the sales was to reduce our sizeable information technology sector overweight at the start of 2020 to a sizable underweight by the end of February.

We used the sale proceeds to initiate new positions in Texas Instruments and CMS Energy. These are two very different companies; one is a semiconductor manufacturer and the other a regulated utility in Michigan. However, both are high-quality franchises with durable earnings streams. Moreover, their valuations had moved lower while their high dividend yields should help provide some ballast in a volatile market. Against the backdrop of a significant market decline, we have also continued to opportunistically add to many of our highest conviction names.

More generally, how do you think about risk management and downside protection in your portfolio?

Our best risk management tool in a concentrated portfolio is looking at security-level risk using our Confidence Quotient (CQ) framework, with a focus on financial condition, fundamental momentum, and market position. We leverage the deep domain knowledge of our equity research team to stress test the business models and balance sheets of our holdings.

Early in the COVID-19 crisis, we analyzed exposures to China and the broader Asian supply chain impacts across our covered companies. As the coronavirus spread more widely, we considered the implications of a broader global economic slowdown. We looked at financial leverage, interest coverage ratios and debt maturity schedules. We questioned the impact of a sharp economic recession on the revenue models and the implications for margins and free cash flow. And beyond 2020, we considered whether the current environment would have lasting consequences for the secular growth drivers and relative market positions of our companies. Overall, we remain confident in our portfolio positioning along with the quality and durability of our individual holdings.

The portfolio performed relatively strongly in 2019 and has continued to do so through the recent turbulence. What have been some of the drivers of that? Any lessons learned?

We continue to focus on our core investment philosophy around quality, sustainable growth and reasonable valuation. The bulk of our relative performance in 2019 was driven by stock selection. The top stock drivers were broadly based across technology, industrials, real estate, healthcare, communication services, financials and consumer staples. The common thread was a high level of conviction by our analyst team around the idiosyncratic aspects of the investment thesis for each name.
With the market up over 30% last year, we also utilized our valuation discipline to trim the positions of many names that had performed well. We believe that positioned us well coming into 2020 and, so far this year, we have stayed moderately ahead of the benchmark through March 31, 2020. We have used the recent market sell-off to re-allocate to some of our highest conviction names at what we consider to be attractive valuations. Our goal is not to optimize short-term performance but to focus on positioning the portfolio for the long term. We believe this will allow us to continue to compound at a rate in excess of the market, while doing so with lower risk given our focus on quality and durability.

Even before COVID-19, concerns were expressed about the length of this economic cycle and the ability of equities to continue higher. Has your outlook for equities fundamentally changed?

As COVID-19 has become a global pandemic, the macro implications have expanded. What began as a regional crisis has progressed to a point where entire countries are on lockdown, with businesses not considered “essential” shut down by state governments. With many citizens in self-isolation, consumer spending on retail, travel, dining and entertainment has plummeted. Fed rate cuts in response to the crisis have materially hit financial stocks as net interest income is negatively impacted.

The macro slowdown has also intensified the disruption in the crude oil market and the energy sector has been devastated. Overall, companies across the board have less visibility on revenue and, in many cases, have cut capital spending and removed financial guidance. We have lowered our own earnings estimates for individual companies and for the market overall. We began the year looking for mid-single digit earnings growth for the S&P 500 and have cut our outlook to a modest decline for 2020, while also taking down expectations for 2021. It’s hard to say how much lower earnings will decline, but we are considering 2020 to be a lost year for earnings. We are focused on establishing where earnings can get back to in 2021 and 2022 as we hopefully move past this situation and return to a more normalized environment.

You invest in a select group of 30–40 US stocks. What do you look for in those companies? Are there any recent examples you can share with us?

Our investment philosophy is based on investing in high-quality, reasonably-valued companies that we think can generate sustainable growth over the long term. How we define quality differs from many in the industry. We use a framework called Confidence Quotient (CQ) to assess companies in five broad areas, including things like market position and management talent. The goal is to identify companies with a durable competitive advantage which will lead to lasting sustainable growth.

Two recent additions are Lowe’s and Waste Management. Lowe’s is a leading home improvement retailer, with the bulk of its business in the US. Making modest revenue growth assumptions, we believe the company can improve sales productivity and operating margins under a refreshed leadership team. With operating leverage and a disciplined capital deployment plan, we believe that Lowe’s should be able to drive double-digit earnings growth over the medium term. Earnings will clearly take a hit in 2020 given the ongoing pandemic, but the balance sheet is strong and the stores have thus far remained open as an essential service.
Waste Management is the leading provider of waste collection and disposal services in North America. As we detail elsewhere in this publication, WM has a healthy balance sheet and a resilient revenue model; we think it is a stable compounding with a strong market position and associated pricing power. The company is diversified geographically across the US and across the various client segments of commercial, residential and industrial. With mid-single digit revenue growth and stable-to-improving margins, we believe that WM can drive durable earnings growth at an above-market rate with lower-than-average earnings volatility. The current market environment has provided an opportunity to build this core position at what we believe is an attractive valuation.

This information should not be considered a recommendation to invest in a particular security or to buy or sell any security shown. It is not known whether the securities shown will be profitable in the future.
Investing for the Long-Term During a Global Pandemic

The Fundamental Growth and Core Equity team engages in deep fundamental analysis. Usually the goal is to identify investments that we can hold for the long-term, but in extreme market environments, our team becomes a resource both internally at State Street and for our clients.

Below are two recent pieces our team published. One is a discussion of the lessons learned from China written by our Emerging Markets portfolio management team, and the second is a look at vaccine development by our global pharmaceutical analyst.

**Learning from China’s Experience Fighting Coronavirus***

By

**Andrew Xiao, PhD, CFA**  
Senior Portfolio Manager  
China Equity

**Laura Ostrander**  
Emerging Markets Macro Strategist

**George Bicher**  
Asset Class CIO and Portfolio Manager

*Originally published 31 March 2020.*
As Covid-19 disease reaches more countries and new reported cases continue to rise, public anxiety will increase and add more uncertainty for investors. Beyond efforts to contain the outbreak, we expect countries to intensify their fight against this highly contagious disease. We think significant insights can be gained by studying China's experience in combating Covid-19.

The outbreak first started in China in December 2019. Following the government’s decisive actions, available data suggest that the coronavirus has now been largely contained. The economic and social costs of these measures are unfolding, but the actions have been effective.

Some observations from China's experience with Covid-19 are:

- Epidemic curve in China indicates successful containment
- Commitment to contain the virus was directed by the highest level of leadership, which mobilized all available resources
- Draconian actions, such as factory closures and mandatory quarantines, were taken at high costs
- Fatality rates outside the Hubei Province are materially lower than inside it
- China has provided measured, targeted stimulus as well as rate cuts to cushion the impact on small-and-medium enterprises and households; more stimulus measures are expected
- Economy is coming back to life, gradually, as evidenced in various high frequency measures of economic activity

Key ongoing challenges for China are:

- Containing imported cases
- Preventing a flareup of virus cases as normal daily life returns
- Implementing sufficient fiscal and monetary stimulus to ensure economic growth recovers, while at the same time not creating excessive and/or inefficient credit growth

Profound changes in consumer and business behaviors taking place during the outbreak may have lasting consequences. Social distancing has become a key operative word in the time of Covid-19, driving accelerated adoption of e-commerce, telecommuting and online entertainment. Also, the virus has increased awareness of the need for preventative health care as well as health and life insurance. The short-term negative impact on the global economy and capital markets could be significant. To eventually win this war, we need an effective treatment for and vaccine against the Covid-19 and this may take some time.

Investment Implications

From an investment viewpoint, China looks to be in a better spot compared with most other countries. As the first country going into the war against Covid-19, China has managed through the initial surge phase of the outbreak and containment now looks achievable. The Chinese economy has taken a huge hit, but high-frequency economic activity data to date, such as coal consumption, suggests there is a gradual yet steady recovery in economic activity as the outbreak is contained.
In contrast, most other large economies are still in the midst of a very tough battle against the raging Covid-19 pandemic. The transient nature of the virus’ economic impact along with expectations of continued policy support may also be contributing to China’s outperformance in the MSCI Emerging Markets benchmark.

As active fundamental emerging market investors, we believe that excess returns above that of a passive index can be achieved through a disciplined investment process that aims to identify long-term winners among all the listed companies.

There will be winners and losers among sectors and industries in the war against Covid-19. Among the likely losers we see are travel & leisure, transportation and energy. Among the likely winners are e-commerce, online entertainment and health care. Higher-quality companies with more resilient business models and stronger financial positions will likely emerge from this crisis in a better position to deliver returns for shareholders.

---

**Drug Companies Are Rushing to Develop Treatments for COVID-19**

<table>
<thead>
<tr>
<th>A Unique Challenge</th>
<th>Therapeutic Options</th>
<th>Vaccine Development</th>
</tr>
</thead>
<tbody>
<tr>
<td>It appears that COVID-19 is more transmissible than flu/SARS and can have very muted symptoms, which further complicates understanding of fatality and transmission rates. Urgent current concerns about COVID-19 come from lack of treatment options, higher initial mortality rates, asymptomatic presentation, and worse survival outcomes for older people with underlying respiratory and other comorbidities (diabetes, cardiovascular etc.).</td>
<td>Antivirals are normally the first line of defense (for example, HIV is controlled with antivirals), followed by monoclonal antibodies (man-made antibodies made from cloned human immune cells), and finally vaccines developed to prevent future outbreaks.</td>
<td>Novel vaccines for COVID-19 are currently under development (see table) and are still in early stages of clinical enrolment and trials. In a pandemic situation, the FDA works very closely with companies to bring products to market rapidly – but the FDA also has to closely monitor the safety of these products because they may be rapidly adopted and widely used.</td>
</tr>
</tbody>
</table>

*Originally published March 20, 2020.*

By

**Shalabh Gupta**
Global Pharmaceutical Analyst
Fundamental Growth & Core Equity

---

Antiviral drugs will deliver some late-stage clinical data in a few weeks from trials that are ongoing in China. Gilead Sciences’ Remdesivir, originally developed for Ebola, is an example of an antiviral drug. The goal with an antiviral drug is to reduce the intensity and duration of the infection (which is particularly important as healthcare systems become overwhelmed), but they are not a cure or a prevention. The advantage of antivirals is that they could potentially be brought to market relatively quickly. Remdesivir’s initial trial results are due in April.
The biopharma industry is fully engaged in finding a solution to the COVID-19 pandemic, but it will take at least 8 to 12 months to develop a vaccine. Most companies are developing vaccines using traditional approaches, and some are using a messenger RNA (mRNA) approach based on the body’s natural protein synthesis processes. mRNA approaches also simplify manufacturing and help clinical trials start sooner; they would also bring the product to the market sooner. Yet the industry may not ultimately be successful in the endeavour. Our belief is that treatments will come in the form of a cocktail of therapies for patients with initial use of antivirals and antibodies, followed by vaccines as they come to the market.

State Street’s Fundamental Growth & Core Equity team takes a long-term perspective and is focused on quality, sustainable growth companies. We have held positions in several of the companies listed in the table for some time based on their long-term fundamentals, including their overall development pipeline and portfolio of drugs as well as their specific relevance to COVID-19 diagnosis and treatment. From an investment perspective, we are mindful of the continued uncertainty of the situation but are also looking at opportunities that the market dislocation has created, always with an eye on long-term fundamentals.
<table>
<thead>
<tr>
<th>Company</th>
<th>Drug</th>
<th>Mechanism of Action (MOA)</th>
<th>Status</th>
<th>Trial</th>
<th>Next Update</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gilead</td>
<td>Remdesivir</td>
<td>Nucleoside analog</td>
<td>Ongoing Severe Ph3 Asian study</td>
<td>NCT04257656</td>
<td>Initial results April 2020</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Ongoing Mild/Mod Ph3 Asian study</td>
<td>NCT04252664</td>
<td>Initial results April 2020</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Ongoing US NIAID led study</td>
<td>NCT04280705</td>
<td>Results in May</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Severe Ph3 Gilead led study</td>
<td>NCT04292899</td>
<td>Initiate March 2020; results in May</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Mild/Mod Ph3 Gilead led study</td>
<td>NCT04292730</td>
<td>Initiate March 2020; results in May</td>
</tr>
<tr>
<td>Moderna</td>
<td>mRNA-1273</td>
<td>S-protein mRNA vaccine</td>
<td>Ongoing Ph 1 NIAID led study</td>
<td>NCT04283461</td>
<td>—</td>
</tr>
<tr>
<td>Regeneron</td>
<td>TBD</td>
<td>S-protein directed antibody</td>
<td>Pre-clinical</td>
<td>—</td>
<td>Candidate selection and manufacturing by late summer</td>
</tr>
<tr>
<td>Sanofi (Regeneron)</td>
<td>Sarilumab (Kevzara)</td>
<td>anti-IL6 receptor; tx of immune-related sx</td>
<td>Entering clinical studies in next couple weeks</td>
<td>—</td>
<td>Results in following weeks to months</td>
</tr>
<tr>
<td>Roche</td>
<td>Tocilizumab (Actemra)</td>
<td>anti-IL6 ligand; tx of immune-related sx</td>
<td>Approved in China for patients with severe complications</td>
<td>—</td>
<td>China study completion expected in May</td>
</tr>
<tr>
<td>AbbVie</td>
<td>Ilopinavir/ritonavir (Kaletra)</td>
<td>Protease inhibitors</td>
<td>Approved in China for patients with severe complications</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>BioCryst</td>
<td>Galidesivir</td>
<td>Nucleoside analog</td>
<td>In vitro testing against current strain (prev. shown activity against other coronaviruses); in discussion with US govt about utility</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Vir Biotechnology (Alnylam)</td>
<td>TBD</td>
<td>siRNA</td>
<td>Ongoing preclinical work in collaboration with Alnylam</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Vir Biotechnology (NIH)</td>
<td>TBD</td>
<td>mAb</td>
<td>Ongoing preclinical work in collaboration with the NIH</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
<td>TBD</td>
<td>Vaccine</td>
<td>Initiated a project on vaccine development</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Novavax</td>
<td>TBD</td>
<td>Vaccine</td>
<td>Entering clinical studies May or June 2020</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>BioNTech/Pfizer</td>
<td>TBD</td>
<td>m-RNA-based Vaccine</td>
<td>Pfizer considering collaboration with BioNTech to develop mRNA vaccine</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>BioNTech/???</td>
<td>TBD</td>
<td>m-RNA-based Vaccine and/ or other modalities</td>
<td>While BNTX hasn’t commented on a specific plan, the co is working on COVID-19 and considering multiple approaches</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

Source: State Street Global Advisors as at 20 March 2020.
Stock Study: Waste Management, Inc — More Than a Trash Collector

Waste Management, Inc (WM) is the largest solid waste collection company in North America with over 20 million customers. The company also owns and operates the largest network of landfills. Solid waste volume has consistently grown 2–3% per annum over the last 10 years, making it one of the least cyclical industrial end-markets. Even in times of economic slowdown, waste collection remains an essential service.

Patrick Bernard
Assistant Director of Research

Figure 2
Steady Growth of North America’s Solid Waste Industry

Source: Environmental Business Journal, Waste Management. Estimated based on annual revenue. Canadian dollar amounts have been converted to US dollars using the exchange rate on May 29, 2019 of C$1.00=US$0.7433.
Waste Management, Inc (WM) is the largest solid waste collection company in North America with over 20 million customers. The company also owns and operates the largest network of landfills. Solid waste volume has consistently grown 2–3% per annum over the last 10 years, making it one of the least cyclical industrial end-markets. Even in times of economic slowdown, waste collection remains an essential service.

On top of resilient waste volumes, the Municipal Solid Waste (MSW) collection industry operates under long-term contracts (3–10 years), which provides good visibility on revenues and cash flows. The industry has also become more efficient through higher internalization rates, which is the amount of waste hauled to a collector’s own landfills; firms thus avoid paying “tipping” fees to landfill owners and has helped the industry raise prices faster than inflation.

WM scores well in our proprietary Confidence Quotient (CQ) framework. The company has a strong market position driven by high barriers to entry and strong pricing power. As the best-positioned company within this industry, WM generates industry-leading returns and strong free cash flow, giving it a good financial condition score. This also allows the company to fund organic and external growth while returning capital to shareholders in the form of share buybacks and dividends.

WM's business model is highly transparent, and is driven by resilient solid waste volumes and long-term customer contracts. Overall, we believe that WM is positioned well to be a long-term winner in the environmental services sector.

Another key element of our investment thesis for WM is its strong external growth opportunities. The MSW industry remains fragmented, with almost half the market operated by municipalities and small private operators.

Source: State Street Global Advisors, Company reports, UBS estimates.
Given its strong financial position and superior free cash flow generation, WM is the leading consolidator of the North American MSW industry. A proposed acquisition of Advanced Disposal Services (ADSW) is a clear example of an accretive M&A transaction; it would allow WM to subtract substantial costs through capex synergies while driving further share gains with existing customers.

While the ADSW deal is a large transaction, we expect the company to continue to roll up the private operators that are facing succession issues or don’t have the financial resources to invest in their business; initiatives like fleet automation and the conversion of their fleet to more environmental fuels such as compressed natural gas (CNG) require an outlay that some may be reluctant to make.

**Sustainable Growth and Leader in Sustainability**

WM’s high CQ score gives us conviction in its ability to sustain its long-term earnings growth rate. Another area of strength in WM’s CQ is its strong track record in Environmental, Social and Governance (ESG) practices.

WM is a leader in sustainability with 60% of its truck fleet fueled by CNG, which reduces its greenhouse gas emissions by about 20% while lowering operating expenses. Furthermore, WM’s 130 renewable energy plants allow it to receive renewable energy credits (RIN) that lower its operating expenses while increasing its competitive position, especially against the small operators.

Under proprietary State Street Global Advisors ESG scoring method, R-factor, WM is designated a Leader. The company is a clear example that strong ESG practices create positive social change, while also improving competitive positioning.

**Conclusion**

We were attracted to WM as an investment opportunity for a number of reasons. Among them is the benefit of operating in an economically resilient end-market; one in which it has the largest market share. Moreover, the company is run by an experienced management team that has allocated capital well and has successfully executed company strategy. The company’s belief that strong ESG practices will lead to superior financial performance and sustain the creation of shareholder value in the long run dovetails with our own beliefs about long-term sustainable investing.

**Contact**

Thomas Kronzer
Portfolio Strategist
Fundamental Growth and Core Equity
For four decades, State Street Global Advisors has served the world’s governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world’s third-largest asset manager with US $3.12 trillion* under our care.

* AUM reflects approximately $43.72 billion USD (as of December 31, 2019), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.