Q&A with Hamish Douglass

Hamish Douglass, the Chairman and CIO at Magellan, talks about the recent performance of the stock market and the global strategy, analyses what the US election result means for equities and outlines the biggest difference between regulation of technology in China and the US.

January 2021

Q: The global equity strategy failed to match the stock market's rally over the last two months of 2020 after outperforming over the prior 10 months. Could you explain what drove the rally and why the global strategy lagged the broader market recently?

A: Stocks surged because of two major events. The first of these was encouraging vaccine trial results from early November that boosted the likelihood that everyday life could return to normal. The vaccine trial results were like a massive oil strike and stock investors rapidly repriced risk, particularly for economically sensitive, or cyclical, stocks.

The other event was the result of the US election that raised expectations of more fiscal stimulus. Obviously, the more fiscal stimulus there is, the greater the chances of an economic recovery. The results of the Georgia senate run-off elections in January that completed the Democratic Party's control of congress and the presidency – but only just, because its senate majority is effectively one vote – completed a nirvana outcome for markets of more fiscal stimulus but nothing radical. The result was that global stocks surged 13% in November, their biggest rebound in nearly 46 years. It was an extraordinary rally that continued into December.

When it comes to assessing the strategy's performance over these two months, I'd say first it's a short period over which to make an evaluation, especially when considering what happened over the first 10 months of 2020. Over this time, markets plunged when the pandemic hit and then recovered thanks to stimulus and a drop in infection rates. The strategy fared well over the first 10 months of 2020 but lagged over those extraordinary last two months.

The way we see it, the pandemic is an event of huge scientific complexity and many investors seem oblivious to these risks. Due to the challenges the world still faces, our priority is protecting investors from losses. Our portfolio has defensive characteristics that should see it hold up relatively well in adverse markets. We typically have 50% of our portfolio in cash and high-quality defensive equities to provide protection. The defensive half of our portfolio didn't decline overall but it didn't surge like cyclical and discretionary stocks.

Do I lose sleep over missing out on some of this short-term rally? No. Our aim is to deliver satisfactory returns while protecting people's capital. This approach has delivered strong performance during many market downturns since inception in 2007. We are never going to bet on an oil strike or the equivalent, which is one way to see the vaccine results. After all, some important vaccine trials failed.

Q: What does the Democratic sweep of congress and the presidency mean for the 60% of the portfolio that comprises US-domiciled stocks?

A: The election result offers positives and negatives. The positives include that we will probably see a stronger recovery in the US. We can expect more stable US foreign policy, especially in regards to the ties between Beijing and Washington. That's important when it comes to investing in US businesses that are focused on China or investing in Chinese businesses.

Another positive is that we are unlikely to see anything radical from the Democrats because they only control 50 senate seats, the same number as Republicans – Vice President Kamala Harris provides the tiebreaker because the constitution decrees that the vice president is the president of the senate. Most legislation requires 60 votes in the senate to overcome the filibuster and that will be hard to achieve. Moderate Democrats, including Joe Manchin of West Virginia, have said they will not vote to remove the filibuster. This restraint will stay even though many Democrats before the November poll said they would remove the filibuster if they gained the senate majority the polls anticipated.

When it comes to the negatives, it's likely we will see higher US corporate taxes. The impact of higher US taxes isn't as great as you may expect as the US utilities we own, which comprise about 13% of the portfolio, are insulated from higher taxes because they can pass on such burdens to their customers, and most of our US holdings are multinational companies that derive only part of their earnings from the US. Overall, I would say the election result is a net positive for the US stocks held by the strategy.

Q: What risks concern you heading into 2021?

A: The biggest risk the world faces right now is that the virus might mutate in a way that reduces the effectiveness of the vaccines developed so far. Scientists are already concerned about some strains of the virus such as the South African variety. There is the possibility of an escape mutation developing during a prolonged vaccination process.

No one can accurately gauge the probability of whether or not the current mutations or an escape mutation might make the vaccines we have ineffective. Now is not the time to be oblivious to the pandemic risk, especially given infections we are seeing in Latin America, the UK and the US. Hold on to your chairs if investors suddenly decide that a mutant strain has rendered ineffective the vaccines that drove the November rally.

Q: What about the risk of even more fiscal stimulus?

A: The risk some investors are concerned about is the risk of inflation due to the extreme amount of fiscal stimulus. If vaccines are distributed widely and no mutations make them ineffective, the extremely large US fiscal stimulus is likely to drive a short-term surge in economic growth. Inflation might rise briefly but we don't think we will see meaningful and sustained inflation in the near term. Importantly, we don't believe central banks are about to increase interest rates in reaction to the first signs of inflation.

Another risk is the potential rise in longer-term bond yields in response to the massive increase in government debt associated with this fiscal stimulus. While US longer-term bond yields have drifted higher in recent months, they are still very low by any standards and we believe it is likely the US Federal Reserve will increase its bond-buying program if there is a large jump in bond yields.

Q: Alibaba Group and Tencent have come under the scrutiny of Chinese regulators. How do you view this development versus the regulatory scrutiny hovering over western companies such as Alphabet and Facebook?

A: When it comes to China, we need to separate the issues with Jack Ma and Alibaba from anti-trust issues. The Chinese Communist Party is intent on showing it is in control of China by punishing Ma and stopping the IPO for Ant Group, which is 33% owned by Alibaba, following Ma's comments about financial regulation that were an implicit criticism of the party. We had thought that Ma would have shown more restraint when making public comments, given his previous run-ins with the party. His comments in October surprised us.

But when it comes to Alibaba and Tencent, we still think our investment theses for these high-quality companies hold. These companies are incredibly advantaged and are strategically important to China. We don't think the regulators focusing on anti-trust measures will materially change that.

In many ways, the anti-trust risk in China is not much different from the anti-monopoly scrutiny in the west, where the regulatory risks are real and growing because regulations are aimed at genuine market failures or social and economic risks. While regulatory change will have some economic impact on these companies, we don't expect regulatory changes that will fundamentally damage any of these businesses.

That said, it's quite likely that Ma's comments accelerated the Chinese government's regulatory timeline. It's worth noting that regulatory actions can occur much faster in China compared with the west. In the west, there is usually a process of debate, lobbying and short-term electoral considerations that policymakers must take into account. The regulatory risk in China is higher because the government can act unilaterally and there's no right of appeal. The final outcomes in China and the west could be similar but the speed at which they might happen could be faster in China.

Q: How do you feel about the portfolio and its positioning as we start 2021?

A: We are confident we have a portfolio of outstanding businesses that due to their strong economic moats give the portfolio superior growth prospects. We think the global portfolio is well placed to deliver attractive returns over the next three to five years while protecting the capital of investors.

Markets are at all-time highs. The assumptions underpinning record prices leave little margin for error. We think it appropriate to focus on protecting the downside, especially given the continued scientific uncertainty with the pandemic.