Hosking Partners®

Quarterly Commentary

Q1 2025

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15 April 2025

In times of extreme uncertainty, as we have seen late in the first quarter and amplified even further in the first weeks of April, we return to our Capital Cycle discipline. "*Over the long run, it is a company's return on capital, not changes in quarterly earnings, which primarily determines the direction of its share price. The return on capital of any company is largely subject to the state of competition within its industry.*" Written 20 years ago in the introduction of *Capital Account*, this remains the central premise of the Capital Cycle theory.

When companies trade at a premium in the stock market to their replacement value, there is a strong incentive to increase investment. Given that demand forecasts are inherently unreliable and competition is rising, there is a great danger of supply exceeding demand. On the contrary, when companies trade at steep discounts to replacement value, we tend to see curtailment of spending and consolidation within an industry, driving an improvement in returns.

The Capital Cycle framework has helped the Hosking Partners team navigate the major investment cycles over the last three decades, seeking to avoid areas of overvaluation that so often end with a bubble bursting, and to identify the capital-starved areas that trade at steep discounts to replacement value. Since *Capital Account* was written, each decade has been shaped by market-defining capital cycles: In the 90s, the Asian Tiger economy boom/bust and then the telecom boom. In the late noughties, the overinvestment into housing and the subsequent global financial crisis (GFC). The last ten years has seen 2015-16's commodity bust, and then 2020's Covid Pandemic. Today's AI investment cycle may represent another such defining period. Characterised by hundreds of billions in capital flooding into a potentially revolutionary technology, new foundational model entrants disrupting the market, and management teams trapped in a prisoner's dilemma, investing defensively to protect their multi-trillion-dollar market capitalisations, we can hear the echoes of past cycles. This makes us sceptical that today's index-dominating incumbents will emerge unscathed. Whilst earnings for these companies continue to rise, competition is intensifying, and the burden of

heavy investment is likely to depress future returns on capital. We have been early in positioning the strategy for change, but we believe we may now be on the cusp of a new market regime.

In the first quarter, the strategy benefitted from a regional allocation that reflects this view of a new environment. Our 27.2% and growing underweight to the US, 10.0% overweight to Japan, and 4.9% overweight to emerging markets were the primary drivers of outperformance. Conversely, our relative underweight to developed Europe (ex-UK), MSCI ACWI's top performing region, was the largest regional drag on relative returns. Similarly, our underweight position within IT was the largest relative sector contributor, tempered by absolute and relative underperformance in our overweight position in Energy and lack of more defensive areas Health Care and Utilities in an uncertain environment. Additionally, Financials, which were a top performer in 2024, reversed course amid rising fears of inflation and a potential recession, weighing on absolute and relative returns. Whilst this report concerns the first quarter, it is worth noting that this trend has continued in the post 'Liberation Day' volatility.

The attribution analysis showcases some of our most differentiated individual ideas as top contributors in the quarter, including (among others) Babcock, Impala Platinum, and Hikari Tsushin. We initiated our position in UK Defence company Babcock in 2023, as the shares traded below the replacement value of an irreplaceable asset base responsible for maintaining the UK's submarine and naval fleet. At the time, this intrinsic value was overshadowed by a turnaround and depressed demand. The turnaround is nearing completion, and demand has become a tailwind as Europe increases spending targets. Holding company Hikari Tsushin, our largest Japanese investment, has benefitted from Japanese equity market strength with its portfolio of 600 stakes in local small-to-micro-caps, which the company started buying in 2017 using cheap Yen-dominated debt. Impala is our largest platinum group metals (PGMs) miner, a thesis Django Davidson discussed in a Hosking Post last year. The company owns one of the industry's two major smelting assets and trades at approximately one third of its replacement cost. Our largest stock detractors included economically

sensitive US Financials, such as Jefferies and Synchrony, as well as more cyclical businesses like American Airlines, coal company Peabody Energy, and tanker company Hafnia.

Extending a multi-year-long trend, the last quarter saw us position the strategy even further into value territory. As a result of each portfolio manager's independent and bottom-up process, our strategy weight in the Magnificent Seven has declined to c.3% compared to a benchmark weight of c.19%. Similarly, our underweight position in the broader Information Technology (IT) sector has increased to 17% – the lowest since inception – as we fully exited Nvidia in March and reduced our holdings in other AI-related companies such as Broadcom and Applied Materials. Many of these investments were originally acquired when the semiconductor industry was perceived as highly cyclical and commoditised. Over time, the rising costs associated with advancing Moore's Law led to industry consolidation, with most segments of the supply chain dominated by oligopolies and even quasi-monopolies that are extremely hard to dislodge. In recent years, the market has begun to appreciate these qualities, and the bottlenecks created by strong AI demand have driven valuations to new heights. These valuations no longer reflect the inherent cyclicality of the industry.

The Capital Cycle framework can also provide insights into the operation of the business cycle. *Capital Account* highlights, "*A combination of optimism and cheap capital works on the economy at large, in much the same way as it does on a single sector, to stimulate investment.*" In 2025, the exuberant herd of animal spirits that the market believed had been unshackled after the election ran right off a cliff in the face of highly uncertain policymaking. This reversed most of last year's momentum run.

The team continues to view Japan as one of the most attractive investment opportunities worldwide. Jeremy Hosking wrote last August about our long-term investment case for the region in "Japan: The Best Game in Town" on the back of the Japanese flash crash. While investors have speculated for decades over pending Japanese corporate governance reform, Jeremy and Omar came away from a February visit to the country – in which they met 25 small-to-mid cap companies over four days –

feeling confident that we have indeed passed a tipping point on the journey to reform. Most listed companies in Japan trade at <1.0 book value, generate sub-scale capital returns, operate with highly inefficient balance sheets, and are just beginning to reassess their business portfolios for the first time. The last twelve months saw us grow our overall Japan strategy weight by 2% to ~15%. The runway here is long.

This is a stark contrast to the US, where we generally find high valuations, finely tuned business models, and highly optimised balance sheets after a decade of repurchasing shares at any price. Just as Japan's dominance once felt unshakable, the US now stands at a similar crossroads to Japan in the late 1980s, its exceptionalism embraced as unquestionable. The first weeks of April suggest that certainty is being shaken.

Shortly after the quarter end, the scale of the tariffs announced by US President Donald Trump on 'Liberation Day' surprised markets. If retaliatory tariffs remain and global supply chains are upended, US growth could slow while inflation accelerates as import prices rise, resulting in a recession. At first glance, the Hosking Partners strategy appears challengingly positioned for such an eventuality, with 13% in Materials and 11% in Energy. Indeed, in the first week of April, these positions were unduly punished in the immediate reaction to tariffs. The GFC of 2009 and growth slowdown in 2015-16 led to substantial equity erosion and even bankruptcies in these sectors. As such, share prices have responded with a Pavlovian alarm to recent events. We believe this market response overlooks supply dynamics that are fundamentally different to previous downturns, which should limit the downside in these sectors over the medium term.

According to data from broker-dealer Empirical Research Partners, capital expenditures relative to depreciation in developed markets Metals & Mining and Energy stocks have fallen from >2x in 2009-2016 to less than 1.5x today. When we account for significant recent inflation – particularly given depreciation is calculated using historical costs – the implications become even more pronounced. In brief, equilibrium between supply and demand should be reached more quickly than in previous

cycles. There may also be instances where recent commodity price movements reinforce capital discipline, suggesting opportunities to increase exposure. Additionally, both sectors have significantly reduced leverage since the last downturn, and our holdings in these sectors carry even lower leverage levels than average. Measured on an annual basis, the strategy's Energy exposure has an average debt-to-equity ratio 7% below the sector, while Metals & Mining is around 6% lower.

An advantage of our diversified approach is the ability to take more stock-specific risk at the low end of the cycle. With share prices falling in unison, we have been using this opportunity to upgrade our exposures within these more cyclical sectors to companies with greater upside in a recovery scenario, without taking a commensurate balance sheet risk. One of the largest purchases during the quarter was Canadian upstream oil and gas company, International Petroleum Corporation, run by the Lundin Family, which has demonstrated excellent capital allocation since spinning out of Lundin Petroleum in 2017. It is pursuing a project which will expand production by 50% by 2028 whilst simultaneously shrinking the share count through aggressive buybacks. We also added to our holding in the industry-leading operator of offshore support vessels (OSVs), Tidewater, given its combination of a significant discount to replacement cost and a net cash balance sheet. Trims of Occidental, ConocoPhillips, and Valaris funded both purchases, as we reassessed the risk-to-rewards within each basket.

The level of uncertainty in markets has grown exponentially in recent weeks. There are many unknowns, and there are likely to be more 'unknown unknowns' on the horizon. However, what is increasingly becoming clear is that markets are undergoing a regime change, shifting away from the US megacap domination we have seen for the last decade. We point to a simple pattern in history: What worked in the preceding decade rarely works in the next. Markets will obsess over the path because they crave the comfort of a play-by-play understanding of each headline and policy announcement. However, the end game is a significant change in the global order, and prior beliefs are being upended. This could lead to a very different set of sectors and countries outperforming as we move forward. We have spent five years positioning the strategy for such an environment.

A final lesson from *Capital Account* feels particularly relevant today: *“The progress of the capital cycle in the economy is from high stock market valuations and a low cost of equity to rising investment which produces excess capacity, followed by declining returns and a sinking stock market, ending in the curtailment of investment and recession. The boom carries within itself the seeds of its destruction.”* As markets sell indiscriminately in the short term, we believe that value businesses offer an even more compelling proposition, given fundamentally different supply dynamics. We are using the early stages of this longer-term shift to sift through the global market wreckage for the best long-term opportunities. Whilst we are essentially fully invested, our high-quality compounders – that have been amongst our top performers over the last decade – may prove a sensible source of capital to position the strategy for the next.

**Weights based on a representative account and benchmarks weights as at 31 Mar 2025.*