Hosking Partners®

Quarterly Commentary Q3 2024

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In the third quarter of 2024, the Hosking Partners strategy net return was 4.1% relative to a 6.6% return for the benchmark. Over the last twelve months, the net return has been 27.9% relative to a benchmark return of 31.8%.

Strong monthly performances for the Hosking Partners strategy in both absolute and relative terms in July and September bookended an August which may best be described as turbulent. The action mostly occurred in the space of a week at the start of August, after a rate hike by the Bank of Japan (to 0.25%) and more cautious signalling about rate cuts by the Fed. Beginning with what was regarded as a weak US jobs report causing an increase in the perceived likelihood of a recession, what has been variously described as a flash crash or carry trade unwind saw Japan's TOPIX index lose 12% in one day and the S&P fall a cumulative 6% over several days. Things then quickly reversed, and by the end of the week the S&P and the TOPIX had recovered most of their losses. For the strategy, recessionary fears translated into weaker performance during the month as a result of its exposure to more cyclical sectors such as financials, resources and energy.

Japan nevertheless made a strong contribution to the strategy's performance during the quarter overall, with c. 40 bps of relative outperformance, thanks to the diversified selection of mid-caps more than offsetting weakness in larger exporters and financials. The combination of stock selection and a strengthening currency within Japan more than offset the regional allocation effect to the country. Japan now represents 13.5% of the strategy, a significant overweight to the benchmark's 5.0%. Contributions to the positive side of the performance ledger were also made by individual stocks such as CBRE (easing real estate market worries as a result of Fed easing), Qantas (reported strong FY24 earnings), Suncorporation (activist pressure resulting in market appreciating value of non-core subsidiary) and 3i (continuing proof of the Action retail roll-out). Underweights in index

heavyweights such as Microsoft, Nvidia, Alphabet and Amazon also contributed positively to the strategy's performance during the quarter.

On the other side of the ledger, negative contributions were made by the memory semiconductor manufacturers (Micron, SK Hynix, Samsung) as fears grew that the tailwind from AI spend will be short-lived, something the companies themselves strongly refute. E&P stocks (Occidental, ConocoPhillips), oil drillers (Noble, Seadrill, Valaris) and tankers (Hafnia, International Seaways) were all weak on energy market concerns. Energy now represents just 4% of the benchmark, around its historic lows, whereas it constitutes c. 12.6% of the Hosking Partners strategy. Most of the energy positions were initiated on the basis of historic supply constraints affecting their sub-industries, but they may also be viewed in capital cycle terms as recognition of the further supply distortions which arise from trade wars and even more kinetic geopolitical confrontations. In the meantime, the energy sector trades at a record normalized free cash flow yield according to Empirical Research Partners.

New arrivals in the strategy included Wise, the scale-economies-shared cross-border payments processor, Centrica the energy utility, and Loma Negra the leading cement producer in Argentina. Additions were made in the form of the platinum group metals (PGM) basket (Impala, Anglo American Platinum, Northam, Sibanye Stillwater and Sylvania) and a number of Japanese companies to exploit weakness following their August price drop (Nomura, SMFG, Hikari Tsushin, Nippon TV, Toyota Motor and Industries, Tosei and Dai Nippon). Housekeeping resulted in the departure of distributor Wesco (poor execution) and Flex LNG (looming deliveries of LNG carriers), while trims were made to Microsoft, Alphabet, JP Morgan, Costco, Elevance, Nvidia and Micron among others.

From a capital cycle perspective, the PGM industry is a compelling example of high barriers to exit, and as unsustainably poor historic returns eventually result in industry consolidation and capacity rationalisation, there is an exciting upside opportunity. The PGM basket is currently about 1% of the

Hosking Partners strategy. We have just returned from an investment trip to South Africa, where we met management of the four major operators and took a group of brave clients on a “deep dive” one kilometre beneath the surface of the earth in Sibanye Stillwater’s Rustenberg platinum mine. Stay tuned for a future Hosking Post on the compelling capital cycle in this industry and our takeaways from the trip.

As we enter the final quarter of the year and look to what the future might hold, we are reminded that ultimately there are just two ways of forecasting – extrapolation of current trends and mean reversion. For over a year now, since US rates peaked in August 2023, there has been a debate whether the Fed will be able to engineer a “soft landing”, but it appears we are already in such a soft landing. For the first time since 1994 the Fed is easing without a recession, and as China launches its own US$560 bn stimulus programme the global stock market capitalisation looks set to surpass its October 2021 all-time high according to Bank of America. As Hegel said, however, “the nature of the being of finite things is that they have within them the seeds of their own destruction; the hour of their birth is the hour of their death” or less imaginatively, Stein’s law propounds that if something cannot go on forever, it will stop.

As short-term extrapolation eventually gives way to longer-term mean reversion, markets will slowly recognise how much stretched elastic is out there. UBS’ Holt points out that market cap and value creation concentration among mega caps is as high as it has been since the 1970s, and the last three times mega caps’ economic profit concentration dropped from peaks coincided with outperformance of value over growth. Meanwhile, Bank of America says that 43% of the S&P 500 market cap is now under antitrust investigation by the Department of Justice or the Federal Trade Commission.[1] Capital cycle analysis tells us that if the competitive moats enjoyed by these companies are undermined by such investigations, and the returns on capital of the companies are therefore less sustainable than assumed, then lower valuations are in order. Adverts for Heineken in the 1970s UK told us that “Heineken refreshes the parts other beers cannot reach”, and the market

broadening away from the mega-caps will bring welcome cheer to parts of the market such as commodities where investors are the most underweight since June 2017 (according to Northern Trust) with a Materials benchmark weight of just 4.1%. By contrast, the Hosking Partners strategy has a c. 13.5% Materials weight. The combination of still subdued capex by the big miners, increased construction activity as deglobalization and nearshoring result in the rebuilding of manufacturing capacity that was previously outsourced offshore, not to mention the drive to net zero and the inflationary pressures it brings, gives us some confidence in our lonely wait for the opportunity in "stuff" to be more widely appreciated.

The Italian Marxist Antonio Gramsci referred in his prison notebook to periods of change as an interregnum: "the crisis consists precisely in the fact that the old is dying and the new cannot be born; in this interregnum a great variety of morbid symptoms appear". While this may be an overdramatic way to describe a change of market regime, we are able to observe a number of unresolved paradoxes in today's market, whether the Chinese yuan initially strengthening on the announcement of the recent stimulus package, strengthening US PMIs weakening the case for further Fed cuts, or the oil price barely reacting to the ongoing conflict in the Middle East.

The diversified Hosking Partners strategy is a collection of bottom-up ideas which deliberately eschews macro predictions, searching instead for easier wins. Although it has limited direct China exposure, restricted mainly to the Internet names which trade at stark discounts to their Silicon Valley peers, the strategy has China gearing at one remove via its Hong Kong overweight (c. 2.1% strategy weight vs 0.5% benchmark weight) and at one further degree of separation via its aforementioned Materials overweight. We shall wait to see whether the recent China stimulus results in a temporary sugar rush for the market (the CSI 300 index of Chinese stocks rose more than 20% in less than a week) or has a more concrete impact in terms of lifting economic growth. We have exposure to both outcomes despite remaining largely offshore.

Appearances may be misleading too when it comes to US exposure. The strategy is 24.1% underweight the US (40.1% vs 64.2%), yet nine of its ten largest positions are US listed (the exception being the European 3i). Under the hood, however, there is a long-tail of non-US stocks in the strategy, many of which would be challenged to find their way into more concentrated portfolios, whether due to their size, liquidity or other stock-specific risk. Collectively they result in a forward p/e for the strategy of 12.4x (vs benchmark 19.4x) and a 1.4x price/book (vs benchmark 3.2x). As we wait for the future to unfold, we take comfort in the margin of safety that valuation gives the strategy, while in the meantime retaining exposure to (over)stimulus and its consequences.

[1] *NVDA, AMZN, META, GOOG, TSLA, JPM, UNH, V, MA, WMT, KO, PEP, ADBE et al*

**Weights based on a representative account and benchmarks weights as at 30 Sep 2024.*

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