JUL
13
2020

Around THE Curve

Trust the Process: Three Things Learned from the Pandemic

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In Philadelphia where Brandywine Global is headquartered, the city slogan changes, depending on the time of year. Normally, Philly is known as the "City of Brotherly Love." However, during football season, this slogan is replaced by "Fly Eagles Fly" while during basketball season the popular catchphrase around town becomes "Trust the Process." The first two would be terrible answers to almost any investment question we can think of, but the third sounds like it would fit in any RFP answer.

Let's start with a brief historical review of the basketball version of "Trust the Process":

In May 2013, Sam Hinkie was hired as general manager of the Philadelphia 76ers, the city's professional basketball team. The next season the Sixers had 63 losses in 82 games. In 2014, the first mentions of "Trust the Process" appeared in Twitter comments, referring to Hinkie's longer-term view for the team roster. The next season, the Sixers lost 64 games. The following season, 72 games. By April 2016, Hinkie stepped down as general manager, recognizing he would be marginalized. But by the 2017-2018 and 2018-2019 seasons, the Sixers team that Hinkie built put together back-to-back seasons of 50+ wins. The local populace saw the value in Hinkie's plan and steady implementation of that vision.

Of course, portfolios can change much more quickly than basketball rosters. What does "Trust the Process" mean in an investment context and, in particular, during a pandemic?

For Brandywine Global equity teams, it means a trust that value will work and that if we implement in a disciplined, consistent manner, we should outperform our value peers. That is the (really) short version. Even though value factors have failed for more than a decade, we continue to believe that they matter, and that the gap in valuations has grown far too wide.

However, during COVID-19, we have had to distinguish between implementation of our process and our core, value-oriented beliefs. One thing that does not change during a pandemic is that businesses have values. The core of our process is on valuing businesses and assigning probabilities on a range of outcomes. What has changed during the pandemic is the manner in which we assess those values. Valuations may change because the range of possibilities becomes wider, and assigning probabilities becomes more difficult and uncertain. Worst-case scenarios become more extreme and more probable; best-case scenarios become harder to figure out. In this kind of environment, implementation in an "all-in" fashion seems to make less sense, even if it means leaving the gunslinging upside possibilities out of the picture. In many environments, maximizing upside makes sense; in a pandemic without extremely low valuations, it may not. The market downdraft was so quick that the huge mispricings did not last.

<u>In a pandemic, what does implementing the process look like versus normal environments?</u>

What do you do when something comes up that has not happened before in the economy? History gets thrown out the window, and if there is one thing value investors generally like, it is market history.

In place of being students of history, we have had to challenge ourselves to be students of change while remaining true to the core of our process. We have had three main takeaways:

1. **Learn: Learning in the pandemic takes a variety of forms. We need to learn new things: to understand basic epidemiology and who to read and not to read; to look at the history of pandemics; to uncover new data fields, including TSA passenger counts, global passenger counts, hospital capacity, etc.; and to look at financial data in a different way. Normal stress-tests and margins of safety do not factor in businesses closing completely for several months, such as movie theaters and airlines, competitors being wiped out as in the case of restaurants, or working capital analysis where cash suddenly pours out of some**

businesses and into others. Survivability and economic analysis change quickly in an environment like the present.

2. Adapt: Our process is built on valuing businesses with a multi-year horizon. That multi-year horizon naturally embeds a normal range of outcomes, but what if a company—or its competitors—cannot make it to year three given disruption in year one? Can we truly say with confidence that things can return to normal in a reasonable timeframe? A real debate occurs on how to balance long-term opportunities and assumptions with near-term risks. To adapt, we build upon what we have learned, changing the kinds of questions we ask each other internally by widening the range of scenarios we discuss and the probabilities we apply. We cast an even wider net, looking at more companies and a wider range of valuations, given that impacts vary so widely from industry to industry.
3. Be Flexible: Implementation of the process must become more flexible. With data and situations evolving in a way with no modern precedent, we have learned that it is acceptable to change our minds quickly, to be more tactical, to be less "all-in." In portfolio terms, this axiom has translated to a few more companies being owned and much less concentration in the largest weightings.

While consistent, process-driven investing is paramount to professional asset management, that is not the same as saying implementation of a process should remain static. Trusting the process means staying true to core investment beliefs while recognizing the need to learn and adapt to new information and changing environments.

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