EQUITIES

Volatility, Tech & ESG: COVID's Impact on Global Equities

BARINGS CONVERSATIONS

This piece was adapted from an interview with Dr. Ghadir Cooper. The full audio podcast can be found ***here***.*

COVID-19 and the related global lockdown have proved challenging for businesses—but opportunities have emerged as well, particularly for companies with business models built to capitalize on long-term structural growth trends. Dr. Ghadir Cooper shares her views on how equity markets are faring today and what to expect going forward.

*Full podcast URL: https://www.barings.com/viewpoints/equities-finding-long-term-growth-amid-current-volatility

Can you provide a brief recap on how COVID-19 and the related market volatility have affected equity markets in recent months?

When China started to report COVID-19 cases at the beginning of this year, much of our concern was centered on the impact of a sharp fall in demand from the country and the potential short-term shocks to the global supply chain. However, as the virus situation evolved into a global pandemic, and many countries imposed strict limitations on their citizens' movement outside of their homes, what started as a supply shock morphed into demand destruction, throwing the global economy into a synchronized recession. As we know, markets started falling very quickly in response and companies started to conserve cash. Exacerbating the rout, oil prices fell significantly as a disagreement on supply cuts between OPEC and Russia took place just as global demand for oil was declining rapidly.

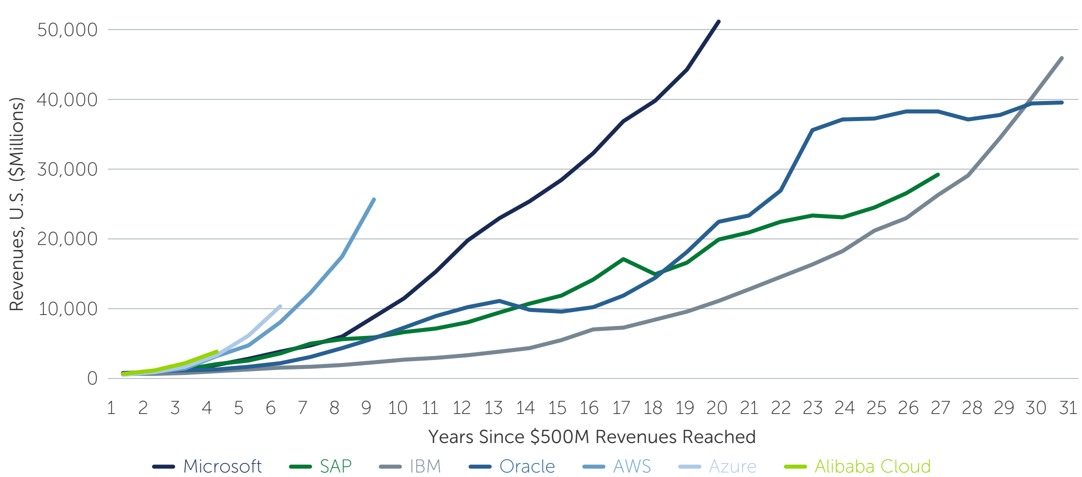
Longer term, we do expect to see demand begin to normalize as lockdown conditions ease and the global economy reopens—even if that comes in starts and stops. Against this backdrop, while we acknowledge the potential for short-term challenges, we believe market volatility can effectively create attractive opportunities to invest in businesses with solid long-term growth potential at more attractive prices. For bottom-up, active managers in particular, we believe these opportunities are rife across the equity markets, from developed to ASEAN and emerging markets, and from small-cap equities to larger stocks.

Much of your focus is on finding companies that can capitalize on segments of growth in the global economy. Where do you expect to see growth accelerate longer term, and how have your views changed (if at all) in light of the current challenges?

There are a few different ways to think about this question, but I would first emphasize that our team does not just invest broadly in trends; rather, we look for companies that are well positioned, from a bottom-up perspective, to capitalize on our identified areas of growth. There are a number of long-term structural trends that are already in place, which many companies were taking advantage of before this crisis and will continue to benefit from going forward.

Disruptive technology and digitization are chief among them, and have been at the forefront of our thinking for years. A prime example is the public cloud, which has significantly disrupted the business models of longstanding tech giants like IBM and Oracle. The public cloud is essentially a way to rent IT infrastructure from a third party, which can dramatically lower the costs of data storage and computing power by sharing capacity across many customers. This is proving to be a far more flexible and efficient alternative to private clouds, which are owned or rented by companies for their own use. The rate of early adoption of the public cloud has been tremendous—and cloud players such as Amazon's AWS have seen their revenues grow at a significantly faster pace than their software predecessors **(FIGURE 1)**.

FIGURE 1: Public Cloud Players Outpace Their Software Predecessors



SOURCE: Barings.

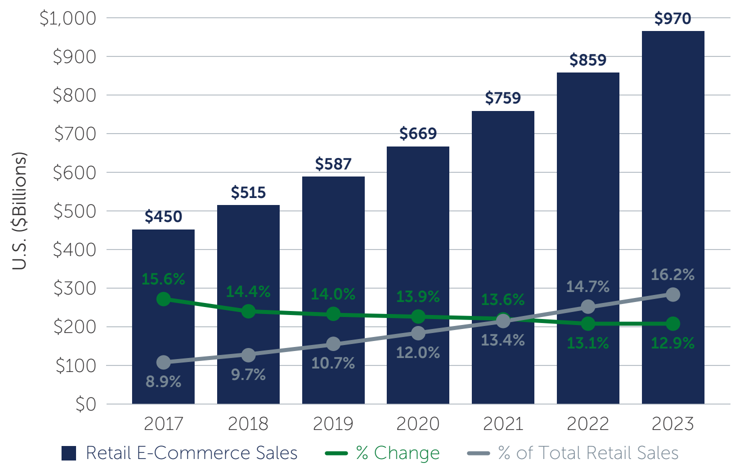
In the context of the global lockdown, with more people working from home and replacing face-to-face meetings with video calls, the migration of enterprises to the public cloud has accelerated this long-term secular trend. For example, demand for AWS' WorkSpaces, which helps companies make their office network and software resources available to remote workers, has risen sharply during the pandemic. Microsoft also announced a surge in demand for their cloud-delivered services and related infrastructure—in late March the company reported a 775% increase in Teams users in a one-month period in Italy, and a whopping 44 million daily users.[1] Other cloud-native companies have reported similar growth during this period—Cisco's WebEx saw its Americas-based usage double[2], and Zoom's video-conferencing app reported a six-fold increase in demand in March.

The rapid acceleration of these trends during the crisis has also exerted additional strains on IT infrastructure. Cloud-native companies have a discernable advantage in this respect as their business models tend to allow easier adoption by customers and are more adaptable to real-time needs. In addition to the cloud companies themselves, we also see opportunities in related companies with the ability to capitalize on this growth. This includes, for instance, the businesses providing internet security for data centers, as well as providers of semiconductors, which are the key infrastructure components of the public cloud.

The long-term trend of digitization has also accelerated in the consumer world. One of the most ubiquitous examples of this, of course, is e-commerce—which has gained tremendous momentum across the world, thanks to the growth of internet and smart phone access for consumers, and the lower cost advantages for online retailers. Notably, this trend—along with a related rise in digital payments—is accelerating amid the global lockdown as a very large portion of the world is currently shopping and paying for goods over the internet. In many ways, the current environment and transition to socially distant living and remote working is a proof of concept, so to speak, and gives a strong indication of where consumption patterns are headed as many of these new behaviors look likely to endure beyond the lockdown. China, for example, reported that while its February retail sales fell 23.7%, online sales of goods actually rose 3%. And in the U.S, e-commerce has grown to represent just over 10% of retail sales, with this growth likely to accelerate in the current environment **(FIGURE 2)**. On the supply side, given that supply chains will continue to be scrutinized, we believe that the growth in automation will increase going forward. As bottom-up investors, we look for companies that are taking advantage of these trends, and/or are enablers of the change.

Another trend that we believe will endure is the structural growth in emerging markets. Continued urbanization and demographically-driven consumption growth have accelerated in recent years due to the the rapid formation and increasing wealth of the middle class. The United Nations estimates that by 2050, almost 90% of the world's

FIGURE 2: Retail E-Commerce Sales in the U.S.



SOURCE: eMarketer. As of May 2019.
Note: Includes products or services ordered using the internet, regardless of the method of payment or fulfillment; excludes travel and event tickets; eMarketer benchmarks its retail e-commerce sales figures against U.S. Department of Commerce data, for which the last full year measured was 2018.

population will reside in emerging markets—a massive shift that will very likely create opportunities in both developed and emerging market companies. For example, a middle class consumer in emerging markets may be expected to buy better healthcare and insurance products, as well as financial services. Businesses exposed to these trends, such as wealth management and insurance providers, likely stand to benefit. While we may see a disruption of this in the short term due to the global lockdown, we believe the shift in demographics is here to stay, and therefore companies with the ability to capitalize, innovate, disrupt and adapt will fare well, especially on a longer-term investment horizon.

Aside from the longer-term growth areas you've highlighted, are there any other companies you believe are benefitting more directly from the crisis?

The pandemic and related global lockdown have been very challenging for many companies, but there are indeed some businesses across the markets that are benefiting in these unprecedented conditions. First, I want to re-emphasize that at Barings, we buy companies, not short-term trends—we take a bottom-up approach to investing, using a Growth at a Reasonable Price (GARP) strategy to identify attractively priced investments that we believe will outperform over time. For every company that we invest in, our research teams take into account its exposure to long-term growth drivers. Specifically, we look at whether and to what extent a company has the management structure and balance sheet strength to effectively capitalize on its opportunity set, whether it is a leader, a consolidator of the trend or a disruptor, and what particular competitive advantage it offers. We also assess the potential

1. Source: Microsoft. As of March 28, 2020.
2. Source: Reuters. As of April 3, 2020.

growth of a company by forecasting its earnings over a longer, five-year time horizon, which allows us to gauge whether current valuations reflect the true potential of the company going forward.

Going back to your question, there are clearly companies that are faring well under global lockdown conditions and, in many cases, now stand to grow faster than we may have initially expected. Because we are all spending more time at home, companies that provide digital entertainment and video games are certainly benefitting—and this not only includes the businesses providing digital infrastructure, but also the chip designers and producers that enable these games to be made and played. With market volatility, valuations have declined in sympathy with the broader market, despite the fact that the companies themselves have lost very little in terms of their long-term growth and investment prospects. While other companies' business models are less likely to recover, we believe the companies identified above should experience a strong rebound.

You and your team have a robust ESG framework that you've been implementing for years. As a result of the crisis and economic fallout, do you think ESG issues risk being relegated to the background?

From our perspective, the analysis of environmental, social and governance (ESG) factors is not just something you can switch on and switch off. ESG is integral to the way we evaluate each company that we consider—it is part and parcel to how we fundamentally evaluate a company. ESG factors impact both the overall view of the quality of the business and also the value of the companies we research. Our proprietary framework takes into account nine factors for every company, stemming from three core considerations—how good its franchise is, how able its management team is and how well it's governed—while attempting to quantify any hidden risks on the balance sheet stemming from ESG concerns. These nine factors are scored on a sliding scale **(FIGURE 3)**.

Furthermore, engaging with companies on ESG issues is an essential part of our overall process and something that we continue to do while working from home. Through engagement, we aim to enhance the performance of our investments to benefit our clients, in line with our stewardship responsibility. We believe this approach, over one which simply applies blanket exclusions on entire sectors, has a greater chance of successfully effecting change in companies' practices. Our approach will not change as a result of this crisis. To us, ESG is not a trend to follow or to take advantage of; it's an essential part of our investment process.

In thinking about ESG in the time of COVID, one new trend that we think will likely result in a permanent change is the reduction in business travel. Prior to the global lockdown, there was reluctance—and a degree of discomfort for some—around fully adopting the newer technology behind video conference calls and similar tools. As much of the global workforce has been forced to do their jobs from home, this difficult transition has essentially been overcome. In fact, many businesses have suggested that they will curtail business travel even as economic activity returns. Compounding this, of course, are the benefits that reducing air travel would have on the environment.

FIGURE 3: Our Approach to ESG

Factors Considered	Nine Key Topics
Franchise: Sustainability of the Business Model	Employee satisfaction | Resource intensity | Traceability/security in supply chain
Management: Corporate Governance Credibility	Effectiveness of supervisory/management board | Credibility of auditing arrangements | Transparency and accountability of management
Hidden Risk: On Balance Sheet	Environment footprint | Societal impact of products/services | Business ethics

SOURCE: Barings. As of March 31, 2019.

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That said, there may very well be companies across the equity landscape that reduce ESG initiatives in the short term as they try to manage through a strained environment—leading to more immediate demands of their cash flow due to deteriorating economic conditions. However, for the companies we look to include in our portfolios, ESG is an integral part of managing business. Thus, while momentum may slow, we do not expect it to reverse.

You've personally invested through a number of crises and volatile markets. Do you have any guidance to offer investors that are looking to navigate equity markets in the weeks, months and years ahead?

COVID-19 and the decline in oil prices continue to dominate headlines, and for good cause—these are unprecedented times that have introduced widespread turbulence into the markets. But in our view, and based on our own experience managing through past crises and periods of volatility, there are many benefits to remaining focused on the long term. Because, despite the many near-term challenges and uncertainties, there are many good companies around the world that stand to benefit as the economy begins to re-open and supply/demand dynamics return to normal.

It is also worth reiterating that very often periods of volatility can result in opportunities to buy attractive companies at reduced prices. However, given the potential for missteps in challenging conditions, risk management is paramount. And in our view, a fundamental, bottom-up, approach is the most effective way to identify companies that can withstand periods of short-term volatility and deliver strong growth over time.

Dr. Ghadir Cooper
Global Head of Equities

Ghadir Cooper was appointed Global Head of Equities in 2016 and is a member of the European management team. Prior to this, Ghadir was Head of the EMEA & Global Frontiers Team and lead manager on the Barings Eastern European Fund. Having joined Barings as part of the Global Emerging Equity Team in 1997, Ghadir was appointed a Director in 2001. Prior to joining the firm's Emerging Equity Team, Ghadir worked at BZW Asset Management, where she was an investment analyst focusing on the Middle East, North Africa and Latin America regions. Ghadir holds a BSc and a Ph.D in Theoretical Physics from Durham University and is fluent in Arabic.

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