Brown Capital Management

# Coronavirus: Isolating Truth from Fear

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**During market shocks, it is particularly important to separate out company fundamentals from plunging investor sentiment and uncertain macroeconomics.**

Starting with the first reports of coronavirus at the end of last year, we have joined observers around the world to watch in horror as the virus has spread. Our hearts go out to the families affected, and needless to say, we hope and pray for a quick abatement of the spread of the virus.

In the month between the first coronavirus fatality on Jan. 11 and the record highs of global equities on Feb. 12, investors seemed to expect minimal exposure beyond the Wuhan province in China. Those hopes have been dashed. As the number of cases grew last week—as of March 2, the World Health Organization reports 88,930 cases with 3,043 deaths—global equity markets fell 12%, according to the MSCI All Country World Index. As the virus spreads, so do the questions surrounding it. What will be the global extent of the virus? How quickly will manufacturing in China bounce back? How will the world's central banks react? What is the impact on global GDP?

Brown Capital's focus is on investing in Exceptional Growth Companies for the long term. With investors clamoring to understand the impact of COVID-19 on the markets, however, it feels appropriate to share our thoughts on our portfolios. In short, while we do not know the answers to the tough questions surrounding the virus—nor does anyone—we can offer a glimpse into how we think that may be helpful.

## Beyond our control

When markets tumble double digits in a week, as they did last week, it is likely that investor sentiment has turned quite pessimistic, and in a hurry. No wonder; as human beings, we all fear the worst-case scenario of a pandemic and worry about the well-being of our families. When shocked investors are focused on their health, it is little surprise they are far from sanguine about the markets. Sentiment, however, tends to overshoot from greed to fear and back again. That is one reason among many why we do not invest aligned with any view on future investor behavior.

Just as we do not try to time investor sentiment, we do not invest based on any macroeconomic predictions. Our job as long-term asset managers is to invest throughout the business cycle. For what it's worth, though, economists and forecasters have already started slashing their estimates for first-quarter GDP growth in the U.S. and globally. Some Wall Street firms say that the macroeconomic impact could extend into the second quarter as well, but that as long as production in Chinese factories gets back to normal in the next month or so, a global recession is not looming. But those forecasts may change as new data comes in.

## Scrubbing fundamentals

This is where we are focusing our efforts—understanding whether COVID-19 or anything else could change the long-term fundamentals of any of the Exceptional Growth Companies in our portfolios. By and large, the management teams of our companies say they do not expect a significant impact on their businesses from the virus, at least so far. However, it is unlikely that any management team is going to stick its neck out until the impact of the outbreak is clear and quantifiable.

We constantly perform our own research on companies' long-term growth rates to evaluate whether these companies warrant a place in our portfolios. As it pertains to coronavirus, questions we are asking of companies include:

- Are our companies exposed to supply-chain disruptions from China?
- Will COVID-19 delay current or future pharmaceutical clinical trials due to a lack of volunteers willing to take the experimental drugs?
- Will demand for travel, entertainment and dining wane over the next three- to five-years?

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On the brighter side, as companies work through supply-chain disruptions, we are also asking:

- Will coronavirus eventually increase demand for supply-chain logistics software?
- Will the virus accelerate the trend to digitize medical records, given the data flows surrounding the outbreak?

Unlike the macro issues listed above, with sufficient research and analysis we think we can get our arms around these questions to make sure that the companies we hold are indeed Exceptional.

## Better positioning

It is perhaps worth noting that we believe the attributes of our Exceptional Growth Companies make them resilient in trying times like these. The companies we invest in tend to be high quality, with low debt levels and cash on the balance sheet to weather temporary revenue shortfalls. This means that, everything else being equal, they are better prepared to ride out a few quarters of economic disruption than other, more leveraged companies.

But the most important point is this: Our philosophy of evaluating companies on a three- to five-year time horizon—and often longer—allows us to have a long-term perspective in uncertain times like these. Given this timeframe, we need to understand whether the coronavirus outbreak has altered the long-term fundamentals of our portfolio companies. On the other hand, managers with high turnover who expect to hold a stock for just a year or less, are in the tough spot of having to predict what the virus is going to do this quarter, next quarter and next year. We think that our "long-termism" is a huge advantage for us during difficult times.

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