

## Q4 | 23 Investment Update

### MFS MERIDIAN® FUNDS – PRUDENT WEALTH FUND

A global equity fund managing market exposure and seeking undervalued, quality companies

Luxembourg – Registered SICAV

**Effective 1 August 2016 this fund was closed to new investors, with very limited exceptions**

#### Strategy

The MFS Meridian® Funds – Prudent Wealth Fund is a flexible multi-cap global equity fund. The Fund is an equity based strategy which seeks to mitigate market risk via a conservative investment approach – by favouring quality names (which are those we believe have durable above-average growth and returns whose prospects are not reflected in their valuation) and with the ability to use other instruments (cash, fixed income securities, derivatives, etc.) to help mitigate downside risk. The Fund follows a disciplined bottom-up investment approach and is managed in a benchmark agnostic manner. Over a full market cycle we seek to outperform the MSCI World Index (net div). The Fund's investment objective is to seek capital appreciation, measured in US Dollars.

#### Important risk considerations

The fund may not achieve its objective and/or you could lose money on your investment in the fund.

**Stock:** Stock markets and investments in individual stocks are volatile and can decline significantly in response to or investor perception of, issuer, market, economic, industry, political, regulatory, geopolitical, environmental, public health and other conditions.

**Bond:** Investments in debt instruments may decline in value as the result of, or perception of, declines in the credit quality of the issuer, borrower, counterparty, or other entity responsible for payment, underlying collateral, or changes in economic, political, issuer-specific, or other conditions. Certain types of debt instruments can be more sensitive to these factors and therefore more volatile. In addition, debt instruments entail interest rate risk (as interest rates rise, prices usually fall), therefore the Fund's share price may decline during rising rates. Funds that consist of debt instruments with longer durations are generally more sensitive to a rise in interest rates than those with shorter durations. At times, and particularly during periods of market turmoil, all or a large portion of segments of the market may not have an active trading market. As a result, it may be difficult to value these investments and it may not be possible to sell a particular investment or type of investment at any particular time or at an acceptable price. The price of an instrument trading at a negative interest rate responds to interest rate changes like other debt instruments; however, an instrument purchased at a negative interest rate is expected to produce a negative return if held to maturity.

**Value:** The portfolio's investments can continue to be undervalued for long periods of time, not realize their expected value, and be more volatile than the stock market in general.

**Derivatives:** Investments in derivatives can be used to take both long and short positions, be highly volatile, involve leverage (which can magnify losses), and involve risks in addition to the risks of the underlying indicator(s) on which the derivative is based, such as counterparty and liquidity risk.

Please see the prospectus for further information on these and other risk considerations.

#### Performance Summary

##### Q4 2023

The performance drivers relative to the benchmark, the MSCI World Index (net div), are as follows:

During the period, the fund's cautious positioning, in particular, the positions in US Treasuries, cash, and cash equivalents as well as index options negatively impacted relative performance. Additionally, the underweight position and stock selection in information technology and stock selection in communication services hindered relative returns.

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Conversely, an overweight position and stock selection in real estate, no exposure to the energy sector and stock selection in consumer discretionary helped relative performance. Underweight position in health care and consumer staples also contributed to relative returns.

The hallmark of our strategy is to grow the real value of capital while limiting losses when markets fall in the context of a full-market cycle, rather than trying to shoot the lights out and perform strongly at all times. Our approach has always been a preference to lag the market in periods of frenzied excitement rather than risk material losses during abrupt market declines as we aim to provide our investors with a level of market exposure which is appropriate to the circumstances.

As such, there have been no changes to our overall investment strategy, and we continue to keep a close eye on any valuation inefficiencies; prepared to take advantage of opportunities as they emerge. The Fund's equity investments continue to be focused on durable companies which we believe can provide long-term earnings growth and durable profit margins. The Fund's cash and cash equivalents are a combination of shorter-term US Treasury Bonds and traditional cash instruments all invested for purpose of dampening portfolio volatility and providing readily investable cash for future investment opportunities.

### Significant Impacts on Relative Performance – Top three detractors – stocks:

During the fourth quarter of 2023, the top detractors were:

- Dental instrument manufacturing company **Nakanishi** (Japan)
- Medical equipment company **Bio-Rad Laboratories** (United States)
- Computer software company **Microsoft** (United States)

### Significant Impacts on Relative Performance – Top three contributors – stocks:

During the fourth quarter of 2023, the top contributors were:

- Real estate company **LEG Immobilien** (Germany)
- Real estate company **TAG Immobilien** (Germany)
- Medical equipment company **Sonova Holding** (Switzerland)

### Other investment impacts on performance – Q4 2023

#### Index Options

The portfolio management team has the flexibility to hold options to provide further downside risk management. The Fund's allocation to index put options negatively impacted relative returns.

- Russell 2000 Index put options: the team's view has been that US small capitalisation stocks are overvalued in light of future prospects.
- S&P 500 Index put options: the team's view has been that US stocks are overvalued.
- Euro Stoxx 50 put options: the team's view has been that European large capitalisation stocks are overvalued.

#### Cash

The Fund's allocation to cash/cash-equivalent instruments/short-term US government securities had a negative impact on relative returns.

The portfolio is built from the bottom-up on the basis of ideas generated by the MFS global research team. The research will also be used to make an overall determination of the risk-adjusted opportunity in the market as a whole. The level of equity market exposure will vary depending on the scarcity of compelling ideas. When the portfolio management team perceives the values of individual companies to be lower than the prevailing market viewpoint, portfolio equity exposure can be reduced and assets may be invested in equity index options, cash, and/or corporate and government bonds in an effort to provide attractive risk-adjusted returns for the portfolio.

### Positioning

*As announced on 2<sup>nd</sup> March 2023, Barnaby Wiener will be retiring from MFS effective 30<sup>th</sup> April 2024. Barnaby has been a portfolio manager of MFS Meridian Prudent Wealth Fund since its inception in 2011. The MFS Prudent Wealth strategy will*

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*continue to be managed by Edward Dearing, Shanti Das-Wermes, and David Cole who have been members of the portfolio management team since December 31, 2019, January 2, 2022, and March 31, 2023, respectively. The following commentary reflects Barnaby's reflections of the strategy's philosophy and positioning, and the portfolio management team share these views and will be continuing to follow the same investment approach following Barnaby's retirement.*

The Prudent Wealth strategy reaches its 13<sup>th</sup> birthday at the end of this month. It's the blink of an eyelid in the history of MFS (100 this year) and I have no doubt that Prudent has many prosperous decades ahead of it. But for this particular member of the team, it is nearly time to head into the long grass, so I am afraid this quarterly letter will be a series of meandering personal reflections rather than anything of substance (no change there).

A good place to start might be: why do we do what we do? More specifically, why did we set up the Prudent strategy and what were we trying to achieve? At the heart of our investment philosophy lies this inherent tension: that equity markets are concurrently a source of both opportunity and risk. Of course, that tension is at the heart of all investing. But for most investment funds, it is outsourced to the client. You choose to invest in an equity fund, you accept the higher risk; you invest in a bond fund, you accept the lower returns. Caveat Emptor.

We were trying to do something different. We wanted to create a “fund for all seasons”: a vertically integrated strategy which took on full responsibility for both asset allocation and security selection, in order to exploit the opportunity for returns while simultaneously managing the risk. Our vision was a product which was not shackled to the fortunes of whichever asset class it was fishing in, and which had the flexibility to create a portfolio that looked nothing like any benchmark and behaved very differently.

So how has it panned out? On the face of it, not especially well. Over the past thirteen years, the Prudent Wealth strategy has compounded at a little under 7% p.a.: by no means a disastrous outcome but comfortably shy of the 9% plus delivered by the MSCI World (and nearly 12% by the S&P 500). With the benefit of hindsight, the smartest thing to have done back in January 2011 would have been to buy an index fund. It has been a buoyant period for equities overall and especially for the largest index constituents which have only got larger during the period.

Of course, the reason our returns have been more pedestrian than the index is that we have run with high levels of cash and treasuries (around 40% for pretty well the duration) and a hedging strategy which produced a further drag of 1-2% p.a. This has had material benefits when it comes to downside protection. With the exception of 2022, the fund has weathered market drawdowns well. Nonetheless, we would be deluding ourselves (and our clients) were we to claim that we have excelled on the asset allocation front.

For many human endeavours, learning from past mistakes is an integral part of progress. You try something, it doesn't work out; you tinker with it and try again. My favourite example of this is WD-40. In the early 1950s, a start-up called Rocket Chemical set out to develop a line of rust prevention solvents and degreasers for use in the aerospace industry. It took them 40 attempts to get the water displacing formula right, but when they did the results were spectacular: a product whose usage – and uses – are still growing and whose formula remains unchanged, after 70 years.

Unfortunately, the laws of physics (or chemistry) do not apply in investing. Investment outcomes are the product of multiple interconnecting actions, many of which occur in a random and unpredictable fashion. A strategy that worked in the past may

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not work in the future, and vice versa. In fact, one could argue that what has worked in the past is almost bound not to work in the future. Part of this is down to valuation: the better an asset performs, the more expensive it becomes. But there are other ways that success can sow the seeds of eventual demise: companies that grow rapidly often attract more competition and/or regulation; and rapid growth can put an enormous strain on the cultural underpinnings of a company.

There are no hard and fast rules to guide one through this maze. Valuation matters, but it follows no pre-determined pathways. There is no ceiling, and no floor either, and aberrations in either direction can last an uncomfortably long time. And then there is the thorny matter of asset quality. We know it makes sense to pay a higher price for a better asset. But what makes for a better asset? On that topic there are always strong opinions, and often strong debate. And when there is not strong debate, that is when you probably need to worry most. As I look back on my career, it is remarkable how many widely acclaimed “great companies” turned out to be not so great after all: GE, Tyco, IBM, Cisco, Nortel, Nokia, Ericsson, Vodafone, Pfizer, AOL Time Warner, AIG, Intel...the list goes on. On the flip side, I can also think of companies which have swung from ugly duckling to glorious swan (a more profitable journey for investors). Take Microsoft: a decade ago it traded at 10x PE and everyone thought it was a melting ice cube; now it’s a market darling and pillar of almost every equity portfolio.

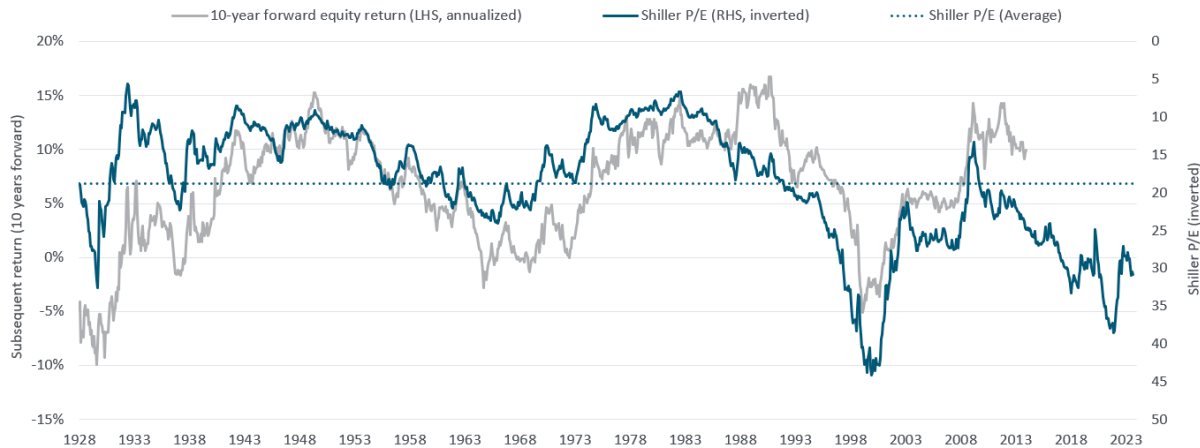
Sometimes I think the only valid lesson investing teaches you is to be humble. Do this job long enough and you will make every mistake there is. And sometimes, the same mistake, over and over again.

But so long as you are still in the game, you have to keep playing. Notwithstanding the reality that no one knows what the future holds, you have to keep making investment decisions. With that in mind, here are some of the things I think. I will no doubt be wrong about some (and possibly all) of them, but for what it’s worth, these beliefs will be driving my personal investment strategy in retirement.

I think that equities in aggregate are materially over-valued. Both profit margins and multiples are extended compared to longer-term norms, and I am unwilling to bet that for either we have reached a “permanently higher plateau” (Irving Fisher, October 1929). Looking at metrics which adjust for cyclically elevated margins, like Shiller PE (see chart below), the downside is anything from 50% (if we return to the long-run average) to 80% (if we reach prior troughs). An investor who is not prepared for this is riding a motorbike with no helmet: the ride will be more exhilarating, but if you hit a bump in the road, you won’t survive.

## A Different Beta Landscape Ahead

US Shiller PE and S&P 500 10-year forward returns



Source: FactSet, S&P US, and Yale University Department of Economics. Monthly data as of 31 January 1928 to 29 December 2023 (Due to availability Shiller P/E data is as of 30 September 2023). Chart is meant to illustrate the subsequent 10-year performance for the S&P 500 Price Return Index (annualized) given the starting level of the US Shiller P/E. US Shiller P/E (CAPE ratio) average is for the entire timeframe. US Shiller CAPE ratio is the price-to-earnings ratio based on average inflation-adjusted earnings from the previous 10 years. It is not possible to invest in an index.

I think the journey matters. It is not just about the destination. I am often told the only risk that we should worry about is the permanent loss of capital. So long as we end up doubling our money, we should not be concerned if it halves en route. I think it is one of those arguments that makes sense in theory but no sense in practice. Anyone who has managed money during a proper bear market will appreciate how difficult it is to remain sanguine as your portfolio slowly implodes. And if you are fully invested, you will not have any liquidity to exploit the once-in-a-generation bargains that bear markets provide.

I think the seven largest listed companies (Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla), which have been such a critical source of investor returns over the past decade, are particularly vulnerable and will underperform the broader market over the next ten years. My concerns vary somewhat depending on the company, but broadly speaking it's a combination of:

- 1) Inflated expectations (i.e. over-valuation),
  - 2) Less durable franchises than perceived – they all operate in rapidly evolving domains which de facto makes them harder to forecast,
  - 3) Excess market power which will eventually be eroded by regulation (if competition does not solve the problem first).
- Given these names account for nearly 20% of MSCI World and nearly 30% of the S&P500, all passive investors and most “active” investors are heavily geared to their performance.

I think Artificial Intelligence (AI) will be the making of some businesses and the death knell of others, but most investor bets on this theme will prove wildly wrong. Generally, the market does a good job recognising important technology shifts and a terrible job identifying the ultimate winners and losers. The Nasdaq in March 2000 reflected investors’ best estimate of who the likely winners from the internet revolution would be. Over the next two and a half years, it fell nearly 80%.

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I think the step change in interest rates over the past couple of years is of profound significance and we have barely begun to see its impact. We had thirteen years of the most accommodative monetary policy in history, followed by one of the more rapid hiking cycles on record. To assume that combination does not cause serious breakage feels like an extraordinary exercise in complacency.

I think the geopolitical outlook is deeply concerning. The last forty years have been an exceptionally benign period. There have been regional conflicts aplenty but by and large there has been nothing to stop people, goods and capital flowing across borders with impunity. I think that is less likely going forward, with adverse consequences for investors.

I think sustainability will matter more and more. I may be conflating hope and expectation here, but when I started out in this industry, no one spared a thought for a company's carbon footprint or the wellbeing of its workers. Now it is a major obsession. I dislike the term ESG (environmental, social and governance) and I think a lot of what is done in its name is nonsensical. But the basic principles behind it are immutable. Societal concerns about environmental damage and social iniquities have moved from the fringe to the mainstream. All companies require a license to operate and those that are unable to demonstrate that they are net contributors to society will ultimately pay a high price.

I think culture is the most enduring source of competitive advantage. It is impossible to define, let alone to measure, and as a result it gets scant attention from investors. But it is the most important driver of corporate performance. Culture is what makes employees work harder, and work together, in aid of a shared purpose. It is what fires up engineers to develop better products, salespeople to make more calls and the whole organisation to go that extra mile on behalf of the client. As I look back on what has worked and what has not, I can think of numerous companies with great cultures which have persistently delivered better than expected results – and a few with toxic cultures which have imploded. That I have not always put my money where my mouth is, and invested on the back of this, is a source of frustration and embarrassment.

Lastly, I think it is an incredible privilege to be entrusted to manage other people's money. I have at times found it exasperating. The market never ceases to make one feel a fool. But I have also found it endlessly stimulating. Every day I have learnt something new and enjoyed invigorating interactions with colleagues, companies and clients. To the latter in particular, I cannot begin to adequately express my gratitude.

*The views expressed in this section are those of the portfolio managers of the MFS Meridian<sup>®</sup> Funds – Prudent Wealth Fund and are subject to change at any time. These views do not necessarily reflect the views of MFS or others in the MFS organization.*

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