Dodge & Cox
Worldwide Funds

**Investment Perspective**

# Evaluating the Coronavirus

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Like many around the world, we are saddened by the loss of life and disruption caused by the outbreak of the coronavirus (COVID-19). As long-term fundamental investors, we consider the risks and opportunities this situation could have on our investment portfolios over our three-to-five year investment horizon. While the outbreak has already impacted equity and fixed income valuations, we believe it is unlikely that these effects will persist over the long-term or impact our ability to fulfill our obligations to our clients.

## Global Macro Environment: Aware of risks, but expecting limited persistent effects over the long term

Anchored by our fundamental research and long-term investment perspective, a large part of our ongoing efforts to assess the situation consists of distinguishing between knowns and unknowns that could affect the macro and markets outlook. So far, the virus appears to be associated with relatively low mortality rates, despite having a relatively high rate of contagion in affected areas. The World Health Organization has reported that the virus appears to have peaked in China, but that it may continue to spread within or into other countries. Economic indicators on production, trade, and confidence have begun to reflect the impact of quarantines, regional factory closures, and supply chain disruptions. As a result, we anticipate growth rates in China and other countries will be negatively impacted at least in the short term.

Despite the rapid market reactions around the world, a lot is still unknown. It is not clear how government containment measures, seasonality effects, potential virus mutations, or possible mitigation from medical treatment and vaccine developments may affect the spread of the virus. The ultimate extent of disruptions to supply chains, global trade, and tourism patterns is uncertain, as is the potentially self-fulfilling damage that could be caused by market dislocations. While these uncertainties could be resolved in a way that validates the worst of the fears underlying recent market moves, it is also possible that the outcome could be more favorable.

Given what we know so far, our view is that the virus is unlikely to have a persistent impact on returns over our long-term investment horizon. This conclusion is based on our analysis of a variety of probabilistic scenarios. To formulate these, we have relied on information about the resolution of past outbreaks, our expectations around government and economic agent responses to the virus, and the likely reaction of markets to the evolution of the economic outlook over our investment horizon.

## Equity Strategy View: Leaning into selected opportunities while assessing long-term impacts

We consider downside scenarios as a regular part of our analysis of long-term company fundamentals. We then evaluate the range of potential outcomes for company fundamentals against valuation to assess the potential investment opportunity. In our view, the market volatility this week creates opportunities as well as risks to evaluate.

We are monitoring the virus and its potential for long-term impacts. While it appears likely to impact short-term results, it is less clear that impact will continue for the long-term. We are evaluating individual holdings to assess their ability to weather shorter term macro pressures, such as lower interest rates, supply chain disruptions, and subdued demand. We are also factoring in lower valuations to identify where, if at all, the current disruption may create more or less attractive investment opportunities for our portfolios.

Against this backdrop, we may lean into opportunities where we believe the market has overreacted. As with all portfolio changes, we will continue to rely on rigorous debate and the collective judgment of our Investment Committees. Any changes we make will likely be gradual and incremental, giving us the opportunity to continually revisit and retest our thinking.

## Fixed Income Strategy View: New challenges

U.S Treasuries, befitting their ultimate "safe-haven" status, have seen strong price appreciation as the virus situation has unfolded. The magnitude of the move in U.S. Treasuries—higher in price, lower in yield (e.g., the 10-year Treasury yield is down nearly 0.50% in two weeks to its lowest level ever) implies market expectations that the virus will create significant and long-term economic drag. Other fixed income markets, like Credit and Securitized Products, have also participated in the upswing from a performance standpoint, though not to the same degree. Concerns about weaker economic activity on corporate creditworthiness and lower rates on refinancing risk, respectively, lie behind these sectors' relative underperformance.

Scenario analysis, across "up," "base," and "down" scenarios, has always been an important part of our security selection and portfolio construction processes. We seek security and portfolio exposures that can provide reasonable performance across a wide range of potential outcomes. This discipline has served us well in the past. Given recent developments, we are re-assessing the "down" economic scenarios in anticipation of some degree of near-term deterioration.

In the coming days and weeks, as we continue to assess the possible long-term economic and financial market effects of the virus, differences between our views and the markets' may provide opportunities, as high-volatility periods often do. Importantly, our broad market (i.e., "Core") strategy portfolios entered this period of volatility and uncertainty with balanced exposures to Treasuries, Corporates, and high quality mortgage- and asset-backed securities. We are well positioned to consider opportunistic changes to portfolio composition that could benefit long-term returns.

## Dodge & Cox Business Impacts: Prepared for contingencies

Other than postponing planned trips to Asia, the virus has not had an impact on Dodge & Cox's operations. Our analysts have been making greater use of conference calls in order to protect the health of our workforce. Dodge & Cox also has a robust business continuity plan with backups, redundancies, and remote work operating models. We test it regularly and are prepared to invoke it if there is an outbreak of the virus in San Francisco, where the majority of our employees are located, and/or London.

## In Closing

Times of uncertainty and market fears are when the rigor and selectivity of active management matter the most. Dodge & Cox was founded in the midst of the Great Depression, and remains focused on applying time-tested principles of investing during periods of uncertainty. This has served our investors well over our 90 years of experience managing through challenging market situations. We study what history has taught us and we are measured in the moves we make.

Our equity and fixed income portfolios are well diversified, positioned to perform well in a variety of scenarios, and exposed to undervalued segments of the market. As with other price dislocations, we are exploring opportunities to add deliberately and selectively in some areas based on our assessment of solid long-term fundamentals. We will continue to assess this developing situation in our efforts to deliver lasting value to our clients.

Thank you for your continued confidence in Dodge & Cox. As always, we welcome your comments and questions.

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