

# Neil Hennessy: The Case for Japan and Energy Stocks

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by Robert Huebscher

Neil J. Hennessy is portfolio manager and chief investment officer at Hennessy Funds, where he personally manages or co-manages the following funds: **Cornerstone Growth Fund, Cornerstone Mid Cap 30 Fund, Cornerstone Large Growth Fund, Cornerstone Value Fund, Total Return Fund and Balanced Fund.**



He has nearly four decades of financial industry experience. Neil began his career as a financial advisor, and in 1989 he opened his own broker-dealer firm. In 1996, Neil founded his own asset management firm and launched his first mutual fund. Neil has a successful history acquiring asset-management companies and starting mutual funds, and today he oversees the entire family of Hennessy Funds.

Neil is a recognized and respected asset manager, ranking among Barron's Top 100 Mutual Fund Managers for many years, and he is a frequent guest/contributor in national financial media. Neil's unique strength comes from employing a consistent and repeatable investment process, and combining time-tested, stock selection strategies with a highly disciplined management style. Neil leads his investment team to manage portfolios for the sole benefit of their shareholders, never straying from this core value.

Neil graduated from the University of San Diego.

I spoke with Neil at the Schwab IMPACT conference on October 29.

**When we last spoke a year ago, you said it was time for advisors to prepare their clients for a market correction. Are we seeing that correction now? Please put the recent market declines and volatility into perspective.**

Volatility can cause investors to overreact and do things that they shouldn't, and that's what we're experiencing. This will be the 20th correction since 2010, with the largest one being a drop of 15.75%.

I've been trying to get to the advisor community to advise them that they should tell their clients that the correction is coming. I'm not sure what the impetus is for what's currently happening; a lot of people don't understand that once the pendulum swings one way too far, something's going to happen.

The asset management industry has moved from active investing to passive investing. When you have that much money in passive investments or index funds, and they start to sell, then they're all selling the same companies at the same percentage at the same time. It has nothing to do with the individual companies or the stock market. It has to do with this move to passive investing in today's market.

**How does this market compare to the bull market of 1982 to 2000?**

I see similarities. The headlines focus on the fact that this has been a nine- or 10-year bull market, but it's not the longest bull market in history. From 1982 to mid-2000, we experienced 18 years where the market was up each year, with the exception of 1990 when the market was down 0.5%. That was in an environment with 21.5% interest rates, 18% inflation, the crash of 1987, banks and savings and loans going under in 1989 and 1990 and the dot-com craze – the whole nine yards.

**What's ahead for markets and the economy in 2019?**

I believe we will recover from this correction and that the bull market will continue. Corporate earnings are up and unemployment is low. Cash flow is up, acquisitions are being made, dividends are being increased, and stock buybacks continue. There's tons of cash sitting on the sidelines; the S&P 500 companies have over \$5 trillion in cash. They're going to deploy it at some point in time, in one of the ways I just mentioned. Overall, as we continue into 2019, the economy is growing steadily around the 3% range. We're in great steadfast growth, and there's no reason this bull market is going to end any time soon.

**How does the trade war play out? Some of your investments are focused on Japan. How will its economy and your investments be affected by U.S. trade policy?**

Japan is a unique situation. Between Japan and the U.S., that's where you should have your money. Specifically on trade, we're trying to get to a level playing field. The way it's set up today, if you want to do business in China, you have to join with a Chinese company. You have to give it your technology. It gets your technology for essentially nothing. That doesn't happen if a Chinese company wants to join somebody in the U.S.

You can't go in and tell a country what to do, but you can make it painful enough that they give up and say, "Okay, we're going to come to your side." The tariffs are not going to hurt anybody. Look at what the farmers are going to do in the Midwest. They've been planting soybeans, and now they're going to plant corn.

The businessmen in the United States are going to figure this out. There's absolutely no doubt.

**Tell me more about why Japan is so compelling.**

It goes back to September of 2009, when we acquired our two Japan funds. We saw something different in Japan and what was culturally changing.

In June of 2010, things began to change in Japan. An example that illustrates how Japan is changing is tourism. In the past a Chinese visitor to Japan had to prove an income of \$37,000 a year, travel with four or more people, and hire a Japanese tour guide. Prime Minister Kan relaxed those restrictions significantly to attract China's 350 million middle-class citizens to come to Japan. Mr. Kan wanted to increase tourists to Japan from six million visitors a year in 2000 to 20 million in 2020. By 2017, Japan had 29 million visitors. Now Japan has a target of almost 60 million visitors, and it is probably going to get there. If you think about it – 60 million visitors– that's half of Japan's population; they only have 120 million citizens. With the 2020 Summer Olympics in Tokyo the whole world is going to realize how beautiful Japan is, how nice the people are, how good the service is, how good the food is and most importantly how safe it is.

Japan has moved out of its decades-long deflationary environment, yet it hasn't yet hit its inflation target. The country is pursuing many structural reforms, importantly labor market reforms, which should help Japan to continue moving in the right direction.

With an aging population in Japan, there is going to be a transfer of wealth. Japanese companies are doing so well, and there is a strong move toward better corporate governance and shareholder-friendly practices. There's a lot more to the story, but that's really the gist of what's going to happen here.

**To what extent are you concerned about rising rates and the impact on equity valuations?**

Interest rates are going to go up, and everybody knows they're going to go up. I love the headlines in the media when the Fed's raise rates. That wasn't a surprise!

I chuckle because I remember my first mortgage was 14% or 15%. Now, we're talking about 4.5% or 5%, maybe 6%, mortgages. I don't think interest rates are going to hurt companies. They're not going to hurt the economy. The Fed has to move rates up so that, should we run into another economic problem, they have room to maneuver.

**In July, you announced the acquisition of the BP Capital TwinLine Funds. What was the opportunity that you saw and what made those funds attractive?**

BP Capital is the firm that Boone Pickens founded, and these funds were modeled with the Pickens Plan for American energy independence in mind. We are pleased to have retained the Funds' portfolio managers as sub-advisors. They have decades of experience in energy investing and that is their sole focus.

The acquired BP funds complement our Hennessy Gas Utility Fund, and we are now able to offer investors a suite of energy-related products. The Hennessy Gas Utility Fund focuses on the distribution side of natural gas. The Hennessy BP Midstream Fund focuses on midstream oil and gas companies. The Hennessy BP Energy Fund opportunistically moves up and down the whole energy value chain – upstream, such as E+P companies, midstream, downstream, and includes energy end users.

**Do you expect energy to come back into favor in the coming year?**

We believe energy will come back into favor. Sectors move in and out of favor, and the energy sector has lagged. When

the sector comes back into favor, we have products that are well poised to take advantage of that rotation.

A big part of the energy story is natural gas. Gas is the cleanest of the fossil fuels, and it has bipartisan support. In the future you're going to see more gas-powered electricity plants, more gas-powered vehicles, and more gas-powered everything. We have an abundance of natural gas here in the U.S. and exportation is a major theme driving growth for the industry.

### **What about financials?**

Financials have been getting crushed, but in reality, this whole market is about patience. If you look at the banks, you will see they've never been stronger; they've got so much capital. Their biggest problem is trying to loan it.

As more and more infrastructure is built out, more capital improvements require investment. Companies will go back to the bank knowing that they can cover it. They'll just take a little bit of write-off, but they're strong.

### **Last year we also talked about the flow of funds from active to passive strategies. That trend has abated. What is your outlook for active asset flows, particularly if this level of higher equity volatility persists?**

We've seen this movie before, so you don't have to wait around for the ending. Let's say you specifically take a spot in time and say, "Okay, if I go from March 31 all the way back 10 years, you would have been better off investing passively than with active." But there is a big difference this time.

Index funds, which are passive, primarily own the same companies and at the same percentages. In a downturn, when they get a sell order, they have to sell, and everybody sells at the same time. It just feeds upon itself. They have to sell at market, whereas an active manager can use a limit order. That's a big advantage.

An active manager can say, "Well, I'm not going to sell this company. This is just ridiculous." For instance, in a mutual fund, we can borrow money in the short-term so that we don't have to sell, and we can use limit orders. But when you start talking about the index funds, they might be able to borrow money too, but at the same time they've still got to sell at market to get that money out.

### **What are you hearing from advisors? What is the key message that advisors should communicate to their clients now?**

The key message to communicate is patience. This bull market is a long way from being over. You're going to have pullbacks and corrections, it's just the nature of the beast.

Don't let volatility distract you because the client isn't really looking from today to one year to see how they did. They look at a year from January 1 to December 31. Your clients should be concerned about making money and meeting their long-term goals. If you beat an index, so what if you lose 30% of the money?

If you have a good active manager who has done well in the past and continues to follow their philosophy, and they're down 5-6% or 10%, you should consider that a buying opportunity.