ADVISOR PERSPECTIVES

The Fund That Isn't Following the ESG/SRI Herd

December 11, 2019

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In the U.S., between one quarter and one third of all assets managed are done so with an ESG or SRI mandate. Outside the U.S., that percentage is even higher. The Vitium Global Fund, formerly the Vice Fund, buys what most ESG/SRI investors scorn, stocks in the tobacco, alcoholic beverage, gaming and aerospace/defense industries.

Charles Norton and Jeff Helfrich were recently named to manage the Vitium Global Fund. They bring nearly 40 years of combined investment management experience to the fund.

Charles previously served as portfolio manager of the fund from 2005 to 2010. In addition to their duties as Vitium co-managers, Charles and Jeff also serve as portfolio managers at Penn Davis McFarland.

Here is a link *to the Vitium Global Fund web site.*

I spoke with Charles and Jeff on November 11. To listen to this interview as a podcast, go here*.*

Tell me a little more about your backgrounds and why you were chosen to take over the management of the fund.

Jeff Helfrich: I've been at Penn Davis McFarland for about 10 years, managing separate accounts for individuals. Prior to that I worked at Janus Mutual Funds and a multibillion dollar family office, selecting investments.

Charles Norton: I have over 20 years of experience managing money. I've been at Penn Davis McFarland for about five years. I was previously involved with the fund from 2005 to 2010 and, prior to my time at Penn Davis, I was at a private bank. Before that, I was at a hedge fund and was also an investment banker in New York for a period.

Why did the fund change its name from Vice to Vitium Global?

Jeff Helfrich: The Vice Fund name was a little bit too brash. People didn't take it seriously. This is a serious fund. We decided to change the name and keep it true to its legacy. Vitium is Latin for vice, but we didn't want to have that upfront, knee-jerk reaction to the fund. We also liked having a Latin name because these industries have a long and lasting history. They've been around since Roman times. We thought that was reflective of the nature of the industries. We added "global" to the name because we're increasing the international exposure above 40% and we wanted the name to reflect that.

Why did you choose to go more international and what are you doing about currency risk?

Jeff Helfrich: The fund has always been international. If you looked at it over the course of the last five years, it's been 30% international over that whole time. We were acknowledging how the fund is already invested. These are global industries and some of the biggest, most important companies in those industries are international. We're going to be investing there no matter what, and we wanted to formally reflect it in the name.

The other reason is that now's the right time to increase the exposure. The S&P has had a huge run over the last 10 years. Valuations internationally are more attractive.

We don't hedge the currency risk. We view it as a global fund. We will hold the local shares and the currency will do what it will. In the end, the currency movement washes out. Our job is to pick good companies, not make bets on currency.

Tell me about the fund's mandate. What are the buy and sell criteria? What are you looking primarily to buy?

Charles Norton: We start top-down and we look at the secular, industry macro trends, because every single company within a particular industry is influenced by those major trends. We spend a good deal of time trying to ascertain which way the winds are blowing within a particular industry. Then we get very detailed from the bottom up looking at company

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positioning. What categories is the company exposed to? What is the geographic mix? How strong are the company's brands? What is the company's market share and is it gaining share or ceding share? These are some of the things we look at when we do the bottom-up analysis. The final piece is valuation. Even if we love a company, but we think the valuation is too expensive, we'll wait until we have a better opportunity.

On our sell discipline, if the industry trends change, that will influence our view of every company within the industry. We keep a close eye on that. The trends we're talking about tend to be longer term in nature, at least three- to five-year trends. A company could be well-positioned, but if it is not delivering on our expectations, we'll use that as an opportunity to sell it. If the valuation becomes too stretched and it becomes too expensive of an idea, we might look to pare it back. Finally, we always look to remain concentrated in our best ideas. If we find a better idea, we'll sell something that's currently in the portfolio for a new idea that has more upside.

There are four sectors that you primarily invest in: tobacco, alcoholic beverages, gaming and aerospace/defense. What fundamentally ties those four sectors together?

Charles Norton: Apart from the fact that all of those sectors tend to be screened out from ESG mandates and therefore offer a compelling valuation opportunity for us, they tend to be global in nature. There are high barriers to entry due to regulation. For example, in gaming there's a finite number of licenses. If you have a license, competitors can't enter that market. Because of strong brand equity and distribution, all of these industries create high barriers to entry. Many of the companies operate in an oligopoly, which can help their pricing power and also make it harder for new entrants. They are relatively resilient in terms of the demand, regardless of economic cycle. They have strong pricing power and that is a result of market structure, brand equity, and relatively inelastic demand. Fundamentally, they have high margins and strong free cash flow, characteristics that we like and look for. Finally, they have government support, either as a beneficiary of a tax collection or as a customer in the case of defense. To some degree, the government is a quasi-partner in those businesses. From a long-term perspective that ensures that they won't just stay around, but that they'll thrive. It's in the government's best interest that they do so.

Are there stocks or even industries that you won't invest in because of what the companies do, regardless of how compelling an investment they might be?

Charles Norton: We're investors first and foremost and we're not looking to put a social commentary on the portfolio. We're wearing an investor’s hat and we look at the investment merit of every industry and company. We judge it based purely on the fundamentals.

You can now have up to 20% of the portfolio outside the four core sectors. What types of names are you looking to include?

Jeff Helfrich: With that 20% we intend to take advantage of opportunities that arise outside of our four core sectors but still have a similar social controversy associated with them. Some examples of things that people might consider controversial that aren't in those four sectors are things like nuclear power or even video games. People say that video gaming is a bad habit. The idea is to take advantage of a mispricing because of perceptions that these are not socially ideal industries. We try to find individual names in those sectors.

Charles Norton: That 20% in related areas, but outside of our four core sectors, adds an additional benefit of industry diversification.

Jeff Helfrich: Even in tobacco, there are a lot of reduced-risk products. The concept is that if people are going to smoke, you should smoke something that's less harmful to you. Even those industries are moving to reducing risk. We're not investing for the sake of doing harm. We want people to be healthier and happier. All of these industries can move further in that direction.

It's largely a misperception in other words.

We're speaking in early November and your October 30 positions were just made public. Were there any significant additions or deletions that you want to discuss?

Jeff Helfrich: We broadened our gaming allocation. Historically, the fund had been heavily invested in Macau. We still have exposure there, but we broadened it to other areas. One area we added is more online gaming. We added direct exposure to U.S. sports betting through an online player. We've added some online live gaming and we think the future will be fewer people going to the casinos but more people playing on their phones.

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Another area we added in gaming was a whole segment of REITs that own casinos. The idea is that those cash flows are very stable because the rent is the first thing that gets paid. In tobacco we added some companies with reduced-risk products in their portfolios, including a new name that's got no combustible cigarettes at all. We're positioning the tobacco portfolio for a less cigarette-centric future.

We bought one of the largest uranium miners in the world, touching on that nuclear theme. Generally, we concentrated the portfolio. We trimmed out some of the smaller positions and concentrated in our best bets.

Speaking of tobacco, vaping has gotten a lot of media attention, particularly in Massachusetts, where I live. Is U.S. tobacco still a viable investment over the long term?

Charles Norton: We believe that U.S. tobacco is viable. It might look different in the future than it does today. In fact, we hope it does. But the CDC report and the lung injury cases have gotten a lot of media attention. It turns out that it is almost exclusively a result of illicit THC vaping, which is totally different than vaping e-cigarettes. We hope that regulation will come through the industry, which we would welcome if done right. But e-cigarettes are part of the reduced-risk, less-harmful solution. There are other products that could go in that category as well, but the fact is that combustible cigarettes are the most harmful. As consumers switch into e-cigarettes or any other of these less harmful reduced-risk products, then that's in the best interest of the public health.

The tobacco manufacturers have strong brand equity, very strong pricing power, generate enormous free cash flow and pay strong dividends. We don't see any of that going away,but we hope that the future includes more reduced-risk products, which would be a benefit to the tobacco industry.

You spoke earlier about gaming. Where are you seeing opportunities in the gaming world, particularly beyond Macau? You spoke about how gaming on phones might be the wave of the future. What are you're looking at in terms of investing in that online gaming world?

Jeff Helfrich: The online gaming world has been around for quite a while in Europe. We've found the best opportunities are with European providers that are starting to come into the U.S., particularly as the sports gaming and online gaming is coming to the U.S. They've partnered up with U.S. casino operators and existing U.S. players to capture that market. They bring decades of expertise in the European markets. U.S. online gaming's going to grow fairly significantly. We're excited about that opportunity.

Charles Norton: There's been some crackdown in the UK on the regulatory front, which has caused an overhang on these stocks and made them extremely cheap. The U.S. sports-betting opportunity is not priced into a lot of the stocks at current level.

In the world of beverages, do you prefer beer or spirits? What are your best ideas in the world of beverages?

Charles Norton: We look at growth rates globally. If you look in the U.S., for example, consumers have been shifting from beer to spirits for quite a while. When they are drinking beer, they're drinking either imported or premium beer. That leads us to companies that cater to that demographic. Internationally, we're seeing a lot of growth in the emerging markets and we're also seeing this “premiumization” trend. The higher the price point, the more the growth. Companies are gearing their portfolio to invest in their more premium beers and spirits. That translates into our portfolio based on companies that have the best geographic mix and the best portfolio to capture that trend.

We haven't talked about defense and aerospace. One of the risks or opportunities that the industry faces will come with the upcoming election. How do you see the political landscape shaping up for how the defense industry will be impacted?

Charles Norton: The fact that Republicans are better for defense is an old wives’ tale. It's not supported by the data. Defense stocks are tied to budgetary cycles and, in particular, spending on modernization. If you look at the data, there's no correlation between the party that's in the White House or the split of Congress and the relative performance of defense stocks.

One of the key things that we look are the threat levels. Obviously threat levels are very high around the world, but especially the long-term threat of the rise of the military power in China and Russia. Because of that, there's likely to be continued support for defense spending regardless of the political party in the White House or controlling Congress.

Given the popularity of ESG/SRI investing, I'm sure that you've had a lot of awkward moments at cocktail parties when you tell people that you manage a portfolio of so-called sin stocks. What do you say to advisors and their

clients who are grappling with the issue of sustainable investing and the belief that they can "do well by doing good"?

Jeff Helfrich: This goes to the question of how you define sustainable investment.AB InBev has huge commitments to water conservation and energy efficiency across every aspect of its business. Las Vegas Sands has won a bunch of awards for sustainability. When it builds a casino, it is LEED certified. It makes a serious effort on its environmental footprint.

Where do you draw the line? Our view is if the industry is legal and regulated by the government, you should consider it. We don't want to limit ourselves. A lot of studies have shown that you encumber returns when you eliminate industries due to social screening. These are very stable industries with great growth and high returns on invested capital and good cash flows.

The valuations are attractive because people are mandating that they don't invest in these industries. It's an opportunity. It's very hard to define what exactly ESG is. Every individual advisor and client would probably define it differently.

Do you think that your fund is benefiting by the popularity of ESG/SRI and the fact that there's seemingly such a big herd of investors that are mostly looking away from the types of companies that you're buying?

Jeff Helfrich: Absolutely. With the rise of ESG, particularly since it's not well-defined, people are screening out a lot of these industries and it's giving us an opportunity to buy these companies at distressed valuations relative to what they'd be otherwise. Now's a great time to be looking at these industries.

Charles Norton. The whole premise of our strategy is that there are structural valuation opportunities in our sectors. There are trillions of dollars of institutional money screening these stock out. It creates an opportunity for us to go where the crowd is not.

If there's one piece of advice that you would give relative to investing in sin stocks, what would that be?

Charles Norton: We don't believe they are sin stocks. These businesses are engaged in perfectly legal activities supported by the government. We don't pass judgment. We focus on the investment merit of what we're investing in and we are contrarian – going against the crowd. That's where the greatest opportunity is. From that perspective, all roads lead back to the sectors we follow at the Vitium Global Fund. Advisors might wish to take a closer look.

For top ten holdings of the fund, clickhere.

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectuses contain this and other information about the investment company, and they may be obtained by contacting 866.264.8783 or going to www.usamutuals.com. Read it carefully before investing.

Mutual fund investing involves risk; principal loss is possible. The Fund will concentrate its net assets in industries that have significant barriers to entry including the alcoholic beverages, tobacco, gaming and defense/aerospace industries, the Fund may be subject to the risks affecting those industries, including the risk that the securities of companies within those industries will underperform due to adverse economic conditions, regulatory or legislative changes or increased competition affecting those industries, more than would a fund that invests in a wide variety of industries. The Fund invests in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. The Fund invests in smaller companies, which involve additional risks, such as limited liquidity and greater volatility. Derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could result in losing more than the amount invested. If a security sold short increases in price, the Fund may have to cover its short position at a higher price than the short sale price, resulting in a loss.

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