Firstlinks
Connecting investors with ideas

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Why we're not buying the market yet

Marcus Padley

The US Federal Reserve has thrown the kitchen sink at the markets, cutting interest rates to zero (0 to 0.25%) and announcing US$700 billion in money printing.

Market sentiment and individual opinions about the market are bi-polar at the moment. Someone told me at the weekend (after the 13% bounce on Friday 13th) that they are going "All in". One of our clients (although happy with our service) has withdrawn their money because they now want to take on the investment role themselves and aggressively buy.

We have thought very hard about whether this Fed move will create a stock market low and whether we should start buying. No is the answer.

A few things are holding us back

- What has the Fed seen that we haven't?
- Coronavirus has been the catalyst to finally take us to zero interest rates.
- No interest rate is a disaster for a lot of retirees as the risk-free return goes to zero and the real return goes more deeply negative. Retirees are already losing money in cash.
- Negative interest rates are next and that's a disaster for anyone with capital.
- The next step is money printing again and we still haven't paid the price for the post-GFC decade of money printing yet.
- We are risking deflation ... ingrained deflation.
- The central banks are now out of policy weapons. Nothing left. The economy will now turn to politicians and fiscal policy for salvation and as Japan taught us in the 1990's and 2000's, fiscal policy is like throwing snowballs at hell, it will achieve nothing meaningful beyond budget deficit blow out and regular political change as government after government continuously fail to turn the economy.

- There is heightened economic uncertainty at the moment.
- There are a host of profit downgrades related to coronavirus that have not been quantified yet (have we had any at all?) – they are coming. Earnings expectations are in flux.
- The social impact of things like the US being shutdown have only just begun. The US is preparing for lockdown. Supermarket shelves are being stripped. If you think we have a problem with loo paper, gun shops in the US have seen queues around the corner as Americans stockpile guns and ammo. Ohio and Illinois have closed all bars and restaurants. It is taking six hours to collect bags and three hours to get through screening into the US airports.
- The biggest one-day rallies in the market come during a bear market. We saw a 13% rally in the S&P/ASX200 from bottom to top in a few hours. That's not a trend change, it's a bounce in a very volatile market.

Trump has tweeted "It's terrific" and "very good news". It's not. The Fed can do what it likes but this is going to get worse before it gets better. We have not seen the social end game yet so it's unlikely to be the stock market end game either.

Our decision is to stay out.

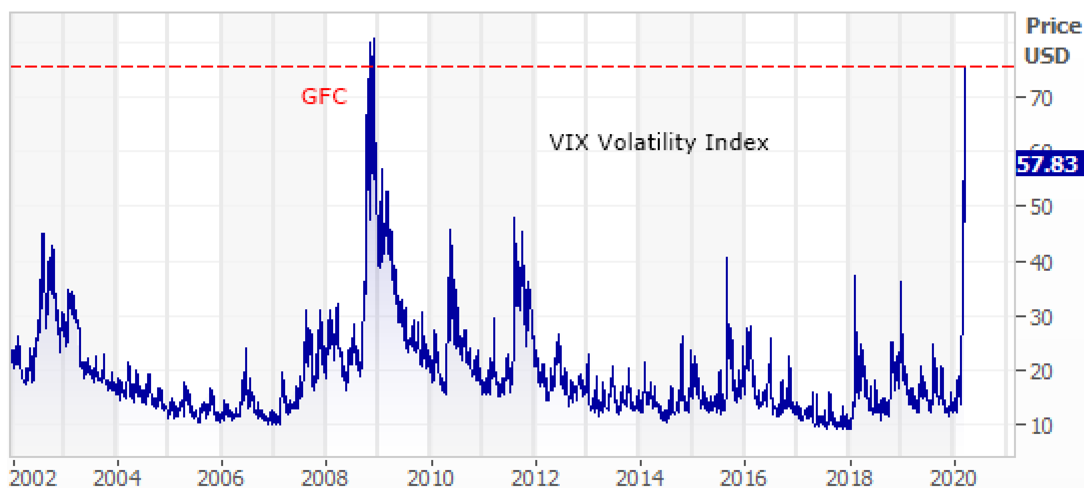
That's our assessment of the current risk-reward equation. Standing on the shore has a better risk-reward than sailing in the storm. But you need to decide for yourself, because the reality is, we're guessing, everyone is. If this is the bottom and you call it, you guessed. We're guessing it's not the bottom.

The opportunity

This is certainly a buying opportunity. Big corrections are almost never bigger than 50%. We have seen an over 30% correction from top to bottom so far.

The odds are the economic rebound when it comes will be quick. The stock market rebound will precede the economic rebound and will be even quicker.

Here is the VIX Volatility index. We are back to GFC levels. If you are supposed to buy when others are fearful … we must be getting closer.



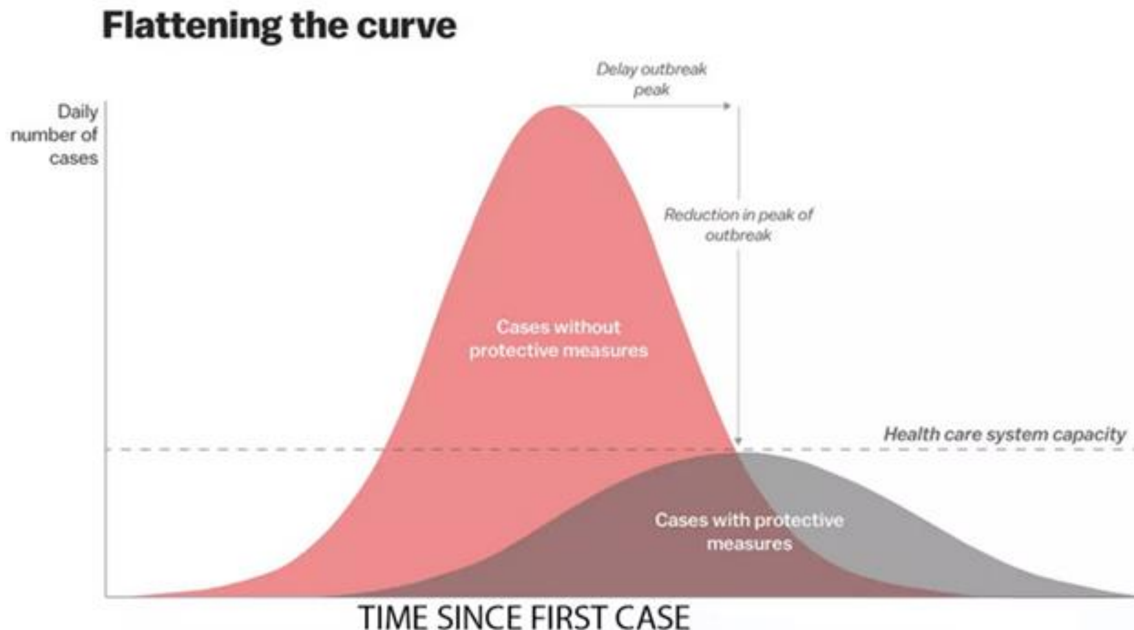
The only game in town now is to time the buying. There is unlikely to be a clear 'moment'. We will almost certainly progressively buy as the risk reward ratio improves rather than go "all in" on one day.

Why it might take a while before the bounce

The main variable is the depth of the GDP impact and the corporate damage, and how long it lasts. Until that is envisaged by investors, the markets will not bottom. If we knew the size and timing of the economic impact, the market would price it in and bottom.

The problem is that for the following reasons the impact is likely to be prolonged not momentary.

This is the central chart, and its not good news for a quick recovery. This is from the CDC (Centre for Disease Control) and it's on the media everywhere.



It’s the 'flatten the curve' chart

This chart is telling governments that they need to enforce a lockdown as soon as possible and have it last as long as possible. This chart tells governments that the primary focus must centre on the capacity of the healthcare system to handle cases. A percentage of patients will need hospitalisation and some will require intensive care. We only have so many places, an estimated 2,000 in Australia.

The mortality rate will be significantly improved over the disease cycle if the number of cases that need to be handled by the health system is kept within capacity. To ensure everyone that needs treatment gets treatment, government has to prevent a rapid spread of the disease. In Italy, coronavirus spread too fast and the result was an overrun healthcare system and a higher mortality rate than there needed to be. Governments cannot be responsible for deaths, so their only option is to stop spread, and flatten the curve.

From the stock market point of view, if the primary focus of the government becomes the capacity of the healthcare system to cope, then to hell with the economy. It is the rate of spread of the disease that matters and the government can do something about that. It involves taking some economic damage early, and it's beginning. We expect Australia (and the US and Europe) to go into lockdown pretty quickly and remain there until the coast is clear.

Economic summary

• The Government will focus on the rate of spread not the economy.

• The economic impact is secondary and not a priority.

• To slow the spread government will advise lockdown periods for individuals, schools, sports, gatherings and businesses.

The conclusion is that the duration of the economic impact will be long not short.

There is a long long way to go in this story. We watched that bounce in the Australian market on Friday 13 March and a smaller rise on Mpnday 16 March. We watched particular stocks jump 20% to 35% in two hours and like you, we kicked ourselves for missing the opportunities. And like you, we started thinking about buying (we are in 62% cash in our Growth Separately Managed Account).

But we shouldn’t. Missing that quick rally is all that’s prompting us to even think about buying. It's FOMO, not logic. Everything else says don’t.

We are still in this storm

That jump up was not the bottom, it was some fund manager somewhere who decided, maybe in Sydney, or maybe in a skyscraper in New York, to buy some SPI futures in big size. We don't know why, but my guess is that they too, were guessing, as Twiggy Forrest was guessing when he bought FMG shares this week (never follow emotional billionaires making gestures), and as we are guessing and as you are guessing.

On the financial front we should take the same tack as the medical advice at the moment – too cautious is better than reckless.

Optimism today might look silly in a month or two when you, and those futures traders who caused the bounce on Friday 13th, are sitting at home sharing a bowl of rice with their kids whilst the stock market is shut.

Plenty of clickbait cowboys will call the bottom every day. We'll call the bottom after the avalanche of coronavirus earnings downgrades the market has not even begun to absorb yet.

Marcus Padley is the author of the daily stock market newsletter Marcus Today. See marcustoday.com.au for a free trial. This article does not consider the financial circumstances of any onmvestor.

Pandemics in perspective

Phil Ruthven

Epidemics and pandemics are an integral part of human history, with each outbreak bearing both social and economic costs. The world has endured a few outbreaks over the past century, and if the early decades of this new century are a reliable indicator, we can expect to see more in the 2020s and beyond.

The first table below outlines the main epidemics and pandemics in recent history, when and where they struck, and the resulting death toll.

Year(s)	Disease	Geography	Deaths
1899–23	Cholera (6th)	Europe, Asia, Africa	80,000
1910–12	China Bubonic Plague	China	40,000
1918–20	Spanish Flu	Worldwide	50,000,000+
1957–58	Asian Flu	Worldwide	2,000,000
1968–69	Hong Kong Flu	Worldwide	1,000,000
1960–	HIV/AIDS	Worldwide	30,000,000
2002–04	SARS (Coronavirus)	Asia, Canada	<1,000
2009	Flu Pandemic	Worldwide	203,000
2019	Coronavirus (COVID-19)	Worldwide	>3,000

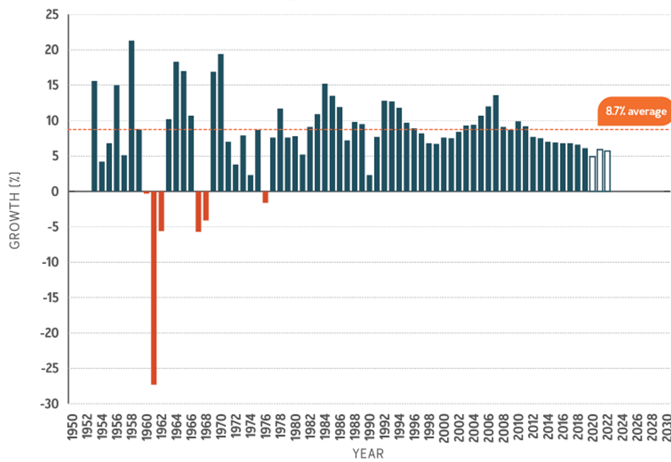
SOURCE: Ruthven Institute 03/03/2020

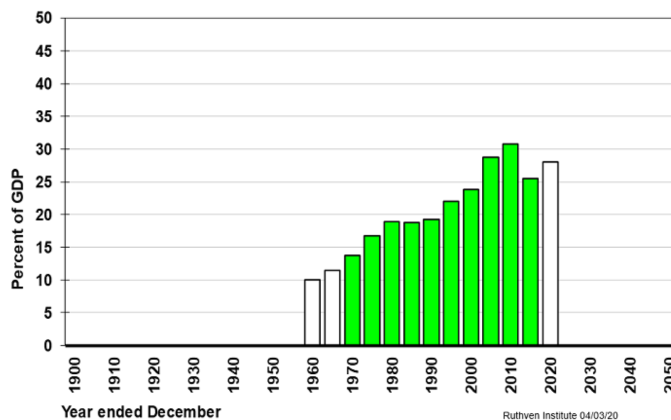
Impact on coronavirus will prove severe

Of the above list, the two standouts were the Spanish Flu and HIV/AIDS. The first, which occurred in 1918–20, resulted in over 50 million deaths (over 2.5% of the population). The second, which was first observed in 1960s and is still present today, has resulted in 30 million deaths to date (0.6% of the average population until now).

Coronavirus, or COVID-19, originated in China in December 2019 and has since spread rapidly worldwide. The economic impact to global GDPs and stock markets is proving more severe than was anticipated in mid-February, and we are yet to see the full extent of the damage.

The epicenter of the COVID-19 pandemic, China, has expanded at a record-breaking rate since adopting a state-controlled market economy. Averaging 8.7% GDP growth since 1970, the nation has not seen a recession since Mao Zedong's death in 1976. However, China's economy has trended downwards in recent years, as observed in the below chart.





At present, China is also taking an economic hit from swine fever, which is affecting pig production. Now coronavirus is affecting China's population, trade and general economy to an unknown extent. This setback has in turn affected other economies around the world, including Australia's export trade of tourism, higher education and minerals.

If the 2002–04 SARS epidemic is any guide, these conditions may only affect economic performance in 2020. However, a looming debt bubble in China may see other problems emerge further into this decade.

Why is the latest pandemic such a worry?

In short, it's a worry because the world economy now relies upon a lot more international interdependence between economies and businesses. Exports have trebled their percentage share of the world's GDP from 10% to 30% over the past 70 years, as we see in the next exhibit.

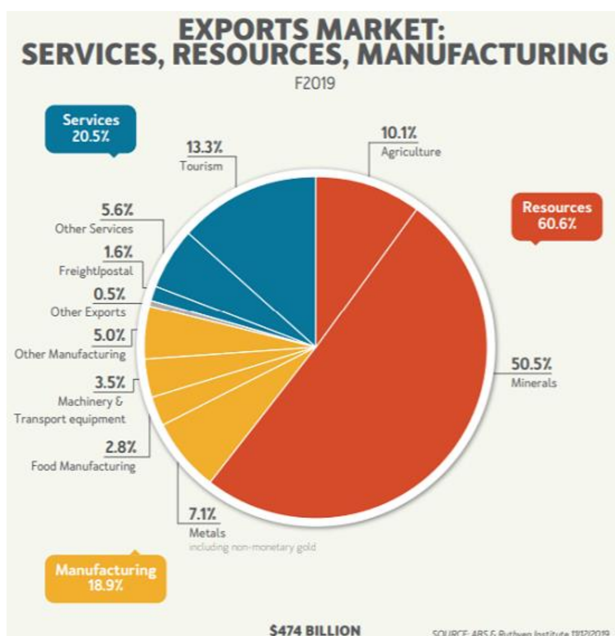
So, the world's GDP is more vulnerable than ever to any economic downturns resulting from pandemic activity, even if the disease itself is not as virulent on a social scale as, say, the Spanish Flu or AIDS.

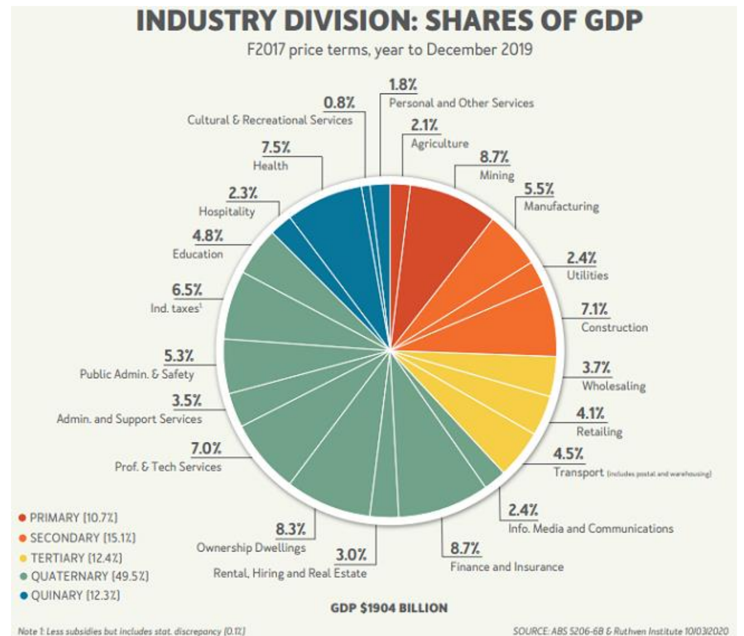
A world recession? Doubtful. But a recession in some countries? Quite likely.

Any nation with a growth in 2020 of under 1.5% could be exposed to a recession. If those economies also have high shares of mining, manufacturing, wholesaling, retail and tourism in their industry mix, then they have increased vulnerability due to the high interconnectivity of trade these days.

Australia is vulnerable as a result

The first chart below shows our export mix (being almost 25% our GDP) with the vulnerable minerals and tourism industries accounting for nearly two-third of those exports. These are two of the main industries at risk due to slowing global trade and problems in China.



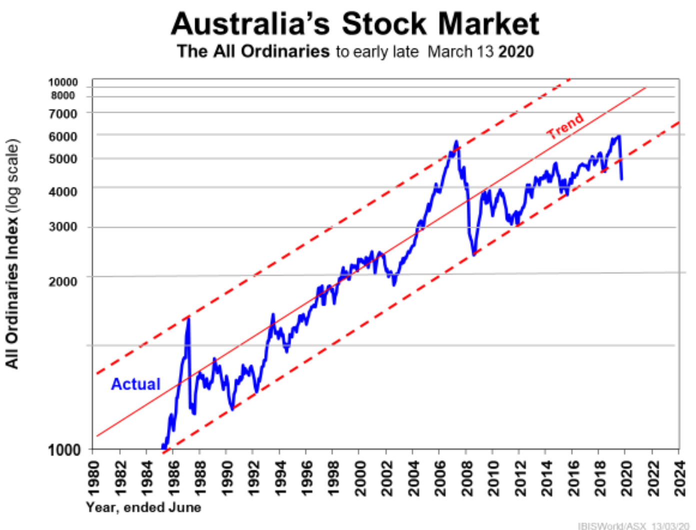


The second chart shows our mix of industries in our $2 trillion economy. Our small dependence on manufacturing is a big help, but mining is a bigger industry these days. We may escape a recession but only with a sooner-rather-than-later stabilisation of the viral pandemic and abatement of the fear contagion.

The human impact and equity markets

Of course, the human impact of the coronavirus, as separate from the economic impact, cannot be ignored. Shorter quarantine periods, coupled with apparently longer gestation periods than originally thought, have contributed to a faster and greater spread than was anticipated. On the plus side, advances in modern medicine mean vaccines may now become available in record time; but despite a relatively small number of deaths so far, there is no certainty as to how long the pandemic will last.

In times like these, we must consult the experts. It is worth dusting off Peter Curson's and Brendan McRandle's 2005 paper, *Plague Anatomy: Health Security from Pandemics to Bioterrorism*, which addresses the challenge of disease control within the context of national security.



All that said, while stock markets are in meltdown in the early days of March, they have a habit of exaggerating threats as well as perceived opportunities, as seen below. Bond rates can be expected to now stay low for a longer time, but the stock markets could make up a lot of losses as we enter 2021.

Perhaps the best news, for those prepared to take the long-term view, is that complacency in both health and interconnective trade dependencies is giving way to better planning, safer strategies and contingency plans.

Phil Ruthven is Founder of the Ruthven Institute, Founder of IBISWorld and widely-recognised as Australia's leading futurist.

Shaken by stock market carnage? Forget everything

Vishal Khandelwal

All I am reading and hearing all around is this. Volatility is your friend. Stick to the long term. Don't touch your portfolio. Keep some cash. Invest that in a staggered manner. Recheck your asset allocation. Shuffle your stock portfolio. Don't borrow to invest. Don't speculate. Quickly search for new stock ideas. Stop watching news.

Well, let's cut it all.

The markets are sneezing bad, and your portfolio may be in a sea of red on account of the big recent declines.

Amidst this, what can you do?

Rue your losses and hold on to them? Sell your winners so that you don't lose your paper profits? Become greedy because others are fearful? Become fearful because others are fearful? By the way, who are these *others* anyways?

Things look so confusing out there. And so are all kinds of advice that is floating in the news and social media. Everyone is out there to remind you of how dumb you have been and how smart they are. Stop there!

Here's something simpler, very soothing to the soul, and very effective too, that I advise you to do now. This is the exact same advice I've given to myself, so we are in the same boat.

So, what's my advice?

Let bygones be bygones. Forget everything. Start afresh.

Nobody has any clue what is going to happen, short term or long term. After the dust (sorry, virus) settles, people who will get it right will simply be the ones whom luck chose to side with. They may appear on television and remind you how their prediction went right, without revealing which one, and how their skill shone through the crisis. But, believe me, those would just be the lucky ones.

Even you don't have any clue of where all this is heading. All you can see now and act upon now is what has happened in the recent past and how you have done through it all. Your brain, like mine, is poisoned by a heady cocktail of anchoring bias, endowment bias, availability, hindsight bias, social proof, sunk cost, confirmation bias, loss aversion, etc.

How do you maintain sanity with such poison running through your mind?

Simple. Forget everything. Start afresh. But how do you go about it? Where do you start? What do you forget?

Here's what to do.

Take a print of your current portfolio but just the names of stocks you own. Exclude your buy price and the current stock price. This is so that you forget at what price you bought a stock and whether that is up or down from that level till today.

This is another reminder that your cost price *must* not matter when you are deciding what to do with your stocks today. What matters is where the stock is today, and where the business and its intrinsic value may be 10 years down the line.

Anyways, coming back to your portfolio, take a re-look at your thesis on each stock, one by one, and objectively.

Ask this question for each stock you own: "If I did not own this stock already, and of what I know now about this business, management quality, competitive advantage, staying power, long term growth, and current valuation, would I buy it for the first time today?"

If the answer is yes, keep the stock. Period.

If the answer is no, sell the stock. Period.

Then run this question on other stocks in your watchlist, this time forgetting from where those stocks have fallen or risen from.

Ask this question for these new stocks – "Of what I know now about this business, management quality, competitive advantage, staying power, long term growth, and current valuation, would I buy this new stock for the first time today?

If the answer is yes, buy the stock. Period.

If the answer is no, skip the stock. Period.

Most biases that wreak havoc on our minds as investors are creation of what stock prices have done in recent times and whether we have earned or lost money on them or have seen others earning or losing money on them.

Performance of underlying businesses – good or bad – don't cause us much trouble as their stock prices do.

So, if you wish to really clear your mind and get into a position of some sanity as things fall apart around you, the most potent tool in your arsenal is the idea of forgetting, better ignoring, what stock prices – of your portfolio companies and those in your watchlist – have done since the time you own them and especially in recent times.

Plus, don’t listen to anyone who would remind you how smart they are and how dumb you have been. Forget them too.

Just forget everything, also forgive yourself for any past mistakes, and start afresh.

Vishal Khandelwal is a writer, educator, investor, and Founder of SafalNiveshak.com. This article is for general information only and does not take into account any person’s individual financial situation.

How stock markets recover and the perils of timing markets

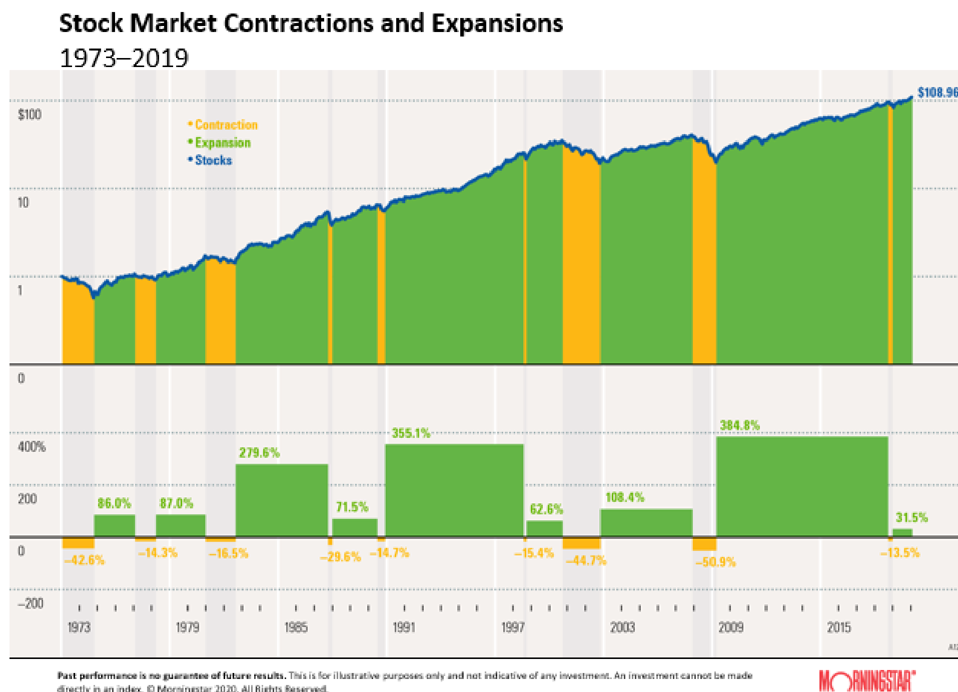
Graham Hand

Investors in shares must expect market shocks as part of the long-term benefits of owning part of a company. Over time, stock markets fall one year in every five. History provides a valuable guide to how markets normally recover from shocks, and this article provides four charts illustrating the dangers of exiting equities and not reentering.

However, it must be acknowledged that coronavirus did not start as a financial shock, such as a rapid fall in share prices or a market collapse such as the GFC or tech wreck. This started as a social and health scare and has spread into financial markets, which might limit what history can teach us. As supply chains close and countries shut their borders, the wealth created by globalisation will be compromised, and with it, economic growth and business activity.

Morningstar has prepared a series of slides based on US data which show market recoveries and some basic investing principles, and we have selected the following four highlights.

1. Stock market contractions and expansions



Note: Large stocks are represented by the Ibbotson® Large Company Stock Index. The data assumes reinvestment of all income and does not account for taxes or transaction costs.

The stock market moves in cycles with periods of contraction followed by periods of expansion. There have been eight market downturns in the past 47 years. The regions shaded in orange below highlight a contraction phase of a stock market cycle, and the green regions show an expansion phase. A contraction is defined as a period when the stock market value declines from its peak by 10% or more.

These declines seem to happen at random and last for varying time periods. Expansion measures the recovery of the index from the bottom of a contraction and the subsequent performance of the index until it reaches the next peak level before another 10% decline.

While some periods of decline have been severe, the market has increased over time. For instance, the stock market fell by 14.7% from its peak at month-end May 1990 to its trough in October 1990 but grew by 355.1% from November 1990 to its next peak in June 1998.

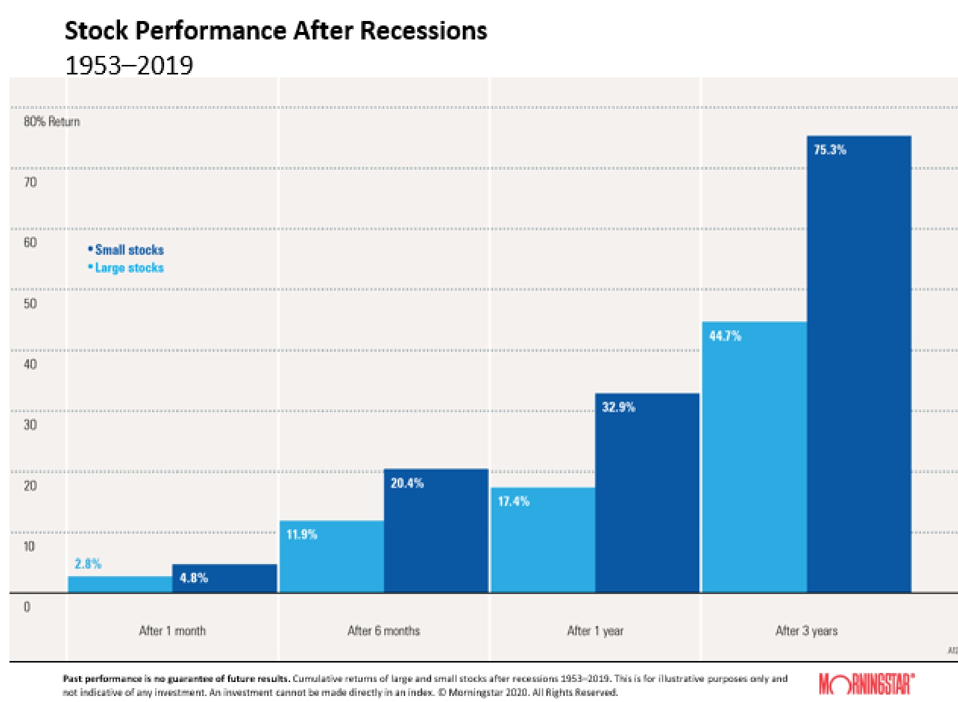
No one can predict market declines with certainty. Investors should have a long-term investment horizon to allow their investment to grow over time but returns from stocks are not guaranteed.

2. Stock performance after recessions

History reveals that small stocks have been among the strongest performers after recessions. Many investors fear the volatility of small stocks, but the potential of this asset class should not be ignored. The chart below shows that, on average, the cumulative returns of small stocks outperformed those of large stocks one month, six months, one year, and three years after the end of a recession.

Diversification does not eliminate the risk of investment losses. Stocks are more volatile than other asset classes. Furthermore, small stocks are more volatile than large stocks and are subject to significant price fluctuations and business risks and are thinly traded.

(On the data, the average cumulative returns are calculated from the end of each of the 10 recessions in U.S. history since 1953. The National Bureau of Economic Research defines a recession as a recurring period of decline in total output, income, employment, and trade, usually lasting from six months to a year and marked by widespread contractions in many sectors of the economy).

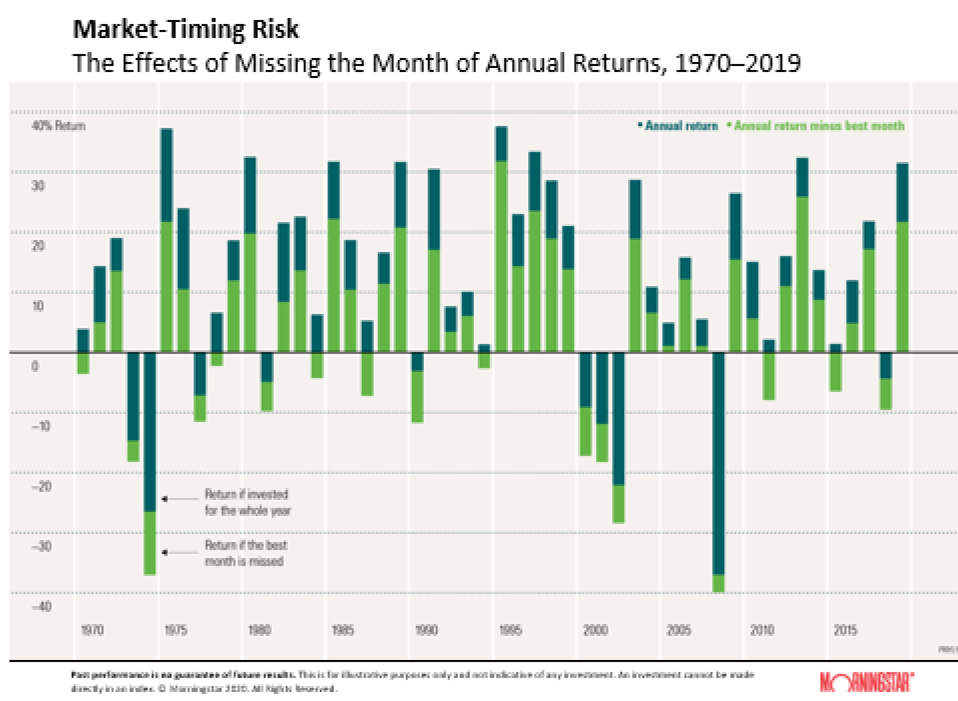


Note: Large stocks are represented by the Ibbotson® Large Company Stock Index. Small stocks are represented by the Ibbotson® Small Company Stock Index.

3. Risk of missing the best month each year

Investors who attempt to time the market run the risk of missing periods of exceptional returns, compromising an otherwise sound investment strategy.

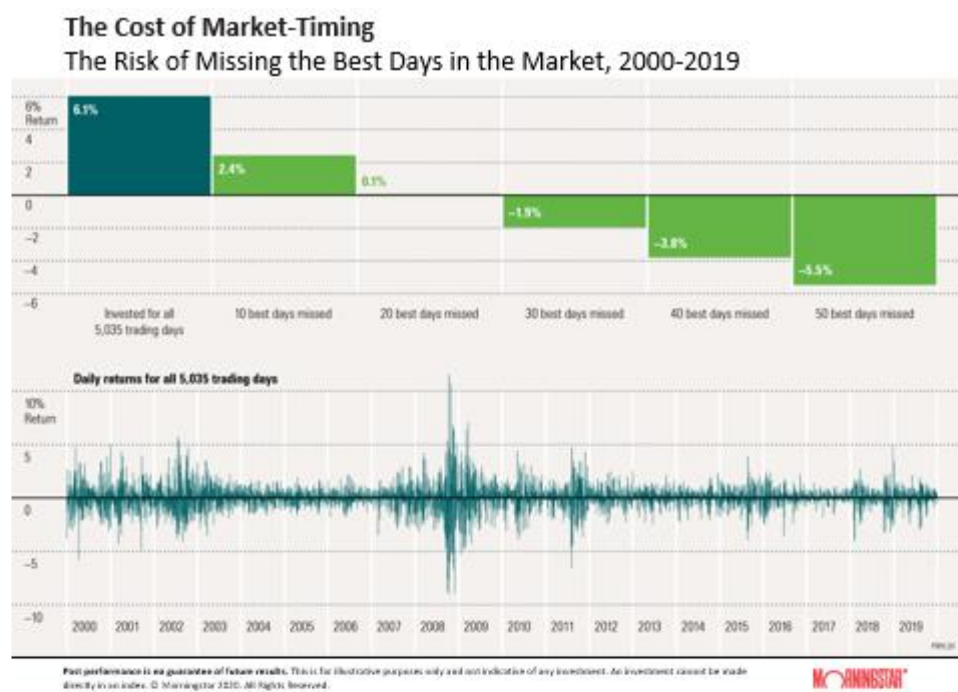
Missing the one best month during a year drastically reduces returns in this chart. During years when returns were already negative, the effect of missing the best month exaggerates the loss for the year. In seven of the 49 years shown -1970, 1978, 1984, 1987, 1994, 2011, and 2015 - otherwise positive returns would have been dragged into negative territory by missing the best month.



4. The cost of market timing from missing the best days

Investors who attempt to time the market run the risk of missing periods of exceptional returns. The following chart illustrates the risk of attempting to time the stock market over the past 20 years by showing returns if investors had missed some of the best days in the market.

The bottom graph illustrates the daily returns for all 5,035 trading days in the sample.



Note: Stocks in this example are represented by the Ibbotson® Large Company Stock Index.

Investors who stayed in the market for all 5,035 trading days achieved a compound annual return of 6.1% from 2000 to 2019. However, that same investment would have returned 2.4% had the investor missed only the 10 best days of stock returns.

Further, missing the 50 best days would have produced a loss of 5.5%. Although the market has exhibited volatility on a daily basis, over the long term, stock investors who stayed the course were rewarded.

The appeal of market-timing is obvious. Investors want to improve portfolio returns by avoiding periods of poor performance. However, timing the market consistently is extremely difficult, and unsuccessful market-timing (the more likely result) can lead to a significant opportunity loss.

The overall lessons are:

- Timing the market is extremely difficult and likely to lead to suboptimal performance
- The safest way for an investor to gain from the long-term benefits of investing in equities is to stay invested over time
- Responding to short-term falls may mean exiting at the wrong time and struggling for a reinvestment point
- Although recessions and market falls can be painful, so is missing the subsequent recovery.

Graham Hand is Managing Editor of Firstlinks. All data is supplied by Morningstar. This article is general information and does not consider the circumstances of any investor.

Unisuper's Pearce suspends stock lending to help stabilise markets

Graham Hand

In a major development arising from the coronavirus-inspired market crash, John Pearce, Chief Investment Officer at the $85 billion Unisuper, told *Firstlinks* that he has suspended its stock lending programme. Pearce said on Friday:

"I suspended our stock lending program today and I'm hoping that other superfunds follow. My position is that we are comfortable with lending stock to promote market efficiency in 'normal' times but these times are clearly abnormal. I think it's the responsibility of funds to do what they can to bring some order back to the market."

Stock lending is an arrangement where a holder of shares provides them to a borrower for a set period of time, for which the lender receives a fee. It allows the borrower to 'short sell' the stock to benefit from price falls.

Hedge funds that manage long/short funds often go 'long' shares they expect to rise in price, and 'short' shares they expect to fall. They must borrow the shares they don't own to facilitate the shorting.

The practice comes under some criticism because it creates selling pressure in shares the traditional investor holds in the expectation the shares will rise in price. However, Pearce is a strong supporter of stock lending in normal market conditions, as it adds to liquidity and generates revenue in the lending programme. For example, Pearce told *The Australian Financial Review* on 25 September 2017:

"In general conditions – and I would call these days general market conditions – the presence of short sellers is extremely important for the liquidity [and] price discovery process in the market. They play a very important role. As a matter of fact, you would have a dysfunctional market if you didn't have short sellers."

Encouraging other super funds to suspend

As Pearce now says, these coronavirus times are far from normal, and he sees the suspension as helping some order to return to the market. It discourages short-side activity of hedge funds in particular selling to push the market down at such a vulnerable time.

It is known that many of the major super funds, such as AustralianSuper, QSuper and Hostplus participate in lending programmes. If Pearce is successful in gaining widespread support, a major source of access to shares will be withdrawn. He added:

"We are only one fund and the efficacy of our actions will depend on how many other funds follow a similar path. Of course, we are not privy to the thinking of other funds who lend their stock."

This table from the Association of Superannuation Funds of Australia (ASFA) shows that of the almost $3 trillion in super, industry funds hold the largest asset segment, at $771 billion in December 2019. Domestic and international equities make up almost 50% of the asset allocation of institutional super funds.

Overview

Type of fund	Total assets ($billion)	No. of funds	No. of accts (June 19)
Corporate	61	18	0.3 million
Industry	771	37	11.3 million
Public sector	685	37	3.6 million
Retail	639	112	11.1 million
Funds with less than 5 members	742	595,923	1.1 million
Balance of statutory funds	55		
Total	**2,952**		**27.5 million**

Source: APRA Statistics – December quarter 2019 and APRA annual statistics for no. of accounts

Major Unisuper holdings

Pearce is not shy to take large positions in Australian listed companies. Unisuper's holdings of companies on the ASX have traditionally been available to prime brokers which specialise in stock lending, and here are their Top 10 positions on the ASX:

1. Transurban Group
2. Sydney Airport
3. ASX
4. APA
5. Scentre Group
6. Woolworths
7. GPT
8. BHP
9. Commonwealth Bank
10. Macquarie Group

The availability and cost of shares for shorting varies, and Pearce's decision will place further pressure on the supply of borrowing capacity.

Member movement to cash stemmed

In his latest video update to Unisuper's 450,000 members, Pearce admits there has been substantial switching from growth options to cash. He made the presentation to ensure members know the implications of their move. He told me:

"The main objective (of the video) was to stem the flow of switching from our members and I'm told by our call centre that it has definitely had an impact."

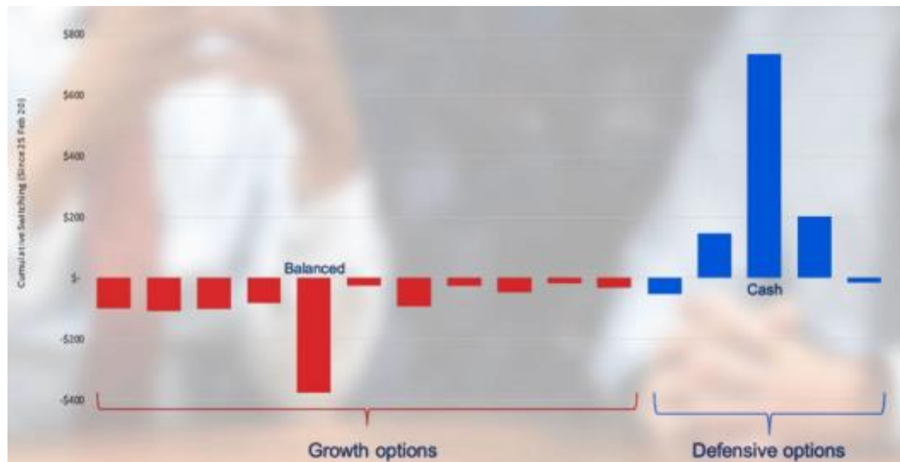
His 15-minute video to Unisuper members is linked below (note it was filmed on 11 March 2020 so some of the numbers are not quite up to date):

Investment market update – March 2020 from UniSuper on Vimeo.

On managing member redemptions, he says:

"On the graph in front of you, we have the switching behaviour of members over the recent past. What have we seen? To date, about $1.3 billion of money flowing out of our growth options into our defensive options. You can see the big ones there - big outflow from the Balanced option, big inflow to the Cash option."

Unisuper member switching (25 February to 10 March 2020)



Pearce then explains Unisuper has not needed to sell stocks to manage these switches:

"A switch out of a growth option is effectively a redemption. A member is effectively asking you for cash. At UniSuper, because of our high levels of liquidity, we don't have to do anything in the market. We can simply fund that through our own cash levels. It's a very fortunate position because it means that we have not had to sell into a distressed market."

Other messages in the video

Pearce argues that accumulation members with a long time before they retire have nothing to worry about in the latest market fall.

Some notable statements include:

"We also have to bear in mind that we've had 10 consecutive positive years. So it's almost the correction that we had to have."

"So, despite the magnitude of the fall that we're seeing, given the diversification of the Balanced option, we're still looking at a flattish result for the financial year. But who knows what's going to happen over the next few months."

"The market is now pricing in a pretty severe recession and a long recession. But that's not the experience of previous types of epidemics or pandemics."

"I think there are two pre-conditions that have to be met to see a turning point. The first one is that we have to see evidence of market capitulation. That is, those investors that have borrowed too much, those investors that have to hedge portfolios, the program traders, and people who are generally worried for their own health and are panicking out of things. I think we've seen evidence that that condition has been satisfied. The second condition, of course, and most importantly, we have to go past the point of peak infections."

The concluding advice to members

Pearce's final message to his members makes a distinction between accumulation and retirement:

*"**Accumulation members** with a long time before they retire—this is absolutely nothing to worry about. In fact, in a paradoxical sort of way, we've got to welcome these corrections. Because what you're doing is you're effectively buying assets at cheaper prices. And the last thing an accumulation member needs is to keep on buying assets at higher and higher prices."*

*"But what about **retirees or pre-retirees**? … Our Balanced option post the GFC took about three years to recover all of its losses. It recovered 50% of its losses in as low as seven months. So when you think about*

yourself as a retiree, you're obviously not having to sell everything to fund your lifestyle, it's usually a very small component. As a diversified portfolio, we expect a reasonably quick recovery as well. So I think that's reassuring."

Graham Hand is Managing Editor of Firstlinks. The video and content are reproduced with permission. The web channel is provided by UniSuper Management Pty Ltd. Trustee: UniSuper Limited. This article is general information and does not consider the circumstances of any investor.

Vivek Prabhu on managing bonds in changing times

Graham Hand

Vivek Prabhu is Head of Fixed Income at Perpetual Investments and Portfolio Manager of Perpetual's Diversified Income Fund and Ethical SRI Credit Fund. This interview took place in mid-February 2020 before the full implications of coronavirus were known.

GH. Fixed interest and high-yield trusts have attracted billions of dollars of retail money in the last two years. What are the dangers an investor should watch in that sector?

VP: Obviously, the interest in high-yield trusts is driven by cash and term deposit rates paying less than 1%. The key risk factor in these products is whether they're concentrated in one sector. In credit markets, you're paid a premium to cover for default risk. It's a highly asymmetric risk profile. You receive regular and frequent small returns from interest coupons, but if the issuer defaults, you're exposed to potentially losing all your capital. It makes diversification really important, not only by company but also sector.

GH: What's a sector where some listed trusts are not diversified enough?

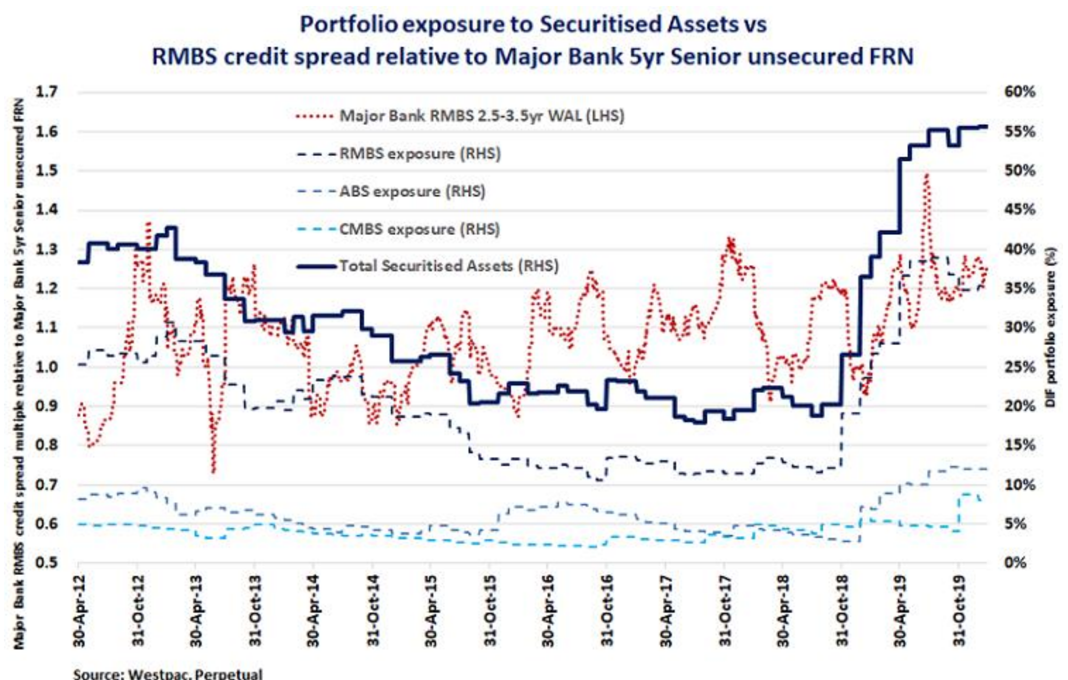
VP: For example, property construction and property development. Some trusts are offering over 5% but concentrated in a risky sector.

GH: Indeed, any retail investor who owned bonds issued by Axcesstoday which defaulted recently now knows that even if they held another nine bonds from other companies, that's not enough for portfolio diversification.

VP: Yes, there are not many free lunches in investing, but diversification is definitely one.

GH: Most asset classes have done well in the last few years. Would you identify anywhere in the credit markets that you think is either cheap or expensive at the moment?

VP: There are some good opportunities in RMBS (residential mortgage-backed securities). In the chart below, using the left-hand axis, the red dotted line shows the ratio of credit spreads on RMBS relative to senior major bank issues. RMBS gives a good pickup. Senior unsecured major bank paper is rated AA-, and there are only a handful of banks around the world which carry a AA rating, and Australia has four of them.



GH: Make sure I understand this chart. A multiple of 1.0 means senior unsecured bank paper trades at the same margin as a major bank RMBS, right?

VP: Yes. At the moment, prime RMBS earns a credit premium of around 100bp (1%) compared to senior major bank credit premiums in the low 70 basis point area (0.7%), but unlike the bank paper, RMBS is secured by the underlying mortgages as collateral. And so the RMBS gets a AAA rating. The benefit of the RMBS structures is that as homeowners repay the principal and interest on their mortgages, the bondholder receives some of the principal back.

It's very different to a corporate or bank bond, where the principal is repaid on maturity. It greatly reduces refinance risk because something is repaid monthly or quarterly. So not only is it higher rated and secured against collateral, you're also getting your principal back and a higher return.

GH: Yes, I personally own some RMBS and the regular cash flow is much greater than from a bond. You just have to record that the principal is no longer 100 on maturity.

VP: Yes, and the underlying risks in RMBS are similar to banks since residential mortgages make up over 60% of bank assets, plus with RMBS the underlying assets are in a more robust structure.

In the chart above, the dark blue line measured on the right-hand axis shows the percentage of my portfolio in all securitised assets and it's over half, currently 55%, which is a record high in the 15-year history of the fund. It's been as low as 20% when the relative credit spread was not as attractive. Since the end of 2018, I've been derisking my portfolio into quality securitised assets. The move up to 55% has been in lockstep with improving valuations as well.

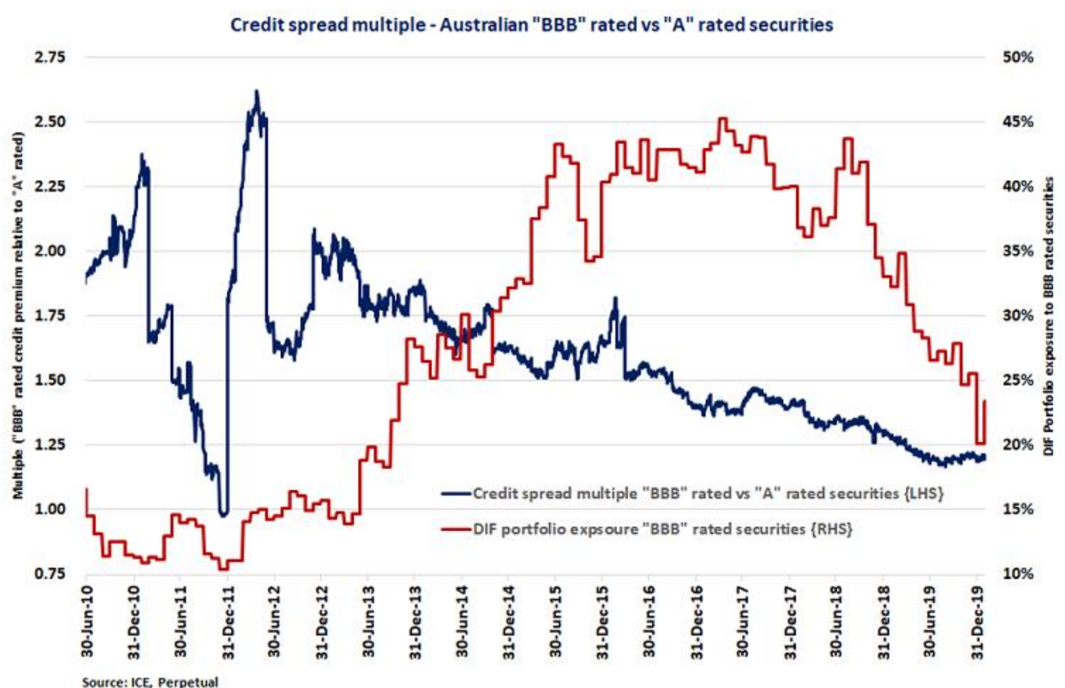
GH: Are you buying the RMBS AAA class or also lower down the credit spectrum?

VP: Predominantly I'm in AAA but I am permitted to buy across the capital structure in RMBS and bank paper. Where I have reduced my exposure to fund the buying of AAA is by selling the BBB-rated securities. Look at this graph below which shows BBB credit spreads versus single A spreads. At the end of 2011, I had a low exposure to BBB (the red line below based on the right-hand axis), only about 10% of my portfolio. At that time, a BBB spread was equal to a single A spread (the multiple in the blue line measured on the left-hand axis).

GH: Again, a multiple of 1.0 means the BBB and A traded at the same margin, the blue line?

VP: Yes. At a multiple of 1.0, you're getting paid the same credit spread on A rated securities as you were on more risky BBB rated securities. The multiple has averaged 1.6 times over the last decade, and you can see it's been as high as 2.5 times.

Then in early 2012, BBB credit spreads blew out and so I started to add BBB exposure. Now, since that period, my exposure has gradually drifted down. My BBB exposure peaked around mid-2015 when BBB spreads were close to their long-term average and I held this overweight position until late 2018. Not only was the multiple attractive, but it was falling consistently, which benefitted portfolio performance.



But as I mentioned, towards the end of 2018, in August, September, I began to derisk in the portfolio. Part of the thinking was that central banks were aiming to withdraw liquidity from the financial system for the first time since the GFC.

GH: That's the late 2018 fall in the equity markets as well.

VP: Correct, a big risk-off time across all markets. My derisking moved into AAA senior secured amortising RMBS. But as we all know, in 2019, central banks did a big pivot, not withdrawing liquidity. And so the underlying catalyst for derisking changed, but notwithstanding I maintained the exposure to senior AAA asset backed and RMBS securities because the valuations were attractive.

GH: How much money is in the Perpetual Diversified Income Fund?

VP: Across the strategy, we have about $2.2 billion, and this Fund holds about $1.25 billion.

Going back to your first question on the fixed income risks, a lot of people who've chosen to maintain return (rather than accept lower returns for a given level of risk) have been chasing high yield or unrated bonds, but also pushing down margins at the bottom of investment grade (BBB). So I've been reallocating to the top of the credit spectrum.

GH: Last year, the Diversified Income Fund earned about 4% and the most recent running yield is 2.48%. Have the gains already been made in this sector?

VP: Well, if we look at the returns of that Fund over the long term, it has generated about two-thirds of its alpha from the running yield, or the credit premium, currently about 170bp above the bank bill rate. Plus we generate about one-third, or another 90bp, from active management strategies. So all other things being equal we could generate a gross return of 3.5%.

GH: Perpetual also has a listed credit fund, the Perpetual Credit Income Trust (ASX:PCI). What's the relationship between that and this?

VP: Not a direct relationship in that PCI has a less-constrained credit strategy, whereas the Diversified Income Fund is predominantly investment grade with a target return of BBR plus 200bp (2%). The Diversified Income Fund requires a minimum 75% of the portfolio in investment grade securities of BBB or above. It's currently 91.7%. The PCI requires a minimum 30% in investment grade.

GH: How much change in credit spreads can the Diversified Income Fund tolerate before it starts to make losses?

VP: The portfolio has a maximum weighted average maturity limit the five years. Currently, the weighted average maturity is 2.8 years. And with a credit spread of 170 basis points (1.7%) above BBR, if you divide 170 by 2.8 years that's your 12-month break-even point on credit spreads. So we can afford spreads to widen by 60bp (0.6%) before we erode the credit yield premium. Looking at the total portfolio yield of 2.48%, credit spreads could widen by 90bp before you erode portfolio returns. And because it's floating rate, from an interest rate point of view, there is no meaningful exposure to capital volatility as interest rates go up and down because it simply affects the income generated from the portfolio, not the capital value.

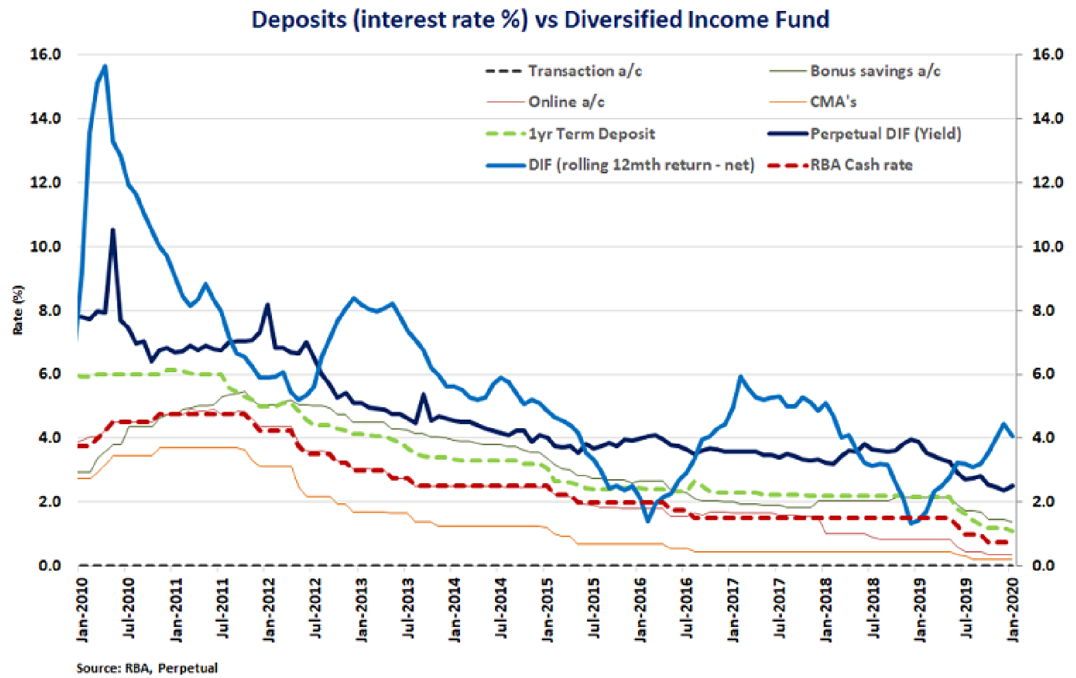
GH: In SMSFs, there is still a large allocation to term deposits. Why have term deposit rates fallen so much recently, further even than cash rates?

VP: Here's a chart of cash rates, term deposit rates and the return on the Diversified Income Fund (light blue and dark blue lines). Cash is currently at 75 basis points (0.75%) and was subsequently cut to 50 basis points (0.5%) in March.

The green line dotted line is the one-year term deposit rate, which fell substantially recently. Part of the reason is that as we approach the lower bound of interest rates close to zero, banks are unable to pass on those rate falls to some of their deposit accounts which are already close to zero. It leaves the TDs to do the heavy lifting for the banks' net interest margin. The average today is about 1.2% for 12 months (which would be even lower following the 25 basis point RBA rate cut in March), so depositors are not even maintaining a real return above inflation (1.8%).

That's where a fund like the Diversified Income Fund plays a role. The dark blue line above shows the running yield of the portfolio, currently 2.5%. But 4% is the actual net return on the portfolio with value added by active management over the year.

GH: And on a mark-to-market basis, it looks like a loss in November and December 2018.



VP: Yes, from the widening credit spreads already discussed, we had a negative return in those two months. But the light blue line is a rolling 12-month net return, and over the last 10 years, the return has been below TDs in only 10 months in the period since 2010. That's 115 months of history and over 90% of the time, the Diversified Income Fund has delivered a rolling 12-month return better than term deposits.

GH: Is that after fees, and what are the fees?

VP: 70 basis points (0.7%) if someone comes in through Perpetual. Unlike term deposits, this Fund also offers daily liquidity, plus a positive real return.

Our active approach to credit investing is based on relative valuation, which is why we do this sort of analysis. Studying different credit ratings bands or different parts of the capital structure, allows us to identify where the best value is and where the risks are.

Graham Hand is Managing Editor of Firstlinks, of which [Perpetual Investments] is a sponsor. This article is general information and does not consider the circumstances of any investor. The margins and analysis are as at mid-February 2020, and since the interview, markets have experienced significant changes. Nevertheless, the general lessons in managing a fixed interest portfolio remain valid.

For more articles and papers from Perpetual, please click here.

Minimum drawdown reductions needed for retirees

Olivia Long

Without a doubt we are in very scary times. I was at the airport yesterday and it was eerily empty. Shops and food outlets were fully stocked and waiting for customers and there were none. Cabs lined up at the taxi rank, again no customers. At least five people I spoke to in one day didn't know how they were going to make their next mortgage payment.

The Federal Government's stimulus package is generous, without doubt, but they've forgotten about one important segment of our community: the self-funded retiree drawing a superannuation pension.

Once a super fund member moves into pension mode, they are required to draw a minimum amount out of the pension account each year which is a percentage of a member's pension balance based on their age. This forces people to reduce their superannuation balances and dispose of investments to satisfy minimum drawdown requirements, unless large cash balances are held.

Reduced drawdowns during the GFC

During the GFC in Australia (2007-2009), the Government made the welcome decision to decrease the minimum pension withdrawal requirement for retirees in pension mode. This measure of relief was then extended over several financial years. Minimum pension payment amounts were halved for certain pensions and annuities for the 2008-09, 2009-10 and 2010-11 years. It was then increased for the 2011-12 and 2012-13 years but did not return to the pre-GFC levels until 2013-14, as shown below.

Percentage of account balance factors, by age

Age	2007–08	2008–09, 2009–10, 2010–11	2011–12, 2012–13	2013–14 onwards
Under 65	4.0%	2.0%	3.0%	4.0%
65–74	5.0%	2.5%	3.75%	5.0%
75–79	6.0%	3.0%	4.5%	6.0%
80–84	7.0%	3.5%	5.25%	7.0%
85–89	9.0%	4.5%	6.75%	9.0%
90–94	11.0%	5.5%	8.25%	11.0%
95 or more	14.0%	7.0%	10.5%	14.0%

Source: ATO Pension Standards

As the table indicates, pensioners over the age of 80 must drawdown a substantial 7% of their balance, rising to 14% for the over-95s. This is a substantial amount in a market where prices have collapsed over 30% in the space of a few weeks.

Many pensioners who don't need to live off their pension savings wait until the end of the financial year to make the draw-down from their fund. But this year, following the severe impact of coronavirus, a significant number of Australian pensioners will be required to liquidate investments to satisfy the pension minimum. In many cases, the values of shares or investments have plummeted. How is this fair?

I'm delighted to see the government making stimulus handouts but let's extend the focus to the superannuation sector.

I'd like to see the Government repeat the precedent set during the previous GFC and decrease minimum pension requirements. Give pensioners the opportunity to sit on their investments until market conditions (eventually) recover.

Other items for retirees to consider

1. Postpone drawdowns

I'd suggest that anybody that doesn't need to draw down their pension consider holding off to see if the Government announces any relief.

2. Pension stop and restart

People with pensions that want to preserve their money in the super environment may consider commuting their existing pension and commencing a new one with a lower balance. If their investment value has decreased, it will mean that the pension value is lower. The percentage they will then need to drawdown will then be lower.

3. Arrange an Enduring Power of Attorney

An Enduring Power of Attorney (EPOA) is a legal agreement that enables you to appoint another person or people to make financial, personal/medical or property decisions on your behalf in the event you are unable to act. It's important to note a Power of Attorney is effective if you have mental capacity. If in any event you lose mental capacity, a Power of Attorney ceases to operate.

As we cannot foresee our future, all SMSF trustees in particular, should have an EPOA in place for their SMSF operations as once a trustee loses capacity to act an EPOA cannot be put in place.

4. Check your trust deed is up-to-date

My final tip for SMSF Trustees is to ensure your trust deed is up to date! If it doesn't allow you to utilise any of the strategies in this article, you can't do it!

Olivia Long is Managing Director, SMSF at Prime Financial Group. This article is general information and does not consider the circumstances of any individual.

Morningstar: Douglass interview, 29 top picks, corona research

Leisa Bell

Hamish Douglass exclusive interview

29 quality stocks at great prices

By Mark LaMonica, Individual Investor Product Manager, Morningstar

Great companies carve out a solid competitive advantage and as coronavirus rattles markets, many such names are trading at hefty discounts. Morningstar's list of 5-star rated stocks has expanded rapidly as prices fall and now includes 29 companies.

Market shocks can be cause for anxiety but if investors have the capital, such shocks can be an opportunity to pick up the stocks of great companies at discounts.

Investors define 'great' in different ways. From Morningstar's perspective, great companies are those that have carved out solid (and in some cases growing) competitive advantages that will allow them to thrive for years to come--in Morningstar parlance, they've built economic moats. Such companies are typically led by adept managers who have a record of allocating capital in ways that add value.

To find such exceptional firms, we looked for the following three qualities.

1. Economic moat: First, they need to boast wide or narrow Morningstar Economic Moat Ratings. In other words, these companies have strong competitive positions.

2. Exemplary stewardship: Second, they must earn our top Morningstar Stewardship Rating—exemplary or standard. In other words, these companies are led by exceptional corporate managers who have a proven record of making investments and acquisitions supporting the competitive advantages and core businesses of their companies--and they won't pay an arm and a leg to do so. They'll divest underperforming or noncore businesses. They'll find the right balance of investing in the business and returning cash to shareholders via dividends and share repurchases. And they'll assemble a portfolio of attractive operating assets and skilled human capital, and then execute well.

3. Discounted price: And lastly, the stocks of these companies must be trading at a decent discount to our fair value estimates, selling at Morningstar Ratings of 4 or 5 stars at the of writing.

We used the Morningstar Stock Screener to look for these qualities. Only three stocks made the cut. Don't think of this as a list of 'buys' though. Instead, think of it as a collection of names to investigate further. A 5-star rating does not suggest that the stocks won't drop further. The aim is not to pick the bottom, but to highlight to investors that they can pick names up at a discount.

The three companies are:

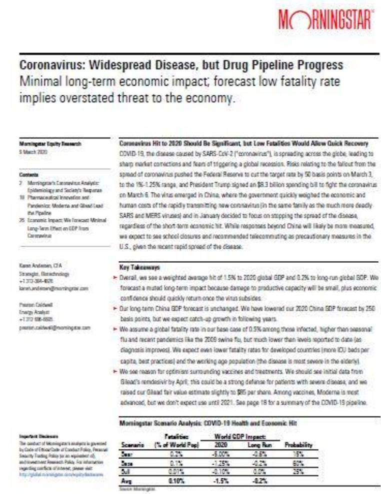
- **Ansell Ltd**: we view Ansell as well-managed and able to deliver a consistent, growing earnings stream
- **Ryman Healthcare Ltd**: We believe Ryman can roughly triple its annual revenue by the end of our 10-year forecast period, as the group expands the number and maturity of villages under its management
- **Macquarie Group Ltd**: Macquarie Group is a successful global asset manager and investment bank. Its main strengths are risk management, business unit interconnectedness and an ability to evolve and adapt to changing market conditions.

Although nobody know when the market will bottom, more companies are offering value than at any time in recent years.

Click here for access to Morningstar Premium for a free four-week trial, including portfolio management services from Sharesight and detailed research on 1600 global stocks as well as 450 ETFs and Funds, including the companies Morningstar currently rates as 5-star investments.

Coronavirus: widespread disease but drug pipeline progress

Morningstar's detailed research on coronavirus concludes there will be minimal long-term economic impact, with forecast low-fatality rates. It implies the threats to the economy are overrated, although please note this paper was first published to US subscribers on 9 March 2020. Click on the image for the full free paper.



MORNINGSTAR

Coronavirus: Widespread Disease, but Drug Pipeline Progress
Minimal long-term economic impact; forecast low fatality rate implies overstated threat to the economy.

Morningstar Equity Research
5 March 2020

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Karen Andersen, CFA
Strategist, Biotechnology
karen.andersen@morningstar.com

Preston Caldwell
Energy Analyst
preston.caldwell@morningstar.com

Coronavirus Hit to 2020 Should Be Significant, but Low Fatalities Would Allow Quick Recovery
COVID-19, the disease caused by SARS-CoV-2 ("coronavirus"), is spreading across the globe, leading to sharp market corrections and fears of triggering a global recession. Risks relating to the fallout from the spread of coronavirus pushed the Federal Reserve to cut the target rate by 50 basis points on March 3, to the 1%-1.25% range, and President Trump signed an $8.3 billion spending bill to fight the coronavirus on March 6. The virus emerged in China, where the government quickly weighed the economic and human costs of the rapidly transmitting new coronavirus (in the same family as the much more deadly SARS and MERS viruses) and in January decided to focus on stopping the spread of the disease, regardless of the short-term economic hit. While responses beyond China will likely be more measured, we expect to see school closures and recommended telecommuting as precautionary measures in the U.S., given the recent rapid spread of the disease.

Key Takeaways
- Overall, we see a weighted average hit of 1.5% to 2020 global GDP and 0.2% to long-run global GDP. We forecast a muted long-term impact because damage to productive capacity will be small, plus economic confidence should quickly return once the virus subsides.
- Our long-term China GDP forecast is unchanged. We have lowered our 2020 China GDP forecast by 250 basis points, but we expect catch-up growth in following years.
- We assume a global fatality rate in our base case of 0.5% among those infected, higher than seasonal flu and recent pandemics like the 2009 swine flu, but much lower than levels reported to date (as diagnosis improves). We expect even lower fatality rates for developed countries (more ICU beds per capita, best practices) and the working age population (the disease is most severe in the elderly).
- We see reason for optimism surrounding vaccines and treatments. We should see initial data from Gilead's remdesivir by April; this could be a strong defense for patients with severe disease, and we raised our Gilead fair value estimate slightly to $85 per share. Among vaccines, Moderna is most advanced, but we don't expect use until 2021. See page 18 for a summary of the COVID-19 pipeline.

Morningstar Scenario Analysis: COVID-19 Health and Economic Hit

Scenario	Fatalities (% of World Pop)	World GDP Impact: 2020	World GDP Impact: Long Run	Probability
Bear	0.2%	-5.00%	-0.6%	15%
Base	0.1%	-1.25%	-0.2%	60%
Bull	0.01%	-0.10%	0.0%	25%
Avg	**0.10%**	**-1.5%**	**-0.2%**	

Source: Morningstar

Important Disclosure

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