Firstlinks
a Morningstar company

Edition 357, 15 May 2020

Contents

Howard Marks on uncertainty, forecasting and doubt *Graham Hand*

Capital retention will shake dividends in 2020 *David Walsh*

Don't invest just for yield: the smarter way to generate income *Rudi Filapek-Vandyck*

How do you pick the right global stocks during Covid-19? *Garry Laurence*

Bank reporting season scorecard May 2020 *Hugh Dive*

How retail investors are responding to a bear market *Gemma Dale*

Lessons in oil ETFs, futures and negative prices *Alistair Mills*

It's like opening your best champagne at 5am *Angus Coote*

Corporate bonds: why now and in what structure? *Brad Dunn*

Editorial

There is a remarkable concentration similarity between the Australian and US stock markets that has delivered poor results for Australians and great results for Americans (and global investors). As the share prices of five Australian banks have tanked, the prices of five US tech companies have surged. Each group now represents 20% of their respective indexes, but the journey has been a disaster for many Australians.

Despite the rapid fall in market value of the Big Five Australian banks, they still comprise 20% of the S&P/ASX200 Index as at 13 May 2020, down from about 30% a few years ago.

Bank	Weighting in ASX200	Price fall in last 12 mths
CBA	7.4%	-18%
Westpac	4.0%	-44%
National Bank	3.4%	-37%
ANZ Bank	3.3%	-41%
Macquarie Bank	2.0%	-11%
TOTAL	**20.1%**	

In contrast, the amazing success of **Microsoft, Apple, Amazon, Alphabet and Facebook** to become the largest five companies in the US now means they also comprise 20% of the S&P500. Where traditionally the US market was admired for its diversity, an index investment now has a solid exposure to only five companies (chart below is as at 23 April 2020).

Source: Compustat, Goldman Sachs Global Investment Research

The 12-month price changes to 12 May are Microsoft +44%, Apple +58%, Amazon +25%, Alphabet +18% and Facebook +12%. Australian retail investors who have held our banks for their high yields are now suffering as dividends are savaged. In investing, what matters is the future, but can anyone make a convincing case that the prospects of our banks are better than the five US companies? Boosted by these tech giants, the S&P500 has fallen half as much as the S&P/ASX200 in calendar 2020. Thank goodness for CSL.

We start with **Howard Marks** and his latest update on uncertainty and forecasting during a crisis. For those of you struggling with whether we are in a bear or bull market, he explains why nobody really knows meaningful information about the crisis.

David Walsh shows most of the return from local stocks has traditionally come from dividends, and companies preserving capital will have major ramifications for our market. Then **Rudi Filapek-Vandyck** says this dividend income focus and reliance was always a poor strategy, as investors should have looked more to share price growth for reliable income.

In his half-yearly Bank Scorecard Report, **Hugh Dive** summarises the dramatic changes hitting banks, especially loan provisions, and he sees much in their financial accounts which is guesswork at this stage.

Garry Laurence explains how varying performance comes from different sector exposure, and how he is finding global opportunities after the recent sell offs.

It's not all bad news for retail investors. **Gemma Dale** goes inside the client dealing of nabtrade and suggests many investors had held cash waiting for these better buying opportunities.

While we are all hearing the latest catch phrase, 'the market is not the economy', **Angus Coote** says this as a poor explanation for the failure of risk markets (equities and credit) to realise how bad the coming corporate results will be. Crucially, liquidity cannot fix insolvency.

While also concerned with lesser-quality credits, **Brad Dunn** is more optimistic that there is a role for investment grade paper in a defensive asset allocation.

The remarkable events in the oil market are explored by **Alistair Mills** who shows how oil ETFs are managed and how investors can take a view on energy assets. It's better for most people to invest in commodities using funds rather than futures, as this extraordinary (unrelated) story shows.

This week's White Paper from **Fidelity International** looks at the new economic order likely after Covid-19, and the opportunities that will come from the dislocation.

> Syed Shah usually buys and sells stocks and currencies through his Interactive Brokers account, but he couldn't resist trying his hand at some oil trading on April 20, the day prices plunged below zero for the first time ever. The day trader, working from his house in a Toronto suburb, figured he couldn't lose as he spent $2,400 snapping up crude at $3.30 a barrel, and then 50 cents. Then came what looked like the deal of a lifetime: buying 212 futures contracts on West Texas Intermediate for an astonishing penny each.
>
> What he didn't know was oil's first trip into negative pricing had broken Interactive Brokers Group Inc. Its software couldn't cope with that pesky minus sign, even though it was always technically possible -- though this was an outlandish idea before the pandemic -- for the crude market to go upside down. Crude was actually around negative $3.70 a barrel when Shah's screen had it at 1 cent. Interactive Brokers never displayed a subzero price to him as oil kept diving to end the day at minus $37.63 a barrel.
>
> At midnight, Shah got the devastating news: he owed Interactive Brokers $9 million. He'd started the day with $77,000 in his account.
>
> *Source: Bloomberg*

Howard Marks on uncertainty, forecasting and doubt

Graham Hand

Howard Marks is Co-Chairman of Oaktree Capital Management, and we have featured several extracts from his memos to clients to help understand how a global leader is investing during a pandemic.

This is a summary of his latest memo dated 11 May 2020, titled simply 'Uncertainty'.

Like many of us, Howard Marks has been at home for two months. It has given him plenty of extra time to be philosophical about markets, and it is reflected in a memo which poses more questions than answers.

He admits with some frustration that many economic forecasts vary significantly when presented with exactly the same facts and assumptions. He quotes economics consultant Neil Irwin:

"The world economy is an infinitely complicated web of interconnections. We each have a series of direct economic interrelationships we can see: the stores we buy from, the employer that pays our salary, the bank that gives us a home loan. But once you get two or three levels out, it's really impossible to know with any confidence how those connections work."

And Ian E Wilson, former Chairman of GE:

"No amount of sophistication is going to allay the fact that all of your knowledge is about the past and all your decisions are about the future."

We all have in-built biases

Marks acknowledges there are some things we know for certain about the future, such as the trend to shopping online, but since everyone is aware of the change, it does not help in the pursuit of extra returns. Most forecasts are mere extrapolations of recent trends and are already built into prices.

The conundrum is that while forecasts are unlikely to create above-average returns, all investors like to frame their buying and selling into some macro picture of the future. The investment industry thrives on making a vast amount of forecasts which clients devour.

Marks says our views of the future reflect our biases:

"One of the biggest mistakes an investor can make is ignoring or denying his or her biases. If there are influences that make our processes less than objective, we should face up to this fact in order to avoid being held captive by them. Our biases may be insidious, but they are highly influential."

We should all reflect on how we consume news and absorb gleefully the views that confirm our biases. We all seek confirmation biases. Marks quotes Shahram Heshmat in *Psychology Today*:

"Once we have formed a view, we embrace information that confirms that view while ignoring, or rejecting, information that casts doubt on it. Confirmation bias suggests that we don't perceive circumstances objectively. We pick out those bits of data that make us feel good because they confirm our prejudices. Thus, we may become prisoners of our assumptions."

The best example in global news is the Murdoch empire including Fox News. Those who embrace its right-wing views feel affirmed by the authority of its presenters, including in Australia, Andrew Bolt, Alan Jones, Peta Credlin and Chris Kenny. They often have strong opinions on climate change, Donald Trump and nationalism that their audience loves. Their programs are watched by people who want their views affirmed, and generally ignored by people who disagree with them. Most people are also drawn to reading one newspaper, say *The Australian* versus *The Sydney Morning Herald*, and the political and social emphasis in the respective letters to the editor clearly reflect this.

So it's difficult to be objective and open to opinions from all perspectives.

Marks goes as far as saying that excessive trust in forecasting is dangerous. We need to admit to uncertainty, investigate before we invest and proceed with caution. At the same time, to outperform the market requires a departure from the crowd. Great investments begin with discomfort, since the market is usually avoiding them. It also takes resolve and confidence to hold a position when it declines, until it eventually becomes a winner. Or not, as investors must also decide when they have made a mistake.

Intellectual humility

Marks dwells in this memo on the concept of 'intellectual humility' and its impact on decision-making abilities in politics, health and elsewhere. It is similar to open-mindedness, where people with strong beliefs recognise their fallability and are willing to be proven wrong.

He says people with a view of the future should also assign a probability that their opinion will be correct. Not all predictions are equally likely and should not be relied upon to the same extent. Anyone who is sure about what will happen is probably deceiving themselves. He adds:

"To put it simply, intellectual humility means saying 'I'm not sure, 'the other person could be right', or even 'I might be wrong'. I think it's an essential trait for investors; I know it is in the people I like to associate with."

In fact, experts should not only know about their subject, but the limits of their knowledge and expertise. In the pandemic, the experts are not sure because they know it is reasonable to disagree on the best policies to pursue. We should be wary of supreme confidence. As medical statistician, Robert Grant, said:

"I've studied this stuff at university, done data analysis for decades, written several NHS guidelines (including one for an infectious disease), and taught it to health professionals. That's why you don't see me making any coronavirus forecasts."

Amusingly, Marks writes that incompetent people have a double disadvantage, not only because they are incompetent, but they are probably unaware of it. How many amateur epidemiologists have surfaced in the past couple of months? True experts should express themselves by acknowledging the limits of their knowledge.

And so Marks concludes (to quote him):

- The world is more uncertain today than at any other time in our lifetimes.
- Few people know what the future holds much better than others.
- Investing deals entirely with the future, meaning investors can't avoid making decisions about it.
- Confidence is indispensable in investing but too much of it can be lethal.
- The bigger the topic (world, economy, markets, currencies and rates) the less possible it is to achieve superior knowledge.
- Our decisions about smaller things (companies, industries and securities) have to be conditioned on assumptions regarding the bigger things, so they, too, are uncertain.
- The ability to deal intelligently with uncertainty is one of the most important skills.
- We should understand the limitations on our foresight and whether a given forecast is more or less dependable than most.

Graham Hand in Managing Editor of Firstlinks. Howard Marks has written regular memos to his clients and they can all be accessed here.

Capital retention will shake dividends in 2020

David Walsh

Moves by regulators to encourage financial institutions to retain capital, coupled with lower earnings across most sectors, may have far-reaching implications for investors, companies and investment managers this year and beyond.

Realindex is a systematic equities manager and we used a range of data points to look at the impact of several themes affecting dividends in the current market. In particular, we considered the way central banks and regulators around the world have initiated policies in an attempt to constrain dividend payments by financial institutions.

Regulators take a proactive stance

The European Central Bank asked banks not to pay dividends for the financial years 2019 and 2020, nor buy back shares during COVID-19 pandemic. This appears to cover all EU banks (117 of them at last count)

While the US Federal Reserve has not specifically asked banks and financial institutions to suspend or reduce dividends, it has barred dividend payments by any firms that have received funds from the CARES Act (the US coronavirus aid bill). It is also providing facilities to support the flow of credit, which include a gradual phase-in of dividend restrictions if a bank's capital buffer declines.

In the UK, the Prudential Regulation Authority released a supervisory statement (on 31 March 2020) that banks should not pay dividends, buybacks or other distributions, such as cash bonuses to staff, until the end of 2020, and to cancel any outstanding 2019 dividends.

Closer to home, APRA released a guidance note on 7 April 2020 recommending banks and insurers defer, reduce or cancel dividends, without specifying a time period. ANZ, Westpac and Macquarie's decision to defer, and NAB's move to reduce, interim dividends suggest institutions are complying.

It is worth noting that there has been a somewhat limited response from emerging market regulators directly on this issue. The largest emerging market economies of China, India, Brazil and Russia (the so-called BRIC economies) have been slow to formally request financial institutions to constrain or cease dividend payments.

Flow-on effects to the market

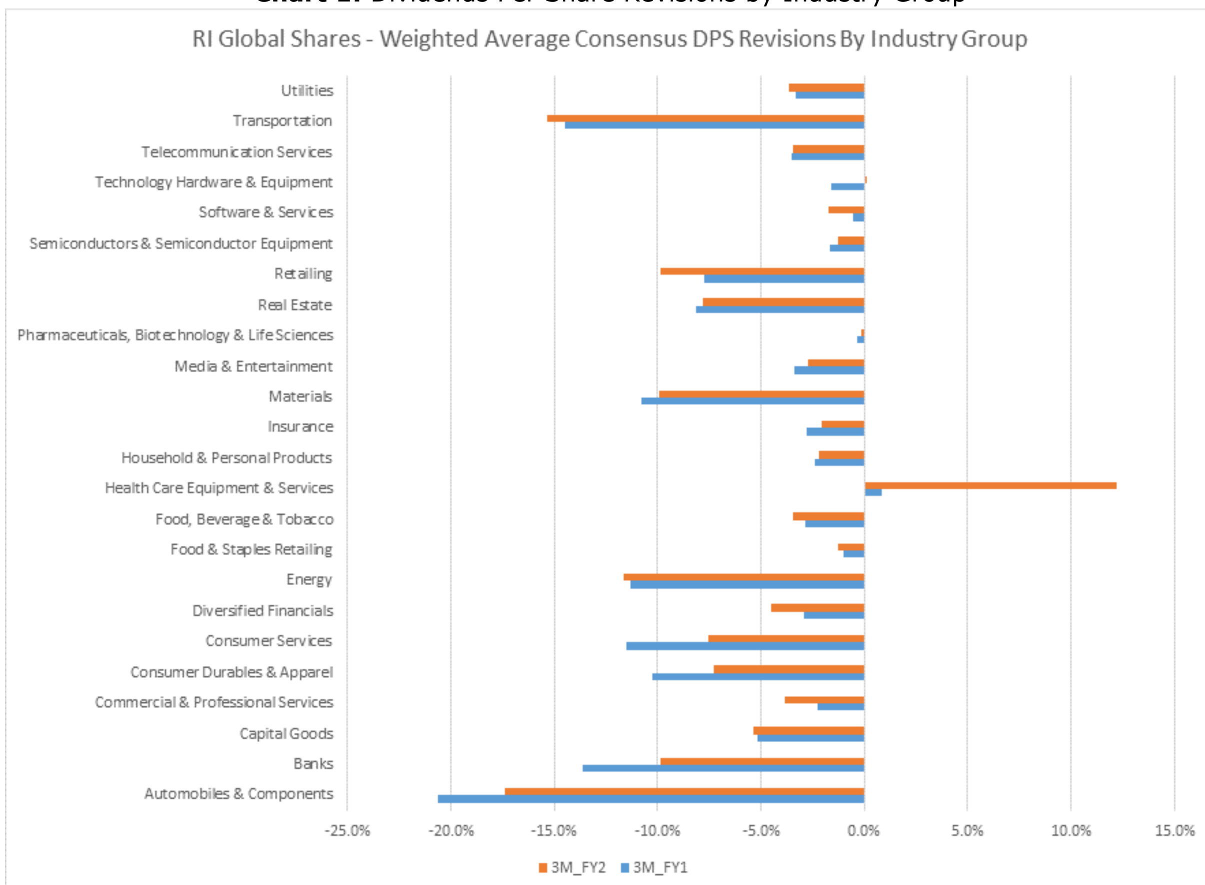
This could have a notable impact on markets. Realindex's modeling suggests that historically, 60% of the ASX200 benchmark's total return is due to dividends and for Financials, that rises to more than 70% of the total return (including dividends and buybacks). Moves to limit dividends could both reduce investor incomes and affect valuations.

We know that dividend payments are an important component of returns to shareholders, especially retirees. They are also the chief source of franking credits in Australia, and so they are a key part of the attraction for investors. The potential enforced cancellation of dividends will likely move capital to companies that *do* pay dividends. This could drive up the prices of stocks such as Telstra, Wesfarmers or Coles.

Such forced reductions are likely to come at the same time as lower earnings in other sectors put dividends at risk. Modeling of the Realindex portfolio shows that at the end of April 2020, the weighted average consensus of Dividend per Shares downgrades was -25% for Australia and -17.3% globally, with downward revisions led by energy, transport and banks.

The extent of dividend cancellation or withdrawal is not clear yet, but many dividend forecast downgrades have already appeared in analyst forecasts and there are some sectors that look quite at-risk (see Chart 1).

Chart 1: Dividends Per Share Revisions by Industry Group



Source: Realindex, Factset as at 31 March 2020

Impact on Australian portfolios

Realindex's modeling suggests dividends in Australia will be more severely impacted from COVID-19 than other developed markets.

A decline in aggregate demand from China is likely to affect earnings in the Materials sector, at least in the short term. Real Estate, especially retail, is at risk of distress. Additionally, the low oil price will test the

resilience of many energy companies, and we assume that this will lead to dividends being at risk, especially for global portfolios.

Beyond providing income, dividends can also play a key role in influencing corporate behaviour because they act as a signalling mechanism for firms. Strong, consistent dividend payout ratios and payments are a way for investors to understand the confidence that management has in the business.

In addition, companies that cater to the demands of investors by paying dividends can attract a premium for their shares. Significant changes to this behaviour could see changes in valuations going forward.

A changed dividend landscape could affect investment managers too, given that many investment processes rely on dividends as a key measure of company performance. This could be through core company metrics, or more widely through dividend yield and dividend futures. We are in the process of analysing whether we need to amend our normal processes in light of current market conditions, and we expect other managers will be doing the same.

Potential long-term consequences

Overall, the impact of these trends will depend on the length of the crisis. A critical point is that it is not clear how long this change will continue for. If it is a temporary change, many investment processes and market and corporate behaviour will probably not move markedly when averaged over a longer period. However, if this represents a longer-term change or permanent shift, then the implications may be very different. Only time will tell.

David Walsh is Head of Investments at Realindex Investments, a wholly owned investment management subsidiary of First Sentier Investors, a sponsor of Firstlinks. This article is primarily for information. It discusses ideas that are important to the Realindex investment process and clients but may not be implemented in the ways discussed here.

For more articles and papers from First Sentier Investors, please click here.

Don't invest just for yield: the smarter way to generate income

Rudi Filapek-Vandyck

Bad news hits the weakest the hardest.

Australian investors already endured a rather disappointing latter half of 2019 when companies, including banks and resources companies, announced sizeable cuts to dividends.

It shows not all was well even before the Covid-19 pandemic spread across the globe and forced countries into lockdown.

Facing the reality of massive dividend cuts

Now 2020 is shaping up as the worst year on record in Australia as far as corporate profits and shareholder dividends are concerned, in particular hitting those shareholders hard whose strategy is aimed at receiving sustainable income from the share market.

However, the truth is that many of those investors blissfully ignored the very basic number one rule when making investment decisions (to quote Warren Buffett from a long time ago):

1. -Rule number one: never lose money
2. -Rule number two: never forget rule number one

What Buffett tells us all through this seemingly facetious and simplistic two-rule mockery is that successful investing is about ‘managing’ risk, not about ‘taking’ risk or 'ignoring' it.

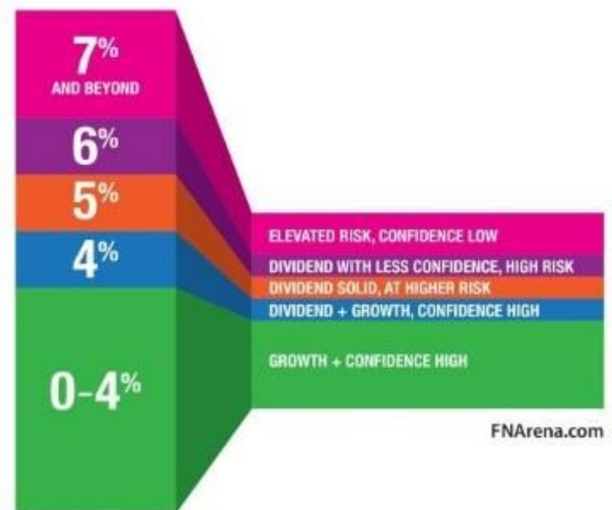
And many Australian investors and their financial advisers have ignored the risk that comes with investing in high-yielding stocks on the share market for far too long.

Rethink a faulty income strategy

Many now facing serious budgeted income shortfall would not necessarily have realised but buying 5% or 6% yielding equities (forward looking) in the share market pre-corona implies a serious step up on the overall risk ladder.

This is because government bonds, theoretically the ultimate low-risk financial instrument available beyond cash under the mattress, are now yielding so little, financial markets have pulled back all yields across instruments and markets accordingly.

Years ago, I illustrated this process through the diagram below (first published in 2015).



The validity of this general assessment of risk as implied by stock market pricing of securities follows through the observation that most cuts in dividends last year and in 2020 are from the higher-yielding cohort on the ASX. Plus most dividend cuts announced tend to be much larger than for lower yielding equities.

Investors would be wise not to underestimate this process of absorbing the fall-out from the lockdowns and the subsequent economic recession still has a lot longer to run. Dividends will still be absent and cut next year and in some cases maybe even in 2022.

Maybe this is as good as any time to pause and reflect on what went wrong and set out on a better strategy for the future. A faulty income strategy starts with the wrong focus.

Step **number one**, for all kinds of investors, no matter experience, age or specific strategies, is to look after your capital.

Step **number two** is to adopt a total return strategy whereby everything is taken into account, including costs, fees and taxes.

Step **number three** is to incorporate potential income.

Too many investors, panicked by the change in the yield and income landscape post 2012, ignored the natural order for setting up a robust investment portfolio and moved straight to step number three. And many an adviser failed to inform or educate their clients otherwise.

Even prior to last year's dividend cuts, and this year's bear market for equities, the failings of strategies with a sole or extreme focus on income 'right now' had already revealed themselves in spades.

Look no further than the fact three of the major four banks' share prices had lost about one-third of their value since April 2015, prior to sinking near GFC lows in March this year.

Many a stock held for the sole attraction of the dividend has fared a lot worse, including the likes of AMP, G8 Education and, indeed, Telstra.

Focusing on income and not capital is a mistake

Even those investors hiding behind the fact they purchased their initial shares many moons ago at much lower prices still cannot deny that any strategy providing income while the capital base erodes away is not a good strategy.

Especially not when after the fall in capital comes the realisation there will not be a dividend at all this year, or a substantially reduced pay-out.

A much better strategy is one that incorporates the one key element that separates equities from bonds and other income-providing investment products: growth.

Investors should consider there are two ways for creating income from owning shares: one is through dividends, the second is via selling at a higher level than the purchase price.

The best way to combine both key share market characteristics is through adopting a wholistic approach: by constructing a portfolio that combines growth with income and income with growth. The end result should be a strategy that is much more protected against negative developments, including capital erosion, while offering growth of capital and income instead.

A truly superior outcome.

Sounds too good to be true? I've done the groundwork over the past five years. I can report from first-hand experience it's not a theoretical chimera. Get the basics right and you too can grow your capital while enjoying a steady income.

Past research indicated the share market's sweet spot lies between 4%-4.5% in forward-looking dividend yield (see also the diagram earlier). But because of the significant drop in global bond yields, I believe the optimal point where risk, income, growth and return meet on the ASX is probably now around 3%.

Even with franking credits added on top, 3% won't be sufficient for most retirees and pensioners. So we have to be smart and add in growth.

Growth adds two key features to our portfolio: share prices for companies that grow to a higher level plus today's dividend payouts will be higher in the future as well when supported by growth. By combining income with growth, a portfolio that today yields 3% (for the portfolio as a whole) can yield 4%, then 5%, and more as time goes by.

In the meantime, the capital inside the portfolio grows to a higher level and investors can sell a portion each year to make up for the initial shortfall in income from dividends.

In case you are still not 100% convinced, I'll meet you half-way.

The importance of growth stocks

A simple ETF (exchange-traded fund) that mimics the ASX200 Accumulation Index would have done a better job than owning a large overweight portfolio positions in banks, energy companies and retail REITs (all bought for their high yield) and the like over the years past.

The ASX200 combines CSL with CBA and other financials, BHP, Woodside, JB Hi-Fi, and others (200 stocks in total) for an average dividend yield of circa 4%.

Assuming most investors are aiming for 6% income plus franking, they would have to sell circa 3% initially each year to generate the required income (there are some costs to take into account as well).

Starting in January 2015, such a basic index-following strategy would have generated the following returns (ex-dividends)

- 2015: -2.13%
- 2016: +6.98%
- 2017: +7.05%
- 2018: -6.90%
- 2019: +18.38%

The above returns are ex-costs, but ETFs are low cost. Also, because of the significant underperformance by yield stocks in recent years, the average dividend yield for the ASX200 has actually been closer to 4.5%, which makes the past return from an index ETF even more attractive.

Even without the spectacular outcome in 2019, a simple ETF would have provided a superior total return than your average ill-conceived, dividend-oriented strategy over the past five years.

Because of the heavy overweight positions for the banks, Telstra and other large cap dividend-paying stocks in the index, a carefully constructed portfolio with less exposure to the share market's weak spots can generate an even better outcome.

We have managed our 'All-Weather Model Portfolio' in accordance with this smart income principle and it has done better than an index ETF over the period, including this year when losses incurred are significantly lower.

Admittedly, constructing a low-risk basket of stocks during a time when dividends are being deferred, reduced or cancelled, and when company profits are expected to fall by most since the GFC is more of a challenge this

year. However, I still maintain the outcome from combining growth with dividends will be superior over the years to come.

Rudi Filapek-Vandyck is an Editor at the FNArena newsletter. This article has been prepared for educational purposes and is not meant to be a substitute for tailored financial advice. FNArena offers impartial analysis and proprietary tools and insights for self-managing investors. The service can be trialled for free at www.fnarena.com.

How do you pick the right global stocks during Covid-19?

Garry Laurence

Over the past few months, we have entered a troubling time for the world. Lives are being lost, and most countries have entered varying degrees of lockdown. Most don't have enough hospital beds, ventilators or medical professionals to deal with the pandemic and any spike in cases. The world as we know it has changed and the economic impacts are significant and difficult to quantify.

How deep is the recession?

We know that the world has entered a recession, but we don't know the magnitude or extent. Economists are forecasting unemployment rates around the world will hit 10-20% over the next few quarters. The US has seen jobless claims rise to over 20 million, which implies an unemployment rate of 16%.

Fortunately, governments are stepping in with fiscal policies to provide varying degrees of unemployment benefits and wage support to companies, where employees are furloughed (forced leave). This will lead to a surge in government debt as trillions of dollars are spent, which will one day need to be paid back by taxpayers. In Australia, the government has announced $320 billion of support, representing 16.4% of annual GDP, while the US is providing a US$2 to US$3 trillion relief package.

The last time global economies looked this weak was in 1938. If you asked me a few months ago how much would I expect the stock market to be down under this scenario, I would have expected a lot more than the current 11% decline in the S&P500 and 3.5% decline in the Nasdaq year to date.

Let's not forget that the US market was trading at elevated valuation multiples before these declines. European markets have been some of the hardest hit, with the French CAC down 25% year to date, and the UK FTSE down 23%. Australia's All Ordinaries Index is in the middle of the pack down 18.5% this calendar year.

Stock market rejoicing on liquidity

The varying degrees of performance has more to do with the mix of sectors and stocks in each index than the economic impacts of the pandemic. The S&P500 is now more concentrated than ever with the top five companies representing 21% of the index. Microsoft, Amazon, Apple, Alphabet and Facebook have performed incredibly well over the past few months. Amazon is up over 28% year to date while Microsoft is up 13%. Facebook has been the worst performing stock out of the top five down 13%.

Many of these companies benefit from the current situation of people staying indoors. Ecommerce is accelerating, benefiting Amazon, while Microsoft Teams and the growth of the cloud are supporting Microsoft's businesses. Alphabet's and Facebook's businesses will be tested as it is hard to see advertising spend holding up in the current environment.

The difference between the current GCC (global consumer crisis) and the GFC (global financial crisis) is that the consumer represents a bigger proportion of GDP than banks and the financial industry did. So, when people stay inside and stop spending, this has a larger impact on incomes and GDP.

The second large difference is that while central bank rates were above 4% prior to the GFC, most central banks have started this recession around 2%. Central banks have shot every bullet they have in the past month, with the Federal Reserve cutting the fed funds rate to zero and announcing a plan to provide up to $2.3 trillion in loans to support the economy. They are purchasing $700 billion in US treasuries and mortgage-backed securities. This has flooded financial markets with liquidity, which has quickly found its way into equity markets.

Other central banks have taken similar steps with the Reserve Bank of Australia following Europe and Japan into a path of quantitative easing. So, we are at a crossroads where money is free and while fundamentals appear to be deteriorating the stock market is rejoicing in this new flow of funds and declining discount rates.

Positioning a portfolio

About three weeks ago, we suggested it may be time to invest in global stocks while hedging the currency back to Australian dollars. The Australian dollar had dipped below 60c to the US dollar but the interest rate differential between Australia and the US has disappeared. Furthermore, Australia has dealt with the pandemic exceptionally well over the past three weeks.

The issue we have in Australia is that we don't have a deep pool of stocks in a variety of sectors. We have been adding to existing positions and buying stocks in essential service sectors. These stocks include technology stocks like Alibaba, which is the leading e-commerce and payments company in China, as well as the leader in the cloud. They are China's equivalent of Amazon, but Alibaba trades on valuation levels that are half of Amazon. While most people have only heard of US large-cap tech stocks, we think the opportunity to buy high quality businesses trading at a discount to fair value is much greater outside the US.

Consumer staples stocks are also winners in the current environment. Woolworths and Coles are doing well. This phenomenon is similar all around the world. Proctor & Gamble recently posted its biggest US sales increase in decades, with US sales up 10% for the March quarter. In the months of March and April, packaged food sales around the world have been growing at a double digit pace.

The largest position in the fund I manage is Nomad Foods. It is a leader in frozen foods in Europe, with over 15% market share of the UK frozen foods market with brands such as Birds Eye and Aunt Bessie's. They have also seen double-digit sales growth over the past few months as people eat at home more. Both Nomad foods and Alibaba also fit our criteria of companies with leading goods or services, managed by owner managers.

Healthcare is another sector that will continue to do well, irrespective of how the economy goes over the next year or two. Companies like United Health, a leading health insurer and technology provider to the US healthcare system, and Fresenius Medical, a leading provider of dialysis equipment and services for patients with chronic kidney failure, continue to deliver a steady stream of earnings and cashflow.

Watching for fear and greed

It's important to accumulate stocks over the long term and buy when others are fearful. A month ago, there was a lot of fear and valuations were attractive. Now we see more greed despite economic fundamentals that are still deteriorating.

I think the biggest bounce will come from cyclical companies when we exit this recession, although it is not clear exactly when we will exit this recession. For the time being, the best plan of attack is to continue to accumulate quality companies in essential services, that are trading at attractive valuations. Investors should keep some powder dry for a reporting season in three months' time, which will reveal how weak the economy really is.

Charlie Munger, Vice Chairman of Berkshire Hathaway Inc. and Warren Buffett's long-time business partner, likes to say that one of the keys to great investing results is "sitting on your ass." That means doing nothing the vast majority of the time but buying with aggression when bargains abound.

Berkshire Hathaway is also one of our biggest positions, and Buffett hasn't really deployed the significant pile of cash on the balance sheet, which represents about 20% of their portfolio of companies and stocks. Munger was recently quoted in the *Wall Street Journal* as saying:

"Of course we're having a recession. The only question is how big it's going to be and how long it's going to last. I think we do know that this will pass. But how much damage, and how much recession, and how long it will last, nobody knows."

Garry Laurence is a Global Equities Portfolio Manager at [Perpetual Investment Management](), a sponsor of Firstlinks. This article contains general information only and is not intended to provide you with financial advice or consider your objectives, financial situation or needs. For more articles and papers from Perpetual, please [click here]().

Bank reporting season scorecard May 2020

Hugh Dive

For much of the past decade, the profit results for the banks were rather simple to analyse. Coming out of the GFC, the major trading banks steadily grew profitability on the back of solid credit growth, declining bad debt charges and reduced competition as foreign competitors either exited the Australian market or were taken over.

This changed with the Financial Services Royal Commission in 2018, which had bank executives wringing their hands over remediation provisions and increased compliance costs during the profit results presented in 2018 and 2019. After CBA's solid result in February 2020, this year was seen as the year when banking got back to normal.

How wrong we were. I suspect that bank management teams would prefer the stern gaze of Commissioner Hayne to wondering whether a $1.5 billion provision for bad debts stemming from Covid-19 shutdowns will be enough.

This article looks at the themes in the 800+ pages of financial results released over the past two weeks including Commonwealth Bank’s third quarter update, as we award gold stars based on performance over the past six months.

Reporting season scorecard May 2020

Company	Share Price	Market Cap $B	Cash earnings per share growth	Dividend growth	Net interest margin	Credit Impairment charge as % of loans	Size of new CV-19 Provision $M	Capital Ratio	Return on Equity	Forward PE Ratio	2021 cash dividend yield	2020 total return
Westpac	$ 15.20	$ 56.5	-44.0%	Dividend Delayed	2.1% ★	0.80%	$ 1,619 ★	10.8%	6.7%	12.36	4.6%	-37.1%
ANZ	$ 15.50	$ 44.8	-50.0%	Dividend Deferred	1.7%	0.53%	$ 1,013	10.8%	4.7%	12.50	4.2%	-37.1%
NAB	$ 15.52	$ 51.1	-51.0%	-63.9%	1.8%	0.38% ★	$ 807	11.2%	9.0%	13.50	3.9%	-35.8%
Commonwealth Q3 May 13th 2020	$ 60.29	$ 106.5	-4.3% ★	unchanged	2.0%	0.80%	$ 1,500 ★	11.1%	12.4%	17.37	5.0%	-22.8%
Macquarie	$ 107.00	$ 39.5	-16.0% ★	-28.0% ★	n/a	n/a	$ 488	12.2% ★	12.7% ★	14.99	4.5%	-22.4%

Source: Company reports, IRESS, Atlas Funds Management

Uncertainty and loan provisions

Gold Star

Uncertainty was the key theme for the May 2020 results with the banking sector making guesses as to the impact that rising unemployment will have on both house prices and more importantly, bad debts. Significant rises in unemployment see increased business failures as well as the difficulty for stressed consumers to service mortgage and credit card debts.

In previous downturns such as 1982/83, 1991 and 2009, unemployment rose gradually, which allowed banks time to adjust their risk settings. The Covid-19 shutdowns will likely see unemployment move from 5.2% in March to a number close to 8% when the ABS releases April's unemployment rate, heading to over 10% by June. This dramatic step-change in economic activity would have been outside any of the bank's stress tests.

Gold Star

Due to a timing issue, the banks reported profit results to 31 March, so the data released would only capture a few weeks of business closures. Outlook statements contain a degree of guesswork on impairment charges, which will determine the size of the provision for bad debts. NAB has taken the lowest provision, which would typically get it the gold star, but there are no prizes for being too optimistic.

The market would prefer to see a provision written back than new provisions raised at the full-year results in October. Surprisingly, the two banks with the biggest exposure to mortgages (CBA and Westpac) have taken the largest provisions. Historically, ANZ and NAB have seen higher losses in downturns due to their greater exposure to business banking which is often unsecured.

Capital

All banks have core Tier 1 capital ratios above the Australian Prudential Regulation Authority (APRA) 'unquestionably strong' benchmark of 10.5%, despite the billions of dollars of provisions taken. This allowed Australia's banks to enter 2020 with a greater ability to withstand an external shock than was present in 2006 going into the GFC. For example, in 2006 Westpac had a Tier 1 capital ratio of 6.8% vs 10.8% today even after taking into account the $3 billion in provisions.

Gold Star

In the May results, there was a tone of self-congratulation from bank managements at their prudence for high levels of capital allowing management of Covid-19 from a position of strength. However, this is more due to a combination of luck and pressure from the regulator APRA (Australian Prudential Regulation Authority). APRA made moves in 2015 to increase the banks' capital to be "*unquestionably strong and have capital ratios in the top quartile of internationally active banks*". This saw Australia's banks raise $20 billion in capital, which at the time was unpopular with both investors and bank management teams and was viewed as excessively heavy-handed.

Additionally, both ANZ and Commonwealth Bank sold their wealth management and insurance businesses between 2017 and 2019 which generated excess billions of excess capital. This was expected to have been returned to shareholders in 2019, but this was derailed by the fallout from the Hayne Commission. NAB's slow moves to sell MLC saw the bank raising $3.5 billion in late April at a price that was dilutive for existing shareholders.

Macquarie comes out ahead of the trading banks, but this is due to the differences in the business model of the global investment bank that has seen lower loss provisions as well as an opportunistic capital raise conducted in mid-2019.

Dividends

Given the degree of uncertainty, the banks cut and suspended their dividends in May 2020, with encouragement from APRA which announced that expected "prudent reductions in dividends" during the crisis.

MACQUARIE
Gold Star

Westpac and ANZ could have paid a dividend underwritten by an investment bank, but this would not have been in the long-term interests of shareholders. An underwritten dividend would have seen the investment bank selling newly issued shares on market throughout May to pay for the dividend, diluting existing shareholders and putting further pressure on the share price. NAB paid a 30c dividend in May, which was an exercise in financial gymnastics as it was coupled with a capital raising, which saw investors give NAB capital which was immediately returned.

CBA's dividend in February was unchanged, but we expect a cut in August depending on the trajectory of bad debts. Macquarie cut their dividend but had a dividend payout ratio of 56%, which is well below their target range of between 60-80%.

Falling Net Interest Margins?

Falling Net Interest Margins (NIM) now seems like an issue of little significance given the other problems facing the banks. Bank NIMs [(Interest Received - Interest Paid) divided by Average Invested Assets] were expected to narrow in 2019/2020 given the collapse in Australian interest rates in 2019 and increased competition for lending.

Gold Star
Australian banking oligopoly

The May 2020 reporting season saw NIMs remain stable at between 1.7% and 2.1%, with the banks more heavily exposed to mortgages (CBA and Westpac) traditionally having higher margins than the business banks (NAB and ANZ). The crisis has seen many borrowers in particular corporations increase their loans to ensure that they had liquidity on hand, particularly in March 2020. ANZ, for example, saw a $29 billion increase in its corporate loan book over the half, commenting that a significant proportion of these loans taken out were immediately put on deposit with the bank.

Additionally, these new loans are being priced at higher rates than the existing loan book, which has supported the banks' NIM. We expect loans to be repriced upwards when they come up for renewal, based on the banks pricing for higher levels of bad debts.

Our Take

The past few years have been tough for investors in Australia's banks which have faced hefty fines from regulators, a royal commission and now rising bad debts from a shutdown in the economy.

A big difference between the Covid-19 crisis and previous crises has been the speed and size of the fiscal responses. During the GFC, it took about 12 months for the politicians to respond, mainly due to the impression that those most affected were bankers and US sub-prime borrowers. In 2020, our political masters can see the impact of the virus on voters.

During the GFC peak, stimulus spending in Australia accounted for around 1.8% of GDP, while in 2020, the announced measures represent 9.5% of pre-crisis GDP. These policies will soften the impact of loan losses. Australia's banks have historically performed well coming out of crises that have reduced foreign competition and allowed them to absorb second-tier domestic banks. The threat posed by neobanks may well reduce as the Covid-19-inspired 'flight to quality' sees deposits switch to the major banks at a time when losses on the neobank loan books are increasing.

Hugh Dive is Chief Investment Officer of [Atlas Funds Management](). This article is for general information only and does not consider the circumstances of any investor.

How retail investors are responding to a bear market

Gemma Dale

After the longest bull market in history until early 2020, and record low volatility for several years, many investors may have been lulled into a false sense of security. The aggressive turnaround in market fortunes since March has seen a five-fold increase in volatility. Far from avoiding the market as a consequence, nabtrade has experienced a 300% increase in share trading volumes and a 500% increase in new investor applications. Retail investors have responded to the sharpest bear market on record, followed by another bull run of surprising speed.

Is this increase in activity wise or worrying?

Investors appear to have been waiting for a correction and they see this turnaround as an opportunity rather than a threat. The clearest sign that investors were not completely convinced by the market’s previous record highs was increasing levels of cash. SMSF trustees have been slowly reducing their heavy exposure to cash and term deposits, but still hold over 20% of their portfolios in secure, low-rate deposits. nabtrade investors have actually been accumulating cash over the past five years, despite low rates, indicating that they were waiting for better buying opportunities when the sharemarket (or other asset classes) offered them.

Instead of selling as prices fell, as many pundits predicted, we saw a swift swing to the buys on nabtrade, after weeks of profit-taking through reporting season in February. This buying continued throughout March and into mid-April. Investors bought heavily in bank shares, which are now down approximately 45% from their highs, and continued to buy despite the deferral or reduction of dividends. They also bought enthusiastically in hard-hit travel stocks, including Qantas, Flight Centre, Webjet and Sydney Airport. (Virgin, thankfully, was not among the popular buys and has only a small number of shareholders in the nabtrade investor base).

In addition, many investors were keen to cash in on lower share prices but didn’t have a strong view on which stock to buy, which led to aggressive buying in indexes, especially the ASX200 and S&P500 ETFs (listed in Australia).

Despite all the buying, investors were clearly open to the possibility that further falls are to come. The cash book continued to increase throughout March and April despite the buying, meaning that investors were bringing cash from other sources to ensure they could move quickly in the event of future share price falls in preferred stocks.

In other sectors, BetaShares' three bear fund ETFs, offering a positive return when the ASX and S&P500 fall, were extremely popular. In fact, they pushed the ASX200 ETFs, which usually dominate ETF purchases off the top spot for turnover.

Spectacular falls in the price of oil led to large buys in oil ETFs, both in Australia and the US, and companies leveraged to the oil price. This has only slightly abated as volatility has dropped.

Other sectors that had previously been popular include the Buy Now, Pay Later space. Afterpay has been in nabtrade's top 10 stocks for several years. After its heavy falls, investors bought the stock, but gladly took profits following the announcement of Tencent's $300 million stake. Zip Co and SplitIt, having previously been popular, fell out of the popular buys and were replaced by PushPay.

Response to the rally

The recent rally, delivering the market's best month in several decades, clearly concerned some investors. There was a slight swing back to the sells in the last week of April as investors took profits in companies that had had significant share price increases. But then the 5% drop on the first day in May brought the bargain hunters out again, further confirming the contrarian investing approach taken by many reatil investors.

Investors buying US shares directly have taken a slightly different approach. While still enthusiastic for value, they continue to prefer high-flying tech stocks such as Microsoft and Apple. As the Nasdaq is actually up in calendar year 2020, this part of the market appears to have weathered the Covid-19 crisis much better than others. Berkshire Hathaway is popular, as well as Tesla, despite its volatility. Particularly intrepid investors have been buying battered travel and cruise companies, including Carnival Cruises and Royal Caribbean.

Many share market gurus tout the benefits of contrarian investing for investors who have the stomach to buy when markets fall. Warren Buffett's famous line about being fearful when others are greedy and greedy when others are fearful is one retail investors have committed to memory. Despite concerns about retail investors selling at the worst possible time or buying at the peak, this time around, it appears they have had the confidence to buy in a falling market and take profits in a bull run.

Video: Dividends, capital raisings and the outlook for the ASX

Fidelity's Kate Howitt joins Gemma Dale to discuss why she believes Australia is privileged and her view on dividends and capital raisings.

Gemma Dale is Director of SMSF and Investor Behaviour at nabtrade, a sponsor of Firstlinks. Any statements as to past performance do not represent future performance. Any advice contained in this Information has been prepared by WealthHub Securities without taking into account your objectives, financial situation or needs. Before acting on any such advice, we recommend that you consider whether it is appropriate for your circumstances.

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

Lessons in oil ETFs, futures and negative prices

Alistair Mills

The past few weeks have been a turbulent time for the global oil market, with oil futures prices falling below zero for the first time ever. In this article we discuss the alternatives for investors who are looking for exposure to oil.

Unless you own a storage tanker to physically hold oil, it is virtually impossible to invest in oil at the spot price. The most common way of gaining exposure is through oil futures contracts, but investing in futures directly can be complex and tedious. Most investors prefer to gain access to the oil market via exchange traded funds (ETFs), leaving the fund to manage the futures exposure for them.

Oil futures and contango

A key component of the performance of oil futures and any ETF that aims to track oil futures prices is 'roll return', which in turn depends on the shape of the oil futures curve.

Futures expire according to a predetermined schedule. On the futures settlement date, anyone holding a contract must take physical delivery of the oil. In order to avoid this, investors (including in oil ETFs), must 'roll' from one contract to the next prior to the settlement date. Rolling involves either a cost, or a credit, depending on the shape of the futures curve.

When the futures price of a commodity is higher than the spot price, this is known as 'contango'. A market is in 'backwardation' when the futures price is below the spot price.

It is crucial that anyone considering investing in an oil ETF understand the impact this can have.

I'll use the time around the roll period in early April 2020 of the BetaShares OOO fund (Crude Oil Index ETF - Currency Hedged (synthetic)) in the example below, but the concept of contango and its impact on performance applies to any futures-based oil ETF, or to anyone rolling futures themselves.

OOO aims to track an index that normally provides exposure to front-month West Texas Intermediate (WTI) Crude oil futures. WTI futures contracts settle on the third business day prior to the 25th of the month and therefore need to be rolled to maintain exposure. OOO's Index gradually rolls the current contract over a five-day period commencing on the fifth business day of each month.

We have been witnessing extreme conditions with both demand and supply-side shocks. As you can see in the chart and table below, the futures curve has been very steep at the front end (steep contango). The curve has shifted dramatically over the last few months—it was still in backwardation in January. Following the S&P GSCI Crude Oil Index rebalance ending 13 April, however, the roll cost was as high as 27% per month.

Source: Bloomberg. Data as at 14th April 2020.

Month	Options	Charts	Last	Change	Prior Settle	Open	High	Low	Volume	Hi / Low Limit	Updated
MAY 2020	OPT		20.78	+0.67	20.11	20.72	20.86	20.69	3,887	No Limit / 0.01	17:59:52 CT 14 Apr 2020
JUN 2020	OPT		28.01	+0.61	27.40	27.84	28.02	27.84	1,316	No Limit / 0.01	17:59:47 CT 14 Apr 2020
JUL 2020	OPT		32.42	+0.55	31.87	32.36	32.44	32.34	245	No Limit / 0.01	17:56:55 CT 14 Apr 2020
AUG 2020	OPT		34.09	+0.44	33.65	34.08	34.09	34.08	248	No Limit / 0.01	17:59:39 CT 14 Apr 2020

Source: CME. Data as at 15 April 2020.

The premium of the subsequent month's futures contract will decay towards the oil spot price as the expiry date approaches. This is an unavoidable component of commodity futures.

At the time of the screenshot above, the June contract was trading at US$28.01, while spot WTI oil was US$20.78. If the spot price had stayed stable at that price, the June futures contract would have to erode 26% from then until expiry on 19 May 2020. This erosion would be reflected in a fall in Net Asset Value (NAV) of any oil ETFs, which aim to track these contracts.

Negative oil futures prices

On 21 April 2020, US oil futures prices were negative for the first time in history, following the largest one-day sell-off ever. This was based off the May WTI Crude futures contract, which settled on 21 April in the US.

Due to the supply glut and lack of demand for oil resulting from the global pandemic shutdown, the cost of storing oil has risen astronomically. Traders were desperately trying to offload contracts before settlement to avoid taking physical delivery. Given the cost of shutting a well, many producers were willing to pay someone to dispose of their oil.

What does this mean for funds that aim to track an index which provides exposure to oil futures?

The index the BetaShares OOO fund aims to track finished rolling into the June contract on 13 April, so was not holding May contracts when they traded negatively. On 21 April, when the May contract fell below zero, the June contract was trading at ~US$20. Of course, the performance of the ETF over that time was affected by the prevailing price of the June contract (it had been trading at highs closer to ~US$24 the day before).

Whilse oil futures prices are now back in positive territory, the risk of turning negative again remains. In the current environment, as the settlement date of the June contract approaches that risk may increase.

In view of these unprecedented market developments, and to reduce the risk of exposure to negative prices (which potentially could reduce an ETF's value to zero), many oil ETFs have considered it prudent and in investors' interests to temporarily replace exposure with longer-dated contracts. In our case, exposure has been temporarily replaced with the less volatile three-month forward contract until further notice. This was done with the aim of reducing the risk of permanent loss of capital, and should also reduce the cost of rolling futures.

These types of de-risking changes have not been limited to ETF providers. Index providers have also made changes to benchmarks linked to short-term oil futures prices.

What lies ahead for oil?

Oil is a physical spot asset, the price of which is determined by supply and demand, unlike equities whose prices are based primarily on expectations of future earnings. In order to behave functionally, markets must square off all supply and demand. Until the global lockdown ends or unless there are monumental supply cuts, the dynamics look likely to remain extremely out of balance.

The US WTI Crude has been hardest hit, primarily due to geographic location. The landlocked city of Cushing, Oklahoma, is the major trading hub and delivery point for WTI crude contracts. While the shortage of off-land oil tankers is less severe, the global shutdown has caused US storage facilities, pipelines and refineries to approach physical constraints.

Oil markets are currently hitting transportation bottlenecks, without having filled storage capacity. If we do test global storage capacity in the coming weeks (beyond US onshore), there will likely be significant volatility, and oil futures prices could decline further until supply meets demand.

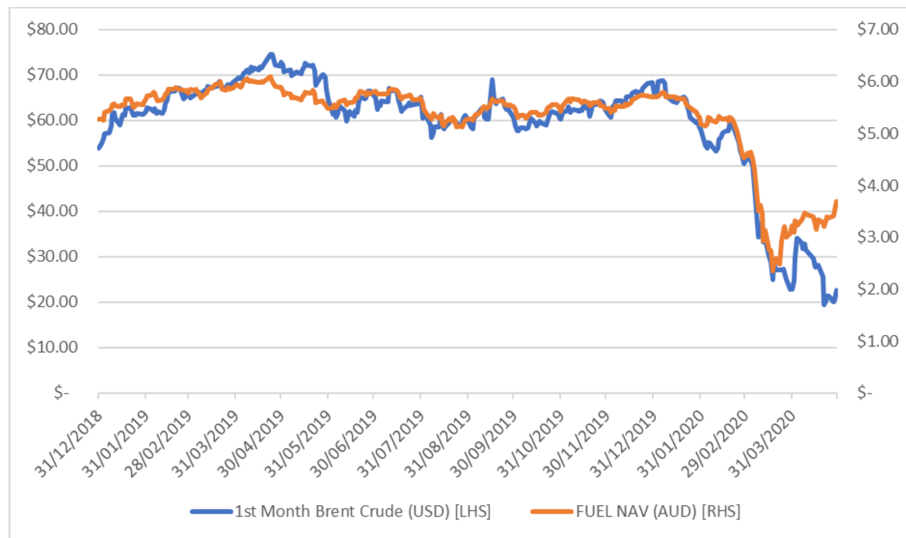
Looking beyond and to the eventual recovery, there is the chance that if we see sweeping refinery shutdowns and pipelines get clogged, we could see a supply-led inflationary shock when demand returns to pre-crisis levels. However, for those looking to capitalise, the strength of this rebound will depend on both a sharp increase in demand and how much excess inventory is built.

Energy companies

The current oil rout could see the energy industry finally undertake the critical restructuring it needs. Shale producers were already seeing sharply higher costs of capital, and the COVID-19 crisis could see that capital dry up entirely. The potential for widespread bankruptcies could see global energy markets once again be the domain of energy's 'supermajors'.

Energy remains a sector that's crucial to any eventual recovery in global growth. One option for investors looking at a cyclical recovery by major energy companies is an ETF such as the BetaShares Global Energy

Companies ETF – Currency Hedged (ASX:FUEL), which provides exposure to the 50 largest energy companies globally ex-Australia. These companies historically have shown a high correlation to the price of oil futures as can be seen in the chart below.



Source: Bloomberg, BetaShares. Data as at 29 April 2020. Past performance is not indicative of future returns

Note: As discussed above, the price of oil futures contracts is not the same as the 'spot price' of oil. As such, the performance of oil futures, or an ETF that is linked to oil futures, may be materially different to the performance of the spot price of oil itself.

Alistair Mills is Associate Director, Portfolio Analytics & Adviser Business at BetaShares, a sponsor of Firstlinks. This article is for general information purposes only and does not address the needs of any individual.

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

It's like opening your best champagne at 5am

Angus Coote

Last week's US payroll number cemented the fact that over the last month or two *'good news is good news and bad news is good news'*. Job losses in the US amounted to 20.5 million in April (and are still climbing) with the unemployment rate coming in at an eye watering 14.7%. Both numbers were the worst on record since the Great Depression.

The job losses will clearly weigh heavily on expectations for recovery, yet the equity market rallied nearly 2% on the day of release because these numbers were perceived as '*good*'.

Risk markets (equities and credit) are playing the old game we saw post the GFC. Bad news was greeted with glee by equity and credit markets given it meant more stimulus from central banks desperate to prop up inefficient economies and industries. Last week, the fact that bond futures started to price in negative interest rates got risk markets moving, despite Jerome Powell and the US Federal Reserve (Fed) explicitly saying they don't like negative rates. In reality, negative pricing was a technical short stop and not driven by market expectations. However, many risk participants didn't seem to care.

Did we learn from the GFC?

The lesson from the GFC was that despite the monumental volumes of stimulus from central banks globally, there were tremendous potholes along the way. Think European banking and sovereign crises of the last decade.

Today, the global economy has come to a complete stand still and yet some equity markets are now higher than they were pre COVID-19. Yes, there are some winners out of this but to have an entire stock market index trade above its starting point of the year is highly questionable.

The last decade was unique in that it was the first time in history that the US economy did not experience a recession in the entire 10 years. The US economy posted its longest expansion ever in over 170 years of data. In addition, the bond market yield curve inversion last year foresaw the current predicament with 3-month, 10-year and 2-year versus 10-year treasury rates inverting.

Of course, they didn't predict COVID-19 but they didn't need to. The economic cycle had gone on for way too long. This recession is not going to end after one month. It will take months and years of pain to work through this mess.

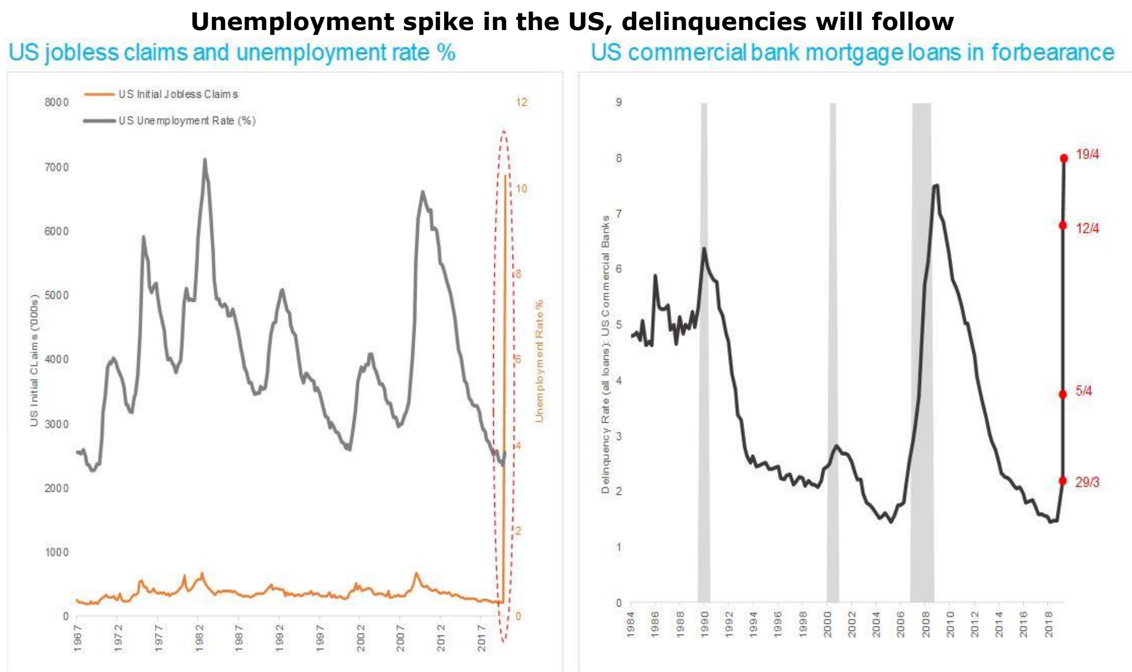
Liquidity will not solve the problem of bankrupt companies

The twitterised fast-paced 24-hour news cycle has sped everything up now, including expectations on how bad recessions can become. Recessions take a long time to play out (during the GFC in 2008-09 in the US it took 18 months) yet risk markets are arguing that it's almost all over and things will be fine after only six weeks of pain.

Risk markets rallying 30% plus from the nadir of March is truly extraordinary and we believe way too much. Yes, we have seen the most aggressive response from central banks and governments in the history of mankind, which has spawned the '*good news is good news and bad news is good news'* paradigm.

However, the Fed is reaching all the way into the fallen angel part of the junk bond market but **liquidity will not solve the problems of bankrupt companies.** It will only lower their borrowing costs and if you have no revenue or a fractured business model, it really won't matter. It doesn't replace revenue lost forever. And thus, we lurch from the liquidity crisis (which the Fed mostly solved) to the solvency crisis which will take years to play out. We believe equity markets over the past month have chosen to ignore this.

Unemployment spike in the US, delinquencies will follow

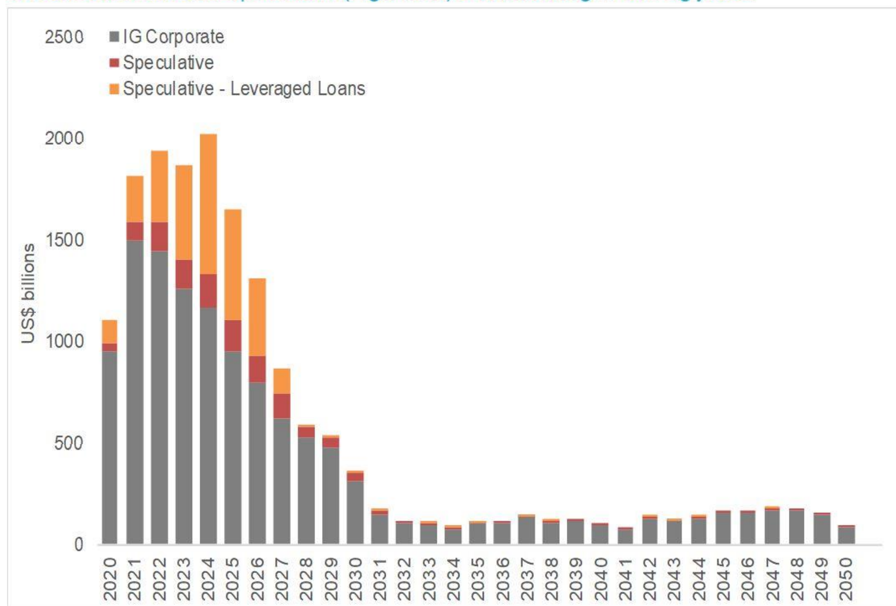


Source: Jamieson Coote Bonds, Bloomberg data.

We have a truly extraordinary amount of investment grade and junk bonds to refinance over the coming years with many of these industries hobbled into the future. We will see more pain emerge via the second- and third-round effects and it will hurt the investors and institutions they owe money to.

Refinancing risk – corporate debt maturities step up through 2021

Investment Grade and Speculative (High Yield) Debt maturing in coming years.



Source: Jamieson Coote Bonds, Bloomberg data.

Focus on a balanced portfolio

Risk investors shout 'Don’t fight the Fed' and they argue forward P/E ratios of 21 times on the S&P500 are cheap (this is the average P/E and the highest multiple since the Tech Wreck). This may be the case if you are a 25-year-old starting out in your career investing in growth stocks. However, we believe the optimists are misguided as they are betting on earnings growth or P/E expansion.

For a retiree or someone close to retirement who needs income, buying stocks with a P/E of 21 times can be incredibly dangerous. It will take the company 21 years of forward earnings for an investor to recoup the initial investment. For someone who retires at 65 with an average life expectancy at 85, investors might be well advised not to risk their wealth. Better to add balance to their investment portfolio by allocating a portion to more defensive assets.

Let’s not forget that the biggest buyer in equity markets over the past 10 years was corporations buying back their own stock. Printing trillions of dollars of debt to buy back equities was tax effective but as a consequence, a monster headache was created with so much corporate debt in the system. Now, an enormous structural buyer has been taken out of the market.

The limit of 'Don't fight the Fed'

We agree with not fighting the Fed, but only up to this point. We are now at an inflection where, barring a vaccine, good news is as good as it gets, and bad news is actually bad. We are truly at the hard part where we need to go back into work to pay down the massive amount of fiscal stimulus. We must open shuttered businesses and economies while avoiding the threat of Covid-19.

Employment will come back from the current 15-20% level but it certainly will not head back to the 3.5% pre-virus number in the US.

The question investors should ask themselves is how much pain will a 80% or 90% economy and all the multipliers of that 80% or 90% have on corporate profits and economies?

There are tremendous clouds on the horizon in the near and medium term, yet risk markets have separated themselves from the reality of economics. They have opened their finest bottle of champagne at 5am on the dawn of the recession.

Amongst it all, one thing we have seen over many cycles and crises is that the hangover will be brutal and the pain will last for years, despite whatever medicine Dr Fed prescribes going forward.

Angus Coote is Executive Director and Chief Operating Officer of [Jamieson Coote Bonds] (JCB). This article contains general information only and does not consider the circumstances of any investor.

JCB is an investment manager partner of Channel Capital, a sponsor of Firstlinks. For more articles and papers from Channel Capital and partners, click here.

Corporate bonds: why now and in what structure?

Brad Dunn

Allocation to fixed income is often seen as a residual allocation, made only after an equity and property portfolio has been painstakingly constructed with sector and style diversification closely scrutinised. However, the performance of various fixed income instruments in March and April 2020 clearly shows that the same level of discernment is pivotal when making fixed income allocations.

While the medium-term outlook remains highly uncertain, now is a good time to undertake the detailed work needed to understand which securities and funds have performed to expectations, and those which have seen existing risks magnified or in some cases new risks brought to light.

For investors with a medium-to-long-term outlook, and a preference for income and liquidity, the good news is that the current market is creating opportunities to reimagine defensive asset allocations, which may include quality corporate credit.

Why corporate credit?

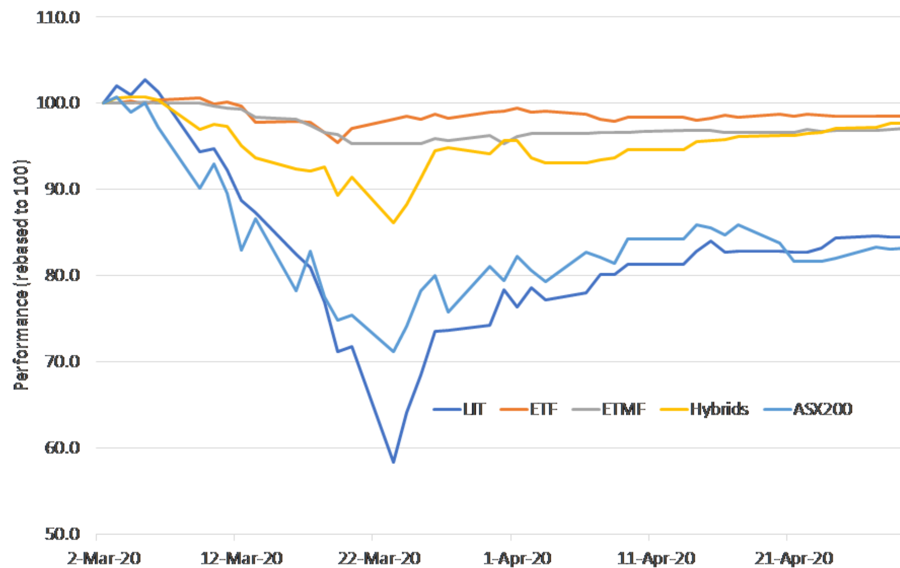
An index-unaware, actively managed and globally oriented corporate bond portfolio offers several advantages:

- First, detailed credit analysis ensures that all holdings adhere to **strict selection criteria aimed at avoiding defaults**. Even a well-diversified portfolio can be significantly impacted by an issuer that does not meet its obligations.
- Secondly, interest rate risks and credit spread **risks can be managed to reduce volatility of returns over time**. While coupon income is the dominant source of return from corporate bonds, funds with the flexibility to adjust exposure to interest rates and credit spreads can more effectively manage risk in real-time and ideally also use skill to generate additional investment return.
- Finally, **because issuers offer bonds in multiple currencies, an active manager can seek out the best relative value** regardless of the currency. Implemented consistently over time, this flexible approach can lead to incremental return improvements.

Whether they be traditional managed funds or listed high yield bonds, Australian investors have never had a wider range of investment options when it comes to fixed income. Most recently, Listed Investment Trusts (LITs) have provided access to the global 'high yield' market for corporate bonds with credit ratings below investment grade. Offering attractive yields, they were enthusiastically adopted by retail investors.

However, the COVID-19 crisis has revealed the Achilles Heel of LITs - the ability of the unit price to trade below the underlying value of the assets (of course, they may also trade above the underlying value but this has not been evident in the recent crisis). Compared with other fixed income options, LITs have displayed equity-like volatility, although distributions continue to be paid. The longer-term risk is that these valuation discounts persist well beyond the duration of this crisis, a precedent evident in Listed Investment Companies (LICs) focussed on equities.

Figure 1: Average product performance, March-April 2020



Source: Bloomberg, company websites. Following are ASX/Chi-X codes - LIT constituents: MXT, NBI, KKC, PGG, GCI. ETF constituents: IAF, VGF. ETMF constituents: ECOR, EMAX, XKAP, PAYS. Hybrids: HBRD.

Quality fixed income remains attractive

Current market conditions have created a real 'stress test' of investment options across all asset classes. Take residential property for example. Long seen as a stable option that offered a mix of income and capital growth, scores of investors are now facing the possibility of many months with little or reduced rent, reduced ability to evict troublesome tenants, and a difficult market for sales.

For income investors, the issue is a simple lack of diversification. While corporate bonds can become difficult to sell at times, a corporate bond portfolio provides significant diversification, protecting a continuing income stream even if one issuer runs into difficulties.

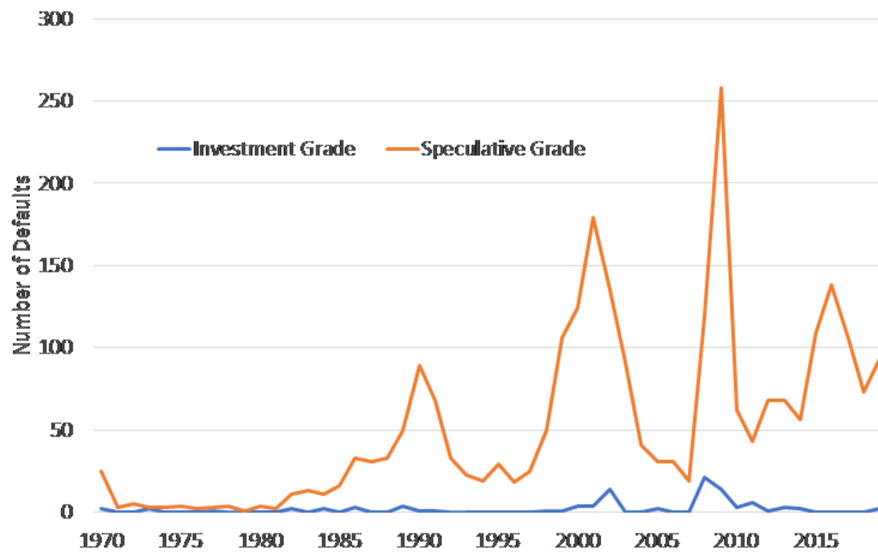
Investors with large allocations to liquid cash or government-guaranteed term deposits have contended with reinvestment risk for years now, and sadly continues to loom large. Even though consumer price inflation is expected to remain subdued for some time, falling returns and cash flow from deposit products is impacting a saver's ability to meet their commitments.

Add to this the likely reduction in equity dividends in response to profit and economic contraction, and self-funded retirees are potentially facing several years of significant income deficiency. Corporate bonds, by comparison, have clearly defined payment schedules, and the vast majority are mandatory payments that cannot be cancelled or varied without severe consequences for the issuer. After the volatility of recent months, yields on offer relative to deposit products are the highest for some time.

With the economic outlook still highly uncertain, the spreads of lower-rated bonds have (understandably) widened much more than investment grade debt. While it might be tempting to gravitate towards the higher yields on offer in some of these instruments, it is possible that we are only at the end of the beginning of this crisis, rather than on the cusp of a sustained recovery.

If this assessment is right, there is a strong case to tend toward investment grade securities. One key fact supporting this view is that observed defaults in higher-rated bonds are orders of magnitude lower than in the high yield market, a trend proven through countless market cycles. Avoiding defaults is the single most effective way to ensure success in fixed income investing.

Figure 2: Long-term defaults, IG and HY



Source: Moody's

Being nimble in fast-moving markets

Among the wide variety of fixed income offerings in the market, there has been considerable variability in outcomes for investors over March and April. Given the unprecedented and fluid nature of this crisis, it is difficult to establish any investment views with conviction.

While these uncertainties do extend to corporate credit as they do to all risk assets, this crisis is showing that not all fixed income instruments are created equally. With such an array of securities available in the market, additional work is not just necessary, but crucial to ensure that risks have been adequately weighed against the expected returns. Investors can increase their chances of success by exposure to well-diversified investment grade portfolios with a laser focus on liquidity and remaining nimble in the face of fast-moving markets.

Brad Dunn is a Senior Credit Analyst at Daintree Capital. This article contains general information only as it does not take into account the objectives, financial situation or needs of any particular person.

Disclaimer

This message is from Morningstar Australasia Pty Ltd, ABN 95 090 665 544, AFSL 240892, Level 3, International Tower 1, 100 Barangaroo Avenue, Barangaroo NSW 2000, Australia.

Any general advice or 'class service' have been prepared by Morningstar Australasia Pty Ltd and/or Morningstar Research Ltd, subsidiaries of Morningstar, Inc, without reference to your objectives, financial situation or needs. Refer to our Financial Services Guide (FSG) for more information at www.morningstar.com.au/s/fsg.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest. To obtain advice tailored to your situation, contact a professional financial advisor. Past performance does not necessarily indicate a financial product's future performance.

For complete details of this Disclaimer, see www.firstlinks.com.au/terms-and-conditions. All readers of this Newsletter are subject to these Terms and Conditions.