Love in the Time of COVID-19

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(with apologies but we couldn't think of a better title. The book Love in the Time of Cholera has only tenuous thematic connections with this article, but the problems of separation are one of them! Read the book – we all have way more time on our hands than we ever thought)

Another brief update from Delft on what to do with your hard-earned savings. We are not epidemiologists so won't be pontificating on the myriad possibilities and uncertainties of the virus – mutations, complications and infections. We have concluded that the most important statistics are the ones that show the healthcare systems can: 1. cope with the influx of new cases, 2. provide in-situ testing with blood and thermometer equipment, and 3. produce an anti-viral. Without these developments the social contract between governments and people will break down. Most countries in which we invest have promised to provide healthcare for citizens. If they can't honour this promise, then history is clear about the consequences.

Governments are also promising money to furloughed workers and cajoling companies into keeping employees on the books. This is an essential source of demand and confidence and while government indebtedness will be increased, there is no alternative.

Currently the news flow, while sensation seeking and sketchy, appears to be getting better. Even in the USA which was late to take action. Again, we are reminded of the perspicacity of a certain Winston Churchill who apparently said, "Americans can always be trusted to do the right thing, once all other possibilities have been exhausted".

On to the point of this article – What are we doing? What do we recommend you do? It's disarmingly simple and there are only 3 rules.

1. **Invest don't speculate**

A lot of junk has been floated on markets in the last few years. Over 50% of USA IPOs in the last 18 months have been loss making entities. Private Equity firms will be rushing to achieve liquidity by floating some of their investments as soon as there is a window. Many of these will be 'concept stocks'. You don't need to own this stuff or if you do, it should be a tiny piece of your portfolio. See 3 below. Junk is unlikely to come back; if it does it will be with a serious recapitalisation which dilutes original holders.

Returns to 'Quality' companies with good balance sheets tend to do better when earnings are being downgraded and volatility is elevated – like now.

The next few years won't be the same as the last few. Some companies won't survive this (Tourism and Cruise ship operators?), some will but equity holders will have been heavily diluted (airlines, aerospace companies?), and some will come out stronger. We see significant and permanent shifts in the behaviour of individuals (consumers), companies and governments. This will create opportunities.

We purchased Thermo Fisher Scientific, Kimberley Clark, Johnson and Johnson and Gilead in the Global Trust since we see permanent mandated changes in the way we live in public. Since we can't shut down the economy every Winter when we have a flu virus there will be significant changes to protocols for travel, shopping in malls and even in public spaces? This means more hygiene. Technology companies will sacrifice 'lean and flexible' for robust, meaning additional supply chains and consequently more investment in logistics and production equipment – even on-shoring back to the USA?

Governments will be under pressure to take equity stakes in exchange for granting taxpayer money to companies (and so they should) especially as the (Investment) banks in 2009 managed to socialise the losses and then privatise the profits. Unlikely to happen again. Share buy backs in the USA have been running at about $800bn pa. To put this in context, dividends are running at about $400bn pa. Buy backs increase leverage in a company and so they are likely to be suspended (already happening) – if your investment is buying back shares to boost executive option value then think about looking elsewhere if this is the only thing supporting the equity price currently.

We doubt anyone knows with certainty yet what the trends will be, so be flexible and prepared to change your mind.

2. **Be patient – think long term (>3 years)**

Earnings forecasts for the next few months are useless and probably dangerous to follow. Estimates are outdated almost immediately, companies don't know, and can't give, guidance, and each country has different customs with respect to frequency of updates. Look beyond this period and buy, if you can stomach it, on down days and vice versa, as you rebalance the portfolio.

To give you an idea of how much uncertainty about the short term there is currently, the volatility of Asian equity markets is about 7 standard deviations from normal. We look forward to the day when equity markets move less than +/- 1% per day. Equity valuations are not really impacted by the loss of even 6 months earnings or dividends. They are a long duration asset in which the value is back ended. We calculated a present value-based estimate of the S&P 500 using serious reductions in share buy backs (see above) and at 2,400 the prospective returns look to be about 8% pa. At a time when interest rates are very low and likely to be managed that way (since governments can't afford the interest cost on the massively expanded debt burden if rates rise), 8% pa is a decent return.

At the end of 2019 we stated that 8% was the new 15%. We had no idea we would reach it this way.

3. Diversification and rebalancing to obtain a spread of risk, are very important. They always have been!

Active fund managers have done an appalling job at explaining risk (implementing too, some of them); that risk is the independent variable and return is a function of risk taken. Portfolios are collections of risk exposure and they should be diversified risks. Many fund managers still choose stocks in isolation and have no idea what the collective pool of risk looks like, nor what it does to the clients' existing asset exposures such as houses or fixed income holdings. Fund management is managing risk AND return.

After such a violent move of, and between, equity prices it makes sense to review the risks. Are Australian banks now a larger part of your portfolio than before? If so, is your house value likely to be correlated with the returns of the banks given that bank profits are increasingly derived from mortgages? Healthcare stocks have held up well – are they now a disproportionate share of the value of the equities? In Australia the scarcity value of some stocks can drive their valuations way above what can be purchased offshore for a similar product profile. Compare Baxter Laboratories or Grifols in Spain with CSL for example. Quest diagnostics with Sonic Healthcare.

The A$ tends to fall in a crisis; Australia is a large net debtor nation. Unhedged currency exposure to the US$ and the Yen is quite a good diversifier. Unhedged equity returns from the USA to Australian investors were about -6% in March compared with -25% on the Australian market. The USA market fell about 13% in March in US$ but the fall in the A$ of about 6% boosted unhedged returns.

It is easy to rebalance liquid assets and less so for investments in credit and houses and certainly in private equity. If you believe that markets will remain volatile for a while, then locking up your savings in illiquid assets reduces your flexibility to take advantage of sell-offs and irrational exuberance. The PRICE of illiquid assets by definition will be less volatile than the price of the listed equities, but PRICE is NOT RISK. Many of the currently stable prices in illiquid assets are not being 'marked to market' and are risky/worth less. Consequently, think about how much flexibility you want to keep and don't confuse an asset which is priced only periodically with its risk.

Concluding:

As we write this, the news flow is marginally improving in the USA. In an election year there will be a desire for 'no negative news' and so back to Churchill's comment. The USA will mobilise. Summer is coming which tends to kill flu viruses naturally. More medical equipment is being manufactured and deployed. Australians are behaving less convivially and more appropriately. Governments are promising money to furloughed workers and cajoling companies into keeping employees on the books. This is a source of demand and while indebtedness will be increased, there is no alternative.

In short, the chaos is likely to end in the second quarter and while we won't return to where we were, the new environment offers plenty of reward if you follow the 3 principles. We will be.