Core Value Portfolio

Monthly Update - March 2020

March Performance Overview

March was a turbulent month for global financial markets. Evidence of the Covid-19 virus spreading into Europe triggered a sharp fall in equities and other assets, combined with a liquidity squeeze as demand for USD cash rocketed. The AUD fell nearly 10c against the USD. Volatility rose across many asset classes, with equities moving up and down by 10% in a day.

These conditions continued until around the middle of the month when central banks stepped in to cut interest rates sharply and implemented programs to supply trillions of dollars of liquidity to global markets and banking systems. However, equity markets did not really take heart until a few days later when governments around the world, including Australia but particularly the US, announced fiscal packages amounting to trillions of dollars in total.

Against this backdrop the Core Value Portfolio (CVP) generated a return of -9.96%, somewhat shielding investors from the sharp fall in equities and other risk assets.

The Australian equity market ended the month down -21.2%. All active managers within the Portfolio underperformed, suffering from indiscriminate selling. Allan Gray Australia Equity was worst hit (-26.9%), followed by SGH ICE (-25.2%) and Firetrail Australian High Conviction (-22.3%). IML Equity Income (-21.2%) was also down in line with the beta exposure held through the Macquarie Australian Shares True Index Fund (-20.8%). It is worth noting that these managers have slightly rebounded through April to date.

Global equities were also down in March but the active managers in the Portfolio fared better. The strategies that performed the best were the Loomis Sayles Global Equity Fund (-7.4%) closely followed by the Talaria Global Equity (-9.2%) which both outperformed their benchmarks. Loomis Sayles currently has a strong overweight to IT and healthcare sectors and the Portfolio should remain resilient through the crisis. Northcape Emerging Markets was down -10.8% with the largest detractor being Lazard Global Equity Franchise (-17.4%). Global Equity returns were also partially insulated by their unhedged FX exposures.

The alternative exposures were not isolated from the market volatility, however they delivered better results than other asset classes, with the BetaShares Gold Bullion ETF (-2.7%) and the Bennelong Long Short Equity Fund (-4.5%) the best performers. Partners Group Global Multi-Asset was down -16.9% but is well placed to take advantage of opportunities which are presenting themselves via secondaries and distressed assets.

Property and infrastructure was one of the hardest hit asset classes in March and saw considerable declines. The best performers were the AMP Core Infrastructure Fund (-8.0%), followed by Resolution Global Property (-10.6%). The largest detractors were Lazard Global Listed Infrastructure (-16.7%) and Cromwell Phoenix Property Securities (-35.2%), which fell in line with the AREITs sector which was also down -35.3%.

Fixed income exposures also delivered negative results in March however, it should be noted that performance was also impacted by several managers adjusting their ‘sell spreads’ given the tighter market conditions. Australian fixed income managers Aquasia Enhanced Credit (-0.5%), Ardea Real Outcome (-0.7%), and the Alexander Fixed Income Fund (-3.8%) were the best performers. Global fixed income managers CQS Credit Multi-Asset Fund (-16.8%) and Payden Global Income Opportunities Fund (-13.4%) were the key detractors as they experienced repricing of securities with limited liquidity through the crisis period. It is worth noting that the sell spreads have since eased.

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Portfolio Summary

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Unit Price at 31 March 2020		$0.9923
Asset Class Ranges & Current Allocations [1]		**Current Exposure**
Cash & Fixed Interest	15% - 60%	47.5%
Property	0% - 25%	10.2%
Equities	25% - 65%	27.8%
Alternatives	5% - 35%	14.5%

[1] The total exposure may not sum to 100% due to any direct derivative investments (such as options and futures).

Top 10 Investment Holdings (ex cash)	
1.	Alexander Fixed Income
2.	Ardea Real Outcome
3.	Aquasia Enhanced Credit
4.	Talaria Global Equity
5.	Bennelong Long Short Equity
6.	Loomis Sayles Global Equity
7.	BetaShares Gold Bullion ETF
8.	Payden Global Income Opportunities
9.	Lazard Global Equity Franchise
10.	AMP Core Infrastructure

Market Performance and Outlook

The equity markets have somewhat rebounded since 20 March. After this bounce, some of which is already fading, the question now is where to from here? Do we have a fast drop in the economy and an equally fast recovery to be back on track by early 2021, or are we in for a more protracted downturn?
There are two clear schools of thought among investors at the moment:

1. The virus is coming under control and policy will provide enough support so that the economic recovery will be 'V' shaped. That means we can ignore short run data no matter how bad it gets because we will be back at pre-virus levels of activity sooner rather than later; and
2. The damage to confidence from the virus so far will delay the pace at which households and firms resume spending. In addition, the risk of a second wave of infections is high enough to keep social distancing in place for longer than might be expected. Expectations for growth of EPS for this year, next year, and quite likely 2022 need to be revised down. The recovery is 'U' shaped.

A recent global investor survey (by BofA Securities) shows 15% of respondents expect a 'V' shaped recovery, while 52% expect a 'U' shaped recover and 22% expect a 'W' shaped profile, where an initial recovery is curtailed by a subsequent loss of confidence. Other results from the survey include:

- 57% of respondents see a second wave of infections as the biggest risk for the global economy;
- 49% think Trump will win the re-election, down from 56% the previous month.

We are in the more cautious camp about the shape and speed of the recovery. It seems counter-intuitive that economic agents can suffer such a huge shock and simply return to a pre-crisis state quickly and cleanly, especially if there is no conclusive solution for the virus until well into next year.

Also, it is hard to reconcile the logic of looking through the coming falls in earnings per share (EPS) that we expect with current market valuations. For example, our forecasts show US EPS growth down around 35% in the next 12 months. At current levels of the S&P 500, that implies the forward P/E ratio would rise to 30 in the next six months, which would be higher than at any time in the last 35 years of available data. The same analysis for Australia shows an expected 26% fall in EPS and at current levels of the ASX200 implies the forward P/E rising to 20 in the next six months. That would be the highest reading in 33 years of available data.

The bottom line is that what we are seeing now looks like a big momentum trade moving further away from fundamentals. Sooner or later the two will have to re-connect. This implies that we may see a retracement in equities in coming weeks or months, though obviously it is impossible to say exactly when. In light of this, the Portfolio remains defensively positioned with higher cash and fixed income allocations to help preserve capital. We continue to track conditions very closely to assess the balance of forces between the data on the economies, the virus and future stimulus moves. Further, the Investment Committee has plans in place for how we will use further retracements in markets to unwind some of the defensive measures and re-establish higher equity exposures in the Portfolio.