Quarterly

AUTUMN 2020

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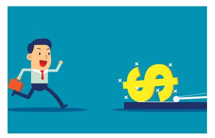
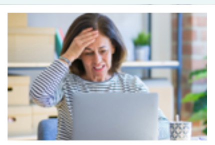




DNR investment review

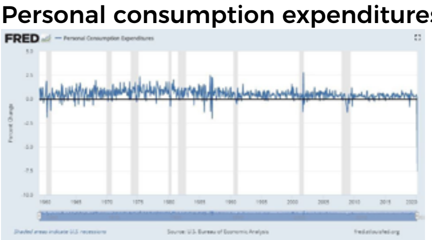
By Jamie Nicol

Markets bounced in April following the shock of the lockdown that caused markets to sell off through March. The bounce has surprised many market commentators, given the obvious stark economic impacts we can all observe. This month we discuss the bounce in markets, the ongoing gap between value and growth stocks, and the major opportunities presenting.

Is the market bounce justified?

The economy has hit a brick wall and the rally in stock markets is seemingly at odds with this clear economic reality. The economic collapse is unprecedented. Any number of charts highlights this. The dire numbers reflect the fact that economies are closed. Investors are looking through this short-term collapse and grappling with what earnings will look like on the other side of the crisis. Economies will not be shut forever, and it is important to value stocks based on long-term cashflows rather than on one or two quarters' earnings.

Personal consumption expenditures



Source: U.S. Bureau of Economic Analysis

The fall in equity markets in March was also large by historical standards – a fall of 25% is a large pullback and the sharpness of the fall reflects economies grinding to a halt.

XJO

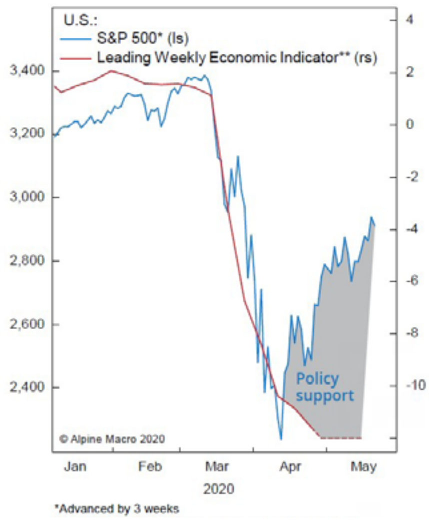
Source: Iress

The investor sentiment of 'buy when there is blood on the streets' or 'when fear is at its greatest' is true, yet this can only be measured with the benefit of hindsight.

Many commentators have been looking for markets to retest their lows or to make new lows on the back of the uncertain economic climate. However, we are not so sure. March was a period of exceptional uncertainty – regarding the number of COVID-19 deaths that would occur, the length of the shut down and the level of economic impact. Since then, the level of the impact from COVID-19 has become clearer and economies are slowly opening. The strength of the economic recovery remains unclear but stocks are forward looking. Unprecedented policy supports, both monetary and fiscal, have stabilised market expectations, bridging the gap between the current economic fallout and future economic recovery.

A major rally in stock prices almost always occurs when a recession is at its worst. This was true in the savings and loans (S&L) crisis of the 1980s and 1990s, the 2001 dot-com bust and the 2008 global financial crisis. Clearly it is not unusual for stocks to rise before the economy recovers.

S&P 500 versus Leading weekly economic indicator



Source: Federal Reserve of New York

The COVID-19 crisis has caused unprecedented economic contraction and the question of whether policy support is enough to fill the economic hole remains.

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DNR investment review

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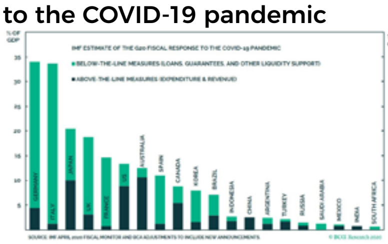
Our sense is that the fiscal packages launched so far are enough to stabilise the economy – they certainly are unprecedented by historical standards. Interestingly, the Australian fiscal spend is the largest in the world despite our lockdown being shorter than other nations. The OECD estimates that the aggressive containment policies will cause real GDP to be 1.5–2.5% lower for each month the lockdown is in effect. This implies an impact of around 6% from the initial shock, assuming an aggressive return to normal. This implies an output loss of around $1.6t in the US. The US government has enacted support packages valued at around $3t, which should offset the output loss. Adding the monetary efforts, the US is pumping in $7t into the economy. Global governments have reacted quickly and aggressively to this crisis – a sharp contrast to their behaviour in previous downturns.

IMF estimate of the G20 fiscal response to the COVID-19 pandemic

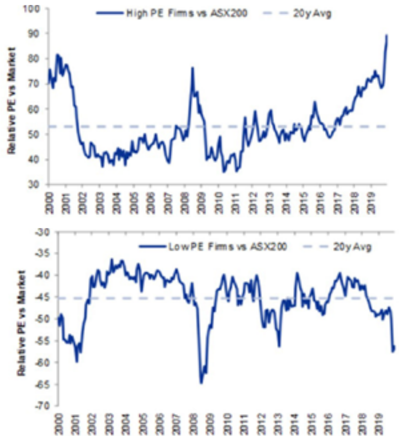


Source: BCA Research

Valuations

Understandably a key concern for market participants is the value of the market. Usually markets will bottom during a bear market at low multiples. In this downturn, multiples for stocks with greater economic sensitivity have traded cheaply, while those with defensive earnings or growth characteristics have remained elevated.

Relative PE of high value stocks versus low value stocks



Source: FactSet, Goldman Sachs Global Investment Research

We argued last month, and continue to argue, that markets have become very short-term focused during the crisis. It is difficult to value companies that have little short-term earnings, but therein lies the opportunity. Crowding into food retailers enjoying a profitable month selling toilet paper is a very short-term strategy. We talked to the Metcash (MTS) example last month, which was up 40% in March as investors chased the toilet paper trade. In April it reported its result, which failed to live up to expectations and the stock fell back 30%.

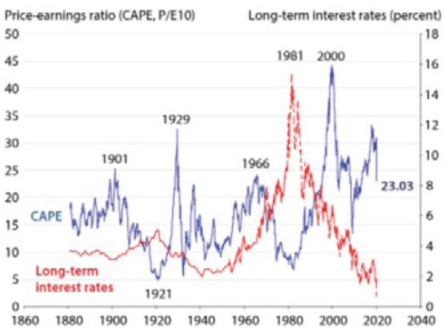
Metcash

Source: Iress

A further rotation out of the expensive segments of the market will occur as the economic recovery takes shape. This can occur as various segments of the market open.

Longer term it is also worth thinking about the appropriate rating for equities. Lower interest rates imply higher multiples. The lower the rates on long-term bonds, the less they can compete with stocks. Of course, stocks are much riskier in the short run but investors with a 10+ year horizon are far more likely to see growth in purchasing power by buying stocks rather than bonds. In a low interest rate environment, not only can the US finance deficits and stimulus programs at low rates, but the low interest expense also flows down to companies and individuals. The following chart shows that low interest rates should support higher multiples.

Robert Shiller's cyclically adjusted price-earnings ratio and long-term interest rates



NOTE: The figure shows monthly data on Robert Shiller's cyclically adjusted price-earnings ratio and long-term interest rates from 1880 to April 1, 2020. We obtained the figure from a downloadable XLS file on Shiller's website. The data are from Shiller's book, *Irrational Exuberance* (Princeton University Press 2000, Broadway Books 2001, 2nd ed., 2005); http://www.econ.yale.edu/~shiller/data.htm. P/E 10, the price-earnings ratio evaluated over earnings per share from the past 10 years.

Source: Robert Shiller

Where to from here?

We see the following positive drivers for markets:

- Europe and US economies continuing to open and incremental positive news flow occurs as economies begin to recover. Policymakers appear to have made a conscious policy choice of reopening the economy while allowing for certain levels of infections and mortalities. This is "controlled herd immunity" and has become a public policy choice for most Western governments. This is good news for stocks, although not necessarily optimal from a public health point of view.
- Any signs of pent-up demand creating a positive early bounce in economies.
- Further news flow on vaccines, treatments and testing procedures to enable greater functionality of economies.
- Further evidence of the stimulus effect and further stimulus announcements.

The negative drivers from here include:

- A second wave of COVID-19 causing markets to shut down. This would further disrupt markets and have economic implications.
- Fallout from disputes between China and the US.
- Political failure to support further stimulus, should the economies need it.

It will take some time for the US economy to return to pre COVID-19 levels, but this does not necessarily mean stock prices will have to retest their lows. Stocks and the economy often go separate ways, and this is especially so when there are powerful policy stimuli in the pipeline. Our focus is on finding quality companies at attractive valuations. Opportunities continue to be presented in a volatile environment.

Article source: DNR Capital

Don't fall for dividend yield traps

By Tony Kaye

Australian shareholders are set to reap around $27.5 billion in interim company dividends over the next two months, courtesy of the latest corporate earnings season.

Those dividend flows will be very welcome to many investors during some of the most volatile market trading conditions on record, and following another cut to official interest rates last month to an all-time low of 0.25%.

Yet, investors seeking out dividends, especially from companies that currently appear to be paying very attractive dividend yields, should be extremely careful.

What may look like a good yield opportunity at the moment may not pan out that way over the medium term, particularly as the economic and financial fallout from COVID-19 on the 2020–21 earnings results of listed companies becomes much clearer.

The spike in yields

Right now, the notional dividend yields on many of Australia's largest listed companies look very attractive.

Dividend yields are calculated by dividing a company's prevailing share price by its declared annual dividend payment per share. Yields move constantly, in tandem with share prices.

Take the major banks, for example. All of the "big four" are yielding between 7% and 12% based on their share prices at the close of trading on Friday 27 March.

But keep in mind that a month ago, at the point global equity markets began to tumble, the same banks were yielding between 5% and 7%.

The recent upturn in their dividend yields directly correlates with the plunge in their respective share prices since late February – on average their share prices have fallen around 40%.

In fact, the same scenario is evident for all of the companies in the ASX top 20 when their share price to dividends ratios are compared between 20 February (the market peak) and late March (following weeks of sharp falls).

Dividends pain ahead

Australian shareholders have a distinct advantage over those in many other countries when it comes to dividends, thanks to favourable tax laws.

Dividend imputation enables some or all of the income tax already paid by a company to be distributed back to shareholders, or imputed, as a tax-paid franking credit.

But there are now widespread expectations that many ASX companies, including the major banks, will either cut or defer dividend payments to shareholders as a result of severe business losses stemming from COVID 19. Franking credits could also be cut at a company's discretion, based on its earnings results.

After announcing a 30% increase in its final dividend to 13 cents per share fully franked in August 2019, last week Qantas said it was deferring the payment of its 2019 December-half interim dividend from 9 April to 1 September.

Which is one of the fundamental lessons for income-focused investors – dividend payments are not locked in stone, in the same way that dividend yields, especially during volatile trading conditions, can gyrate wildly from day to day.

In the latest earnings reporting period, for the half-year to December, a slightly smaller percentage of ASX 200 companies (87%) have chosen to pay a dividend – down from 88% in the August 2019 reporting season. Of these, just over half elected to lift dividends.

Difficult operating conditions, even ahead of the latest market downturn, are largely to blame.

Reducing dividend income risk

The easiest way for investors to reduce dividend income risk – the risk of being over-exposed to the payout policies of specific companies – is through diversification.

And the best way of achieving that is by having broader exposures to diversified income streams via a large pool of listed companies, such as though a managed fund or exchange traded fund covering the largest companies in a single market or across multiple markets.

Think of funds as a form of fishing net that will catch the dividends of very company that falls into their investment focus, for example every company that's contained within the S&P/ASX 300 Index.

The key advantage for investors is that irrespective of individual company dividend yields and payouts, a fund will aggregate all dividends and distribute them to investors.

While dividend flows may decline over them medium term, having exposure to many companies allows investors to capture a greater amount of the total dividends spectrum.

Doing this also eliminates the need to focus on the dividends of individual companies and their dividend yields, which recent events have proved can be a dangerous trap for investors.

Article source: Vanguard Investments

Ride the market to recovery

By Robin Bowerman

Severe market downturns feel anything but fair. In many ways the biggest risk facing investors now is the impulse to take action and to make hasty, short-term decisions based on emotional factors rather than accepting where we are today and riding things out.

The loss of market value that seemingly evaporates overnight is deeply unsettling and challenging even for committed, well-diversified long-term investors.

But market downturns are not unexpected – most of us will experience several during our lifetimes – particularly after such a long bull market run where market surprises were generally on the upside.

Australia we also should remember has not felt a recession in 29 years. That may feel like cold comfort at this time particularly because we are first and foremost dealing with a global health crisis that unravelled extremely quickly, and then the economic impacts that flows from the measures required to contain and combat it.

Uncertainty and the sense of loss of control are powerful emotions to grapple with. But what we know from past market events is that patience will be rewarded and recoveries can be just as sudden and strong.

The positive news is that the general consensus among economists is that while the recession will likely be sharp it is also likely to be relatively short and the upswing quite rapid. It has also been encouraging to see governments around the world prescribing measures to help hasten the recovery.

But the question about what to do – now – remains. There are five things investors should think about:

1. Tune out the noise. We all want to be informed but with dedicated television channels, websites and newsletters all on top of our normal media consumption habits this type of news event can be overwhelming. Consider checking in with one or two trusted sources and tune out the rest. It's ok not to be checking account balances when markets are falling.
2. Revisit your asset allocation. These type of market events impact investors differently. But it is not all doom and gloom. Younger investors have that incredibly valuable asset – time – while those approaching retirement have just been given a sharp example of how much risk is in their portfolio. If it has surprised you then going forward as markets recover it may mean you should re-evaluate your risk tolerance and rebalance your portfolio to take a more conservative approach.
3. We know we cannot control markets but there are some things we can control – like costs. Costs are particularly painful during downturns so take the time to review high cost investments in your portfolio. For those already in retirement it may mean temporarily trimming back on discretionary lifestyle spending to lighten the amount you need to draw down.
4. Stay diversified. Different asset classes and sector exposures can help insulate your portfolio by spreading the risk.
5. Set realistic expectations. Have a long-term plan and be realistic about returns you expect in the decades ahead.

Staying the course can pay off, abandoning course can be costly.

Article source: Vanguard Investments

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