

Pendal Smaller Companies Fund Update and Market Insights

March 24, 2020

Here Pendal portfolio specialist Chris Adams presents the latest COVID-19 insights and activities relevant to our Smaller Companies Fund clients.

Recent positioning and activity

Experience has taught us that in crises such as the COVID-19 outbreak, balance sheet strength is paramount in small caps.

It is not enough to look at current debt metrics. Instead we must model what would they look like if cash flow dried up for three months, six months, nine months or longer.

We have been reviewing the portfolio companies to assess risk to the balance sheet or cash flow. We are also conducting a secondary deep-stress test for worsening trading conditions to assess each company's ability to weather the storm without capital raisings.

We have engaged in a comprehensive program of company contact, speaking with the CEOs of most of the companies we own.

We have been reducing or cutting companies where we see significant negative leverage to current events, either through:

- Direct impact of travel restrictions, eg Webjet (WEB), IDP Education (IEL)
- Material supply chain risks, eg Lovisa (LOV), Mainfreight (MFT)
- Risks to balance sheet funding eg Credit Corp (CCP)
- High fixed cost base, with reduced flexibility, eg Ooh Media (OML).

Within the context of the framework above, we have added to the recession insurance bucket via the addition of gold miners.

We have also added to the high-quality defensive bucket adding Chorus (CNU) and Bapcor (BAP).

We have been very selective around adding to recovery plays, but have taken the opportunity to add to companies such as Nick Scali (NCK). Again, a key focus here is balance sheet and management quality.

We have also added to Monadelphous (MND) – a long-term franchise winner trading at attractive levels on a 3-5 year view.

New purchases have been funded primarily from other positions. We have maintained liquidity (cash and futures) at around 8% of fund.

This cash position is held partly in anticipation of deeply discounted capital raisings for certain businesses where we would look to opportunistically participate.

Market observations

Markets are starting to price in the risk of a material downturn in earnings and recession.

Turnover in the small cap market has been elevated. It has also been higher-than-usual in the Fund as we have repositioned the portfolio. We have been able to trade and shift our positions in a normal and timely manner and continue to see ample liquidity in this part of the market.

The influence of ETFs and passive investing is clearly apparent in the indiscriminate nature of the market sell-off.

This has been exacerbated by the effect of risk parity strategies and other systematic approaches needing to de-risk.

The market's sell-off is rational, but indiscriminate selling has led to outcomes that are irrational - such as the poor performance of traditional hedges such as gold.

We are mindful of heightened near-term uncertainties and second-order effects. But when stocks with limited or even positive sensitivity to the near-term economic environment are selling off to the degree we have seen, there is no doubt there is mis-pricing and opportunities for active managers.

At this point the market has been hit by a valuation de-rating.

Several companies have withdrawn earnings guidance, but we are yet to see widespread earnings downgrades. These will come. But it's only once companies and investors start to dimension the duration of the economic disruption and the softening effect of policy that we will start to gain a sense of the full market effect.

Key factors to watch here include the rate at which infections spread and when they peak, as well as the scale and focus of fiscal and monetary policy measures.

The upshot is we are likely to face further volatility until people have a better handle on how long the economic dislocation is likely to extend – and until we gain confidence that government action will underpin the economy during this period.

At that point, we expect investors will start to recognise the undoubted value that is emerging in parts of the markets on a 3-5 year view.

In this environment active portfolio construction and risk management is crucial.

The ability to weigh risks, recognise opportunities as mis-pricing surges, and provide a clear and disciplined framework to account for an uncertain range of possible outcomes has paid dividends so far.

We believe this will continue as the current crisis unfolds and the path to recovery becomes clear.

Economic observations

There is stress emerging in credit markets, reflecting the fear of widespread business closures.

There is material scope for government intervention to put a firewall between the economic disruption of containment measures and the potential structural economic damage it could cause.

Unlike previous crises, this is not the fault of misallocated capital in a specific industry. This reduces the “moral hazard” of intervention. This is reinforced by the view that the health infrastructure has not been adequately prepared for pandemic.

Hence we are likely to see unusual measures to reduce widespread insolvencies and unemployment. Measures such as industry-based interest-free loans, tax holidays, debt guarantees – and central bank purchases of commercial paper and even equities – are on the table.

The impact of potential businesses closures and unemployment on the broader economy should not be understated.

While industries such as travel, energy, some retail and hospitality are feeling the first-order effects, there are very few industries that will not feel some impact from reduced consumer demand.

The key focus will be the market’s confidence that government stimulus will prove sufficient to underpin vulnerable sectors and see them through the worst of the economic disruption.

Possible outcomes

We have a deeply experienced team that has gone through several episodes of this nature. Each crisis has its own characteristics, but the challenge is the same: protecting capital as much as we can and positioning ourselves to take advantage of the opportunities.

It is important to acknowledge that we do not know the outcome. We are experts in analysing companies – not in virology. We have no special insight into how infection rates unfold.

What we can do is provide a framework in how to think about probabilities of outcomes.

We can then position the portfolio to perform in the most likely outcome, but also make sure we are hedged against the less likely but still possible scenarios.

We see the possible outcomes as follows:

| Scenario | 1 | 2 | 3 | 4 |
|-------------|----------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------|
| | Global widespread pandemic | Rolling outbreaks globally | Milder outbreak (Spring + containment) | Quick resolution (Medical breakthrough) |
| Economy | Severe global recession | 6-9 month downturn Mild recession Followed by recovery | 3 month slowdown Possible recession then quick recovery | Global economy re-accelerates |
| Policy | <ul style="list-style-type: none"> • Zero rates • Unconventional policy • Large fiscal stimulus | <ul style="list-style-type: none"> • Zero rates • Targeted fiscal stimulus | <ul style="list-style-type: none"> • Rate cuts • Limited fiscal stimulus • Bonds back-up | <ul style="list-style-type: none"> • Rate cuts reversed • Bonds fall sharply |
| Markets | Material >20% drop | ~10% decline, with bounce back by year end | Close to lows 20-30% bounce | Major rally 30%+ |
| Probability | 5% | 65% | 25% | 5% |

Portfolio framework

Experience has taught us the important thing is to focus on the things you can control.

We cannot control the outcome of this health issue. We cannot control the market's reaction. But we can control the framework we think best positions the portfolio – and we can control our view on which are the best companies to hold within each of the framework categories.

The portfolio's framework in the environment is designed to weather the more likely of the above outcomes – scenarios (2) and (3) – and to take advantage of the buying opportunities that have emerged.

However we also need to be mindful of protection in case of one of the more extreme scenarios - positive or negative – playing out.

In this context, the portfolio's structure can be considered in the following context:

- **Recession insurance:** We want stocks with the potential to hold up well if economic conditions deteriorate. We have some gold exposure with Saracen Minerals (SAR), Silver Lake Resources (SLR) and Gold Road (GOR). We also hold some AREITs, focusing on those with the backing of strong assets, low gearing and long term stable tenants such as Charter Hall Long WALE (CLW) and Centuria Industrial (CIP). We have avoided those with vulnerable exposure to consumer discretionary.
- **Quality defensives:** Companies that combine strong balance sheets, good management and low sensitivity to the near-term economic dislocation, with relatively limited impacts on revenue. Examples include Invocare (IVC), Bapcor (BAP), AUB Group (AUB) and Chorus (CNU).
- **Beneficiaries of fiscal stimulus:** While central banks have already moved to cut rates, governments are also increasingly expected to inject stimulus to help companies and the economy bridge the expected slowdown. We have several companies that would benefit from expected stimulus including Domain (DHG), Adairs (ADH) and Nick Scali (NCK).
- **Franchise winners:** Good businesses that may see a near-term hit but are well positioned in terms of balance sheets and competitive position to withstand a slowdown. They look attractively valued on a two-to-three year view. Examples here include Monadelphous (MND), IDP Education (IEL), Reece (REH) and Ryman (RYM).
- **Resolution insurance:** There are several stocks we would expect to surge quickly on any sign of slowing infection rates or a medical breakthrough. Where our analysis gives us comfort around balance sheets and debt covenants, we have positions in some high-quality growth names such as Technology One (TNE), Appen (APX) and Bravura (BVS). We would also expect our quality cyclical such as Domain (DHG) and Seven Group (SVW) to perform well under this scenario.

For more information contact your key account manager or visit pendalgroup.com

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