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Pendal MidCap Fund Update

24 March 2020

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

Recent positioning and activity

Experience has taught us that in crises such as this balance sheet strength is paramount.

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.

As a result we have been reviewing the portfolio companies to assess risk to the balance sheet or cash flow.

We are also doing a secondary deep stress test for worsening trading conditions to assess each company's ability to weather the storm without capital raisings.

We want to avoid stocks with highly geared balance sheets, cyclical earnings and a high risk of breaching debt covenants which might force an equity capital raising.

We have gone stock-by-stock through the Midcap universe to identify those most at risk.

This has led to us cutting some positions in stocks where we see too high a risk around leverage.

We have rotated this into some new positions and also deployed some cash, buying selectively in high-quality defensives (A2 Milk), stimulus beneficiaries (Iluka) and long-term franchise winners (JB Hi-Fi).

However we also retain reasonable cash – currently around 6.5%. This keeps the powder dry in anticipation of deeply discounted capital raisings for certain businesses where we would look to opportunistically participate.

Where we have added to stocks the focus in each case has been on ensuring we are comfortable with the balance sheet under various stress scenarios.

Market observations

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

Turnover in equity 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 even at the smaller end of the Midcap 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 which are irrational – such as the poor performance of traditional hedges such as gold.

Emerging opportunities

We are mindful of the heightened near-term uncertainties and second-order effects.

However 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, however it is 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 that 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 be able to underpin the economy during this period.

At that point, we expect investors will start to recognise the undoubted value 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 thus far.

We believe will continue to do so 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

Industry-based interest free loans, tax holidays, debt guarantees – and central bank purchases of commercial paper and even equities – are all on the table.

That said, 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 very experienced team-members who have 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 Global widespread pandemic	2 Rolling outbreaks globally	3 Milder outbreak (Spring + containment)	4 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	• Zero rates • Unconventional policy • Large fiscal stimulus	• Zero rates • Targeted fiscal stimulus	• Rate cuts • Limited fiscal stimulus • Bonds back-up	• 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 that the important thing is to focus on the things you can control.

We cannot control the outcome of this health issue and we cannot control the market's reaction.

However, we can control the framework that 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 protecting it in the 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:

1. **Recession insurance:** We want stocks with the potential to hold up well if economic conditions deteriorate. We have some gold exposure via Saracen Minerals, infrastructure in Atlas Arteria, consumer staples in Metcash and a strong asset-backed REIT with low gearing in Viva Energy REIT
2. **Quality defensives:** Companies with strong balance sheets, good management and low sensitivity to the near-term economic dislocation, with relatively limited impacts on revenue. Examples include Xero, A2 Milk and ResMed.
3. **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 see Seven Group and Cleanaway as two companies set to benefit from likely stimulus actions.
4. **Franchise winners:** These are 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 Monadalphous, JB Hi-Fi and Nine Entertainment.
5. **Resolution insurance:** There are several stocks that have been exposed to the first-order effects of this disruption, but which we would expect to surge quickly on any sign of slowing infection rates or a medical breakthrough. Again, in each case we are focused on the capital position and the company's ability to survive a sustained period of depressed cash flow. Altium is one example — and we are also looking at several other opportunities.

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