Australian Equities Update

COVID-19 scenario analysis framework

April 20, 2020

Markets have stabilised in recent weeks. Nevertheless, this remains the most complex market environment today's investors have ever confronted.

On one hand we have the worst economic crisis in living memory – on the other, the greatest policy response ever seen. Earnings are going down, but liquidity is going up. Business models are being turned on their heads. It is an era of uncertainty – which also means a great opportunity for active managers.

We continue to focus on what we can control: our ability to meet companies to understand first-hand what they face and how they are reacting. We had more than 200 company meetings in March.

We're also focused on managing the risks in the portfolio. At the same time we can sow the seeds of future performance by identifying the opportunities this episode is bringing about. Opportunities like these come along only a few times in an investor's career.

As we have said since the outset, we do not know how this will unfold. No-one does. But as we have detailed before, we have been using a framework of potential scenarios to position the portfolios. We have been positioning the portfolios for the most likely scenario, while making sure we have some hedges against the tail risk of more extreme outcomes.

Our current view on the four key inputs into our scenario analysis are:

i) **Case load and severity:** Australian case numbers, growth rate and severity are well within the capacity of the health system. Better outcome relative to some other parts of the world, though case number growth is slowing in most major economies.

ii) **Depth and duration of economic hit:** Still highly uncertain, but fiscal response and avoidance (so far) of level 4 restrictions critical in containing economic damage.

iii) **Nature of the re-start of economy:** Still unknown. Debate is whether government pursues "elimination/suppression" or "mitigation" strategy. Australia has the option of the former, due to geography, political structure and current control over virus spread. This is not the case in the US or Europe.

iv) **Timing of medical breakthrough:** Anti-viral studies still inconclusive. Optimism around vaccines is high, but length of time until widely available remains an issue.

Our scenario analysis is necessarily dynamic. Initially it was focused on the path of the outbreak – would it be an uncontrolled global pandemic? Would government actions succeed in slowing the spread? We now have a better picture in this regard. Analysis of the data and observation of policy responses suggests the original "worst case" scenario of an uncontrolled global pandemic is off the table at the moment.

With the virus spread effectively under control in some countries – and slowing in others – the focus has shifted to how quickly and in what manner can economic activity re-start. This is reflected in our evolving scenario analysis below:

Scenario	1 Failed mitigation (2nd wave prevent recovery)	2 Successful mitigation (Economy ramps steadily)	3 Elimination / suppression	4 Medical breakthrough
Economy	Severe global recession Structural damage prevents full recovery	Recovers to 90-95% pre-crisis levels by Q4 & 100% be end CY21	Domestic economy operates close to full throttle, borders closed	Global economy re-accelerates
Markets	Material >25% drop	Current levels, potential YE bounce if vaccines are close to being available	Market recovery 10%+	Major rally 30%+
Positioning	Low geared, defensives	Global industrials, defensives	Domestic stocks (retail, infra, ngineering)	Cyclicals, financials, energy
ROW*	25%	60%	5%	10%
Australia*	10%	35%	45%	10%

* Probability of each scenario occurring in Australia and the rest of the world

The potential divergence between Australia and other parts of the world – given the option of elimination/suppression is still on the table here – is an important development. If Australia follows the elimination/suppression strategy, it can mean a more expansive restart of economic activity than may be the case overseas.

This has implications for portfolio positioning with regard to domestically and overseas-focused companies. In the last two weeks we have added a number of domestically-focused exposures and companies in the portfolio to reflect this.

This scenario analysis continues to inform our portfolio positioning. The worst case scenario now reflects a second wave of infections and a need to re-implement containment measures rather than an uncontrolled pandemic. But it still requires us to have some "recession insurance" positions.

Recent developments may have lifted the probability of a medical breakthrough from about 5 per cent to around 10%. But this still remains a tail risk which must be hedged though our recovery plays.

In this context, our key portfolio positions are:

Recession protection: Stocks which should outperform if economic conditions deteriorate (eg Telstra, Metcash, Coles)

Quality defensives: Well-run companies with limited near-term impact from COVID-19 (eg CSL, Xero, IAG)

Policy beneficiaries: Leverage to policy moves that support economy. Initially iron ore miners on the back of China; more recently we see housing-related stocks (James Hardie) in this camp.

Franchise winners: Buying opportunities brought about by the crisis. Stocks which will see a hit from COVID-19, but have the balance sheets and competitive position to endure. (eg JB Hi-Fi, Nine, Mondelphous, Aristocrat).

Recovery plays: Stocks which will respond to economic recovery or a medical breakthrough. We have been more cautious in adding here. We have positions in Qantas and Santos. More recently we have been adding to some more domestically-focused names in this segment to reflect the divergence discussed above. Downer is one example.

Ultimately, our approach – while tailored for the current circumstances – is consistent with the strategy we have employed for 17 years: identify stock-specific opportunities and combine them in a balanced portfolio built to manage exogenous risks. This approach has delivered long-term success, which has served well during this crisis. We are confident it will allow us to navigate the coming months and sow the seeds of future performance.

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