Navigating the Coronavirus Crisis

Hugh Giddy

Senior Portfolio Manager - IML Concentrated Fund & co-Portfolio Manager - IML Australian Share Fund

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We are in the midst of a very unusual crisis that is affecting a world that has become vulnerable on many fronts. Pandemics are not new. Over history the effects have varied in each instance as people have responded differently to try and stay safe and healthy: by staying at home; by quarantining people; or by making sure they got outdoors into fresh air and sunshine (something that is at odds with the "stay at home" mantra now). Because of the prevalence of international travel and the apparent virulence of infectious transmission, the coronavirus or COVID-19 rapidly became global. Governments around the world have responded with very restrictive measures to contain the pressure on health systems.

The virus has affected a world that is extreme in many areas, not all of them positive. We have unprecedented prosperity as many have been lifted out of poverty by economic growth, and there have been great increases in life expectancy, literacy, education and inclusion in the digital economy with the proliferation of smartphones and the internet. However, this has all come at a price.

The prosperity has been underpinned by a mammoth increase in credit, with debt levels in developed and many emerging countries well beyond historic norms. There is also greater inequality now than at any time since the Great Depression. We are also at an extreme in population. The growth in population in the past century has put pressure on global resources, and the natural environment in which we live has been under threat from pollution, forest clearing, species extinction, changes in climate and the waste associated with our consuming and producing habits.

Since the GFC, enormous fiscal stimulus has been combined with even looser monetary policy than we have already been becoming reluctantly accustomed to and we are seeing this even more in evidence today. Central banks around the world have expanded their purchases of government debt and other assets with money that is effectively printed rather than created through labour or other forms of value creation. As an arm of government, central banks are lending money to government, effectively moving money from one magic pocket to another pocket in the same organisation. Central banks are also buying private assets with the money that they have simply created. Money represents trust in exchangeability and a store of value but this is all occurring effectively through electronic entries in the banking system now. There is no fixed value for any currency as there was when there was a gold standard, for example, or a limited number of cowrie shells. In such a system it is easy for central banks to create money and we have to hope and pray that their recent actions do not create high levels of inflation as we have witnessed in Zimbabwe, many Latin American countries, Weimar Germany and elsewhere whenever money printing got out of control.

There is always uncertainty about the future. The confluence of a health crisis, lockdowns of uncertain duration, domestic and international travel restrictions, high levels of debt which have fostered high real estate prices and high financial asset values, looming unemployment and government restrictions on business operations all make it harder than usual to predict how the world will look in six months or a year or longer.

When will air travel resume for example, and will it be at levels similar to the past or greatly reduced?

Will house prices come off as many people will struggle more than ever to deal with their mortgage burden or require rent reductions as their incomes fall?

Will countries become more insular and reduce global trade which has underpinned some of the prosperity we have achieved, particularly in the developing world?

Will we ever see the capitalist system function as it should do, with cycles leading to a cleansing of the system as excessive debts are resolved by defaults and losses and as poor investments fail?

This last scenario seems unpalatable to all politicians and everyone who has benefited from the huge rise in credit. However, the truth is that such a cleansing of the system, while it would cause pain, would also allow for a much better foundation for growth into the future.

Coming into the crisis and for some time beforehand both the ***Investors Mutual Australian Share Fund*** and the ***Investors Mutual Concentrated Australian Share Fund*** were defensively positioned. For some, being defensive simply means having a low valuation. However, at IML we believe the quality of a business is a key ingredient in the sustainability of its cashflows and the defensiveness that the business will display in tough times. A low valuation is often attributed to companies with a poor franchise, a weak balance sheet, suspect management or poor governance. Such investments are unlikely to be defensive when conditions are tough.

Defensive positioning meant a focus on quality businesses with strong franchises, cash flows and reasonable balance sheets. These businesses should do well in good times and reasonably in tougher times.

The nature of the virus and the associated shutdowns has meant that some parts of the economy have been hit very hard while others have actually benefited from the crisis. Casinos, pubs, restaurants and cinemas have been shut, and many retailers have closed their doors. Almost all travel has ceased, affecting airlines, airports, fuel retailers, hotels, travel agents and others. On the other hand, in the retail space, sales of DIY, supermarkets, liquor and laptops for work and study from home have boomed, and hospital and protective equipment suppliers have done well in many cases. As a result this is not a downturn in demand that has been felt evenly and predictably across the economy.

To date the ***IML Australian Share Fund*** and the ***IML Concentrated Australian Share Fund*** have done reasonably well in delivering less downside than the overall market. However, several positions have detracted from performance that had seemed relatively defensive, most notably the gaming sector. Crown and Sky City casinos, and Tabcorp too, have had to close doors to their venues, resulting in essentially no revenues, or significantly impacted revenues for Tabcorp. All businesses have long duration monopoly licences and would normally only suffer moderately in an economic downturn since gambling tends to be resilient and none of these companies have excessive gearing. We are looking through the lockdowns and conservatively estimating earnings and cash flows once normal business resumes and think these positions offer reasonable returns ahead at their reduced prices.

None of our Funds are buying into lower quality businesses that have suffered as much as, or more than, these positions, because in a tough environment some combination of poor positioning, high gearing and weak management will mean earnings pressure for some time to come. Also note that for some time the ***IML Australian Share Fund*** has been very underweight the big four Australian banks while ***IML Concentrated Australian Share Fund*** has had no exposure to the big four Australian banks and this remains the case.

The reason for our continued caution to the sector is because banks are highly leveraged enterprises with large asset bases (or loan books) relative to their equity. The Banking sector did very well for almost thirty years after the last Australian recession in 1990/1 as credit expanded rapidly. In the current environment, with overindebted households, stretched property values and potential material losses from bad debts, the risk-return trade off in banks remains unappealing.

Instead, all IML's Funds continue to target quality, defensive businesses, with cash on hand in our Funds to take advantage of opportunities that arise when selling is indiscriminate. Key features of a quality business include:

- **A strong franchise**, where ongoing profit and cash generation is underpinned by products or services that have sustainable demand and are more of a necessity than a highly discretionary purchase, and where the company is well placed within its industry. It is hard to imagine at this stage that as we emerge from lockdowns, with unemployment higher and confidence hurt by people struggling to pay bills from limited savings, that freewheeling consumer spending will return to levels before this crisis.

- **A strong balance sheet**, where not only are profits likely to amply cover interest obligations, but where the company is able to continue to invest to maintain or grow its business, either through R&D, marketing, customer service or selective acquisitions of bargains that may arise in the tough times ahead. Amcor's acquisition of Alcan's packaging operations in the GFC is a good example.
- **Strong and experienced management teams** which have fostered robust businesses and who are able to take advantage of the opportunities which arise as competitors falter. Companies also need to understand the importance of cash flow, as tough times often place pressure on debtors and working capital.

Of course, valuation remains very important in building the portfolio - but a low valuation or much reduced share price may often be a sign that a company is in serious trouble rather than a bargain.

We are working hard to monitor the companies we own and researching selected new opportunities that volatile markets may throw up. We are conservative in our expectations as the world's excesses - in terms of high debt and overcapacity in many industries - will both limit and stretch out the recovery that will inevitably occur.

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