



## CONCENTRATED AUSTRALIAN EQUITIES PORTFOLIO

# PORTFOLIO UPDATE

### CONCENTRATED AUSTRALIAN EQUITIES PORTFOLIO (CAE)

Unless otherwise stated, all figures are as at 10<sup>th</sup> April 2020. Performance figures are preliminary and gross, based on a representative account.

#### OVERARCHING THOUGHTS AND SOME OBSERVATIONS

**“Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning.” Winston Churchill, November 1942**

- What do we do now? Whilst it is relieving that social distancing has worked in major economies, there is no clear path to getting back to normal. A vaccine or a cure is not on the 9-12 month horizon. It is getting more interesting to look at those trying to wind back distancing such as Denmark and Austria, those who might push for zero, such as Taiwan and New Zealand, and those choosing different paths such as Sweden, Singapore, South Korea and Hong Kong. The path out is not clear and may be a long one.
- Economists are not sure what happens now. Economists models tend to work less well when confronting short, sharp, moves, and large moves. The current environment is both of these. Apart from the inherent problem of not knowing what the medical situation will be and what the political reaction to that will be, this is a situation where models don't work well. We have had numerous conversations with economists in recent weeks and have heard an extraordinary number of caveats, disclaimers and the odd “this is unprecedented so we really don't know”.
- The lower levels of economic activity will most likely be with us for multiple quarters. Whilst it is tempting to look at “normal” earnings in 2022 when we hope to have a widely available vaccine or a cure, the value destruction in 2020 and 2021 is easy to underestimate. Balance sheet strength and trough cycle free cash flow are very important.
- Gold probably wins. There are huge amounts of debt being accumulated by governments all over the world. The only options are pay it back, deflate it away (print money) or default. History tells us the major economies tend to deflate it way. Gold has typically been the beneficiary of these strategies.
- The pressure is still on the oil price. Of the “normal” 90 million barrels per day (bpd) global production and consumption, the oil capacity cuts of 10 million bpd are multiples less than the demand destruction, and represent more like 7 million bpd from the “pre-surge” levels. Storage capacity is filling up. Supply destruction will continue, resulting in stronger prices when demand returns. Which stocks will be part of the supply destruction?

## HOW HAS CAE PERFORMED

- Month-to-date (MTD), the portfolio has underperformed the S&P/ASX 300 by (1.4%) driven by stock and sector selection. An underweight to financials, the worst performing sector MTD, and overweight to materials contributed to performance while holding 10% of the portfolio in cash during the MTD market rally and an underweight to real estate, the best performing sector so far, detracted from performance.
- Stock selection within Financials and Consumer Staples were detractors to performance that were partially offset by strong stock selection within industrials and materials. A key detractor has been not holding CSL, a pharmaceutical company specialized in the production of influenza vaccines which started to develop a treatment for COVID-19 and strongly rallied. We believe the pressure on blood collections are a risk that is under appreciated. Our overweight to Metcash, detracted as it gave up some of its strong gains in March. Financials Westpac, Suncorp Group and NAB all detracted as financials underperformed generally. We maintain a material underweight to financials.
- Key contributors, MTD, for the portfolio included infrastructure services company Downer EDI which bounced back from prior losses and gold mining producers Evolution Mining and Northern Star Resources, driven by the recent gold rally.

## WHAT CHANGES HAVE WE MADE TO CAE'S PORTFOLIO POSITIONING?

- Our goal for the portfolio year-to-date, has been to reduce exposure to COVID-19 risk, increase the value risk premium and invest in companies where we have confidence in their cash flows and balance sheet strength. As a result, we traded eight stocks around key themes which are detailed below. We also raised cash levels to around 10% to create flexibility to participate in equity raisings of distressed companies we don't currently own.
- Energy moved from producers to infrastructure. For example, we sold Woodside Petroleum and Origin Energy and bought Aurizon (Rail) and APA (Gas pipelines) which have more stable cashflow business models.
- Materials moved from US exposed cyclicals with earnings risk to iron ore and gold. For example, we sold Bluescope which owns a large electric arc furnace in the US and bought Rio Tinto which will benefit from recovery in China through iron ore.
- Consumer exposure shifted to a more resilient revenue model. For example, we took profits earlier in the quarter for Aristocrat and sold oOh! Media as ad spend for companies are going to be very weak and balance sheets are under stress.
- We reduced our overweight to cyclical industrials by selling airlines. For example, Qantas and Air New Zealand, that have been hit by a combination of flight cancellations and country restrictions due to COVID-19.
- We decreased our underweight to financials. For example, by buying Suncorp, an insurance business that we believe is resilient to COVID-19.

## WHAT IS OUR OUTLOOK FROM HERE?

- We are concerned that relief about overcoming the first wave is distracting people from the serious issues we now confront. COVID-19 has not been beaten yet, and therefore economic activity will continue to be weak and earnings and cashflows for stocks downgraded. This was illustrated by the acceleration in equity raisings in the last week.

- With regards to the economy, there have been supportive measures introduced from both a monetary and fiscal standpoint with the Reserve Bank of Australia (RBA) reducing the cash rates to an historical low of 0.25%, and the government providing A\$320bn of support through schemes such as JobKeeper.
- Given this, we believe there is a need to look beyond 2020 earnings. The 2021 outlook is highly dependent on a few key sectors, in particular, banks. For example, if unemployment remains well into double digits (not our base case), then banks alone will pull down the index earnings in 2021. So, we remain focused on earnings beyond 2020 and analysing how a range of scenarios play out across the next two to three years and how to position our portfolio accordingly.

You can access our full suite of coronavirus materials on our [Volatility Insights microsite](#)




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The data is based on representative accounts. The results presented above do not reflect the deduction of investment-management fees; your return will be reduced by the management fees and other expenses incurred in the management of your account.

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