AllianceBernstein®

April 16, 2020

MANAGED VOLATILITY EQUITIES PORTFOLIO

PORTFOLIO UPDATE

MANAGED VOLATILITY EQUITIES PORTFOLIO (MVE)

Unless otherwise stated, all figures are as at 13th 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 MVE PERFORMED?

- After very strong returns in the first quarter as markets dropped, month-to-date (MTD), the portfolio has underperformed a rallying S&P/ASX 300 by (4.0%) driven by sector and stock selection.

- An underweight to financials, the worst performing sector MTD contributed to performance while an underweight to real estate and energy, the best two performing sectors MTD detracted from performance. Holding 12.7% in cash as dry powder also detracted from performance amid a MTD strong market rally of 6.2%.

- Stock selection within healthcare and financials sectors detracted from relative returns. Within healthcare, the key detractors have been not holding CSL, where we believe the risk to blood collections is underappreciated, and our overweights to Sonic Healthcare and Resmed. IAG and Medibank also detracted amid the cyclical MTD rebound but continued to be positive contributors year-to-date (YTD).

- The key contributors MTD for the portfolio have been major Australian banks such as CBA, NAB, Westpac, ANZ and gold mining producers Evolution Mining, Northern Star Resources, Regis Resources and Newcrest mining all contributed driven by the recent gold rally. Despite the recent MTD underperformance, the portfolio continues to strongly outperform the S&P/ASX 300 by +7.1% over YTD. Strong sector selection with an underweight to financials and overweight to consumer staples as well as falling equity markets contributed to performance. YTD stock selection also contributed positively with key contributors within materials, financials and technology.

WHAT CHANGES HAVE WE MADE TO MVE'S PORTFOLIO POSITIONING?

- We added a few positions to the portfolio such as APA Group, a firm which operates natural gas and electricity assets and has a solid balance sheet and strong defensive cashflows; Elders, an agribusiness which should benefit from both operating in favourable sector and commodity prices falling; and Ramsay Healthcare, a private healthcare company with a strong balance sheet and defensive cashflows. Companies which, we believe, have been sold down on virus concerns but have business models that should recover strongly when the risk eases.

- Currently, our cash levels are sitting at about 14%, slightly up from our last update. Cash levels have gradually risen from normal levels of 3-5% as we still have a bearish view of the market.

- For international equities, remains unchanged from our last update where we sold down Home Depot (Bunnings of the US), McDonalds, Adidas and wholesale food suppliers Sysco. We invested in names which had strong and stable business such as Citrix which is a remote working technology platform, Johnson & Johnson the pharmaceutical and consumer packaged goods company, and Booz Allen-Hamilton a technology consulting firm.

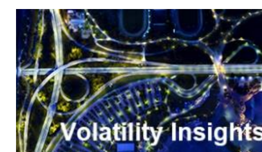
WHAT IS OUR OUTLOOK FROM HERE?

- We are concerned that relief about overcoming the first wave is distracting people from the serious issues we now confront. This is reflected in the portfolio and the changes mentioned above with-defensive positions that we feel provide good downside protection. 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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