

# QV Equities: Update on market conditions and the QVE portfolio

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## Investing through a sharemarket correction

These are very challenging times for equity investors with uncertainty abounding as reflected in sharemarkets around the world currently experiencing plus or minus 5-10% movements on a daily basis.

Most corrections in sharemarkets usually follow market highs and usually occur after a long period where markets have been going up for a while and often when investor optimism is very high. Each major market correction – as in 1987 and 2008 - occurs for a different reason with most seemingly coming out of nowhere, which is why investors are usually very shocked when they occur.

**Here are IML's guidelines when investing during periods such as these:**

- **Understand the companies you own in your portfolio** - Why do you own them? Do you understand the long-term direction the company is heading in? Are you still happy to own them for the next three to five years?
- **Try to stay calm** - This is very difficult when markets are uncertain and volatile and emotions are running high, especially for investors who are experiencing a significant correction for the first time.
- **Look for opportunities to invest in good quality companies** – while we believe the volatility will remain in the market for a while given the many uncertainties, when the world starts to normalise, well established companies with solid business models and reliable earnings generally recover better than the overall market.

## COVID-19 and its impacts so far

**The direct and indirect impacts of the virus**

Virtually every company in the world has been impacted by the virus as Governments around the world have taken drastic actions in fighting the spread of the virus including:

- travel bans which have directly hit sectors such as the airlines, hotels, airports, toll roads, travel agencies and international student sectors. The shutdown of these sectors has in turn contributed to the current slump in the demand for and price of oil affecting all energy producers and service providers.

- lockdowns in various parts of the world, including Australia, are impacting many companies such as retailers, restaurants and coffee shops as well as causing traffic volumes to drop sharply.
- widespread factory closures which have caused some supply disruptions with some companies, particularly those dependent on imported goods, reporting some disruption to normal supply patterns.

While all of the above measures taken will ultimately bring the spread of the virus under control they are also having a huge negative impact on every economy around the world.

### **This is a fairly complex crisis**

The crisis has created uncertainty in three major areas:

**Health** – COVID-19 is most immediately a major health issue on a global scale that is being addressed in a country by country manner. We are hopeful that within six months given the extreme measures in place, that the virus will be under control and the worst of the infection will be behind us.

**Financial chaos** - The second issue we have seen has been chaos in financial markets around the world. Stockmarkets are down sharply and parts of the corporate bond markets are in turmoil. However initially the inter-bank market is still functioning well thanks to intervention by Central Banks.

**The Economic implications** - The third impact, and one that is the most difficult to assess at this stage is the long term economic impact of the various measures put in place through lockdowns. While clearly this will have a severe short-term impact on GDP growth, unemployment and corporate profits, it is fairly difficult to assess what these measures will have on the long term economic outlook.

The longer-term implications will, to a great extent, depend on how long the current restrictions stay in place and whether Government stimulus can help soften the downturn and help engineer an upturn. While in the short term there is no doubt that the economic downturn will be severe, the longer-term outlook is more difficult to forecast with a great degree of certainty.

The economic standstill, at a time when debt and leverage were at a record level across many households and corporates, is putting substantial strain on these sectors. Many companies will have to drastically restructure their financial positions which will result in many recapitalisations through the raising of new equity and many dividend cuts. A decade of reliance on record low funding rates fuelled by most Central Banks' near zero interest rate policies will take time to unwind.

Some of the more optimistic commentators believe that we will see a V shaped rebound in economic activity, while many others are talking more of a U shaped type economic outlook where it will take a sustained period of time before activity levels can return to anywhere where they were before the outbreak of the pandemic.

### **The stockmarket reaction**

All around the world, as the uncertainty about the global economy weighs on investors' minds, we've seen major stockmarket downturns as investors try to factor the length and depth of the downturn into profit forecasts for every sector on the stockmarket.

As mentioned above most companies around the world are being affected, directly or indirectly, and it is the uncertainty over the outlook that is driving the daily stockmarket gyrations we are currently experiencing.

There are companies whose services one would have thought would be relatively unaffected by an economic downturn but which also are being impacted. For example, Sonic Healthcare is a global pathology company that we own in the QVE portfolio. It is a company that provides an essential service (pathology tests) in many countries around the world such as Australia, Germany and the US. Initially the company's volumes were holding up well as Sonic was performing COVID-19 testing for many governments in countries where they operate labs.

However last month, the company announced that many tests in many of the countries in which it operates have fallen significantly in the last two weeks as many people are staying away from doctors and deferring normal blood tests. So, Sonic is a company offering a vital service, with a global footprint whose profits will also be impacted at least for the next 3 to 6 months by the various shutdowns/lockdowns in place in different countries.

Other things one has to be mindful of is the possibility of a longer than expected downturn in the economy. If we do go into a marked slowdown and the recession is sharper and longer than anticipated it will have a flow on effect to other types of businesses, for example: What does a sharper than expected or longer economic slowdown mean for companies that supply hardware retailers, if in three to six months, the unemployment rate stays higher for longer which means that people's discretionary incomes will be much lower than forecast.

IML is taking a very cautious approach in terms of assessing depth and length of the economic slowdown and the impact on various sectors of the economy.

## IML's current focus

- **Trying to look beyond the daily headlines** – The news regarding the spread of the virus in places like the US is likely to get worse before it gets better. While the virus appears to be getting under control in Australia, it is not yet clear when the current shutdowns we have seen across so many sectors will be eased. Only the discovery of a vaccine would radically change this and while many companies are at various stages of looking to develop a vaccine the availability of one in the short term seems unlikely.
- **Company by company review** – We are examining how every company in our portfolios, and those on our target lists, will be affected under different scenarios. Most share prices have corrected significantly and have already factored in some negative news. While this is not an easy job we are trying to assess if the current share prices of many companies have already factored in a worst-case scenario. By doing this we are looking to decide which companies we want to keep in our portfolios, which positions we exit, and which ones we can look to buy as the opportunities arise.
- **What are we looking for?** We're looking for companies that own long duration assets and that have a balance sheet that we assess as being strong enough to be able to work through the coming economic downturn. In terms of balance sheets, we believe the market's perception of what is deemed acceptable gearing will change quite significantly as the slowdown progresses.
- **Look beyond FY 2020** - FY 2020 results for the majority of companies are going to be severely impacted by the current turmoil in many sectors. So, when focusing on companies, we are looking to assess how the company will fare in FY 2021 (and beyond) in what is likely to be a tougher economy than we have seen in the last few years. We are focussed on the long-term value of each business and how this compares to the current share price, many of which have fallen by large percentages in the last month.

## How the QVE portfolio is positioned

What we've always tried to do at IML, is look to buy companies we believed had a strong competitive advantage, that had recurring, predictable earnings (although we never predicted the current circumstances where many sectors are shut) and which we believed were run by capable management teams.

We had been predicting some sort of correction for some time as we thought markets needed a reality check and although this has now happened, it has come from an event that not many investors could have forecast.

Prior to the correction, our plan for the QVE portfolio was to stay away from what we felt were overvalued sectors and companies. We've previously highlighted how overvalued we believed the REIT (listed property trusts) sector was. We have also highlighted many times in the past how overvalued and frothy the local technology sector was, and companies like WiseTech and Afterpay have now seen large corrections in their share price.

We also positioned the portfolio defensively by holding cash of over 15%. Our view is that if we couldn't find anything we believed represented good long term value, we would hold cash to use when value was apparent.

We had also positioned the portfolio in what we believed, at the time, were relatively resilient sectors, such as the utility, packaging, infrastructure, gaming and healthcare sectors. Some of these, such as the utility sector, have held up well. Our holdings in other sectors such as the gaming sector - which has always proven to be resilient in previous downturns - have been directly impacted by the lockdowns we have seen. Having said this we continue to hold these companies as they all own long exclusive licences, are often backed by hard assets and we believe that these companies will be up, operating and generating profits when the lockdowns are eased.

Our approach as always, is to remain disciplined - investing in well established companies and staying away from speculative ones. QVE's portfolio is underpinned by solid companies which are obviously all being tested at the moment by these unprecedented events, but we believe the vast majority of the companies we hold will come through this period in one piece.

We have made some necessary adjustments to the portfolio by selling out of some of the more highly geared companies that we believe are not very well positioned for a longer than expected downturn.

Today, the portfolio contains around 40 well-established companies, all with a long track record of profitability. There are no speculative companies in the portfolio, and the portfolio has just over 20% in cash. Whilst the current volatility and uncertainty make it a very challenging environment, we are positioning the portfolio for what we see as a more normalised - although probably more subdued - environment beyond FY 2020.

We are being extremely selective in terms of investing any of the cash held in the portfolio but continue to look for opportunities to deploy when these opportunities become available - such as corporate recapitalisations whose long-term future we believe is sound.

*Release authorised by Company Secretary, Zac Azzi.*

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