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Investing in Australian equities through the COVID-19 stockmarket correction

By Anton Tagliaferro - Investment Director, Investors Mutual Limited

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.

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 experiencing.

Virtually every company in the world has been impacted by COVID-19 as Governments have taken drastic actions to fight the spread of the virus including:

- Travel bans which have directly hit sectors such as airlines, hotels, airports, toll roads and travel agencies. The shutdown of these sectors has contributed to the current slump in the price of oil, affecting all energy producers and service providers;
- Global lockdowns, including Australia, are impacting many businesses in the retail and hospitality sectors; and
- Widespread factory closures have caused supply disruptions for many companies, particularly those dependent on imported goods.

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

The crisis has created uncertainty in three major areas:

1. **Health** – COVID-19 is first and foremost a major global health issue being addressed in a country by country manner. We are hopeful that within six months, given the extreme measures in place, the virus will be under control and the worst of the infection will be behind us.
2. **Financial** – The second issue is the chaos in financial markets around the world. Stockmarkets are down sharply and parts of the corporate bond markets are in turmoil. Thanks to intervention by central banks, the inter-bank market is still functioning well.
3. **Economic** – The third impact, and the most difficult to assess, is the long-term economic impact of the measures put in place to control the virus. While clearly this will have a severe short-term impact on gross domestic product (GDP) growth, unemployment and corporate

profits, we are yet to fully appreciate the effect these measures will have on the long-term economic outlook.

The longer-term implications will depend on how long the current restrictions stay in place and whether Government stimulus can help soften the downturn and help engineer an upturn.

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 believe it will be more of a U-shaped type economic outlook where it will take a sustained period of time before activity levels can return to anywhere near where they were before the outbreak of the pandemic.

What we've always tried to do at IML is buy companies that have a strong competitive advantage, with recurring, predictable earnings (although we never predicted the current circumstances where many sectors are shut) and which we believe are 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.

OUR CURRENT FOCUS:

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 spread of the virus appears to be slowing in Australia, it is unclear when the current restrictions will be eased. The discovery of a vaccine would provide greater certainty on a timeline for these restrictions to be lifted, although, 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 already corrected significantly. What we are trying to assess is if the current share prices have 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 well-established, proven businesses. In particular, companies that own long-duration assets and companies that have a strong balance sheet to endure the coming economic downturn.

Look beyond FY 2020

Full-year results for the majority of companies are going to be severely impacted by the current turmoil. We are assessing how each company will fare in FY 2021 (and beyond) in what is likely to be a very tough economy. We are focused 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.

Our approach as always, is to remain disciplined and true to our quality and value investment philosophy – investing in well-established companies and staying away from speculative ones. Our portfolios are 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 by selling out of some of the more highly-geared companies such as Transurban and Sydney Airport that we believe are not very well-positioned for a longer than expected downturn.

Whilst the current volatility and uncertainty make it a very challenging environment, we are positioning all of our portfolios 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 portfolios 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.

ARE SHARES STILL A GOOD INVESTMENT?

At this stage of the correction, there is a fair temptation for many investors to sell out, and forget about the stockmarket forever. However, the world will keep turning and things will normalise at some stage. Quality companies will live to fight another day and strong companies may emerge even stronger – and this is what shareholders will benefit from in the long-term.

For those invested in the stockmarket, there are some guidelines to consider 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

We believe the market volatility will remain for a while given the many uncertainties, but when the world starts to normalise, well-established companies with solid business models and reliable earnings generally recover better than the overall market.

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