Australian shares: spot check

By Peter Sumner, Portfolio Manager – Australian Equities & AREITs

Share markets are see-sawing by such large amounts in short order that making forward-looking comments on where the Australian market may end up, later this year, is a high-risk, not to mention irresponsible thing to do.

Rather than going down that path, it's more sensible to draw out some of the larger themes that have emerged since the market sell-off began and link those to what that might mean for investors, and the Australian equity component of MLC's investment portfolios.

Understandable abandonment of earnings guidance

The abandonment of earnings guidance by growing numbers of Australian companies is one of the stand-out themes from recent events. According to one piece of analysis, in the week of 23 March, 70 listed Australian companies withdrew earnings guidance and in the preceding fortnight 52 also withdrew guidance.

Overall, around one-third of ASX 100 companies and about 25% of stocks in the Small Ordinaries Index have withdrawn or reduced guidance over the last few weeks, at the time of writing.

Ordinarily, the market would thrash companies abandoning earnings guidance, but these are not ordinary times.

The 'hibernation' of so many economies and societies, because of COVID-19, including Australia, means that activity has effectively ground to a halt across many industries. Neither the management of companies nor anybody else knows with reasonable certainty when normal life will recommence, and so there is no special punishment for abandoning earnings guidance.

Of course, abandoning earnings guidance does mean that it's very difficult for investors to value companies using conventional measures, and so market participants are in a 'wait and see' situation. A blank earnings outlook makes it almost impossible to know whether companies are better valued now than pre-sell off.

Intuitively, the big market fall would seem to have made Australian equities more attractively valued, but that would be a guesstimate without being able to get a proper handle on earnings.

The value of active management

It's in difficult times, such as the current period, where the deep analytical skills and long experience of our active investment managers is invaluable.

Large emotional swings are currently driving markets, and active management means that our Australian share portfolios have a ‘driver at the wheel’ with authority and knowledge to steer portfolios away from dangers that are ahead. This is not something index funds can do, by way of contrast.

Index funds, while being a cost-efficient way of accessing markets and investing, are also unable to discriminate and take the off ramp towards stocks that may be better placed, from a risk perspective, to make it through the current cycle, and be positioned for take-off when the market recovery eventuates.

Dividends likely to be lower

The US and European company reporting season is coming up, and Australian companies and investors will likely look at what happens overseas as a marker for how corporate Australia will report at the end of the local financial year.

Investors are already preparing for cuts to final year dividends. Generally, the final dividend is bigger than the interim dividend, but this year, understandably, it’s likely to be different with a lower final dividend.

Australian companies will want to conserve cash by cutting costs, cancelling non-essential capital spending and reducing dividends to see them through what promises to be an extremely difficult operating environment. Again, investors are probably not going to begrudge companies for doing so.

The Australian Prudential Regulation Authority (APRA) has also chimed in saying that it:

” …expects Australian Deposit Taking Institutions and insurers to limit discretionary capital distributions in the months ahead, to ensure that they instead use buffers and maintain capacity to continue to lend and underwrite insurance. This includes prudent reductions in dividends, taking into account the uncertain outlook for the operating environment and the need to preserve capacity to prioritise these critical activities”.

This is unwelcome news for investors who’ve become used to high dividend payouts, especially from banks, but given the severity of the economic environment, also understandable.

Companies’ finances stronger than before GFC

The 2008/09 Global Financial Crisis saw a flood of companies reach out to investors for more capital through equity raisings, and debt restructurings.

Equity raisings can sometimes be corrosive from an earnings-per-share perspective, and debt refinancing in the teeth of crisis often means agreeing to stringent terms.

Lessons learned from that experience seem to have had a constructive effect on companies, and as a generalisation, Australian companies’ debt structures were better balanced coming into this period, than was the case leading into the GFC.

This is especially true for banks. They've generally de-risked their loan portfolios over the past decade, implemented stricter lending criteria and beefed up their capital buffers at the prudential regulator's direction. The same is broadly true for large European and US banks.

That said, given the dramatic shutdown of many industries, quite a few companies will undoubtedly want to shore up their balance sheets.

We anticipate that the investment managers appointed by us to manage the Australian share allocations of MLC's portfolios will selectively participate in capital raisings where the opportunity matches their overall investment strategy, and are aligned with other risks in their portfolios.

Our appointed active managers are focussing on companies' survivability and capacity for recovery and growth, post the crisis, rather than emphasising short term trading opportunities or catching "falling knives" – the colourful term describing the risks of buying seemingly better priced stocks that just keep falling.

Portfolios we manage, on clients' behalf, should be able to participate in capital raisings from positions of strength. Capital raisings in stressed markets typically come with attractive terms for investors, and thus can potentially contribute positively to long-term returns.

Diverse investment styles doing what they're supposed to

Finally, I'd like to touch on the importance and value of investment diversification by investment style.

Well diversified portfolios will likely have exposure to a wide range of assets, investment approaches and styles. Each piece of the investment puzzle adds up to creating stronger total portfolios with potentially better risk-adjusted returns than those based on a single idea, philosophy or investment time horizon

In the case of our Australian equities investments — they are managed by a combination of 'growth', 'value', 'quantitative' and 'style neutral' investment managers, appointed by us.

The combination of diverse investment styles of our appointed Australian equity managers is a strength, always, and especially in the current period, we believe.

It means that even if one manager with a specific style is exposed to risks that may be causing them to underperform, the complementary styles of other managers can be a counter-weight. In our experience, investment style combinations contribute to generating better long-term risk-adjusted returns.

It's a kind of a 'wisdom of crowds' effect. Moreover, the managers are not just playing 'defence' doing their best to protect portfolios. They're also playing 'offence', positioning themselves to buy good assets that have been 'over-sold.'

MLC has been managing multi-asset and multi-manager portfolios since 1985, and in following years, we and our external investment managers have steered clients' portfolios through many market crises — the 1987 crash, the 1997 Asian Financial Crisis, the 2000 dot com bust, the post September 11, 2001 market slide, and the 2008/09 Global Financial Crisis, to name some.

The experience and knowledge gained from each crisis has helped to season us a little more for the next. We will get our clients through this difficult period and position your portfolios for the recovery that will eventuate.

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