Private Capital Advisers

Market Update – We are not finished with volatility

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A large part of the downturns in February and March have been recovered as calm has returned to the markets. Nonetheless, we believe that it is too early to say that the market impacts of the pandemic are behind us.

There are still a huge number of uncertainties. We don't know if the Victorian outbreak is about to be brought under control. We don't know if the other states will be able to avoid secondary flare ups and shut-downs. We don't know if and when, and indeed how, the US will bring their rate of new infections under control. We don't know if the extensions to the Job-Keeper and Job-Seeker programs will be enough to prevent a huge number of small business failures in this country. We don't know what will be the permanent effects of the pandemic on consumer spending patterns worldwide.

Right now, the markets seem to be taking all this uncertainty in their stride. But this could change quickly, and we could again see markets fluctuating wildly.

You may ask why, if that is the case, don't we move to the sidelines and wait until we see better prices?

The answer is that we have seen, time and time again, that this is a recipe for achieving poor returns. Time and time again we have seen investors try to second guess the market, particularly in times of stress, only to find they have sold at the low and then have to buy back at much higher prices. As an illustration, since the March lows, the Australian sharemarket has risen 33% - even as infection rates hit all time highs in the United States.

Furthermore, we may not see a correction at all. We may see an earlier than expected vaccine or cure for Covid-19 and all the volatility will be on the upside with prices rising rapidly.

So, at times like this, and, in fact, at all times, our philosophy is to keep our eyes on the long-term and to ignore the short-term. The question we keep asking is this: "Will investors be better off in growth assets or term deposits (TDs) in the longer term. Given how low TD rates are at present, the answer to that question is clear. Stick with growth assets for the time being, no matter what volatility the market may throw at us. This philosophy has served us well in the past and we are confident that it will continue to do so in the future.

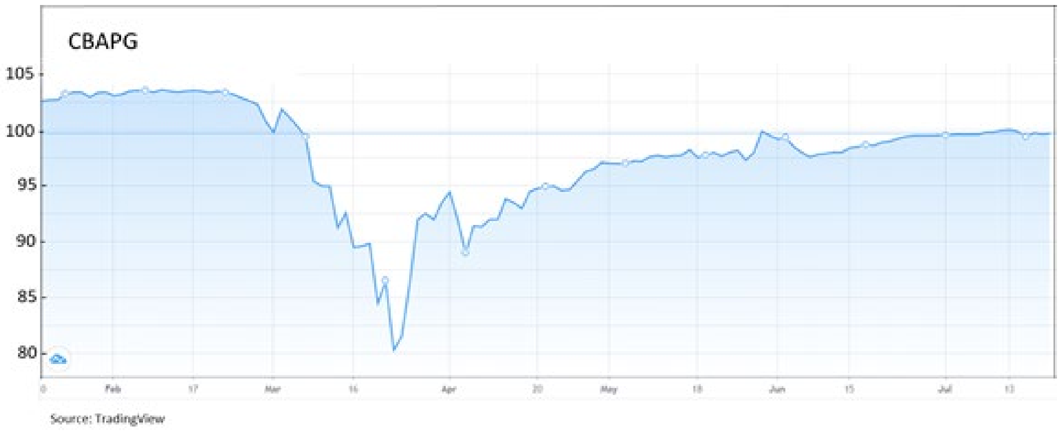
Putting volatility in perspective

The first half of this year saw extraordinary volatility – in both directions. But not all volatility is the same – some is genuinely short-term in nature whereas some downward movements reflect a permanent loss. And there are plenty of examples in between.

Short-term volatility

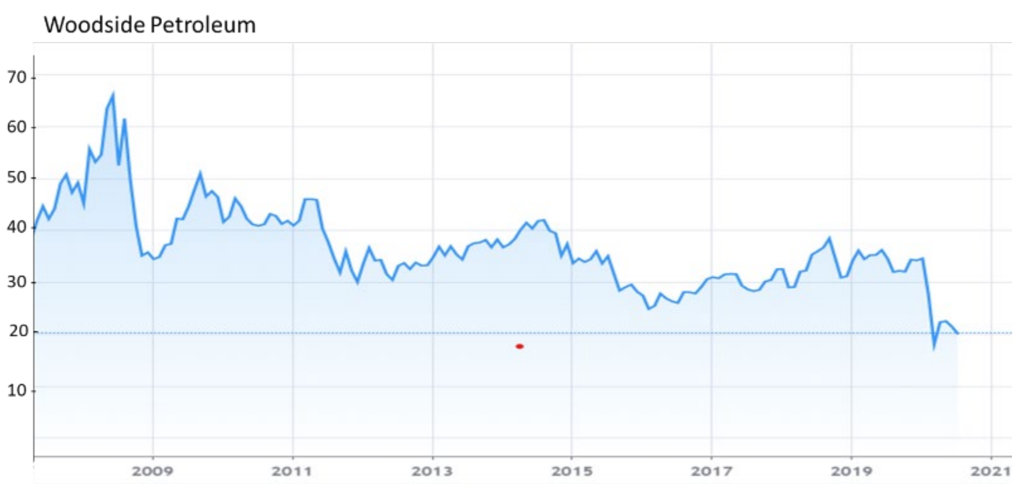
Take bank hybrids as an example of the first type of volatility. The chart below shows Commonwealth Bank Hybrid (CBAPG) which fell an extraordinary 23% during February and March but has since bounced back to trade at around $100. This bounce back was always very, very likely. This is because CBAPG is a convertible note that will be repaid at $100 per share in 2025 unless the Commonwealth Bank makes enormous lending losses over the next few years AND is not required by the regulator to top up its capital base. We view the first as highly unlikely and the second condition as even less likely.

Why then the volatility? Quite simply, markets over-react. In times of extreme uncertainty, many investors, including institutions, simply panic and are prepared to sell at almost any price. When the air clears, the sharemarket starts to function rationally and prices revert to fair value.



Long-term volatility leading to permanent losses

Sometimes markets fall and don't recover because the fundamental value of the asset has fallen as well. This doesn't mean that there will never be any recovery but that it is not likely. An example of this is Woodside Petroleum which, as we can see in the chart below, has fallen substantially over the past decade, even though it has had plenty of good bounces along the way.



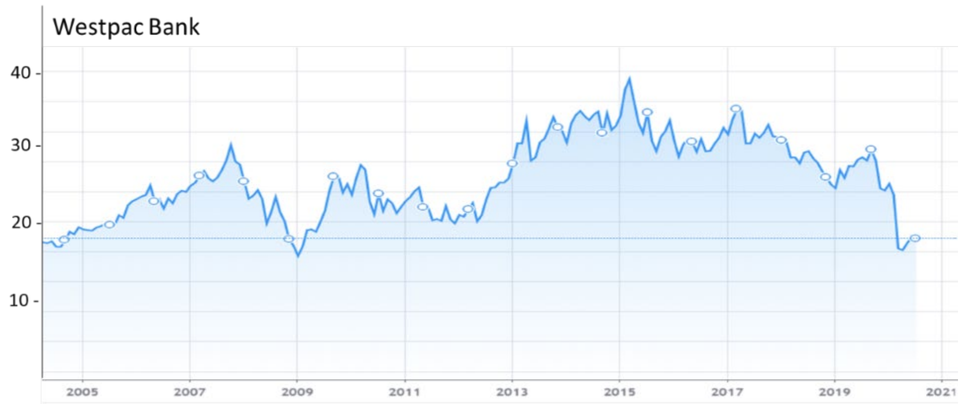
The problem with Woodside is that the dynamics of the oil market have changed; oil prices have fallen substantially, and the value of Woodside's oil and gas reserves have fallen as a result. While the Woodside share price may recover somewhat from these low levels, it is unlikely that we will see the share price back above $60 for decades.

Somewhere in between

Between these examples of volatility leading to losses which will almost certainly be recovered and those that almost certainly won't – we have many in-between cases. Probably the most interesting from our perspective are the major Australian banks.

Many investors have long held portfolio holdings in Australian banks and we see them as particularly attractive right now despite all the fears around the impact of Covid-19 on the Australian economy and therefore lending losses. Quite simply, we feel that the market has, once again, over-reacted.

The chart below shows the price of the Westpac Bank (WBC) over the past 15 years including the fall of around 50% since the brief peak in 2015. These falls have been a result of many unpredictable factors including the regulators demands for more capital (bad for shareholders but good for investors in bank hybrids), the fall out from the Royal Commission and, now, fears of losses arising from the Covid-19 recession.



Will we see WBC back above $35 any time soon? We doubt it – but over the next decade we could easily see a price around that level as the banks negotiate the impact of the pandemic and once again start to expand their lending activities and paying dividends. But it could be a slow grind. Hence, WBC is one of the in-between cases where price falls lead to medium-term capital losses but with a reasonable chance of recovering those losses over time.

It is one of the reasons we diversify. Inevitably, some companies that look attractive at the time of investment disappoint for various reasons. Others (like CSL) surprise on the upside so, on balance, the impacts tend to even out.

One final word on WBC and the banks. Despite their disappointing price falls over the past few years, we expect that, going ahead, dividends will soon be restored at a level in the order of 10%pa based on the current price. At that level of dividends, we don't mind if the share price doesn't rise much above current levels – our total returns, including dividends will make WBC, and the banks in general, attractive investments.

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PCA Investment Committee Member

farrelly's Investment Strategy

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