UNCONVENTIONAL WISDOM

Unique investor insights from Wattle Partners

July 2020

The month that was...

- What started as a positive month for markets and people around the world, ended up where it all began; with a substantial spike in COVID-19 cases and looming extension of stay-at-home restrictions. In Victoria, this is already the case with a 'State of Disaster' declared and sweeping curfews employed, ultimately putting great pressure on the entire country's recovery. Similarly, the south of the US, particularly Florida and California have seen spikes of their own, along with France, Spain and England, suggesting there may be sometime before we are anywhere near through this. Despite growing concerns, markets have reacted passively, delivering a fourth straight month of positive returns, the ASX200 up 0.51% and the tech-driven S&P500 up 5.51%. Markets remain supported by sweeping monetary and fiscal policy, but without another round being announced in the coming weeks, markets may turn once again.

- July saw the release of June quarter GDP growth rates and not unexpectedly, the results were grim. Records were broken across the board, the US shrinking at an annual pace of 32.9%, France -13.8%, Germany -10.1% and Australian expected to contract by at least 8.0%. On the positive side, the authoritarian regime is China is showing its powerful benefits, effectively cutting off the virus and reporting 11.5% growth in the June quarter. With Chinese exports from Australia growing 8% in May and steel production catching up to pre-crisis highs, is it possible China can save us again? Investors in BHP Group Ltd (ASX:BHP) and Fortescue Mining Group Ltd (ASX:FMG) definitely think so with the latter hitting all-time highs and increasing its dividend during the month.

- There is, however, a great deal of change ahead. The rhetoric against Chinese businesses following years of apparent technology theft, is forcing a reshaping of the global supply chain at a time of great uncertainty. Huawei and more recently social media platform, Tik Tok, have been caught in the centre of this particularly following the ramping up of administrative pressure in China. In fact the Japanese Government is now supporting businesses to the tune of $500 million in their efforts to re-shore their operations; expect periphery Asian nations like Vietnam to benefit.

- The apparent existential war on superannuation stepped up another gear during the month, with well-paid industry super board executives chiding the Government's decision to allow members access to their own money. Industry super are highlighting the apparent risk of losing compounding returns for those who access their super now and suggesting the Super Guarantee rate should be increased to 12%

to offset the now $42 billion reduction from the sector. Given some 11% of mortgages have been deferred and unemployment now sits at close to 11% in real terms, the Government seems to be allowing the population to share the load rather than running even larger deficits. Given many of those withdrawing cash may have another 30 years to wait before getting access to their super, there is every chance it may be re-nationalized by then. It seems the tightknit cohort are a little concerned about their gravy train slowing.

- Outside of technology stocks, gold bullion was the standout investment of the month. The precious metal has passed all-time highs in US dollars, closing in on USD$2,000 per ounce, with the AUD still hovering around $2,700. It seems the asset class is finally moving into the mainstream as interest rates fall to zero and concerns about market valuations continue to increase. Whilst the asset is becoming more common in private portfolios, it remains non-existent in most industry and pension funds, which means it may have some more room to run. Gold remains misunderstood by traditional investors and advisers, who remain unable to price it without 'cash flow' or an intrinsic value or assuming it only protects against inflation. Interestingly, it has protected portfolios better in deflationary environments with the worst-case scenario being solid and consistent economic growth; something we are unlikely to see soon.

- The active vs. passive debate was activated once again, albeit with outdated figures, with Standard & Poor's announcing 80% of Australian equity funds underperformed in the five years to 31 December. As we have covered in the past, the assessment includes some 600 funds many of which would not be considered of investment quality. For those who follow our model portfolio, the 2020 volatility has, in our view, truly reflected the benefit of active managers. Six of the eight core managers we recommend, but particularly the global equity funds, outperformed their benchmark to 30 June, some by as much as 15-20% in absolute terms.

- With the new financial year starting on positive footing, it's worth taking stock of what has just passed. If there is one lesson to take away from the COVID-19 crisis and incredible recovery, it's that you can't pick the top or bottom of the market and trying to can be incredibly costly. For instance, those investors who capitulated in March and missed just the five best trading days since, would be close to 40% behind the benchmark. Importantly, you don't need to time the market to boost your returns, you simply need capital available to deploy when everyone else is selling.

- August stands out as an incredibly important month for investors and Australian's in general, with the way Victorian's deal with the escalating virus cases key to the medium-term future of the economy. The month will also see the all—important full year reporting season for most ASX-listed companies, with a particular focus on the dividends previously deferred by a swatch of banks, insurance, retail and infrastructure companies. With end of financial year reporting being delivered the time may have finally come for investors to focus on total returns rather than income alone.

WATTLE PARTNERS

Model Portfolio Update

- Investment Committee -

Index	Index Points - June	Index Points - July	Performance	
			1 Month	1 Year
S&P/ASX 200	5897.88	5927.78	0.51%	-12.99%
All Ordinaries	6001.35	6058.31	0.95%	-10.94%
US Dow Jones	25812.88	26428.32	2.38%	-1.62%
US S&P 500	3100.29	3271.12	5.51%	9.76%
Hang Seng (HK)	24427.19	24595.35	0.69%	-11.46%
FTSE 100 (UK)	6169.74	5897.76	-4.41%	-22.26%
Nikkei 225	22288.14	21710.00	-2.59%	0.88%

Top 5 Performers	1 Month	Bottom 5 Performers	1 Month
Telstra Corporation Ltd	13.89%	AMP Ltd	-21.02%
Gold Bullion	6.19%	Ramsay Healthcare Ltd	-6.83%
Macquarie Group Ltd	6.00%	Qube Holdings Ltd	-6.19%
Munro Global Growth Fund	5.84%	CSL Ltd	-5.89%
Platinum Asia Fund	5.05%	Boral Ltd	-5.28%

Sector Performance

Sector	June	12 Months
A-REIT	0.65%	-25.97%
Communications	3.44%	-10.56%
Cons. Discretionary	2.67%	-2.52%
Cons. Staples	3.29%	3.32%
Energy	-6.55%	-36.82%
Financials	-1.11%	-26.65%
Healthcare	-3.90%	14.01%
Industrials	-3.70%	-21.04%
IT	4.64%	17.67%
Materials	5.82%	-0.77%
Utilities	-0.18%	-9.05%

The theme of COVID-19 continued to playout in July, with market capitalisation (or value) once again shifting from cyclical, highly competitive sectors like energy (-6.5%) and financials (-1.1%), down -36.8% and -26.6% for the 12 months, being quickly usurped by IT (4.64% and 17.67%) and in Australia's case, Materials (5.8% and -0.8%). As has been the case in recent years, the sector performance in increasingly driven by just a few names; Wesfarmer's in consumer discretionary, CSL in healthcare, CBA in financials, and BHP Group in materials. It is for this reason that market wide valuation measures, like the price-earnings ratio become less relevant by the week.

As a change of pace, we have taken the opportunity to highlight what we believe to be the important and powerful trends for investors for both the short and long-term. There are six that are core to the investments we recommend:

1. **Infrastructure** – It's becoming clear that there is only one way out of this; spend, spend and spend. Powered by the support of central banks, governments around the world will resort to a huge and much needed infrastructure plan, with a particular focus on sustainable technology and cleaner energy.

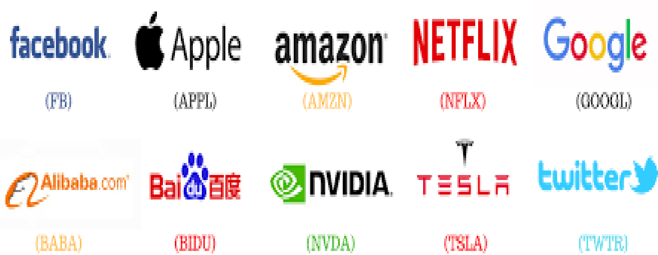
2. **E-Commerce** – Anyway who wasn't buying online before COVID-19, surely must be by now. The trend refers to moving every aspect of our lives online, whether that is ordering groceries, clothes, furniture, cars or even finally shopping at Bunning's. Despite its massive growth, Amazon Inc. has only reached 4% of total retail sales in the US.

3. **Digital Enterprise** – The world of business is transforming and those who don't evolve will die. Traditional sectors are being forced to quickly adopt digital technology from cloud computing, data analysis and automation, to improve margins and have any hope of delivering a profit. The key for businesses in reaching the other side is scale or being able to make something once and sell it twice; costs must be cut quickly and digitization is the only way.

4. **Biotechnology** – The impacts of this pandemic are once again seeing huge amounts of capital flow towards the medical sector. Yet the opportunity is far broader than finding a cure, it expands into genomics, gene sequencing and other emerging technologies being explored by smaller and larger companies alike.

5. **Asian consumer** – With all eyes on the pandemic, investors have been ignoring the more powerful trend spreading throughout Asia, which is the rise of the middle class. COVID-19 will be but a small blip on China, India and the rest of Asia's non-stop growth to become the dominant consumer bloc. The opportunities lie in both traditional and non-traditional consumer sectors, as well as luxury and staples, as diets along with developed world concerns like healthcare grow.

6. **Sustainability** – One of the key criteria of the trillion-dollar stimulus announced by the European Central Bank in July, was a requirement for recipients to move towards greater sustainability. This includes requirements to reduce the production of petrol cars, increasing cleaner energy sources and generally improve business practices.



For those interested, our core exposures to these themes are achieved through two key portfolio holdings: the Munro Global Growth Fund and the GQG Global Equity Fund. The underlying holdings of these funds are as follows:

- Munro
  - Amazon, Spotify & Alibaba – E-Commerce
  - Microsoft, Alphabet – Digital Enterprise
  - TSMC – Artificial intelligence
  - Facebook – Internet Disruption
- GQG
  - Amazon, Alibaba, Mastercard – E-Commerce
  - Microsoft, Adobe, Alphabet – Digital Enterprise
  - NVIDIA – Artificial Intelligence
  - Healthcare – AstraZeneca, Novo Nordisk

As a sign of how these companies are faring in the current environment, here is an update on their latest earnings reports:

- Apple – Shares increased 10.5% on Friday, leading global markets, as quarterly revenue increased 11% to $59.7 billion, on the back of a 22% increase in Mac sales, 31% in iPad sales and 17% in wearables due to the ubiquitous white 'AirPods'. Apple became the largest listed company in world on Friday, surpassing Saudi Aramco.

- Amazon – Shares increased 3.7% with Jeff Bezos reporting $88.9 billion in sales and $5.2 billion in quarterly profits, five times higher than consensus. Growth remains incredibly strong, with product sales up 40.2%, services 38.7% and Amazon Web Services Cloud business up 28.9%. Interesting, 28.9% was a slowdown for the cloud computing division; go figure.

- Facebook – Shares increased 8.2% after management reported revenue increased 11% from 2019 to $18.69 billion. This was a slowdown on the previous quarterly growth of 28%, but still reflective of the company's importance in disconnected, locked down world. The company reported a 14% increase in users and 2.7 billion global monthly members. Whilst a number of high profile clients have boycotted advertising on Facebook, Founder Mark Zuckerberg, noted that most sales actually come from small to medium businesses, not the likes of Unilever and Coca Cola.

- Alphabet – Shares fell 3.3% after announcing a rare fall in revenue, down 2% to $38.3 billion, the first such contraction since it became public. Ads on its Youtube platform improved as viewers spent more time at home consuming digital content. Google Cloud revenue grew 50% whilst the key Ad Words platform fell close to 10% to $6.69 billion for the quarter as advertisers tightened their belts.

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What was an average return for the financial year?

- Drew Meredith -

Sitting at home through another economic shutdown, I can't help but notice the flood of industry super fund advertisements throughout breaks in the now daily AFL games. The sector appears to be making a concerted push to attract new members during the pandemic, in hopes of offsetting the huge withdrawals under the loosened hardship loophole. The advertisements remain focused on two things, performance and fees; in this short article I wanted to focus on the former.

There seems to be a substantial amount of misunderstanding and more importantly lack of access to appropriate benchmarks for DIY investors. Advertisements showing returns exceeding 10%, but with the important disclaimer that past returns are no guarantee, are abundant. In fact, the entire APRA Heat Map system for comparing funds has been based on performance, rather than risk or asset class allocations; meaning the focus is on the wrong area. Unfortunately, many funds both industry and retail, are gaming the system in two ways; 1) taking more risk (sometimes 90% in high risk assets) in a 'Balanced' option; 2) allocating high risk assets to the low risk or Defensive component.

Where do I find an appropriate comparison?

In the first case, they should be compared to your objective return; generally quoted as a CPI + figure. For instance, Australian Super's Balanced option targets a return of CPI + 4% over the long-term; in today's world equating to a return of around 6.0% to 6.5%.

In the second case, you should seek out appropriate benchmarks. Unfortunately, in most cases we are attracted to the most available and best performing fund as a benchmark; which is clearly not accurate or insightful; particular in the case of the so-called 'Balanced' Fund. On this basis, we advise the use of Chant West's Median Super Returns, available shortly after the end each month.

The team at Chant West work tirelessly to ensure that every fund they cover is closely assessed and actually fits into their allocations:

- All Growth: 96 – 100% growth assets
- High Growth: 81 – 95% growth assets
- Growth: 61 – 80% growth assets
- Balanced: 41 – 60% growth assets
- Conservative: 21 – 40% growth assets

According to the information available on Australian Super's website, the asset allocation of their 'Balanced' option actually fits into the High Growth group in Chant West's analysis. As you can see, their market leading 8.8% per annum return for the last 10 years is only slightly above the 8.4% average for the sector. When it is (erroneously) compared against most DIY or SMSF portfolios, which are more conservative at around 30-40% in low risk assets, it looks like the best option around.

So what should my returns be for the financial year?

The table below shows the median return for each asset allocation for periods of 3 months, 1 year, 5 years and 10 years:

Category	3 Months	1 Year	5 Years	10 years
All Growth	9.7%	-2.1%	6.6%	8.8%
High Growth	7.9%	-0.9%	6.7%	8.4%
Growth	6.5%	-0.5%	6.2%	7.7%
Balanced	4.7%	0.3%	4.8%	6.4%
Conservative	3.1%	1.0%	4.2%	5.4%

We have highlighted the 'Balanced' returns before for ease of comparison, representing the most common portfolio carrying 40% in defensive assets like cash and fixed interest and 60% in growth assets like equities, property and infrastructure. As you can see, the average return for the 2019-20 financial year was 0.3% and more importantly, the 10 year return is around 6.4%.

This is clearly vastly different from that reported by many major funds taking substantially more risk, so as they say 'buyer beware'.

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Mercado Libre

- James Dunn -

While more and more Australian investors get comfortable with investing overseas, it's fair to assume that Latin America is not on most people's map of the investable universe – "there be dragons," as the old mariners used to say.

Many people would be hard-pressed to name a Latin American stock, although Australians should be at least familiar with Vale of Brazil, given that it is the arch-rival of our iron ore exporters. The continent is not familiar investment territory. Even some of its largest stocks – the likes of Mexican trio mobile network America Movil, media company Grupo Televisa, even building materials company Cemex – which actually bought Australia's Rinker in 2007, in a poorly timed purchase just before the GFC – or Brazilian plastics and petrochemicals giant Braskem or beverage heavyweight Ambev, are just not on our radar. Latin America lacks the global brand names that would capture Australian investor attention.

But there are several that professional investors – particularly those running global funds – would know quite well.
Argentina-based e-commerce company MercadoLibre is definitely one of these.
Established in 1999, MercadoLibre – "free market" in Spanish – is the largest online e-commerce and payments ecosystem in Latin America, but it has become much more than that.

It is now an integrated regional platform that provides all of the necessary online and technology-based tools, and commercial services, to allow businesses and individuals to trade products and services in the region.

The company enables commerce through its marketplace platform (including online classifieds for motor vehicles, vessels, aircraft, services and real estate), which allows users to buy and sell in most of Latin America – it has customers in 18 countries. MercadoLibre's three largest markets are Brazil, Argentina and Mexico, which currently account for 63%, 19% and 13% of its gross billings, respectively.

MercadoLibre offers the following services:

- **Mercado Libre marketplace:** The platform provides a fully-automated, topically-arranged and user-friendly online trading service. It offers buyers a deep assortment of items that are often more expensive or otherwise hard to find through traditional offline sellers, with new products now representing about 98% of total listings. This service enables both businesses and individuals to list items and conduct their sales and purchases in the largest marketplace in Latin America.

- **Mercado Envios shipping service:** this shipping solution for marketplace users is available in Brazil, Argentina, Mexico, Colombia, Chile and Uruguay. Mercado Envios achieves economies of scale through integration with local carriers and state-of-the-art warehousing services, underpinning it with MercadoLibre's proprietary technology, which drives down shipping costs and eliminates friction for the platform's buyers and sellers.

- **Mercado Pago payments solution:** Initially, Mercado Pago was developed to

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complement the Mercado Libre marketplace facilitating transactions, but the initiative quickly outgrew its initial purpose to pursue the democratisation of payments and financial inclusion, allowing its users to securely, easily and promptly send and receive payments both on and offline. MercadoPago is available in Brazil, Argentina, Mexico, Colombia, Chile, Peru and Uruguay.

Mercado Pago's payments solutions include a mobile point-of-sale (mPOS) card and a pre-paid card, a digital wallet that enables QR payments so that users can pay utilities bills, make P2P transactions, cell phone top ups and pay transportation tickets; Mercado Fondo, an investing and asset management app; and Merchant Services, an online off-platform payments solution that allowing merchants to facilitate checkout and payment processes either by registering with MercadoPago or by providing their credit card information as a "guest user."

Also, through MercadoLibre's partnership with PayPal, Brazil and Mexico-based users of Mercado Pago can use PayPal to make payments at online checkout at merchants offering Mercado Pago, while PayPal will offer Mercado Pago as a payment method at merchants accepting PayPal. PayPal has also expanded Xoom, its online money transfer service, to power remittances paid into Mercado Pago wallets in Mexico and Brazil.

- **Mercado Credito:** a credit solution that allows both consumers and merchants to use the entire MercadoLibre ecosystem and machine learning algorithms to determine a more accurate scoring for each user.

- **Advertising service:** The advertising platform enables large retailers, small and medium brands and various other consumer brands to promote their products and services on our marketplace or in the internet by providing branding and performance marketing solutions.

- **Classifieds service:** Enables users to list their offerings related to vehicles, vessels, aircraft real estate, and services outside the Marketplace platform. Classifieds listings differ from Marketplace listings, as they only charge optional placement fees, and never final value fees. Classifieds pages are also a major source of traffic to our website, benefitting both the Marketplace and non-marketplace businesses.

Financials

In the company's most recent results, for the first-quarter (to 31 March 2020), revenue surged 70.5% (on a foreign-exchange-neutral basis) to US$652 million; with total payment volume 82.2% higher, at US$8.1 billion, and gross merchandise volume (GMV) up 34.2%, at US$3.4 billion. Unique active users on the platform swelled from 33 million in March 2019 to 43.2 million. Live listings offered on MercadoLibre's marketplace reached 267.4 million, up 29.8% in a year.

COVID did slam the company: during the week of the 18–24 March, year-on-year growth for items sold slumped to 3.3%, with Fx-neutral GMV declining by 1.4%. Subsequently, growth rates accelerated in April to 75.8% annualised increase in items sold and 72.6% Fx-neutral annualised growth in GMV. Second-quarter results will show the extent to which MercadoLibre's business has bounced back.

One Australian investor that knows MercadoLibre well is Francyne Mu, Sydney-based portfolio manager and analyst at Franklin Equity Group, which holds the stock in the Franklin Global Growth Fund.

"It's often called the 'Latin American e-Bay', or an Amazon-type platform – it's the the largest online marketplace in Latin America. The stock has a marketplace similar to eBay, and a payments system similar to Pay Pal," says Mu.

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"We like names with strong free cash flow, good competitive advantages and management teams that have been able to invest for the future, and MercadoLibre gives us all of that. It's really well-managed, and has just done superbly well in terms of building-out its ecosystem to enhance its competitive advantage, its first-mover advantage that it has built over time," she says.

Mu says there is a constant sentiment overhang that MercadoLibre is at risk from the threat of Amazon entering Latin America, but she says this theory under-estimates what the Argentinian company has built. "We've addressed that with the company, many times, and we don't see any sign of it in a big way. In particular, the logistical side of the equation in Brazil is fairly challenging, and Mercado Libre having the first-mover advantage, and having been able to bargain with the third-party logistics providers, and build up relationships there, has built up a formidable competitive advantage. They have become to 'go-to' platform for buyers and sellers in Latin America, and we think the fact that they've developed their own payment system has only strengthened that competitive advantage."
Mu says the beauty of MercadoLibre is that it "adds a great deal of value" to the companies that market their products through its platform. Almost 90% of the companies that sell on Mercado Libre are small-to-medium-sized enterprises (SMEs) that do not have the infrastructure or technology to operate their own warehouses.

Also, she says, there is a huge amount of growth left in its market: online commerce penetration in Latin America remains very low, with only about 3% of all retail sales occurring online (about 7% in Brazil), compared to 12% in the US. And the opportunity with MercadoLibre's payments ecosystem is potentially even larger: some 400 million people in the region are still without bank accounts or credit histories.

In fact, if you want a compelling ESG (environmental, social and governance) case for your investments, MercadoLibre CEO Marcos Galperin speaks of the company's mission to open up e-commerce and easy digital payment solutions to SMEs and sole traders as "fostering financial inclusion in Latin America," while also rewarding MercadoLibre's shareholders.

There is only one problem: MercadoLibre looks to be slightly over-valued for now.

Despite having its headquarters in Buenos Aires, MercadoLibre is listed on the Nasdaq Stock Market, under the code 'MELI,' where it is a constituent of the Nasdaq 100. As such, the shares are within easy reach of Australian investors, through the plethora of online brokers offering cheap US trading.

MELI is trading at US$964.72, up from US$282 just three years ago, which capitalises the company at US$48 billion ($68.5 billion) – about the same size as Westpac. On a sample of 24 analysts, Marketscreener.com gives a consensus price target of US$849.57 – but a consensus rating of "outperform."

Of the Marketscreener.com sample, six analysts rate the stock a "buy," six rate it "outperform," ten rate it as "hold" and just two rate it a "sell."

Investing responsibly, not as easy as you think

- Drew Meredith -

ESG or Environmental, Social and Governance investing, has continued to grow in popularity despite the pandemic. While the sector has been a feature of institutional and pension fund portfolios for many years, it remains in its infancy for self-directed investors and advisers. One of the biggest issues highlighted in our discussions and research has been the disconnect between the large pension funds, global fund managers, and the actual investors' views on ESG and other issues.

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In many cases, such as Australia's industry fund sector, ESG is advertised as being core to an investment strategy, however it does not stop investments in gambling or mining companies, such as those who struggle to meet community expectations, like Rio Tinto Ltd (ASX:RIO) or Westpac Corporation (ASX:WBC) following their recent scandals. For example, Rio Tinto had very high ESG ratings for its policies on indigenous land rights, and it was rated the top mining company in Corporate Human Rights for two years running, in 2018 and 2019. Then, in 2020, it (legally) blew up a 46,000-year-old cultural site at Juukan Gorge in the Pilbara.

In some cases, it seems to be simply a glancing consideration of ESG factors, rather than a willingness to engage with their members and investors to understand their views. As a financial adviser, I am privileged to hear these on a daily basis from a diverse array of clients, friends and experts.

In my experience, one of the most confusing parts of the ESG discussion is the lack of a true accreditation process or central body. Before proceeding, it is worth noting that the Responsible Investment Association of Australasia (RIAA) is going some way to improve this. In nearly every meeting with a fund manager, one of our key due diligence questions relates to its ESG policies, and how they impact investment decisions. In most cases, the answer is simple: 'We are signatories to the United Nation's Principles of Responsible Investment.'

Figure 1: SDGs Mapped Against Environmental, Social and Governance Categories

While being an important step in becoming responsible investors and custodians of client capital, the UN PRI are quite broad and tend to lack detail. Despite the fact that the PRI process involves an extensive questionnaire, lodgement fee and regular disclosures around investment policy, it remains a voluntary and truly aspirational code of conduct, rather than anything enforceable. For instance, the Commitment made by fund managers is as follows:

"As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time)".

And ultimately each signatory agrees to the following:

1. We will incorporate ESG issues into investment analysis and decision making
2. We will be active owners and incorporate ESG issues into our ownership policies and practices
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest
4. We will promote acceptance and implementation of the principles within the investment industry
5. We will work together to enhance our effectiveness in implementing them
6. We will each report on our activities and progress

The issue, in my view, is that there is simply far too much flexibility and individual discretion as to what fits certain ESG criteria and what doesn't. Or alternatively, whether avoiding a company on ESG issues is appropriate, or investing in that company but seeking to improve its ESG policies through proxy voting or other influences. It is the way that some of the world's largest gaming, tobacco or even arms-related companies can end up in portfolios with little more than a short comment from the manager.

There is clearly a long way to go for the sector, particularly in communicating with the ultimate providers of capital, being you, our readers. In my view, a great starting point would be for the major global managers to offer investors the same ability,

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excluding tobacco or gaming options, that is offered to the much larger pension funds.

Market Insights

- Paul Xiradis, Ausbil -

This month we hear from Paul Xiradis, Chief Investment Officer of Ausbil Investments, on his outlook post COVID-19.

Q: At the middle of 2020, where do we stand with COVID-19 from a macro viewpoint, and has your outlook changed?

It has been quite an incredible ride over the past few months. Back in March, we were looking into the unknown with a pandemic that was both unpredictable and dangerous. Incredibly, almost in unison, governments and central banks across the world's markets scrambled together the biggest stimulus package in history, over 10% of world GDP in value. Until then, things seemed bleak, but after this wave of stimulus, focus turned to containment and recovery.

We felt that in the second half of this year there would be a recovery, we said this early. A few months on, we are experiencing a far better outcome than most expected. This is largely due to the decisive global stimulus that supported the world economy in hibernation, and the fact that this period of hibernation has been a lot shorter than expected. Australia and New Zealand, in particular, have tackled the virus a lot better than the rest of the world.

What began as panic, with people hoarding toilet paper, and people and companies alike hoarding cash, has seen cash balances across the board grow dramatically. When there has been any softening of the disastrous view, we have seen some of this cash put into action. It is only a matter of time before this pent-up demand is allowed to express itself in spending and investment as the Covid risks begin to subside.

Retail spending has been a lot stronger than anticipated. Activity in construction and trade activity was a lot stronger than expected. We are seeing e-commerce driving activity levels, allowing people to continue to operate, and as a result we saw sales move up, not down. Unemployment did not peak anywhere near, at this stage at least, what the market was anticipating. The JobKeeper stimulus package was undersubscribed by some $60 billion. Most commentators are readjusting their forecasts back to levels nowhere near as dire as first anticipated. I think this provides greater confirmation that we will see a recovery in the second half of this year, that the recession will be shallower to what most were anticipating, and will be shallower to what we were anticipating.

While COVID-19 re-infection risk remains high, developed markets are succeeding with lockdowns. In Australia, we have got COVID-19 relatively under control, and that has allowed the authorities to respond by opening the economy faster, further supporting our view that the economy will begin to recover in the second half of 2020.

In Victoria, locally acquired cases are sharply rising in Melbourne, and will see Stage 3 restrictions reinstated for 6 weeks until 19th August for Metropolitan Melbourne and the Shire of Mitchell, and the closing of the Victorian and NSW state border. The swift containment measures implemented by authorities is reassuring. At this stage, this will probably be a temporary drag on economic activity through the September quarter. Meanwhile, we expect the remaining Australian states to continue with their scheduled reopening dates, enabling activity to resume, which should help to cushion, to some degree, the impact on GDP growth. We continue to monitor this specific development closely as new information comes out but, at this stage, it does not change our current medium-term outlook on the expected 'U-shaped' economic recovery profile for Australia.

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Q: Do you think COVID-19 has changed many sectors for good?

What COVID-19 has done is fast-forward some of the super trends which were already emerging, some of which will now become a permanent way of life. The use of technology to run our lives on a day-to-day basis was forced on us by necessity, and now it could become the norm. Where there was reluctance by individuals to use electronic banking, through necessity everyone has moved to self-service banking. The same with goods and services, people had no choice but to use e-commerce as a way of conducting their lives and obtaining life's staples.

We also saw that in a lot of discretionary retailing as well. These trends were developing anyway, but the inescapable global experiment triggered by COVID-19 has proved that society can operate in lockdown, and a lot of this is down to technology. As a consequence of being shown another way, there is likely to be a high degree of permanency in these behavioural changes.
Another thing we learnt is that there are businesses that can thrive in such environments. A lot of retailers have realised that they can operate using e-channels for sales, and that they don't need to have such a large bricks-and-mortar footprint. This has accelerated the trend giving retailers an upper-hand in negotiating with landlords, this was not the case ten years ago. The shift from bricks-and-mortar retail is not a fad, it is structural.

Q: How about toll roads and airports?

Infrastructure assets in the form of toll roads and airports have been hit very hard by COVID-19. Toll roads saw traffic almost vanish during the initial lockdowns, however, as restrictions have been eased, traffic has returned. This has impacted companies like Transurban (ASX: TCL). There is a view that the traffic volumes on roads is going to increase post-lockdown, as there will be some reluctance to use public transport, but I am not sure how long that will last. We have also seen heavy vehicles bounce back very strongly.

Airports are a little bit different. Zoom and Skype are far more acceptable now, so there is likely to be less travel, with more interaction in this form. You still can't take away from the benefits of travel, and being on-the-ground still has its advantages.

However, we don't see airports experiencing such a strong recovery as other transport infrastructure as international travel is likely to be lower, though domestic travel is expected to approach previous levels. Airports like Sydney Airport (ASX: SYD) and Auckland International Airport (ASX: AIA) have hit recent lows and since rebounded somewhat, however, we remain cautious on airports as it remains unclear how much COVID-19 has fundamentally changed air travel.

Q: How are resources going with COVID-19, especially with the recent geopolitical tensions?

One of the things we have said from the beginning is that, globally, there has been an incredible response by governments in terms of fiscal stimulus. By contrast, if you go back to the GFC it was more about austerity than spending, and it was up to the monetary authorities to do the heavy lifting. This time around, we have seen both monetary and fiscal stimulus applied in concert with plans to bring forward activity and infrastructure projects. This is happening globally as a means of reigniting growth, in China, recently in Australia, and we are likely to see it in other parts of the world.

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On the basis of fiscal stimulus and accelerated infrastructure spending, the outlook for resources, and particularly steelmaking resources, is pretty strong. Iron ore, the most important of these for Australia's terms of trade, is seeing renewed demand as Covid-driven supply constraints shift demand to Australian ore. Companies like diversified miners, BHP (ASX: BHP) and Rio Tinto (ASX: RIO), and specialist iron ore miner, Fortescue Metals (ASX: FMG), are beneficiaries of this strong demand, as are the mining services companies contracted to help deliver this supply to world markets.

Electric vehicles (EVs) is another theme that is looking stronger. During the shutdown, traditional car manufacturers were retooling towards the production of electric vehicles, creating further demand for selective metals. The changing trend towards EVs will see increased demand for copper from companies like OZ Minerals (ASX: OZL), as well as nickel and lithium in the next 12-months.

Q: How are the banks faring, and how do you see them as we move through COVID-19?

If you are optimistic about Australian and New Zealand economic recovery, and we are, you have to be comfortable with the banks. The banks are most leveraged to an improving environment. We are seeing that already. Again, the dire expectations of three months ago, even two months ago, have improved markedly. Banks were provisioning for an economy with far higher unemployment levels than we have experienced, a deeper negative growth experience than has occurred, and a more elongated recovery than we are seeing at this juncture.

We believe that the depths of the downturn are not going to be anywhere near as bad as initially expected, and the recovery is not going to take as long as was expected. If this remains the case, it is a fantastic opportunity for investors to reweight back into the banks. We increased our exposure through the Covid sell-down, and we are now the most overweight we have been in banks for a number of years. This is on the basis that we think earnings will exceed expectations, bad and doubtful debts may not be nearly as bad as the market has been pricing, and if that is the case, they have strong balance sheets, and banks will return to paying an ongoing sustainable dividend, albeit at a lower payout ratio.

Most commentators were incredibly negative on banks, and most institutions were underweight the banks based on some pretty ordinary and dire forecasts in the market. All of a sudden, the banks have become a pretty attractive proposition, and the market is still underweight, so the setup is for the banks to trade up as we move into the second half of 2020.

Wattle Watch - Lazard Emerging Market Debt Fund -

- Jamie Nemtsas -

Lazard: 11.4% return in the June quarter

When we saw this headline we assumed it was from one of Lazard's global equity strategies across its $170 billion portfolio. We were as surprised as anyone when we realised it had actually come from their Emerging Market debt strategy; so we decided to take a closer look.

Emerging Market debt has always been a sector we have sought an exposure to, but as Australian investors the options are limited to say the least. The asset class has been increasingly popular with global institutions and pension funds, attracted to the substantially higher interest rates on offer, anywhere from 4 – 6%. Recent moves towards 0% rates in the US have only accelerated this interest. Emerging markets are generally defined as growing economies that don't quite meet the standards of developed economies when it comes to income, living standards and investment or capital market conditions.

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Emerging markets are seperated into multiple sectors of their own, including the so-called EAGLES: being Brazil, China, India, Mexico, Indonesia and Russia, before moving into second tier (South Africa, Thailand, Vietnam) and frontier markets. Whilst clearly these economies represnet higher risks than traditional developed alternatives, they also offer stronger returns an in some cases much better economic conditions and Government support.

So what is the fund?

The fund in question is the Lazard Emerging Markets Total Return Bond Fund, with total return referring to the managers authority to move back to cash when they believe the risks are outweighing returns. The manager seemingly times this quite well in March, having reduced exposure before the crisis, capping losses at 8%, and managing to increase exposure in April to deliver a market leading 11% 3 month return.

Who manages it?

Lazard has an Emerging Markets debt team of 21, lead to Denise Simon and Arif Joshi, with around $15 billion in assets under management, making them a global leader.

What does it invest in?

Ultimately, the fund will hold between 60 and 80 bonds issued by somewhere between 20 and 40 emerging market countries, generally in Hard Currency, many bonds issued in USD, JPY or EUR. The managers are able to dial up the cash allocation to 75% if they see a lack of value in each of the markets they assess and can only allocate 20% to higher risk Frontier markets.

What does the portfolio look like?

At present, the fund offers an attractive coupon of 5.75% from its current portfolio of investments and a relatively short duration of 3.68 years, compared to most developed market alternatives which are closer to 7 years. This means the fund is less exposed to unexpected interest rate increases.

The strategy is highly diversified, holding 33% in Hard Currency Sovereign Government issued bonds, 17% in Corporate Bonds and 24% in Credit Default Swaps. The latter are effectively insurance contracts through which the owner is paid out if the underlying issues defaults on their loans. In the case of this fund, they are held not with the expectation of failure, but as an exposure to the underlying companies, as they trade more regularly and increase and decrease as conditions in each country change, offering a non-correlated source of returns.

This is obviously quite a new concept to most investors, but a very mature one in global markets. One of the most important considerations for this fund is the outlook for the USD and resultant capital flows. As countries issuing bonds in USD's but which have their own currency can be impacted badly if the USD rises and their interest payments increase, but benefit strongly should the latter occur. Many institutions continue to bet on the latter.

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Joe turns 2!

Our youngest team member is turning two on the 5th of August. Joseph McKinley Meredith is seemingly thriving despite increasing lockdown measures in Victoria!

Happy birthday Joe!

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