WHITEPAPERS

Investing in pandemic markets

It's obvious to say we are living through unprecedented times. It's perhaps less obvious that while the circumstances might be different, the human response in investment markets is surprisingly similar, and some situations even a little predictable. To begin with, forecasting a virus would be the pin that ultimately popped the bubble in asset markets – no one predicted that.

In this note, I will discuss the factors that led us to being out of step with the market and raise cash in our portfolios. And perhaps with a little pride, I will also discuss the thought-leading research that our team has been conducting and their in-depth analysis of the spread of COVID-19. Our thinking should help our investors navigate and prosper through the recovery.

By Roger Montgomery
Montgomery Investment Management
April 2020

We did spend a great deal of time last year warning that asset markets were stretched, very late in their cycle and seemed disengaged from reality. Unfortunately, while it is our sincere hope that investors heeded those warnings, we did look very out of step with the roaring prices at the time.

Stuck with the one per cent returns on cash balances, investors migrated to equities for their superior yields and hoped-for capital gains. What was forgotten in the mad dash for a better return, was that 'one per cent is better than minus twenty'.

> To be fair, the conundrum for investors last year was that cash had been so painfully poor at generating a return that's acceptable, many felt forced to take on more risk. To our minds however, investors hadn't really appreciated the extent of the risks they were adopting.

Markets were expensive

To begin with the U.S. market had been extremely expensive for some time. As Figure 1 demonstrates, the US S&P500 index was trading on a Cyclically-Adjusted Price to Earnings Ratio (CAPE) of more than 32 times in January 2020. To put this in perspective, an investor could look all the way back to the year 1870 and find only one instance when the market was even more expensive, and that was during the Tech Bubble of 1999-2000.

In point of fact, the Coronavirus pandemic struck at the time of the second most overvalued U.S. stock market ever.

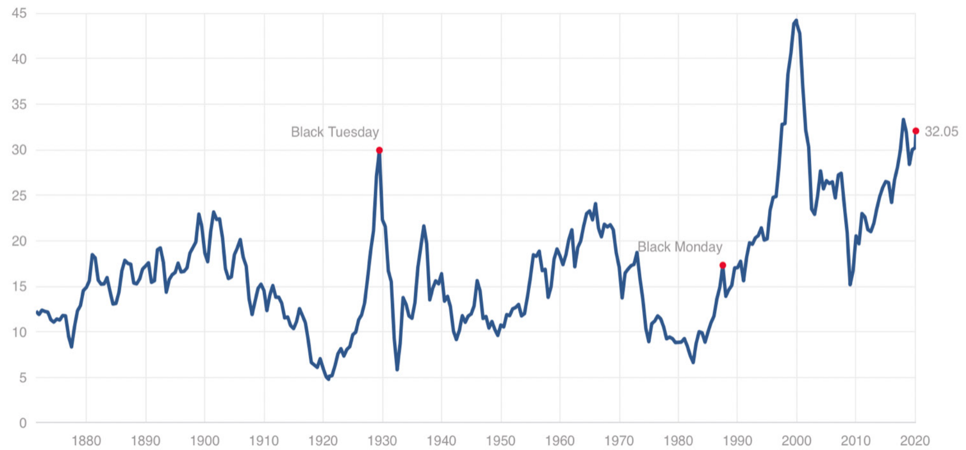
In Australia, the story was very similar. The S&P/ASX 200 Industrials Index, excluding financials was trading on a record earnings multiple of almost 27 times. On its own, that may not have been a problem, remembering that interest rates had declined steeply to record low levels. The issue was consensus earnings estimates were in decline.

Meanwhile, and since June 2019, one-year forward earnings per share estimates for the ASX 300 had been declining. In the absence of a resurgence in economic growth, the combination of rising prices and falling earnings has rarely ended well. In 2019 and in early 2020 investors were paying more for many companies (both high and low quality), and failed to appreciate their fear of missing out caused them to adopt more risk.

We didn't predict COVID-19. Although we were aware of it in mid-January. My family and I returned from overseas in mid-January wearing face masks but were the only Australians on the flight doing so, nobody was talking about it at that time. When we were discussing all the scenarios that might pop the bubble, we didn't know it would be COVID-19.

The basic ingredients of a bubble were in place with investors betting on 'potential' rather than 'proof.' The US market was irrationally expensive and we saw extreme valuations here in Australia, along with declining earnings. We were witness to a retail recession in Australia as well as a collapse of residential construction activity. Then, in Australia, we experienced the personal devastation the bushfires and subsequent floods wrought.

Figure 1. S&P500 CAPE RATIO 1870 – 2020



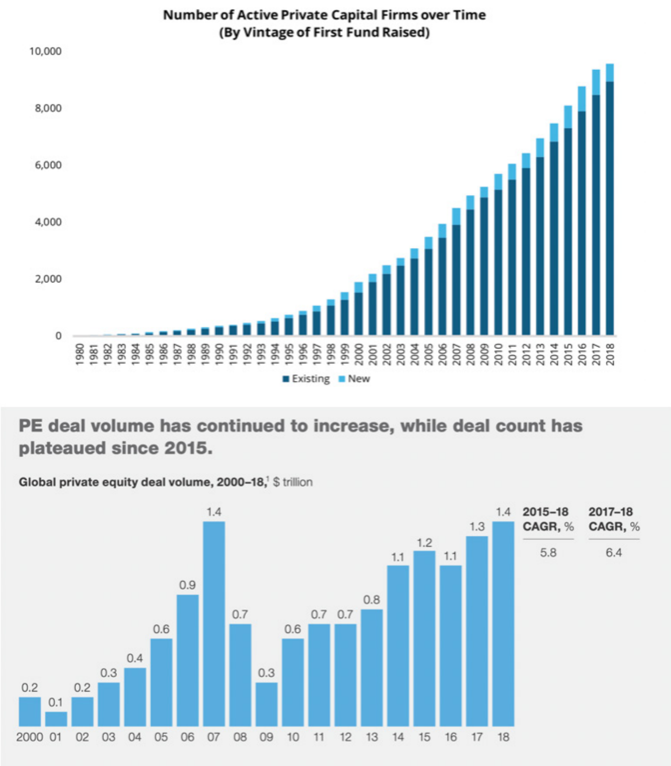
Private Equity – a nail in the coffin

Whenever you see an already-established industry growing at rates much faster than the broader economy or the population, it is relatively safe to assume that pace of growth is unsustainable. Growth simply cannot continue at rates well in excess of the underlying economy or population, lest the industry becomes the economy.

When one observes sustained accelerated growth, it is reasonable to ask whether a bubble exists.

Since the Global Financial Crisis, we observed the same unsustainable global expansion in the number of Private Equity firms hanging up their shingle. Of course, once the shingle is hung, 'private equiteers' need to raise money, and once they raise said money, that money needs to be deployed. The consequence has been a rising number of deals as shown in Figure 2. And thanks to the rising competition from the boom in Private Equity firm numbers, those deals were conducted at an ever-increasing multiple.

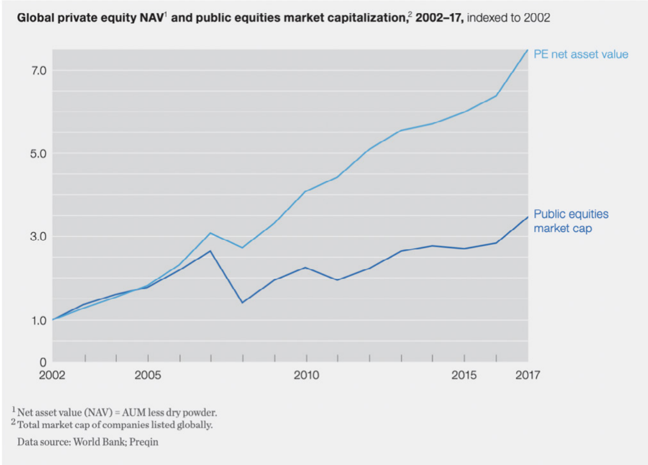
Figure 2. Private Equity boom – number of firms and number of deals



Source: World Bank; Preqin

The boom in private equity firms coincided with, and was a consequence of, ultra-low interest rates on cash that nobody wanted. As more private equity firms incorporated, and more deals were conducted, the rising multiples begot more inflows and a self-fulfilling spiral up began. The result has been that while US public equity markets have, on average, tripled since 2002, net assets in private equity hands have risen eight-fold (Figure 3).

Figure 3. Boom in Private Equity dwarfs even stretched public markets



Source: World Bank; Preqin

One might ask, why a bubble in global private equity should be a concern for Australian equity investors? As we outlined last year in The Australian, there were two expensive issues; first, the belief that all private equity-backed companies, especially the 83 per cent that lost money, are worth owning because they will all be winners, is a flawed proposition that has defined many past bubbles. And the second was that private equity is an illiquid asset class. Consequently, if a high net worth investor, a super fund, a sovereign wealth fund or an endowment fund, invests in private equity, a rapid exit is unlikely if, for whatever reason, one decided to do so.

> We were unable to predict what might trigger a broad desire to exit asset markets, but an investor wanting to take risk off the table, and unable to redeem from their private equity investments, would have to turn to more liquid markets to do so.

In turn, the massive collective investments in Private Equity's hands, meant that any amplified desire for liquidity would put pressure on public markets. I believe some of the extreme volatility we are witnessing is a function of both an information 'vacuum' and an alternative for the very heavy investment accumulated in less liquid markets over the last decade.

The response

Our response to the above concerns, was threefold:

- First, maintain 'quality' as a priority and avoid the highest risk companies – those with prices reflecting 'potential' rather than 'proof'.
- Second, actively move to reduce the beta, or the measurable 'riskiness', of the equity portion of the portfolio. Reducing the beta of the portfolio involves moving out of riskier and more volatile companies and into companies perceived as more stable or defensive within our Quality, Value and Prospects framework.
- And finally, we also raised the proportion of cash in the portfolio. At the beginning of 2020, The Montgomery Fund held almost 20 per cent cash, and as the issues around Coronavirus became more serious, The Fund moved to more than 30 per cent cash. At the time of writing (31/03) The Montgomery Fund holds approximately 33 per cent in cash.

As an aside, and coincidentally, this is a similar level to the cash held and disclosed recently on the balance sheet of Warren Buffett's Berkshire Hathaway.

Our process, built on the back of our combined experience of previous market dislocations, resulted in the avoidance of the higher-risk WAAAX growth stocks, and their peers, in 2018 and 2019.

While this decision put us out of step with the market, out of step with investors and left The Montgomery Fund's performance lagging, it has since rewarded the patient. Value investing has worked for decades and we expect in the future it will again journey through scorn, contempt and derision but patience is all that is required to demonstrate its handiness. Frequently and somewhat predictably, investors forget how far the shares of a company with no earnings can fall. This is especially true when over a decade has elapsed since the last serious correction. Ignoring the unbridled enthusiasm and euphoria has however helped shield our investors wealth from the worst of the recent declines.

Is this correction different?

Invariably, different triggers and nuances accompany each crisis and market dislocation, but each is ultimately accompanied by an information vacuum that produces a correction. Importantly, every correction is also fed by a fear that no solution will emerge, that capitalism or even humanity is at risk. Truthfully, there are equities that benefited from a misallocation of capital during the preceding boom, when the aforementioned potential was valued more highly than the proof. For investors in many of those companies, a permanent loss of capital will be experienced. But it is worth remembering that corrections tend to conclude before a solution is broadly declared, and solutions have always been found. Those focused on quality and value find that opportunities are therefore greatest when that which is temporary is treated as permanent. This too will pass.

In today's crisis we observe that a government can 'stimulate' their way out when citizens are worried merely about the economy. When investors or consumers are worried about their health however, no financial incentive can encourage people to spend and take risk with their wellbeing. Queues of people awaiting social security payments will rekindle memories of depressions and instil even more fear but these too are common to recessions.

Today, it is the market's realisation that concerns about health can have more serious and potentially lasting consequences for the economy, that have exacerbated the market's declines.

This correction is therefore different to the Global Financial Crisis, different to the TechWreck of 2000, and it's different to the corporate debt-inspired crash of 1987. But in many respects, it is the same. It is a crash. Importantly, several of us here at the Montgomery office have invested through those periods, and we know that the long-term reality is not as frightening as the short-term panic inspires. Humans, it should be remembered are adaptable and resilient. As I said a moment ago, this too will pass.

One Australian fund manager, and a friend of mine, noted, "We're likely to see a near total shutdown of the world." It sounds really, really frightening. But as a value investor such sentiments should be welcomed. Yes, it does inspire fear, and losses mount as people panic, but those declines in share prices also provide the opportunity for those with cash.

A few reminders

Remember cash is most valuable when nobody else has any.

In reality, there won't be a total shutdown of the world. Let's remember that China and many Asian economies are operating, re-scaling their operations and economies again. While liberal Western democracies are only just entering a period of rapid detection rates and fatalities, and while markets are surprised, remember again, this too will pass.

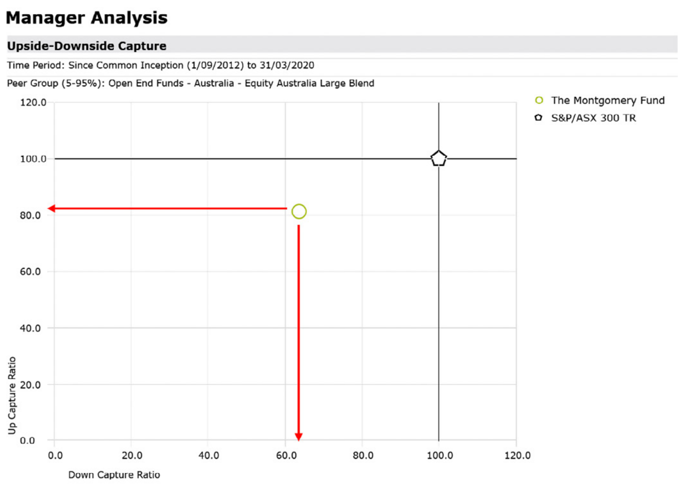
China may already be showing us that steps can be taken to contain the virus and stop its spread. Soon, I expect countries currently experiencing parabolic growth rates of infection to slow those growth rates. Then the panic will abate.

We always thought the panic would be worse than the pandemic. It's hard to be surprised by something expected.

As Figure 4. illustrates, The Montgomery Fund has done a very good job of capturing more of the upside in months where the market has risen, and far less of the downside in months where the market has declined.

In fact, since inception, The Montgomery Fund has captured an average of 81 per cent of the gain in months the market has risen, and just 64 per cent of the declines in months when the market has fallen. That is a function of the lower beta of the equity part of the portfolio, and also the fact that we've had the flexibility to hold cash.

Figure 4. The Montgomery Fund Upside-Downside Capture



Source: Morningstar

Coronavirus and COVID-19

I'm very proud of the work our team at Montgomery have conducted on the spread of the virus and its likely impact on markets. While many other investors, early in the Coronavirus outbreak, were focused on fatality and detection rates, we actually went one step further than that, and we were following testing rates. Testing rates are most important. If testing isn't being conducted, cases won't be found.

What we found early explained why investors were so relaxed. The West wasn't scaling up testing and consequently wasn't discovering many positive cases. And where testing was being conducted at scale, such as in Wuhan and South Korea, Western financial markets were less concerned. Comments such as;

"There is really nothing to worry about", "More people die from the flu" and "not many people are dying – it's not that bad" reflected misplaced security and simply stemmed from a lack of testing.

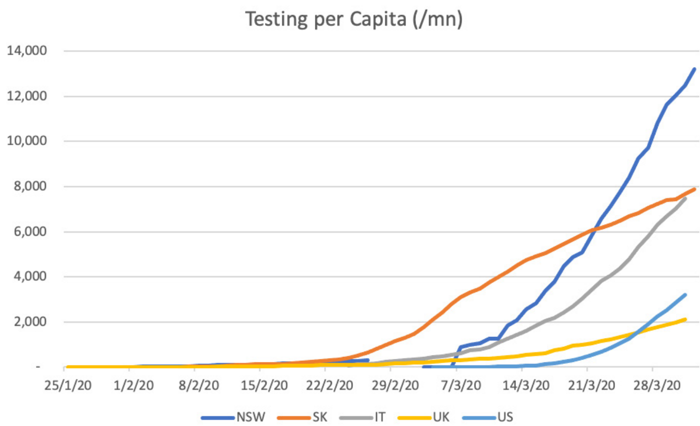
We were confident, indeed almost certain, that delays to testing and its subsequent scaling in Western liberal democracies would reveal a surprising number of cases. We also believed that Western sensibilities might prevent, or at least delay, the draconian but effective lockdowns seen in the East.

South Korea obviously, has been the poster child for testing and controlling this disease.

Figure 5 is what we refer to as The Government Competence Index. It illustrates the amount of testing being conducted per capita in each country as at March 31, 2020.

What really worried us or what did worry us the most in February and early March is, the very little testing that had been conducted in the United States. More on that in just a moment.

Figure 5. Covid-19 Government Competence Index



Source: The COVID Tracking Project, Montgomery

South Korea

Table 1. South Korea Experience (data to 01 April 2020)

Tests	404,962
Cases	9,887
Deaths	165
Test per mn of population	7,899
Detection rate	2.44%
Current fatality rate	1.67%

South Korea were very successful in controlling the outbreak. And the reason why is, they started testing very early. That in turn was probably a function of their geographic proximity to China. They also had a death cult spreading the disease. And so it was relatively obvious to them that they needed to get onto it quickly.

Moreover, South Korea tracked everyone's mobile phones. Once a COVID-19 positive case was found the country was able to take information from the individual's mobile phone and find out precisely, using GPS, how many other mobile phones were in close proximity and where over the previous 24 hours. Within 24 hours, employing the military, South Korea had not only quarantined the person who presented as unwell, but every other person that person was in contact with.

As of 1 April 2020 South Korea, a country of approximately 50 million people, had conducted 404,962 tests, with 9,887 tests returned positive. And because testing commenced early, only 2.4 per cent of all tests conducted returned positive results. Of the 9,887 confirmed positive cases, while it's tragic that 165 people have actually passed away, it's encouraging that it's less than two per cent of all positive cases.

Testing early and testing hard worked. That is not something we expected from Western liberal countries who were apathetic and unprepared.

Italy

Table 2. Italy's Experience (data to 31 March 2020)

Tests	506,968
Cases	105,792
Deaths	12,428
Test per mn of population	7,468
Detection rate	20.87%
Current fatality rate	11.75%

Italy was always going to be the poster child for Western liberal democracies and ultimately fed into our understanding of what would happen in the United States, which in turn, would drive markets globally.

That's why we wanted to follow Italy when the virus broke. And why did it break out in Italy? Italy, and in particular the Lombardy region, has a very high concentration of Chinese manufacturing firms with Chinese workers pursuing that coveted 'Made in Italy' label. Consequently, there's a lot of Wuhanese businessmen and women moving between China to Italy.

The outbreak in Italy wasn't surprising. Nor are we surprised to find that the detection rate was so much higher than South Korea. The reason for that is very simple; Italy took a long time to start testing and that gave time for the virus to spread. Italy only commenced testing in earnest in mid-February. As of 31 March 2020 the country had conducted 506,968 tests. Italy's cumulative detection rate is now almost 21 per cent, and the fatality rate is 11.7 per cent. Consequently, Italy is in a much worse predicament than South Korea. And we believe Italy's experience may be reflected in the United States.

United States

Our most shocking discovery in the very early days of February was that despite the United States having a population of 330 million people, they were only conducting an average of 40 tests per day, on average, through January.

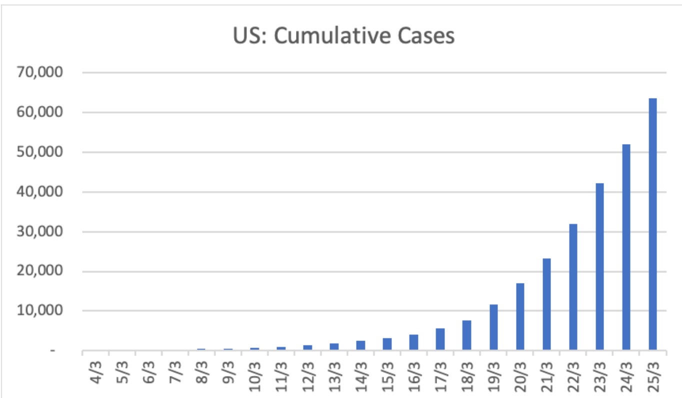
In February, they lifted that to an average of 92 tests per day. I'm not joking, this was the total number of tests being conducted in the United States for COVID-19, out of 330 million people.

Our thesis was a pretty simple one. The United States would eventually ramp up their testing and when they did, as they late as they did, they would be shocked by their detection rates – the number of people confirmed as positive – and also their fatality rates. The market was blissfully unaware of this in early February.

As of 31 March 2020 the US is witness to 17.6 per cent detection rates and the market now fears that rate is going to rise materially, in coming weeks.

As Figure 6 demonstrates, the U. S's handling of Covid-19 can only be described an abject failure.

Figure 6. United States – growing fast from a low base and a very late start



Source: The COVID Tracking Project, Montgomery

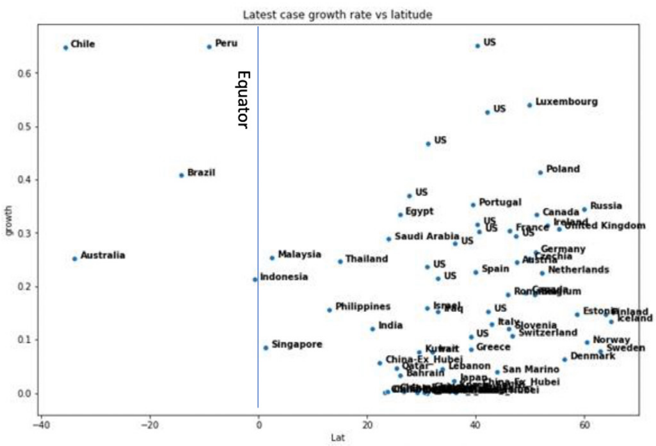
Will hot temperatures help?

One lingering hope is that warm temperatures in the summertime will slow down the spread.

A simple way to test this theory is to plot growth rates against temperatures.

In Figure 7. below we plot growth rates against the Earth's latitude. Latitude on the horizontal axis, and growth on the left-hand side of the virus. You can see Malaysia and Singapore very close to the equator, hot countries, and still very high growth rates for Coronavirus, slower than some of the Nordic countries, but nevertheless still growing. So, it might not stop out of the spread of the virus.

Figure 7. Equatorial temperatures and COVID-19's growth rate



Source: The COVID Tracking Project

You can follow our latest COVID-19 testing analysis and tracking via our website and the range of commentary posted at: rogermontgomery.com

Opportunities

So what are the possible opportunities? What's the path forward from here?

Stage One

Firstly, let's think about a framework for a crash. Stage One is almost complete, and that is accompanied by an unwinding of the growth premium that was built into prices prior to the correction commencing and reflected in those WAAAX stocks referred to earlier.

Also accompanying Stage One is the market being shocked by the extent of the infection. We think there's some of that to go in the United States. Markets are currently in an information vacuum, and when investors don't know how serious the situation could become, that's when asset prices overreact.

Holding cash when everyone else wants cash but doesn't have any is when opportunities can be taken advantage of. Comments about the world ending or this being Armageddon or a great depression, feeds into that vacuum pushing prices down even further.

Stage Two

Stage Two, sees a little more rationality appear at the same time companies start raising money and pulling their guidance. In Australia, toilet rolls may start appearing back on supermarket shelves and remain there. The hoarding slows and the financial market panic eases along with the volatility. Once the market realises humanity will survive, a more rational assessment of the impact on the economy starts to occur. Obviously, we're going to see revenues cut deeply. We know that even for high-quality companies we like, their earnings and revenue will be impacted for the 2020 calendar year.

Assume revenues of zero. Modelling will remain difficult for many months but we are less concerned about very short-term revenue and earnings because our investing time horizon is much longer.

We are going to be targeting those companies that have sufficiently strong balance sheets, can endure a year of zero revenue, and don't need to recapitalise their balance sheets.

We might even look at companies that do need to recapitalize, but only at deeply discounted prices. As an aside, one of the observations we can make is that market bottoms often coincide with a round of companies engaging in deeply discounted rights issues. We have already seen Webjet, Flight Centre and Ooh Media approach the market for capital. The longer and deeper the economic slow-down the more we are going to see capital raisings and bail-outs.

Stage 3 and the Reserve Bank of Australia

Stage Three, could be steep and deep or relatively benign. The magnitude of the third stage depends on the extent of the recession and the degree to which credit supply for corporates is impacted. In times of crisis, liquidity is everything.

We saw the Reserve Bank of Australia (RBA) throw everything it had at markets reassuring participants that liquidity in Australia is not going to be an issue.

The RBA cut its target cash rate to 0.25 per cent to encourage banks to further drop borrowing rates for businesses and households. The RBA also commenced purchases of Australian Government Bonds to maintain a three-year government bond yield of only 0.25 per cent, and reducing the cost of longer-term, fixed-rate business and household loans (which are partly priced off three-year government bond yields).

The RBA is also reported to have offered banks a longer-term funding facility of a minimum A$90 billion on a three-year basis at 0.25 per cent. Finance for individuals and companies will remain cheaply available. Finally, the RBA, along with the Australian Office of Financial Management (AOFM) will launch an AOFM-managed A$15 billion direct investment program in residential mortgage-backed securities (RMBS) and asset-backed securities (ABS) helping to ensure functioning liquid markets.

The Montgomery Fund portfolio positioning

In terms of our positioning, we have a high cash weighting and we are delighted that we've entered this period with all of that cash. That's certainly helping to protect on the downside. But perhaps more importantly, for new investors in our fund, it means that we're going to be able to deploy that cash into new opportunities at lower prices. And keep in mind, that for The Montgomery Fund, because we've underperformed for a period of time by sitting out the bull run, we've got to catch up that under performance before there's a performance fee to be paid.

In terms of sectoral exposures, we note the banks make up 27 per cent of the index, and The Montgomery Fund currently has approximately five per cent of the portfolio exposed to the banks. We believe this will change in the future however we need to be confident that credit and market liquidity concerns will abate.

We also have very low exposure to consumer discretionary, and low exposure to consumer staples. The retail recession in Australia has been something we anticipated since our analysis suggested a collapse in residential housing construction led by a precipitous drop in approvals last year.

We've recently increased our weighting to CSL. CSL is a high-quality global franchise, has a superb balance sheet and people are still going to need plasma. Indeed, plasma could actually be a source of assistance for COVID-19 patients if antibodies are harvested from survivors.

Telstra is one of our largest positions. The internet is likely to be the last service that people will cut off, if they're required to work from home or self-isolate. And there is a longer-term thesis for Telstra, and that's 5G.

We have recently added Sydney Airport to the portfolio. It is thick in the COVID-19 crisis and investors might be concerned but the company owns a monopoly asset. Yes, Sydney Airport will suffer a hit to revenue and earnings, there's no doubt about that – let's assume zero. We however anticipate that its capacity will be filled very quickly in a recovery. We think travel will bounce back reasonably quickly thanks to pent up demand from a still ageing population. Many families separated by the virus will rush to reunite.

There will come a point in the future, where the World Health Organisation announces that the Coronavirus danger is over. There's also the very real possibility of a vaccine. And when those things happen, there's going to be a lot of pent up demand for travel. Sydney Airport should be a beneficiary. And we have seen the Federal Government propose a funding package to help second tier airlines. Clearly, they don't want Qantas to be a monopoly airline in Australia. That's not good for consumers. And two domestic carriers are very useful for Sydney Airport.

Now, in terms of where we've decreased our weightings, we reduced our holding in Aristocrat. Obviously, there's going to be fewer people attending casinos because of the bans on them, particularly in Australia, and the United States.

We've also reduced our holding in Westpac and in Macquarie bank as well, simply because we're a little concerned about the impact of financial market stress on liquidity for now. While the RBA/APRA announcements alleviate some of concerns domestically, we want to obtain a little more comfort about global developments.

In closing

In conclusion, this crisis will pass like all others before it. At Montgomery, we've not only been dynamic with our cash holdings, we've also been very dynamic with adjusting the beta of the equity part of the portfolio. Prior to the outbreak of Coronavirus, we'd been reducing the beta of the portfolio by increasing the portfolio's exposure to larger stalwarts and reducing exposure to relatively higher beta stocks. You can expect that to reverse in the future as we seek to gain exposure to, and leverage, the recovery.

At precisely the same time that everybody else thinks it's time to bail out, we'd like to be 'bailing in.'

We'd like our supporters to be thinking likewise and speaking with their clients about adding to their investment in Montgomery.

My sincere best wishes for the next year or two. Navigating it well will set up portfolios and wealth outcomes for the next decade.

MONTGOMERY

Do you want to get in contact with the team at Montgomery?

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