COVID-19 Update

Over the last month as Covid 19 has spread around the world and various measures have been implemented to try and contain it, we have received questions from our clients who are understandably concerned about what it means for their investments and how we are approaching the situation at Nikko AM NZ. In the short term, we expect market volatility to remain at elevated levels as uncertainty prevails, but this does not mean that investors should panic or act hastily.

At the time of writing, the United States S&P 500 index had lost 29%, the Japanese Nikkei 225 index fell 31%, the UK FTSE 100 index lost 33%, while the Australian ASX 200 index fell 30% and the MSCI World index was down 30% in local terms from their respective highs. The NZ dollar has weakened significantly during this time, which will be helpful for those investors holding unhedged foreign assets.

In New Zealand, the S&P/NZX 50 index has fallen from its previous high by 25% to materially outperform our international peers. This means that investors in the NZX 50 are broadly in line with where they were 12 months ago.

Bond yields have been volatile, falling sharply before rebounding just as swiftly, as investors consider the volume of Government debt required to support the announced stimulus packages. The NZ 10-year bond is trading at 1.58%, the Australian 10-year bond at 1.30% and US 10-year bond at 1.18%.

As countries implement various measures to slow or contain the spread of the virus, economies are working through the impacts of both supply and demand shocks.

In the US, the Federal Reserve has cut its benchmark interest rate to zero and launched a massive $700bn quantitative easing program. The ECB announced a €750bn bond buying program, the UK cut rates by 50bps and will provide a £350bn fiscal package, and in Australia the government has to date promised $17.6bn in economic measures.

In New Zealand, the Reserve Bank has cut the OCR by 75bps to 0.25% in an unscheduled announcement, also advising that rate will remain in place for the next 12 months. Additionally, new capital rules for banks which were due to be introduced have been delayed, opening up a further $47bn in lending headroom. The Government has subsequently announced a $12.1bn rescue package, roughly 4% of GDP, to help deal with the economic fallout from the coronavirus.

At Nikko AM NZ, at this point in time we are still working in the office but expect to be working remotely in the near future. We have a formal Business Continuity Plan and these measures have been regularly tested, so we do not expect any change in the management of assets or service to our clients.

All of our daily priced funds are currently operating on normal liquidity terms, pricing and accepting applications and redemptions.

From a portfolio management perspective, the consideration of economic fundamentals and concentrating upon the medium term outlook is important in times such as these when fear driven markets often price assets for extreme outcomes.

Domestic Fixed Income

Even though the OCR fell, sovereign bonds have fallen in value as rates have risen due to the expectation of larger debt issuance. Credit margins have widened, albeit with little trading occurring, but we are not seeing significant corporate stress in the local market. However, some sectors such as airlines and airports are under extreme pressure.

Within our domestic fixed income portfolios we have limited our exposure to those sectors we believe will feel the most impact from the coronavirus, either by choice or by lack of availability of quality issuance. In particular, we have no direct exposure to oil prices, airlines, tourism, hotels, forestry, or fisheries.

We have been entering the market to buy good quality credit at wider spreads where liquidity allows and we are comfortable with the issuer. Whilst we may experience price volatility in the near term, avoiding defaults by sticking to quality issues during this period will result in stronger returns in future periods.

Domestic Equities

In domestic equities, the virus outbreak has pressured all stocks but particularly travel and tourism-related sectors. The spread of the virus in China and beyond also presents a challenge for the country's commodity exports.

The *other* major risk facing the domestic market at present is Rio Tinto's review of operations at the aluminium smelter at Tiwai Point, which could have negative repercussions on the utilities sector.

With these factors in mind, we have opportunistically trimmed or added to positions where we see value in doing so. Our primary job is looking through the short term noise to best position our portfolios to perform over the medium term.

Across our range of portfolios we have underweight or nil holdings in Tourism Holdings (nil), Auckland Airport (underweight), Port of Tauranga (nil), Port of Napier (nil), and Air New Zealand (nil). We initially had a small overweight in Sky City which we have been reducing, albeit less quickly than we would have liked.

On the positive side we were overweight Spark and have been adding to this position, as they are well placed to ride through this crisis and have even been performing civic duties outside normal business, increasing data allowances and offering their sport package for free as the public grapples with virus containment measures. We have been disciplined in closing our underweight on Fisher & Paykel Healthcare which has been a stand-out performer, and continue to hold A2 Milk as an overweight as another beneficiary of this health crisis.

Ordinarily this would be a fantastic time to hold a greater amount in the generation retailers, but the risk of Rio exiting the market remains. We are overweight in Contact Energy where we see valuation support, and are poised to buy Meridian Energy should the review fall favourably, or the price falls to a level where the worst case is correctly priced.

Global Fixed Income

Our global fixed income mandate, managed by Goldman Sachs Asset Management (GSAM), is reasonably conservative and only allows the fund to hold investment grade securities.

While government bond yields have fallen sharply in the US, UK and Germany, yields on non-government bonds and some European government bonds have moved sharply higher. GSAM thinks risk appetite will remain low until news flow on the evolution of the coronavirus becomes more predictable and market participants gain a better understanding of the economic impact.

There are three additional dynamics weighing on risk asset performance. First, there is considerable uncertainty around the effectiveness of policy easing in an environment which depends on public behaviour amid health concerns. Second, the oil market faces a significant supply-demand twin shock. Third, secondary market liquidity is increasingly challenging; this may impair the price discovery process.

Over time, GSAM believes that a prolonged environment of low interest rates and greater clarity on the macro backdrop may drive demand for higher-yielding fixed income sectors. They expect demand to emerge first in US mortgage backed securities (MBS), which have had high credit quality, offer potentially attractive yield and benefit from renewed quantitative easing (QE) measures.

As investors gain a better sense of the bounds around potential economic scenarios and policy actions, demand could migrate along the risk spectrum to corporate credit. GSAM thinks resumed demand for corporate bonds will initially focus on companies that generate free cash flow, that are naturally de-levering and have the ability to withstand near-term challenges. GSAM's investment strategy is focused on identifying those opportunities, while also locating idiosyncratic investment openings.

Global Shares

Our colleagues in Edinburgh have echoed the thoughts of our local managers, emphasizing the need to maintain a long term approach to investing, providing the comments below:

From a market outlook perspective, equity risk premiums are rising in tandem with deflationary risks. It should be noted that equity valuations were starting from levels that were at the upper end of the historical range and hence were vulnerable to a change in risk appetite.

With regards to the Portfolio outlook we don't pretend that we have any greater expertise than the market on epidemiology. We would observe however that markets are becoming dominated by fear, panic and some evidence of forced liquidation.

From a portfolio perspective we are reminded of an old adage that "turnover is vanity, profit is sanity but cash is reality". This logic is very much embedded into how we assess individual companies and our Future Quality approach. Valuation is based on future cash flows rather than accounting profits. Balance sheet quality and the ability to invest through the inevitable cycles is a key requirement.

The current short term economic conditions will no doubt test the strength of company franchises and their management teams. We are assessing all our holdings for potential impacts to profitability and their ability to manage any changes to shorter term cash flows. We have not changed anything in the portfolio to date as a result of the current crisis. We remain watchful for how these unprecedented events may evolve but remain resolute to our Future Quality discipline for each and every holding.

Alternatives

The multi manager alternatives fund used within our diversified portfolios has performed relatively well in the year to date, providing some insulation from the downturn in equities. The fund is positioned with zero net exposure to energy, and 17% net long exposure to equities. The fund has also benefitted from some option protection strategies, and is down roughly 3% in the year to date.

The Option Fund has had a more torrid time recently as the US 10 year yield has swung around dramatically as investors react to updates from around the world, touching levels as low as 0.31% before returning to currently hover around 1.15%. During the most volatile periods we have reduced the risk in the fund, immunizing open options by purchasing the underlying 10 year treasury bonds and buying back put options. In the last few days we have written new options which are yielding premium income well above normal levels (3-4 times the level seen a couple of months ago), but volatile yields are challenging the fund's performance.

Diversified Funds/Asset Allocation

We are currently completing our annual strategic asset allocation review and will share the outcomes of this exercise with everyone shortly. While changes to interest rates around the world may alter our return expectations for a number of asset classes, we do not expect to be making any material changes to our asset allocation.

Conclusion

It is at times like these that we believe it is important to rely on strong governance and trust robust decision making processes that have been used to set asset allocation strategies. Covid 19 is a real risk to economic activity and will almost certainly result in a global recession this year. However, that impact will pass, and it is also likely that elevated volatility through this period will present opportunities for long-term, active investors to benefit by staying true to their strategies.

If you have any questions or would like further information please do not hesitate to contact us.

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