Perpetual

INVESTING IN THE TIME OF COVID-19

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29/04/2020

It's not all bad news. Interest rates are low, Australian corporate balance sheets at the big end of town are generally strong, the Australian government has a strong fiscal position. A vaccine will be found for COVID-19 and the economy will, eventually, return to normal.

There will be winners and losers. Picking and choosing which companies to own in the current environment involves judgement about the medium-term prospects of a specific industry, and then we need to pick the 'winner' within that industry, the company that will emerge from this situation with a strong balance sheet and market leadership.

The Perpetual Investments principles are probably more important than ever

- **Strong balance sheets:** A strong balance sheet enables companies to survive on materially depressed revenue and cash flow for an extended period, and also to take advantage of opportunities through internal investment or inorganic acquisitions during a cyclical downturn. We believe strong balance sheets are a premium asset in this environment.
- **Good management:** A good management team shares some attributes: a strong team with appropriate incentives, a CEO who can hire and motivate top talent, take risks without betting the farm and has agility of mind and ability to think laterally during a time of crisis. We tend to gravitate towards companies where the major shareholder and founder is either CEO or remains influential.
- **Market leadership:** During an economic downturn, market leaders in each industry tend to grab market share because of their access to capital and ability to operate with lower revenue for longer periods of time. Demand shock in any industry is followed by intense competition as industry participants try and stay alive; however, the companies which are most agile, lowest cost and have the greatest access to capital tend to come out on top.

Invest in businesses uncorrelated to the business cycle

Given current levels of uncertainty, businesses which are less sensitive to the business cycle are more likely to prosper as households and businesses are going to differentiate between what they *want* and what they *need*. Examples include:

- Companies that provide non-discretionary products or services, such as supermarkets.
- Agriculture, because after two years of drought there's been widespread rain recently which, combined with a lower Australian dollar and lower water prices, should put most agricultural companies in a good position. With most food being proven to be non-discretionary and the likelihood of economic nationalism, the demand for agricultural products is likely to remain strong.
- The litigation funding sector, which provides capital to corporates and law firms in return for a portion of the claim. When times are tough and liquidity is desperately needed, there's increased demand for this alternative form of finance.

Look for quality bombed out cyclicals

An uncertain macro outlook doesn't mean you should completely ignore cyclical companies, for this is where many opportunities lie. While market participants have crowded into what they perceive to be businesses uncorrelated to the broader business cycle, they have thrown out companies perceived to be cyclical or with too much earnings volatility.

We're looking for companies trading at a material discount to mid-cycle valuations where we believe the company has the balance sheet, access to liquidity and management team to capitalise on opportunities at the bottom of the cycle. Ultimately, we want market leaders who will increase their market share and eliminate discretionary costs so that they're stronger on the other side of the cycle.

A detailed analysis of the balance sheet is extremely important as we don't want to lose permanent capital through a bankruptcy event or a diluted capital raising.

No guidance, no dividend, no catalyst….no worries

Over the years, many investment strategies have focused on companies which have a good dividend yield or a solid history of meeting or beating earnings guidance. Contrary to popular belief, the value of a company is not determined by the earnings it's going to generate next year, or by what portion of that earnings will be paid as a dividend. Given high levels of uncertainty about the macro outlook, it's prudent of boards to suspend dividends and preserve cash. The level of dividend has absolutely nothing to do with the fundamental value of a company.

In this market environment, our core holdings continue to be companies we believe have low correlation to the business cycle; agricultural shares like Bega, Costa and GrainCorp, non-discretionary retailers like Wesfarmers and Woolworths, and quirky industries we believe are uncorrelated, such as litigation finance or patent attorney businesses.

We are slowly selling some of the winners and increasing exposure to bombed out cyclicals, companies where the discount to mid-cycle valuation makes the businesses extremely attractive. While we may not always buy at the bottom, as long as we're comfortable with the balance sheet and management team, there are excellent opportunities.

This involves judgement based on views we form using all available information, information which is changing daily. We are not going to get it all right; however, we believe that keeping an open mind, using solid logic and sticking to our investment principles, no matter how controversial, will put us in good stead.

Find out more about the performance, strategy and holdings of the Perpetual Share-Plus Long-Short Fund.

› FURTHER READING - COVID-19

Visit our COVID-19 Insights Hub for economic and market updates to keep you informed as the situation evolves.