



# Shifting From Defensive Positions

within Fixed Interest to Higher Yielding Assets,  
Rotating Stocks within Australian Shares.





- We are adding the Bentham High Yield Fund to our fixed interest allocation. This will be funded via a reduction in more defensive assets like government bonds.
- Within the direct equity portion of the portfolio we are rotating out of one stock that is likely to take a long time to recover post the crisis, and rebalancing out of stocks that have held up better than others in order to take advantage of better relative opportunities.
- For the time being we are making no major changes to the overall asset allocation of the portfolio and continue to be biased towards more defensive assets (mainly cash).

From Winston Churchill's ***"Never let a good crisis go to waste"*** to Warren Buffet's ***"Be fearful when others are greedy and greedy when others are fearful"***, not forgetting Baron Rothschild's ***"Buy when there's blood in the streets, even if the blood is your own"***, there's no shortage of good quotes and wise advice to remind us that we should take advantage of the corona virus pandemic to increase our allocation to growth assets.

Investment gurus and wartime leaders notwithstanding, there is another Wall Street adage that best summarises our current thinking: markets go up by the staircase and down the elevator.

Having recently experienced the latter and given the high degree of uncertainty that remains, both on the virus and the economic fronts, we see no reason to rush now to buy more equities. We think increasing allocation to growth assets should be done gradually over the coming weeks and months.

This week's portfolio changes are the first step in this process. Rather than broad-based changes, we've opted for pinpointed ones: focusing on sub-sections of the market that in our opinion offer the most attractive risk/return trade-offs.

## Fixed Interest Changes

Prior to the COVID-19 crisis, investment grade credit (the debt of good quality companies) was offering yields below 2%, which relative to US government bonds (1.5%) didn't represent much compensation for the additional risk. Similarly, high yield bonds (or sub-investment grade, i.e. the debt of companies of questionable quality) were offering yields nearer to 5%, which in our view didn't adequately reward investors for the level of risk either.

As the crisis unravelled, the yield on US government bonds eventually fell to 0.5%, while the yields of investment grade and high yield credit jumped to nearly 3% and 11.5% respectively. The intervention of the US Federal Reserve which are aimed at supporting the corporate bond market have since lowered these yields to about 2.5% and 8% respectively.

If we step back, we can see that the jump in yields (or fall in bond prices) had two main causes: liquidity and fundamentals. The actions of the Fed have put a backstop to liquidity risk, ensuring that securities can be bought and sold at a fair price. However, the fundamental risk of a weak economy that leads to many bankruptcies and debt defaults is still very much present. At present, the high yield market is pricing a sustained default rate of 13% over the next two years.

By comparison, the actual default rate in high yield bonds briefly reached 12% during the GFC, before rapidly coming back down to 2% over the following two years. In other words, the current crisis would need to be both longer and more pronounced than the GFC for high yield to be a bad investment. While this is not impossible, we believe that investors are at least being somewhat compensated for this risk.

On a 3-to-5-year view and holding through short-term volatility, investors should ultimately be rewarded when compared to holding government bonds or cash which are currently offering yields of below 1%.

As such, we are reducing the weight of the Vanguard Australian Fixed Interest Index ETF (comprised mainly of Australian government bonds) and of the Vanguard International Fixed Interest Index ETF (comprised solely of government bonds from other developed world countries), as their yield to maturity (which corresponds to their expected return per annum) is currently situated between 0.5% and 0.9%. After accounting for inflation, this is likely to set investors back.

Instead we are introducing a specialist high yield manager with a 20-years track record of successfully managing this asset class in Australia. (Some portfolios will also see a reduction in the VanEck Vectors Australian Floating Rate ETF, which has exposure to Australian investment grade credit)

## Australian Shares Changes

We conducted a large review of all our equity holdings, specifically to identify stocks that contained material downside risk if the pandemic crisis were to persist (or come back in a second wave). The only stock that came back with a number of question marks was Star Entertainment Group. Not only are casinos likely to be among the last venues to re-open, Star's revenue is also very dependent on overseas tourists, and international travel is set to be one of the last activities to eventually resume normal operations. With the stock having rebounded materially from the lows reached a few weeks ago, we think now is a good time to eliminate this potential risk from the portfolio.

We are also reducing the weight of stocks that (for various reasons) have outperformed during the crisis, like AGL, Blackmores, Newcrest, Orora, Ramsay Healthcare and Sonic. There are two reasons for that: the first is conservative risk management, as these stocks have become a larger weight of the portfolio due to relative market movements, and we're therefore bringing them back to their target weight.

Additionally, these stocks are logically unlikely to outperform on the way up, and we therefore prefer to add to stocks that offer better relative upside or that are likely to recover quicker. These include Challenger, Link, Treasury Wines and Webjet. One notable exception to the rebalancing is BHP, which has outperformed but that we're not reducing, as we like its prospects regardless of what happens to the virus and the economy.

Finally, we are reducing the weights of ANZ and Westpac. Unlike in the GFC, we are not worried about the viability of the banks, however we think their ability to grow earnings has been reduced by lower cash rates and reduced economic activity. By comparison, the market offers select opportunities with much greater upside. We are initiating positions in two of them, Magellan Financial Group and Cleanaway Waste Management. Magellan's funds have performed well during the crisis and we think this could translate to higher inflows for the next few years. Cleanaway is a provider of waste management services and is likely to continue to grow market share from smaller operators as environmental standards increase. Magellan is growth-oriented company while Cleanaway is more defensive.

By adding both we aim to maintain a balance of risk management and opportunistic mindset in the portfolio.

