Quarterly Investment Strategy Q1 2020.

The investment climate.

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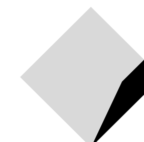

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About the author

David Berthon-Jones is the investment strategist at Commonwealth Private. He is responsible for the investment strategies of Commonwealth Private and the formulation of House Views across all asset classes. David is also responsible for the management of diversified investment portfolios.

The Investments and Research Team

The Investments and Research team specialises in investments, strategy and portfolio recommendations to support Commonwealth Private's Private Wealth Managers. The team researches investment markets and produces a range of publications to help clients deepen their understanding of investing. The team also constructs multi-asset portfolios to help our clients manage and grow their wealth.

All portfolio changes and product recommendations are overseen by the Commonwealth Private Investment Committee.

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Summary

Recently, BlackRock made headlines with their plans to divest from fossil fuels. We discuss this, our views on the impact of climate change, and more broadly ESG (Environmental, Social, and Governance) considerations on our processes and strategy below.

The main financial weapon BlackRock (and we, in microcosm) wield is the denial of capital. It's broader than just avoiding a stock (they can't, given their size and structure) or declining to underwrite an IPO / secondary offering (in their actively managed funds).

It's a move towards a more interventionist approach, attempting, in some cases to spill the board if perceived action on climate concerns is deemed insufficient. That's quite extraordinary, particularly as the main habit of heavy-index-owning-funds has been to vote largely in-line with management.

This impacts much of the broader Australian Stock Exchange (ASX), given the very long tail of small cap fossil fuels related companies. Changes won't happen overnight, but clearly accelerates the pressures.

Given our portfolio positioning, that's a clear positive. Our underweight to energy, particularly thermal coal, hurt performance over 2016-2017, but is paying off now. This has been the case for much of the past year, and, we think, for the future.

While we're underweight in thermal coal, we do have other long exposures to metallurgical coal, potash, oil, gas and plastics, through stocks like BHP, Woodside Petroleum Limited (WPL) and Amcor (AMC), for example.

The BlackRock strategy would ultimately result in less investment demand and less supply of future capital for these kinds of companies. Now, we see our exposures as required for having a portfolio that a) looks at least vaguely like the benchmark, given the respective size of these sorts of companies, and b) for providing a hedge against rising commodity prices, and c) periodically offering an opportune price as the investor base reallocates itself.

Overall, however, we are underweight to the materials sector, specifically due to the expectation that demand is unsustainable at current levels. This is due, in part, to climate change (for example, this translates to a view that Chinese demand for coal and LNG is likely to be lower than the market expects over the long run) and due in part to technological change. Some replacement technology is already well established, in the case of power generation from solar and wind, and only getting better. Others are on the horizon, for example using hydrogen in place of met coal to produce steel. Other replacements are procurement choices, like no longer using virgin plastics, or committing to using scrap in the case of steel.

The discussion has mostly been about sectors you might wish to avoid, but there are sectors favourably exposed to a climate and ESG-related tailwind.

In agriculture, being short on beef and long on synthetic beef (for example, the Beyond Meat burgers), is an understandable strategy.

We've covered long solar, wind and hydro, although the choices on the ASX are relatively limited, not having the larger, more recognised names like First Solar or Siemens Renewables. We aren't suggesting any of these names as investments, but trying to make the thematic clear by using names that most people are vaguely familiar with.

In the transport space, long in electric vehicles (for example, the Teslas of the world), and short in the combustion engines of traditional manufactures. For some, it has meant a bet on nuclear, although we remain of the view that nuclear is difficult to make money on. Most projects seem to take longer than expected and cost more, impacting the return.

With any investment narrative born out of an exciting thematic, there is a danger here, from an investment perspective.

It's very easy to generate an oversupply that crunches the returns on offer. People get the demand side right, but underestimate the supply response. For example, when cannabis was legalised in many countries for medicinal purposes, demand naturally soared (as you would no longer be arrested for having it) but supply increased by much, much more.

When demand for commodities like lithium, graphene and cobalt occurred, as a result of the expected electric vehicle renaissance, prices soared. But supply inevitably followed suit, and the sector is littered with greatly reduced share prices. It highlights the dangers of investing in very new areas, and very new technologies.

Returning to our process, the use of ESG concepts is a standard, everyday consideration when evaluating companies. All of the above points about our underweight position to coal came entirely from that process. Or, similarly, why we don't own payday lenders, despite their tremendous profitability.

However, we also use data from Sustainalytics, a leading player in ESG research, formally bolting their scores into our factor models from a quantitative perspective, and evaluating their qualitative data in a narrative sense. And then our job is to bolt the numbers and the narratives together.

These are examples of using a climate/ESG framework in our stock-picking approach. Below, we describe an example from our managed fund process.

Basically we ask our managers to provide us with data on their ESG strategies, processes and exposures, alongside worked examples. A key recent case study involved the application of a gender diversity metric, which required the portfolio management team under consideration be comprised of a minimum number of women in both the analyst and the portfolio manager ranks. Fund managers that couldn't pass this hurdle exited the screen.

Without hyperbole, ESG impact investing has changed the investment landscape forever, and hopefully the above gives some context to how we're seeing and responding to this change.

Commonwealth Private House View – February 2020

	Asset class	Sub sector	House View	Over the cycle (strategic asset allocation)	Current (dynamic asset allocation)
▼	Australian equities	Large cap	Very under	22.5%	15.3%
		Small cap	Neutral	2.5%	1.7%
▲	International equities	FX hedging level	20%		
		Developed markets	Very over	16%	25.4%
		Emerging markets	Very under	4%	1.1%
▼	Property	Global REITs (hedged)	Neutral	1.9%	1.0%
		Australian REITs	Under	1.9%	1.0%
		Australian direct property	Under	3.8%	2.0%
▲	Fixed income	Australian government bonds	Very over	5.5%	14.1%
		Global government bonds	Neutral	5.5%	4.6%
		Investment grade credit	Very under	9.0%	3.2%
		High yield and EM debt	Under	2.5%	1.1%
		Other (RMBS, ABS, CDO)		0.0%	2.1%
▲	Alternatives	Infrastructure	Neutral	3.8%	4.5%
		Hedge funds	Neutral	11.2%	13.5%
=	Cash	Cash	Neutral	10.0%	10.0%
▼	Growth - Tilt	Growth assets	Very under	62.0%	58%
▲	Defensive Tilt	Defensive assets	Very over	38.0%	42%

Things you should know:

Above, we illustrate our views by asset class. We outline our ‘House View’ on each asset class, and whether we recommend adding or reducing exposure to an asset class. These weightings relate to our Balanced asset allocation profile and are made with a medium term (one-to-three year) investment horizon. The percentage terms are indicative only and may vary depending on your objectives, financial situation and needs. This information is based on information available at the time of publishing, information which we believe is correct and any opinions, conclusions or forecasts are reasonably held or made as at the time of its compilation, but no warranty is made as to its accuracy, reliability or completeness. To the extent permitted by law, neither Commonwealth Private nor any of its related entities accept liability to any person for loss or damage arising from the use of the information herein. This document has been prepared without taking into account your objectives, financial situation or needs, so before acting on the information herein, you should consider its appropriateness, having regard to your objectives, financial situation and needs and, if necessary, seek professional advice.

Summary of Asset Allocation Themes

Asset class	Themes	Strategies
Australian equities	▸ The weak macroeconomic environment is evidenced by the very weak August reporting season. Expect the February reporting season to be disappointing. Recall that the August reporting season of 2019 was the worst since the GFC	▸ Avoid stocks that have seen a material increase in valuation metrics (e.g. price-earnings ratio expansion) that have deteriorating earnings expectations, particularly so if the absolute metric is high
International equities	▸ Global macroeconomic data has improved over the past quarter, with manufacturing and service PMIs bottoming out ▸ Monetary interventions in the US and ECB are warmly regarded, and should, in combination, keep growth close to trend	▸ Modest preference for Spanish/Mexican/German equities, but mainly the capital is spread across international markets without a major relative tilt ▸ Underweight in Emerging Market equities
Currency	▸ Remain negative on the AUD given a whole host of factors (lower real interest rates, weaker commodity prices, lower global growth, higher domestic risk premium)	▸ Low hedging of 20% will benefit portfolios as the AUD weakens again over time
Fixed income sovereigns	▸ Australian government bond yields will follow both expected inflation and lower growth ▸ US short rates are data dependant from here on out, with a slight bias to the upside. 10 years range bound between 1-3%	▸ Overweight fixed income, as a hedge against equity market risk ▸ Overweight Aus government bonds, given economic headwinds ▸ Underweight credit strategies, and preferring >A+ where exposed
Fixed income credit	▸ Spreads are simply too tight, and we are not getting fair compensation relative to breakevens	▸ Prefer investment-grade credit to high yield ▸ Prefer Australian government bonds to investment-grade credit
Cash	▸ Term deposit returns are too low after inflation and tax ▸ We're maintaining around 10% cash (in our Balanced Portfolio)	▸ Reduce cash positions given modest real returns
Alternatives	▸ Alternatives will provide another source of growth and diversification for portfolios outside of equities, which is valuable in this lower-return environment	▸ Continue building an allocation to alternatives which should improve risk-adjusted portfolio returns
Property	▸ Property valuations appear stretched, with cap rates at elevated levels in office, industrial and retail ▸ Given increasing supply and tighter credit conditions, expect property to deliver more modest returns than previously	▸ Prime or premium-grade properties ▸ Target high occupancy, with anchor tenants ▸ Maintain minimal exposure to developers and constructors

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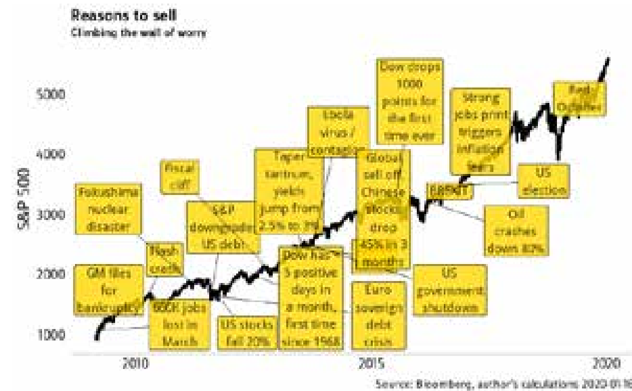
International Equities

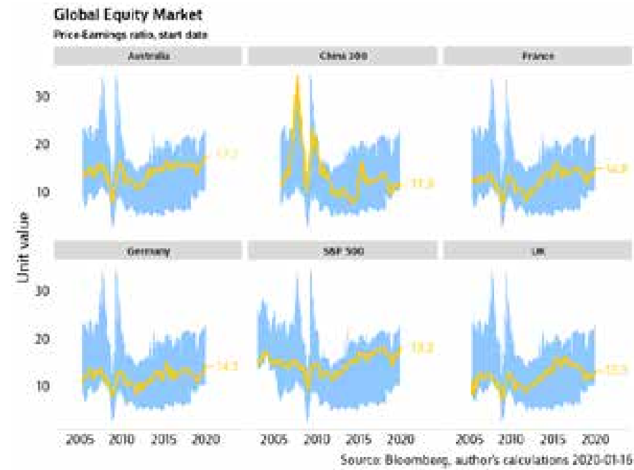
Many clients are asking whether, given the stellar returns over 2019, shares are overvalued. Mind you, we're always asked this, and yet shares have continued to climb the wall of worry.



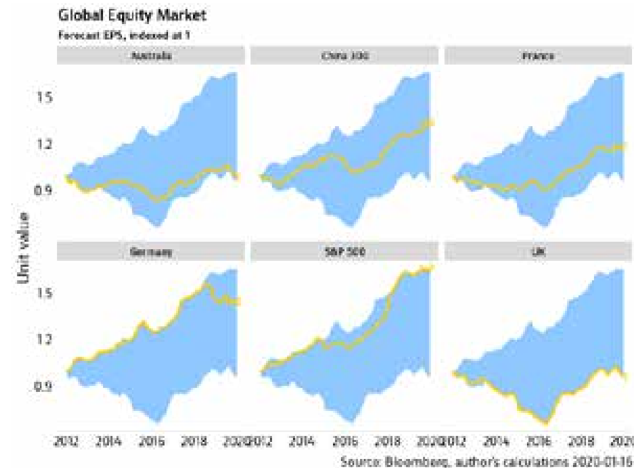
Firstly, global markets do vary considerably in how expensive they appear. The US S&P 500 is towards the upper end of expensive when compared to other countries, but much of Europe, like France, Germany, and Spain is not. The UK is not, and much of Asia is not (like China and South Korea).

In some cases, this reflects earnings. Note the graph titled "forecast EPS, indexed at 1" to the right. You can see expected corporate profits (per share) have grown tremendously in the US, and less well elsewhere.

That earnings profile is generally considered "the fundamentals" and the price people are willing to pay to acquire such fundamentals has risen. This gives rise to the lift in the valuation multiple (the price-earnings ratio).



In most cases we see this as justified.



What's more important than comparing headline multiples, and noting if they are high or low, is to examine the underlying risk premia.

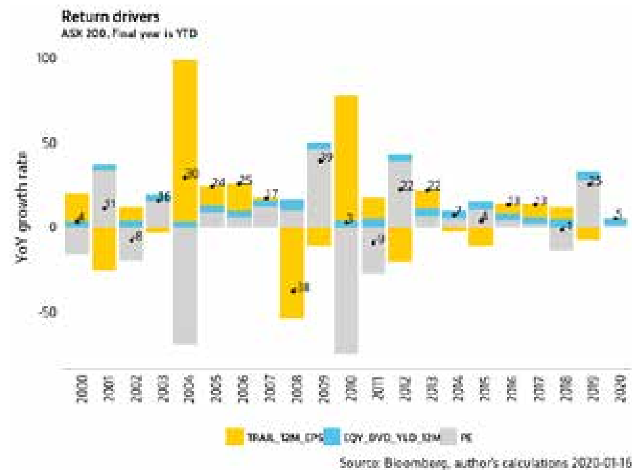
That's really all that matters for attempting to define valuation. Just about everywhere we look, the equity risk premia are either inline with historical averages, or above.

This doesn't mean shares can't suddenly undergo a correction, even a material one. Over the short run, they'll do whatever they do. But over the long run, because of these fundamentals, we are comfortable with our equity exposures. Further, we continue to see any sell-off (usually defined as a fall in excess of 10% for materiality) as a good opportunity to deploy defensive assets (like fixed income and cash) into shares.

Australian Equities

Like international equities, Australian shares had a good 2019.

Also like international shares, most of the good performance came from multiple expansion – that is, the price people are willing to pay for a unit of earnings, or a unit of assets.

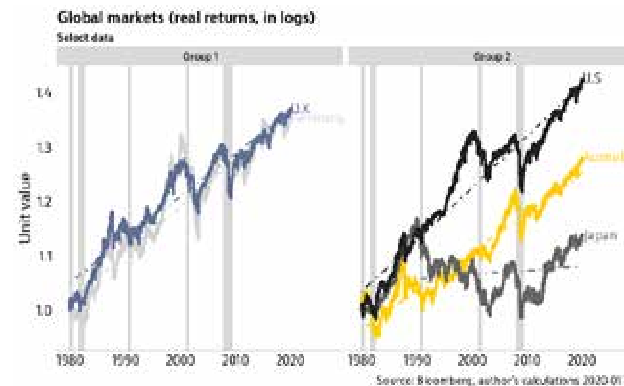


However, in the Australian case, we do think the market is getting a bit ahead of itself. Note the graph (right) depicting the log real equity market returns.

Over the long run, this has tended to equate to ~6% real, per annum. Not coincidentally, the long run real return on equity is also about 6%. A company can pay out 100% of its earnings, in which case the return is the yield. Or, it can retain the earnings, in which case the return is the growth in book value of equity, or some combination in between.

The idea is a sharemarket cannot sustain itself indefinitely above this long-run return, and deviations from it can indicate a bubble.

It seems clear the run in shares from the mid-1990s was a bubble (which collapsed in the tech wreck). The lead in to the GFC appeared to be a bubble for countries like Australia, which was undergoing a tremendous resource boom at the time. This was underpinned by the 'stronger-for-longer China-boom' narrative.



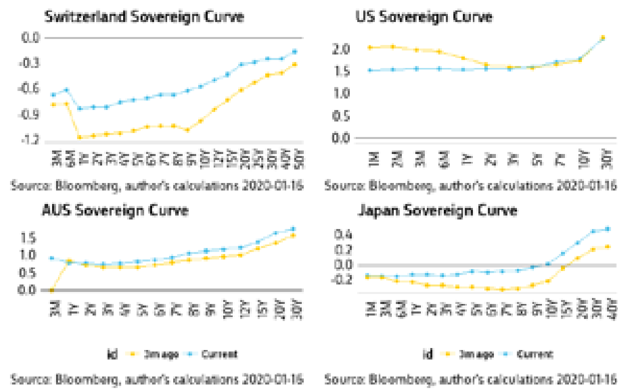
We believe Australia appears to be deviating from the long-run trend, by a noticeable amount, which is a red flag.

Given the performance of the economy hasn't been especially robust, and inflation indicators continue to confirm this, we're wary of the upcoming reporting season.

We're particularly cautious of stocks where the multiple expansion since the date of the last result (usually August, for most companies) has been material, *but the forecast earnings per share falling*. That is a classic set up for an earnings disappointment, and for stocks with a relatively expensive multiple, can set up a nasty downgrade.

Fixed Income

Yield curves have changed a lot over the past quarter. Rates have generally shifted higher, across all maturities, for most countries. The US has been cutting rates, and hence their curve has shifted a little lower, although longer maturities are unchanged.



The general concept of higher short rates and even higher long rates (here we are considering 10-year maturities as the long rate) is known as a 'bear steepener'. The economy is deemed to be in good health, and as such, rate expectations move higher as expected growth and expected inflation move higher.

Unsurprisingly, this tends to be a good environment for risk assets; it's not such a good environment for defensive assets, like fixed income. Note, the very long maturities, like the 30-year are not much changed, however, suggesting that the market expectations for the very long run haven't changed much.

This reflects the market acceptance of lower rates as a structural phenomenon, driven by ageing populations, higher demand for safe assets, low and stable inflation, and lower term risk premia.

You can see these effects for yourself in the graph above, which uses an econometric model to relate movements in long bond rates (like the 10-year) to movements in short rates (which reflect monetary policy) and the host of other variables mentioned.

A related way of trying to determine whether rates are about where they should be, is to consider previous monetary cycles.

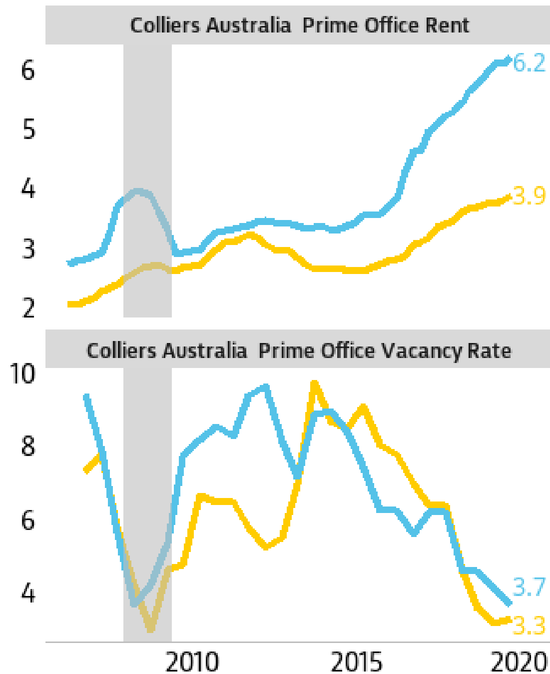
Here we note the term spread (the difference between the yield on the short rate like the two-year and the long rate like the 10-year) is about where we'd expect since the start of the last tightening cycle that began in December 2015. It looks quite similar to the patterns of 1994 and 1986.

The sharemarket reaction isn't anything like the response of the last half of the 90s, which is a very good thing.

But overall, it does lead us to conclude that rates are about where they should be, and as such, fixed income (in government bonds) is fairly valued.

Property

The backdrop for commercial property has remained positive. Rents have risen, and vacancy rates contracted.

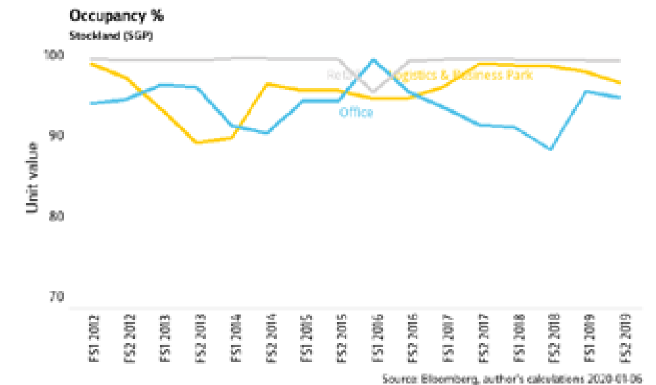


*Source, Bloomberg, author's calculations 2020-01-06.

The pipeline of supply has moderated, which is generally a positive condition for future rental growth, and Commercial Real Estate yields have moved lower over 2019.

Over the past few months, the recent lift in government bond yields (which is used in the discount rate when valuing long-lived assets like property) has caused some mild underperformance in the list A-REIT (Australian Real Estate Investment Trusts) names, but this is coming off some very strong yields, as seen below.

Occupancy rates have remained strong, even across some of the REITs that have been in the more challenged retail space. However, we do see the retail environment getting worse, not better. Most families have seen fit to save their windfall tax gains, or to pay down debt by not varying their mortgage repayments, in response to lower mortgage rates.



The recent Black Friday sales contributed to a blockbuster month for retail sales, but we see this as likely pulling forward demand from December, and thus are much less constructive on the sector.

Given our concerns about the domestic economy, and commercial prices more broadly, we remain underweight in the A-REIT space, preferring to seek our exposures internationally in the Global Real Estate Investment Trusts space.

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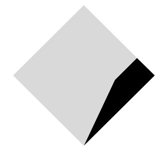

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