Pandemic a shock, but not a surprise

April 2020

Few could have imagined, as we came into the New Year, that just a little while later, we would all become familiar with two new words — 'coronavirus' and 'COVID-19'. It's now difficult to imagine a conversation without those words.

We titled this note *Pandemic a shock, but not a surprise*, because there have already been other diseases that have crossed borders and threatened countries, within the past two decades. Severe Acute Respiratory Syndrome (SARS 2002-2004), Swine Flu (2009), Middle East Respiratory Syndrome (MERS 2012), Zika Virus (2015-16), and Ebola 2018 have already inflicted suffering.

Of course, none of those menaces were truly global like COVID-19, but we can't say we weren't warned. This is the backdrop for 'global pandemic' always featuring in our Investment Futures Framework, which is the architecture for our investment approach. The Framework recognises a vast number of possibilities, including remote possibilities (maybe not so remote, after all) like global pandemics. It imagines what *can* happen, rather than narrow casting by trying to guess what *will* happen.

As it was, our portfolios had been defensively positioned for some time, not because we necessarily thought that a market shock was imminent, but because strong share market returns over most of the post-GFC decade caused us to think that future returns were likely to be lower. Our defensiveness meant going against dominant risk-seeking opinion, but doing so has helped to cushion client portfolios from the full impact of market falls.

COVID-19 and its related social and economic dislocations are probably no more than a 1 in 100-year phenomenon – but it and other 'tail risk events' or 'Black Swans' are ever-present risks whose consequences should never be overlooked by either investors or policy makers. Moreover, these kinds of events, when they erupt, cannot be nullified by social, economic or monetary policy.

In this context, focusing on the pandemic specifically as a flash point for risk is perhaps misleading – for the mayhem need not necessarily have come by way of COVID-19. Other triggers could have been a major war, a global catastrophe (perhaps a natural disaster), or a sudden rise in CPI, for example. Instead, the learnings ought to be that risk can ignite from the non-obvious, and that low probability, high impact events should at least be considered when setting investment strategy.

How investors react to shocks is equally important. The world is not short of disease modelling expertise. Yet, investors caught out by the pandemic too often scramble to build expertise in an area that requires years of education and training. This expertise resides in academic institutes, think tanks and consultancies, not amongst investment teams. At times like this, true investors, true managers of risk, need to focus on identifying uncertainty and hammering out solutions to deal with the unknown, all the while preserving as much client wealth as possible.

Scenarios

In managing MLC's multi-asset portfolios using our Investment Futures Framework, the following are the short-term scenarios that we have assessed as currently providing the highest potential future risks and opportunities.

While at most points in time the outlook relies on multiple sources of uncertainty, the next 12 to 18 months pivot around COVID-19. Consequently, our thoughts on short-term scenarios are all sub-versions of the main global pandemic scenario:

- **Global pandemic: Short disruption: No second wave**
    - The northern hemisphere summer helps rid the community of COVID-19. No substantial second wave of infections arise and seasonality does not emerge.
    - Lockdowns end with only mild earnings implications for this year and next.

- **Global pandemic: Drawn-out lockdown with mild second wave of infections**
    - A mild second wave of infections arises across the globe. Partial lockdowns are re-established.
    - Earnings suffer in both FY20 and FY21.
    - Hospitality and other impacted sectors are severely disrupted.
- **Global pandemic: Drawn-out lockdown with severe second wave**
    - A severe second wave of COVID-19 emerges. Full lockdowns are re-established.
    - Fiscal and monetary stimulus near the point of exhaustion.
    - Populism gains more strength.
    - High risk of global depression.

Return potential and portfolio positioning

Due to a strong sell-off in risk assets, the return potential of all share market sectors has increased, particularly over longer time horizons. From a shorter-term perspective however, lower prices and improved valuations are somewhat offset by higher levels of uncertainty, particularly over a one to two year horizon. This is because the chance of a very negative earnings outlook, stemming from a drawn-out lockdown, has risen materially.

Core bond return potential has also fallen due to extraordinarily low interest rates. On the other hand, economic growth is also likely to be low and so bond yields could stay lower for longer than might ordinarily be expected. The return potential and diversification benefit of foreign exchange (FX) exposure has declined due to substantial Australian dollar (AUD) devaluation.

Portfolio activity and positioning has been directed at MLC Inflation Plus portfolios. This owes to the fact that MLC Horizon portfolios access these exposures through investments in Inflation Plus, and MLC Index Plus portfolios through the real return strategy, which is managed similarly to Inflation Plus.

Summing up MLC Inflation Plus portfolios' activity and outcomes:

- We took profit on a portion of our foreign currency holdings as the AUD fell to 60c. We increased exposure to the AUD and the portfolios still hold US dollar, yen, euro and pound positions.
- Prior to the slide in the gold price, we sold our exposure and bought call options. This locked in substantial profit and retained exposure to further gold upside.
- During the share market sell-off and rise in volatility, we sold tail risk protection (US S&P500 put options) at levels more than 100x cost.
- We have taken small but opportunistic steps to increase risk exposure by adding to defensive/quality global and domestic shares.

In the MLC Horizon portfolios, we have reduced the overweight to FX but maintained a cautious overweight to global shares (unhedged). While the AUD and global share markets tend to move in the same direction, after sharp falls in the local currency, foreign currency may not provide the same level of diversification to share market movements in future. We prefer to reduce foreign currency than add to interest rate exposures for diversification as rate cuts by central banks in March increased the downside risk of most fixed income sectors.

Now is not the time to make bold assumptions and dogmatic portfolio positioning. Instead, an intensive focus on active risk-management is required to preserve clients' portfolios and then position them for participation in the recovery that will eventuate.

More information on each portfolio's positioning is available in the fund commentaries available on the Fund Profile Tool on https://www.mlc.com.au/fundprofiletool.