# What our investment managers are saying

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Given the speed and size of share market falls, it's understandable for investors to feel like there is no 'light at the end of the tunnel.'

Optimism is extremely scarce now. However, each of the market tremors of the past four decades — the 1987 crash, the 1997 Asian currency crisis, the 2000 bursting of the tech bubble, and the 2008/09 Global Financial Crisis — eventually ended, and share markets moved forward to recovery.

Perhaps some thoughts from Benjamin Graham, sometimes called 'the father of value investing' and investment legend Warren Buffett's mentor, are as useful as any, at this moment:

"In the short run, the stock market is a voting machine – tallying up which companies are popular or unpopular. But in the long run, the market is like a weighing machine – assessing the substance of companies."

Right now, the stock market 'voting machine' is thrashing many, many companies.

But, 'substance,' to use Graham's description, matters, even in the current environment.

'Substance', as it relates to companies, includes attributes like good management teams, competitive products and services, a history of strong profitability and cash flows, favourable industry structures, and sturdy balance sheets.

## Discipline being maintained, looking for buying opportunities

Good assets and good investment strategies can set investors up for long-term successes, despite market tumult, like the current moment.

Against that backdrop, insights we've been receiving from our externally appointed investment managers, including global equity managers, are reassuring.

They are all maintaining their discipline, looking for opportunities to buy quality assets that have been sold-off. Bargain hunting, in other words.

What follows is a summary of the views of some of our global equity managers.

## Large valuation gaps between stocks

In certain industries and sectors, valuations are now at multi-decade lows. Furthermore, the spread of valuations between stocks (referred to by investment managers as 'valuation dispersion'), measured by such metrics as price-to-earnings ratios (PE ratios), are now at extremes comparable to the late 1999s tech bubble era and Global Financial Crisis.

This means there are now massive gaps in the values of the 'cheapest' and most 'expensive' stocks across share markets. For active managers, wide valuation differences present the opportunity of owning stocks that they judge have been over-sold, but which they believe will rise in value when the market recovers.

## Falling oil prices favour low-cost producers

While the health, social and economic stresses caused by COVID-19 are the single largest issue shaking investment markets, the recent global oil price collapse has also contributed to jangled nerves. The oil price fall stems from Russia's refusal to join production cuts agreed by other major oil producers, led by Saudi Arabia.

This is good news for oil users, at least in the short run, but not good for oil producing countries, and oil companies like Exxon-Mobil, BP and Shell, for example, and the many companies servicing the oil industry.

The oil price fall is especially bad for ‘unconventional’ energy producers, such as a clutch of US ‘shale gas’ and ‘tight oil’ producers using ‘fracking’ technologies and techniques to extract fossil fuels. This group are high cost producers; many are forecast to go out of business as they will struggle to be financially viable with global oil prices now at around US$20 per barrel.

Our value equity managers[1] with oil exposure have stress tested the balance sheets and cash flows of oil companies in their portfolios. Even on brutal assumptions, they believe the oil producers they own, will come through a period of very low oil prices.

Our managers’ preferred oil companies are low cost producers with good balance sheets, and arguably, will come out the other end even stronger as many higher cost producers will exit.

## Banks with strengthened capital positions

Over the last decade, banks, especially US banks, have worked very hard to rehabilitate their balance sheets, tightened their lending standards to improve asset quality, and restrained dividend payouts to rebuild capital bases.

As a result, global banks have significantly improved their capital ratios — capital ratios are meant to provide banks with buffers that can see them through periods when they have higher numbers of non-performing loans on their books as business and household borrowers struggle to make repayments, or can’t make repayments at all.

The average common equity tier 1 ratios,[2] in both US and Europe banks, are around 13% today: it was around 6-7% back in 2007.

So, banks are much better capitalised today, and appear focused on ‘doing the right thing’ by communities. This is different from the lead up to the Global Financial Crisis.

Back then, US and European banks were regarded as the cause of the problem as they were thought to have taken on too many risks. Those risks blew up, requiring massive government support to save some of the world’s biggest and best known financial organisations.

Now, however, the eight largest US banks — JPMorgan, Bank of America, Citigroup, Wells Fargo, Goldman Sachs, Morgan Stanley, Bank of New York Mellon and State Street[3] — have jointly agreed to suspend share buybacks: share buybacks improve ‘earnings per share’ by reducing the number of shares in circulation and thus are good for shareholders. However, using banks’ capital for share buybacks does mean less capital for lending to businesses and households.

By suspending share buybacks, the banks will, instead, have more capital for lending to support economic activity.

## Changes to supply chains

Companies that are part of popular culture ranging from Nike, Coca-Cola, McDonalds, Apple, and Samsung to Walt Disney and many more, have suffered share price falls. But on a longer-term view, people around the world will likely still want these companies’ products and services.

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[1] Value equity managers/value managers typically own the shares of companies trading cheaply on measures such as price-to-earnings, price-to-book, and price-to-cashflow ratios.

[2] The Tier 1 capital ratio is the ratio of a bank's core equity capital to its total risk-weighted assets (RWA). Risk-weighted assets are the total of all assets held by the bank weighted by credit risk according to a formula determined by the regulator (usually the country's central bank, such as the Reserve Bank of Australia).

[3] Source: *America's Biggest Banks Suspend Buybacks In Effort To Support Economy Over Their Own Stock Prices*. Antoine Gara, Forbes. March 15, 2020. https://www.forbes.com/sites/antoinegara/2020/03/15/americas-biggest-banks-suspend-buybacks-in-effort-to-support-economy-over-their-own-stock-prices/#22caa9271189. Accessed 20 March 2020.

Our global equity managers are also taking the long-term view and holding fast to owning a share of companies they believe will continue to benefit from rising incomes and consumption in countries such as India and China.

On the other hand, global supply chains will probably be reconfigured. The borderless economy that has emerged over the past few decades has also meant the emergence of global supply chains for the manufacture of everything from shoes, to clothing, mobile phones, TVs and cars.

The current crisis has revealed the vulnerability of an over-reliance on China as the world's go-to manufacturer of many everyday items. Companies will start diversifying their supply chains to reduce over-reliance on one source, going forward. That will be positive from a supply reliability perspective.

Undoubtedly, this period is difficult on many fronts, including the share market crash.

But the light will return, and financially strong companies with desirable products and services will thrive again. That will be good for societies and investors.