Entrust Quarterly Commentary
March 2020

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March 2020 Quarter

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No doubt it will come as no surprise that the March 2020 quarter was a sharp turnaround in performance for portfolios, as most asset classes came under varying degrees of pressure. It is near on impossible to avoid drawdowns in portfolio values in the face of such significant uncertainty and volatility but it must be remembered that these drawdowns are part and parcel of long-term investment. As discussed previously, it is these uncomfortable periods of negative performance that allow investment portfolios to generate higher rates of return than cash over the long term. Without periods of heightened volatility (and at times extreme volatility), investors would be rewarded with a return closer to the risk-free rate, which in most developed markets is currently close to 0%, if not negative.

Despite short term negative portfolio performances, these periods do highlight the benefits of taking a long term, high quality, multi-asset class approach to managing money. This is something that can be easy to lose sight of when equity markets are strong and can lead to complacency about the risks being taken. Similarly, this can be overlooked in periods of heightened fear, causing investors to run for cover at the wrong time and lead to long-term underperformance. Thus, having a clearly defined investment philosophy and process that can guide you through these periods is critical.

As a reminder the following key points summarises our investment philosophy:

Through the cycle return objective: CPI +

- An appropriate return objective is the best benchmark for long-term planning.

Multi asset class approach to enhance returns and reduce portfolio volatility

- Aim to optimise returns per unit of risk.

Focus on total return

- Dividend Yield + Capital Growth = Total Return

**This is particularly relevant at the moment given large number of dividend cuts that are expected.*

Quality at reasonable price

- Obtaining exposure to high quality investments but believe this must be done in the context of reasonable valuations.

Agnostic investment selection

- We aim to utilise the most appropriate investment vehicles that will provide the desired exposure taking costs into consideration.

We then seek to manage the risk return profile of portfolios through a three-stage portfolio construction process:

1. Asset class allocation
2. Asset selection
3. Position size

The following chart is also a reminder of the reason for taking a long-term view when investing. As can be seen, over short time periods, investment returns can exhibit high degrees of volatility and dispersion. However, as the time frame of analysis is extended, the dispersion (and therefore risk) of returns is greatly reduced with the balance of probabilities falling far more in favour of positive versus negative returns.

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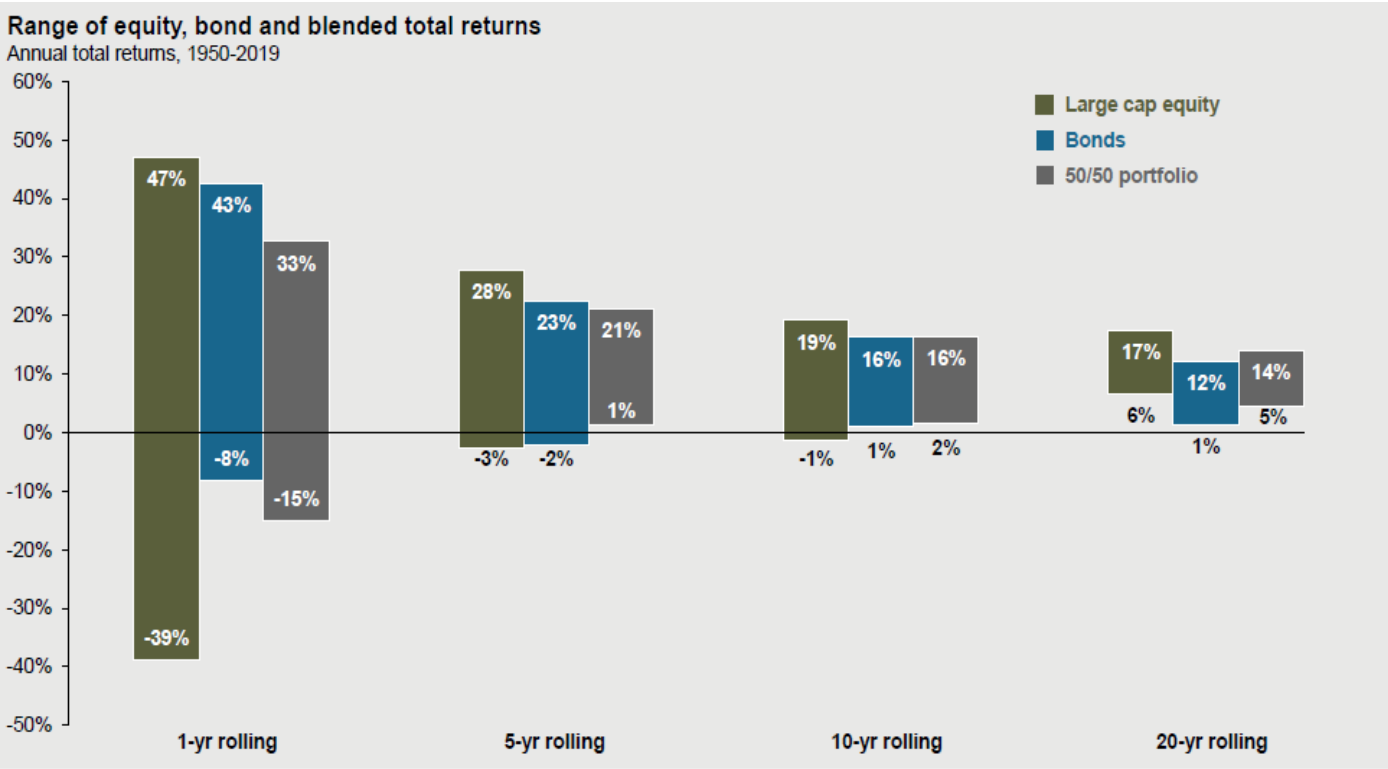

Source: Barclays, FactSet, Robert Shiller, Strategas/Ibbotson, U.S. Federal Reserve, J.P. Morgan Asset Management. Returns shown are based on calendar year returns from 1950 to 2018. Large cap equity represents the S&P 500 Shiller Composite and bonds represents the Strategas/Ibbotson for periods from 1950 to 1980 and the Barclays Aggregate after index inception in 1980. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – Australia. Data as of 31 March 2020.

Model Portfolio Asset Class Performance

Australian Equities was the biggest detractor over the March quarter. After a strong January, February and March in particular, saw large drawdowns as COVID-19 began to spread globally and economies began to shut down.

International Equities were also very weak in local currencies but a sharp fall in the AUD provided strong downside protection. In addition, a number of the active managers in the portfolio had inbuilt market hedges, which helped to reduce their market exposure. These factors meant the International Equity portfolio produced a significantly better result than Australian Equities.

The Alternatives portfolio also produced a far better result when compared to Australian Equities. A positive contribution from a short position on the S&P 500 US index, exposure to USD gold bullion, and a relatively better performance of some of the market neutral managers helped to offset a very weak quarter from one of the portfolio's long/short managers.

Real Estate Investment Trusts (REITS) fell sharply in percentage terms but we have been very underweight this sector so it does not make up a big part of portfolios. The price weakness stems from uncertainty around the ability of these asset owners (retail and office particularly) to collect rent due while COVID-19 business restrictions remain in place. The residential sector has also been impacted from potentially weaker demand as unemployment rises and the outlook for economic growth weakens.

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Fixed Income was mixed with strong performances from Government Bonds as Central Banks moved swiftly to cut cash rates (although they were not immune from some significant intra-month price volatility). Corporate Credit and Hybrid exposures were weak as liquidity evaporated leading to a very large widening in trading margins. Recognising this lack of liquidity, Central Banks have stepped in to markets with large bond buying programs. This has led to an improvement in trading margins although they remain above long-term averages.

Model Portfolio Movements

Because we felt valuations across most asset classes were not particularly cheap and given the late stage of the investment cycle, we entered the March quarter generally underweight growth assets and overweight cash, which was helpful as markets sold off.

As the risk around COVID-19 became more apparent we approached portfolios in two stages;

1. Risk Management
   - Reviewing the thesis behind all holdings in the portfolio;
   - Exiting positions that were non-core and where the thesis was at risk;
   - For those positions to remain in the portfolio, reviewing the appropriateness of position size with respect of the investment thesis and valuation.
2. Looking for Opportunities
   - As uncomfortable as market corrections can feel, they can also throw up some very attractive opportunities to redeploy available cash.
   - Due to the unique economic impact of this current crisis, the true valuation of most assets is highly debatable so the focus has been to target high quality opportunities where a reasonable margin of safety was being offered in the price.
   - This is an ongoing process and will be done in a measured way until there is greater clarity in the outlook.
   - At the time of writing, in general we remain underweight risk assets with available cash ready for deployment.

Because there has been a lot to digest over the quarter, below is more detail than normal on some of the specific changes within the model portfolios over the March quarter:

<u>Australian Equities</u>

- ***VGI Partners Limited (VGI)*** – Added to existing holding. Despite the weakness in markets, VGI's main global fund produced an impressive +3.6% NTA return over the March quarter, while their more recent Asian fund generated +10.90%. Both strategies hold significant cash positions, which puts them in a strong position to take advantage of any continued volatility.
- ***Platinum Asset Management Limited (PTM)*** – Exited in full. This position was sold in late January as it had performed well, was non-core and we felt the thesis was exposed to the growing COVID-19 risk that was developing in China at the time.
- ***Magellan Financial Group Limited (MFG)*** - Added to existing holding. MFG is the largest global equity manager in Australia with an enviable track record. This is a very high-quality business that we are happy to own for the long term, so we used some of the extreme market volatility to lift holdings. At the time of purchase the PE for MFG was trading two standard deviations below its long-term average, which we felt provided a sufficient margin of safety.

- ***Omni Bridgeway Limited (OBL)*** – formally IMF Bentham Limited) – Reduced holding. There are a lot of reasons to like IMF in the current environment, not least that as a litigation fund manager it offers its clients exposure to an alternative investment class that should be truly uncorrelated to equity markets. However, it is not an easy business to value and requires some long-term assumptions to fall into place, which in a higher volatility environment the market may be less inclined to do. As such we felt this it prudent to reduce the position size of this holding for now.
- ***Wesfarmers Limited (WES)*** - Added to existing holding. WES is a very high-quality business that for a long time traded above what we felt was a reasonable valuation. The volatility over the quarter saw the stock trade back to its long-term PE, which we saw as an opportunity to lift holdings. Ideally, we would have liked to see more of a sell off to further lift the position but we are happy we were able to top up somewhat. WES has since further strengthened its balance sheet by selling down more of its holding in Coles. We will continue to look for opportunities to add to this holding.

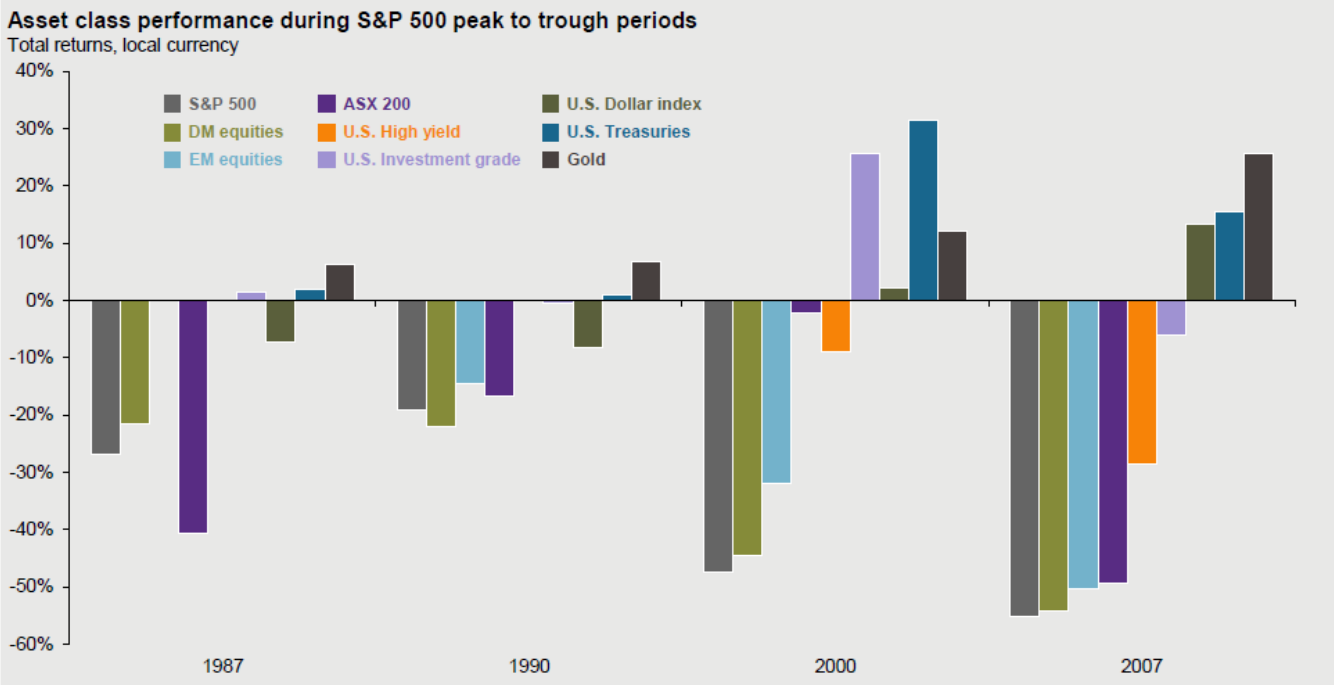
International Equities

- ***Platinum International Fund (PIXX)*** – Initially added to holdings then subsequently exited in full. We had been invested in PIXX for some time. At the beginning of the quarter the improving economic outlook bode well for the more cyclical and value orientated positioning of the PIXX portfolio. As a result, we chose to add to existing holdings. However, PIXX was also overweight China so as the early risks around COVID-19 in China grew, we decided to exit the position in full as part of overall portfolio risk management.
- ***Vanguard MSCI Index International Shares ETF (VGS)*** – Initiated a new position followed by a quick exit in full. This quick trade is unusual for these portfolios and wasn't the intention upon entering the position but we felt was warranted given the rapidly changing situation. Mid-March saw the peak of global equity market volatility for the quarter and as a result we saw markets starting to trade at levels we had noted as potential target levels to add exposure. As an exchange traded fund (ETF), VGS allowed us to gain immediate and liquid exposure to the global benchmark. The night following this purchase markets rallied strongly with the US market up 9.29%, which meant markets moved from arguably cheap to potentially no longer so. Over the subsequent weekend the US announced a number of new restrictions, which highlighted some significant economic risks. Given these two factors we chose to exit VGS and lock in a small profit and keep our powder dry for another day. That night, following our sale, the US market fell 12% justifying the quick exit.
- ***T. Rowe Price Global Equity (Hedged) Fund (ETL0312AU)*** – Initiated a new position. This is a fund we have been assessing for the past few years. The lead portfolio manager is ex Australian but US based Scott Berg. We have met with Scott numerous times and he is a very impressive investor that looks to combine the best ideas of the numerous T Rowe Price analysts into one portfolio. The portfolio construction is quite unique in that it aims to be sector neutral versus the benchmark but attempts to invest in the best companies globally within each sector. Scott is able to utilise the T Rowe Price network to gain rare access to CEOs and CFOs of global companies, which has helped the fund generate genuine outperformance over its history. Because we felt the AUD had fallen to a level that was potentially very cheap we chose to invest in the hedged version of this fund to reduce currency risk going forward. Our aim is to add further to this position.

Alternatives

- ***Australian Leaders Fund Limited (ALF)*** – Accepted Off Market Buy-Back @ 1.10 AUD per share. We participated in a buy-back offer from the manager that allowed us to tender for 20% of our holdings to be bought back at a price that was 13.4% above the share price at the time.

- ***Betashares Us Eq Strong Bear Hedged Fund (BBUS)*** – Exited in full. This ETF provided a short position on the US S&P 500 index meaning as the US market fell the value of this ETF rose providing a partial hedge for portfolios.
- ***Betashares Gold Bullion ETF*** - Currency Hedged (QAU) – Added to existing holdings. With the exit of BBUS we wanted to lift back up our holding to gold as a portfolio hedge. As shown in the chart below, gold bullion has tended to be a consistent performer in large peak to trough movements in equity markets. The scale of the monetary policies announced by central banks also risks undermining the value of fiat currencies, which may benefit gold as a store of wealth. Technically, at the time of entering this position, we were encouraged that the price of USD gold had held its support level around $1450. At the time of writing the price has now pushed above its 12-month peak of $1703 which bodes well for a potential retest of all-time highs in the $1800-$1920 region.



Source: Barclays, Bloomberg Finance L.P., FactSet, J.P. Morgan Economic Research, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Based on MSCI World (DM equities), MSCI EM (EM equities), Bloomberg Barclays U.S. Aggregate Credit High Yield Corporate Index (U.S. High yield), Bloomberg Barclays U.S. Aggregate Corporate Index (U.S. Investment grade), Bloomberg Barclays U.S. Aggregate Treasuries (U.S. Treasuries), DXY Index (U.S. dollar). Peak to trough periods for the S&P 500 are 25/08/87-04/12/87, 16/07/90-11/10/90, 24/03/00-09/10/02 and 09/10/07-09/03/09. For the 1987 period, the ASX All Ordinaries price index is used.
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Fixed Income

- ***CBA PERLS IX (CBAPF)*** – Initiated a new position. We used some initial price weakness as the COVID-19 volatility began to essentially replace NABPC that was to be imminently called. CBAPF is short dated, in line with our current preference, with first call date in approximately 2 years.
- ***NAB Capital Notes (NABPC)*** – Exited in full. As mentioned above this note was called by NAB. Given the settlement for this note occurred in the height of market activity we chose to sell on market rather than wait for settlement from NAB to mitigate any risk that NAB or APRA decided this redemption should not proceed.
- ***NAB Capital Notes (NABPF/NABPD)*** – Completed a partial roll from NABPF to NABPD. As trading margins on credit instruments widen, the price of longer dated notes will be impacted more than shorter dated ones. Given the increasing volatility at the time we chose to roll forward NABPF with 6.25 years to first call, to NABPD with only 2.30 years to first call, while only giving up around 0.50% pa in income. This was part of the risk management phase discussed above. Due to liquidity constraints we were only able to partially complete this roll but nonetheless it did provide a benefit to portfolios as traded margins subsequently expanded significantly.

OUTLOOK

In our last quarterly, we discussed some encouraging economic indicators that suggested the long grinding cycle we had been in since the end of the GFC may want to grind on a bit longer. It would now seem apparent that this cycle has been brought to an abrupt end by a left tail risk that wasn't fully apparent three months ago.

There is little doubt that near term economic data is going to look horrible, but given the somewhat unprecedented nature of this event, trying to present charts and forecasts about where these indicators might land seems futile and, in our opinion, probably adds little value for now.

Let us instead accept that we are in the midst of an economic crises, one that has been largely manufactured by Governments as a consequence of managing a health crisis. Let us also accept that the world has been through numerous economic crises and as devastating as each one of these seems at the time, history shows that we have always been able to emerge on the other side to begin a new cycle.

Of course, times like this come with heightened levels of uncertainty, so below we will discuss some of the key issues occupying our minds and how that translates into portfolio positioning.

V, U or L?

It will take time before we get the official confirmation but it would seem reasonable to assume that we have moved into a recessionary period. A key consideration is therefore what will be the likely depth and duration of this recession?

As discussed in our last quarterly, the economic effects of previous epidemics and pandemics have tended to be significant although short lived, with a sharp V shaped recovery. There is, therefore potential, for a similar outcome from the current situation. However, none of these previous events caused the effective closure of the global economy.

We are working on the assumption that there will be a health solution to the virus, most likely in the form of a vaccine. On this front, there are a number of trials currently being undertaken and at the time of writing there has been some encouraging initial results from one of the frontrunners, Remdesivir, which is being developed by Gilead Sciences. However, the expectation is that any widespread release of a vaccine will be a 2021 event at the earliest.

Until then, we are faced with management strategies, such as lockdowns, self-isolation and social distancing as well as a hope that some form of herd immunity starts to develop.

It would seem there is general progress being made on the containment front with encouraging signs in the growth rate of new infections.

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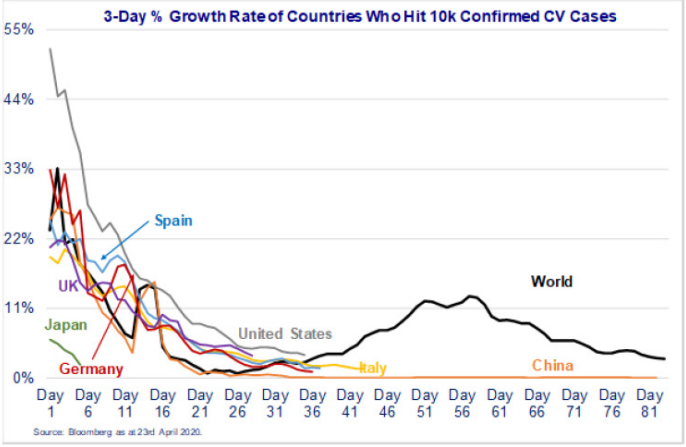
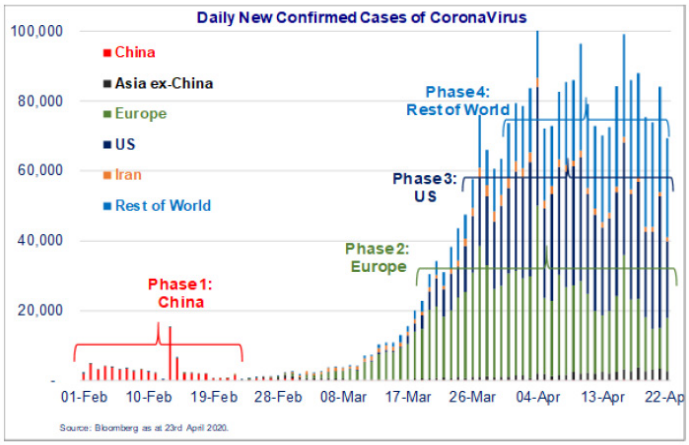
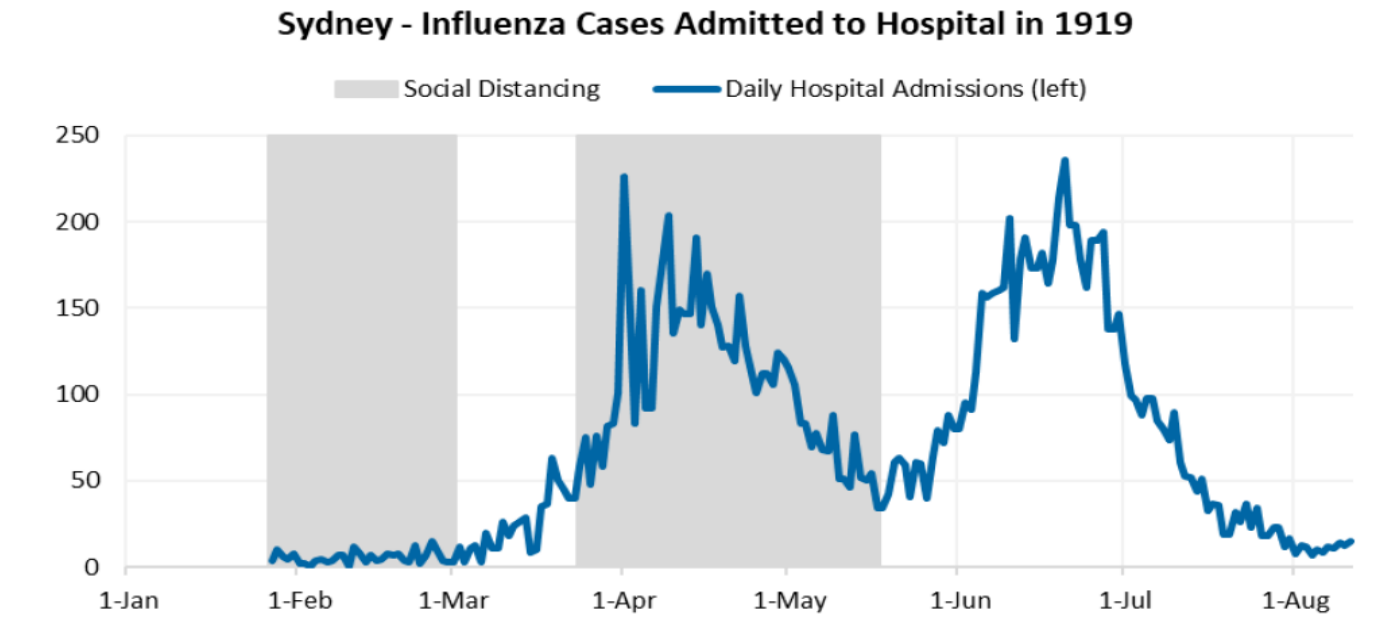




Source: Perpetual Investments

This has led to discussions about the potential easing of restrictions so that economies can start to re-engage. If this can be done and COVID-19 can be kept under control, where it is at least not overwhelming the hospital system, we may very well see some form of a short and sharp V shaped recovery.

The main risk to the above is the potential for reinfection that leads to another period of restrictions and further delays in the economic recovery. The chart below, from Macquarie Research, is useful in understanding this. It plots the number of hospital admissions in Sydney relating to the 1919 influenza pandemic. It also overlays the periods where social distancing measures were implemented. As can be seen, social distancing appears to have worked in controlling the spread of the virus but the removal of these measures saw further spikes in infection.



Source: McCracken & Curson (2003) based on data in the Sydney Morning Herald, Macquarie Research, March 2020

Governments will therefore need to be careful in the way they approach the balancing act of allowing economies to come out of hibernation while keeping the virus under control until a vaccine becomes widely available. This balancing act perhaps increases the likelihood of a slower, or U-shaped recovery, so for now we are using this as our base case.

Clearly, corporate profitability is going to be impacted, the extent of which is something that corporates and investors alike are grappling with at the moment. We are starting to see analysts downgrade their near-term earnings projections but given the level of uncertainty we suspect this will be an ongoing headwind that may cap the near-term upside for equity markets.

Weaker cash flows will also put balance sheets in the spotlight. It is highly likely that we will see a number of overly leveraged corporates fail as they struggle to service or roll over their debt. This will have an impact on both equity and credit markets and reinforces our view that the focus for both asset classes should be on high quality corporates.

Corporate failures aside, we think it reasonable to assume that we will see a sharp rise in capital raisings as companies move to shore up their balance sheets. We have already seen the beginnings of this and feel it will act as a gravitational pull on equity markets as they are forced to digest these capital calls. Having said that, previous crises have shown that as long as the underlying businesses or assets are good, these balance sheet cleansings can provide excellent long-term opportunities, so having some spare cash to be able to selectively participate in these makes sense.

We are also conscious that if we have indeed entered a recession, historically the bottom of equity markets has tended to be in the middle to back half of the recession, not the beginning, so for now we are taking a patient and measured approach in adding to equity exposure.

Of course, any major missteps in the above raise the prospect of an L shaped or a deeper and extended recessionary period. At this point we see this as a lower probability outcome but not an impossibility. In forming this view we take some comfort in the fact that there is some history in how to manage a health crisis, there is a global focus on the issue from Governments, Central Banks and health authorities together with a highly developed and incentivised global health sector with numerous studies underway for an effective vaccine.

Bridging the Gap

The logic behind social distancing in managing the spread of the virus is easy to understand but clearly this comes at a significant economic cost. Governments and Central Banks were quick to recognise this so the fiscal and monetary responses have generally been swift and large.

For Governments, the focus thus far has been more on providing compensation to cushion the cost of the shutdowns rather than a more traditional stimulatory response. Once economies are open again, we may see the need for further rounds of fiscal stimulus focused more on investment in an effort to get growth heading in the right direction again.

For Central Banks, the focus has been on providing liquidity to help keep the wheels of the financial system turning. Fortunately, they had a playbook to follow after the GFC so they were able to move aggressively and quickly by both reducing interest rates and stepping directly into credit markets with large and ongoing asset purchase programmes.

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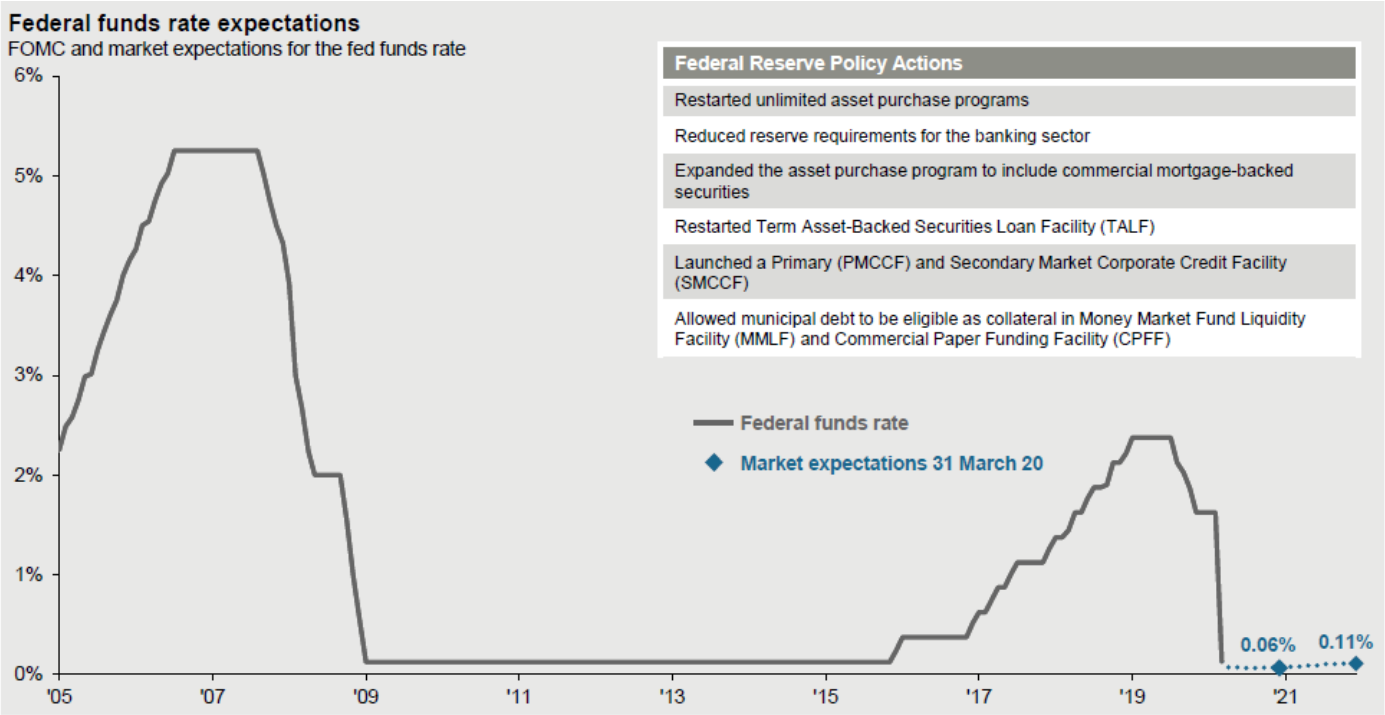

Source: FactSet, U.S. Federal Reserve, J.P. Morgan Asset Management.
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An outcome of these measures will be a significant increase in Government debt so Governments will be looking for Central Banks to keep interest rates low for the foreseeable future. To provide some level of certainty on this, some Central Banks, such as the RBA, have stated that they will not raise cash rates until progress towards full employment is being made.

The weight of this increased debt is likely to have implications for future growth. If the expectation pre-crisis was that we were in a low growth world then this higher level of debt is likely to have only exacerbated the issue. It follows then that this will also have implications for investment portfolios.

Firstly, in our mind, it highlights a reason to remain largely invested. Most asset classes are currently in a valuation discovery mode. A key input needed when assessing value is the net cash flow that an asset can generate over time. Clearly the near-term outlook for those cash flows is highly uncertain at the moment, but once that information becomes more apparent, markets will likely adjust quickly. If you are not invested at that time and you do not participate in that adjustment you face the prospect of only being left with the low growth environment, meaning you may have left a large portion of your medium term returns on the table.

Secondly, in a world of ongoing low interest rates cash, and cash-like investments are unlikely to meet investors objectives so on a medium to long term view cash is likely to forced out into other asset classes, such as equities, in the search for better returns. This will no doubt be a key driver of the next cycle.

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