TILNEY
FOR PROFESSIONALS

Tilney Model Portfolios on Platforms Market Update

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Over the past three weeks, global capital markets have experienced unprecedented levels of volatility. Equity indices have regularly recorded moves of over 5%, market circuit breakers are being deployed almost daily, and the US Federal Reserve has been required to inject significant levels of funding into the US Treasury market, the deepest and most liquid exchange in the world. Despite this, only one market has shut (The Philippines) and price discovery remains possible, albeit with reduced levels of liquidity. While it is tempting to ascribe these falls to the spread and growing threat of Covid-19, the magnitude of these moves suggest a more complex explanation. To date little is known about the infection and mortality rates associated with the Coronavirus. Testing criteria differ widely across the impacted countries, while the test themselves' have a near 50% error rate. This renders almost all projections of the threat posed by the virus as statistically inaccurate. Indeed, small sample testing in near laboratory conditions, such as the quarantined cruise ship, Diamond Princess, suggest much lower infection and mortality rates than erroneously reported in the press. This is not in any way meant to underestimate the humanitarian consequence for those whose lives are impacted, simply to put some context around the current situation.

This leads us to make **two** important conclusions that help point a way to the end of extreme market conditions:

- Firstly, that in the absence of concrete data on the spread and threat of the virus, markets are not trading the virus itself, but the authorities responses. It is the decision to close borders, shut non-essential retail outlets and impose curfews that are unsettling investors, not infection or death rates. This suggests that markets will regain some poise as soon as we reach peak response, rather than peak infection.

- Secondly, that after an almost uninterrupted 11 year bull market, investors positioning has become skewed by excessive complacency and perceived immunity from risk. Crowded but fashionable trades designed to maximise returns in a low inflation, low interest rate environment have led investors into arcane and illiquid areas where risk was clearly being mispriced. At times of unprecedented liquidity provision, it takes so called 'Black Swan' events such as Covid-19 to expose the fragility of these strategies. As investors seek to unwind positions which threaten significant, or even total capital loss, their search for liquidity reverberates through capital markets impacting the good as well as the bad.

At Tilney we have an investment philosophy that guides our decision making at all times. We believe that the power of compounding returns from good quality equities will be the long driver of inflation + returns, and that while short term mark to market losses are periodically inevitable, permanent loss of capital is completely avoidable. By filtering our portfolios to avoid companies with high levels of financial leverage, low profit margins, weak competitive positions, no pricing power, we are deliberately constructing portfolios designed to survive the stresses that will inevitably occur.

In this context we are pleased to report that portfolio positioning going into the current crisis has demonstrated the robustness of our approach. Our key equity funds have outperformed their respective benchmarks through March, while the decision taken last year to focus our bond exposure into government rather than corporate or high yield debt has helped dampen overall volatility. While we will be re-balancing portfolios back to our target weights to take out recent market drift over the coming weeks, we otherwise feel portfolios are correctly and appropriately positioned.

Looking forward, we believe there will be three key phases to the current sell off:

- **In the first phase** the sell-off is largely indiscriminate, driven not by a rational economic assessment of long term prospects, but the search for liquidity. In this phase, good and bad businesses both fall, ironically it can be the good that fall further as there will always be a buyer for a good quality company. Many share prices of the weak simply won't trade in sufficient volume to give an accurate indication of the real price.
- **In the second phase** a degree of discrimination enters investors thinking, tentative buying of bombed out value stocks is met by further selling, while good companies start to secure solid bids with the price performance diverging as a consequence. The realisation that good companies will not just maintain but grow their dividend puts a floor under their share price.
- **In the third and final phase** you see capitulation among investors in many weak companies as they realise there is a prospect of corporate failure, as weak cash flow fails to cover the coupon on the debt burden and bond market defaults rise. In this final phase well managed companies return to their pre sell off valuations that accurately reflect the compounding benefits of their dividend.

It is our belief we are close to the end of phase one of this process and that the degree of discrimination we would expect to emerge in coming weeks will be to the benefit of your portfolios.

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IMPORTANT INFORMATION

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Past performance is not a guide to future performance.

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