Q1 2020 Equity Manager Report:

Special COVID-19 edition

Report Analysis

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The first quarter of 2020 brought high levels of market volatility and significant negative absolute returns across most equity markets as the coronavirus pandemic swept around the globe. Not surprisingly, the quarter was largely a challenging environment for active management, particularly for UK, Japan, emerging markets, Canada and U.S. small-cap equity managers.

On a relative basis, however, China emerged from this period as one of the best performing markets in the world, despite being the probable origin of the virus. This is largely because the country's response to the initial outbreak has allowed it to start returning to some form of normality ahead of other economies.

While China's drawdown was significantly lower than most markets, Japan and U.S. large-cap equity managers also performed relatively better than other large markets. It's also worth noting that currency weakness also played a significant role in the divergence of performance. In addition, the first-quarter environment was moderately more favourable for Europe, Australia and U.S. large-cap equity managers. Nevertheless, all markets delivered negative absolute returns - in most cases, at a level significant enough to trigger a bear market.

On a relative basis, growth, quality, momentum and low volatility performed strongly across most regions, while the value factor significantly underperformed everywhere. The environment proved to be favourable for the information technology, communication services, healthcare and consumer staples sectors, which were deemed to be more resilient and/or defensive. By contrast, sectors such as energy, financials and industrials, which were more heavily exposed to the immediate impact of global lockdowns and slumping growth, faced significant struggles.

By and large, managers across all regions took the opportunity to re-evaluate the resilience of stocks they owned, with many choosing to high grade their portfolios by rotating into positions with stronger balance sheets that have a greater chance of survival. The sell-off, which was largely indiscriminate from a company fundamentals perspective, also gave more valuation-sensitive managers the opportunity to pick up high-quality businesses that had previously been deemed too expensive.

> *Technology, communication services, healthcare and consumer staples sectors, deemed to be more resilient and/or defensive.*

Energy has been the hardest hit sector, and one where managers who have exposure have been particularly active in both reviewing holdings and reducing exposure. Uncertainties surrounding supply and demand for oil in the short and medium-term, coupled with the slowdown in global growth and pressure on potentially levered balance sheets, are all weighing heavily on investors.

Elsewhere, many managers have been adding exposure to innovative technologies, where they expect strength going forward as changes in people's behaviour accelerates. Some value and more contrarian managers, often more willing to be early, are also exploring opportunities in the travel and retail industries - but this has been at the margin, given the current uncertainties.

At Russell Investments, our distinctive relationship with underlying managers allows us access to unique, forward-looking views like these - from a wide range of specialists across the manager universe. Amid extreme levels of economic and market uncertainty, there's arguably no better time than now to tap into these insights.

With this in mind, we've compiled a special, coronavirus-focused edition of the equity manager report. In addition to listing our usual chief tactical observations from key geographic and equity regions across the globe, we've also provided supplemental insights into how the pandemic is impacting manager viewpoints for each region.

Australian equities

Favourable forward environment for active management

- Managers are unanimous about the environment being positive for stock picking. We haven't yet seen significant portfolio rotations, but rather managers opportunistically adding to holdings they consider unfairly punished. Proprietary research is accelerating in pace, focused on likely additions.

Getting set for capital raisings

- Companies are tending to favour existing and institutional investors in raisings, which are often at a generous discount. Managers are identifying which companies they want to own or add to, and positioning to participate in expected raisings.

Gold gains lustre

- Several managers have increased their holdings in gold miners, as they consider the fact that stock prices don't reflect the increased margin between the Australian gold price and costs, and the future impact of easy monetary policy.

COVID-19 manager insights

Experience matters

- Fund managers are placing a high value on company management teams who are experienced, noting many were leading companies through the Global Financial Crisis (GFC).

Access to management not impeded

- If anything, fund managers are saying they are having more conversations with company management, as it is logistically easier to reach them. This offsets not being able to visit sites or meet individuals from lower management as easily.

Thematic risk management

- Most managers are considering themes when assessing the risk of the overall portfolio, with global, domestic and defensives being common ones. As a result of the crisis, we are seeing that managers are trying to reduce their market beta risk and increase stock-specific risk.

Increased opportunity to pick winners

- Managers believe that post-health crisis, some companies will emerge with increased market power. They are identifying these through scenario analysis at both the industry and company level.

Execution challenges

- There was a massive increase in intra-day price volatility and large price moves at market close during the second half of March. Managers have not engaged in trading in these markets, for fear of being whipsawed. They have, however, introduced processes for trading to overcome the execution risks of not being in the same location.

Canadian equities

Hunting ground for stock pickers

- Despite incredible uncertainty, the indiscriminate sell-off has created ripe ground for managers to reshape portfolios for the current environment and beyond. Exceptional stock pickers should perform well as equity markets recover.

Increased attention to quality common among all styles

- Survivability, dividend sustainability and balance-sheet strength were top priorities for all active managers, and drove most decisions in the quarter. Most cited oil producers and companies with high bailout beta among their biggest concerns.

Views on oil are mixed

- Some managers - primarily those with a value bias - added to existing high-conviction oil positions on weakness and/or opportunistically high-graded to those with more sustainable balance sheets, while others sold out of the E&P (exploration and production) and services sector entirely. Energy exposure fell overall.

COVID-19 manager insights

Too much too soon

- The consensus among active managers is that markets will likely re-test March lows before experiencing a meaningful and sustainable recovery. Those with a more significant quality bias or dividend focus are positioned for a recessionary environment and are comfortable being late to the party, while those with greater economic sensitivity are trying to appropriately balance risk aversion with reward by shifting toward higher quality within the cyclicals.

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Repositioning in energy and resources

- Value managers with existing energy exposure have added to their highest conviction positions on weakness, citing integrated oil (i.e., Suncor), best-in-class producers (i.e., Canadian Natural Resources) and pipelines (i.e., Enbridge) as most appealing. These managers tend to be longer-term oriented, with a focus on upside potential in a market recovery. Other managers are looking elsewhere, noting plenty of attractive opportunities outside resource sectors (i.e., gold).

Focusing on 2021

- Managers generally expect that a lack of earnings visibility until the second half of 2020 will push investors to base their expectations on 2021 earnings, rather than the next couple of quarters. Broadly, they are assuming zero earnings for 2020, and are focused on businesses that can survive prolonged weakness, carefully analysing metrics such as cash burn and debt covenants, and those that could thrive in a more normal environment.

Opportunities within banks

- Canadian banks have piqued the interest of many active managers, regardless of investment style. As a group, they are trading below book value, with healthy yields. Although cyclical in nature, as a group they will suffer from net interest margin (NIM) compression and heightened loan losses, as a result of the pandemic. Canadian banks are incredibly well-capitalised and benefit from significant regulatory support, making them a very compelling value opportunity. Dividend sustainability is not a concern, although dividend growth is halted for now.

Emerging markets equities

Growth managers are building on positions of strength

- Managers see opportunities in mid-cap Chinese internet companies. Some are high-grading to large-cap tech firms gaining market share - e.g., chipmakers - elsewhere, to 5G. Quality managers see discount valuations in franchises of smaller distressed economies.

Value managers gearing for a recovery

- With trough valuations, managers have maintained most positions that oversold, but consolidated energy into lower-cost producers and high-graded miners with quality deposits. Some added to fiscal stimulus beneficiaries - e.g., Chinese cement and property - and marginally into tourism.

Macro-oriented managers looking for normalisation

- Managers are moving into normalised beneficiaries such as retail, autos and disruptive technology. They remain cautious on financials, particularly insurers, given falling interest rates - and are wary of capital controls in exposure to carry currencies.

COVID-19 manager insights

Innovation moats

- The recent environment has driven further bifurcation in technology, in favour of disruptive technologies. Many managers see these companies continuing to gain market share over traditional competitors in reaching end-customers, particularly in China - e.g., cloud computing, social internet, mobile content and e-commerce.

Tourism and retail

- Market-oriented and value managers are slowly picking up oversold tourism names - e.g., travel services, airports and Macau casinos. With uncertainty over the end of the lockdown and threat of global contagion, they are treading cautiously.

China stimulus and sensitive global cyclicals

- China is well-positioned to provide fiscal stimulus and deploy its policy toolkit. In response, value managers are gearing into policy cyclicals - e.g., Chinese cement, heavy equipment, 5G and real estate - on the basis of better liquidity and stronger capital injection, compared to other countries.
- Value managers are also positioning early for a recovery in areas of the global cycle where they see demand replacement coming back online, such as autos. With falling interest rates impacting bank margins, they also remain positive on Korean banks, which are trading around GFC levels, but are better capitalised and sensitively positioned toward global growth.

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High-grading for stronger upside

- The collapse in oil prices has seen energy names trough and has allowed value managers to rotate from more expensive producers to lower-cost Russian energy. They have also shifted to higher-quality minerals and metals deposits among miners (i.e., lithium), which are structurally positioned for electrical vehicle (EV) battery demand.
- Quality managers saw dislocation from fundamentals in companies where they like strong management. This was particularly true in troubled economies with carry currencies - (i.e., South Africa and Mexico) - where managers have entered historically expensive consumer franchises, such as retail chains, supermarkets and beverages.

Europe and UK equities

V-shape recovery is consensus, but…

- The consensus among managers is for a gradual return to normal in 2021. As a result of the lockdown, they expect an average 25% hit to companies' top-lines. This is an aggressive recovery scenario which does not leave much room for error as the lockdown begins to be gradually lifted across markets. As a result, they expect volatility to remain high for a prolonged period.

Acceleration of structural trends

- Many industries have come to a standstill amid the lockdown. The expectation among managers is that stronger companies will continue to take steps to improve their positioning. Opportunities exist within industries with accelerating structural trends that could benefit from further focus, such as clean energy, industrial automation, EV adoption, healthy living and digitalisation.

COVID-19 manager insights

European banks

- Faced with uncertainty, and in the absence of many precedents, investors pulled out their 2008 playbook to better understand the heavy selloffs across cyclical sectors and banks in particular. Yet, value managers are quick to highlight how deeply the sector has evolved following the 2008 and 2011 crisis, and how different the environment is:
    - Balance sheets are stronger with high average capital requirement ratios
    - Banks appear to be strong beneficiaries of fiscal stimulus announced by European governments
    - Governments need the banks to raise capital

Tying governmental help to companies' ESG practices

- As the world braces for a wall of liquidity and support from governments in the quarters to come, debates about the conditions of that support have emerged throughout Europe. A few countries have pioneered a new approach, with Denmark excluding dividend-paying and tax-haven domiciled companies from its support plans. France and Poland have followed suit, and debates about excluding high-carbon-emitting companies from these plans are now emerging.

Re-evaluating balance sheet risks

- Managers are reassessing the balance sheet strength of their holdings as appetite to have any leverage exposure is reduced.

Travel and leisure

- Most managers have been reducing exposure to travel and leisure. Some value manages are holding onto these positions as the valuations fall, believing they are holding best-in-class positions. However, they are not significantly adding to them.

Consensus that consumer behaviour will change

- Many secular and technology trends have been accelerated by government lockdowns, such as working-at-home communication services, ecommerce, digital payments and cloud computing. There is a consensus that there will be some strong winners and some losers as a result of these changes.
- However, there is no consensus as to who or what the consumer winners from this pandemic will be.
    - For example, some managers believe the uplift of food retailers is only temporary, and that theses business remain structurally challenged. Others, meanwhile, are adding to them.
    - There are also differing views of fashion retailers, with some strong views on newer fashion retailers such as BooHoo, while others continue to support stalwarts such as M&S and Next.

UK banks

- Banks across the UK have suspended dividends and share buybacks until at least the autumn. However, valuations now look attractive enough to look through this.

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Global and international equities

Sticking with the winners has paid off, especially in growth

- Among growth managers, those who bet on the winners getting stronger have outperformed those positioning for a recovery in cyclical growth. Long duration and quality-growth managers have performed well and done little rotating.
- Those who reduced cyclical risk and/or leverage benefited from it. Many have opportunistically upgraded their quality profiles.

Those who bet on energy and financials are standing still

- Many value managers are unwilling or unable to rotate. They have already expended their risk budgets or highlighted the extreme spread between value and growth. Others have used the general downdraft to deepen their value exposures while emphasising balance-sheet strength.

Volatility remains a headwind for many quant strategies

- Low volatility and risk-minimising strategies have performed better than their peers.

COVID-19 manager insights

Strong get stronger

- Most growth managers believe the winners of the economic environment preceding COVID-19 will emerge stronger. Some are concerned about valuation stretch in these stocks, but few are willing to bet against them.

Rotations and concerns in the energy sector

- In energy, some managers who are willing to maintain exposure are shifting to short-cycle beneficiaries. Others think it's too early. One experienced investor predicted that oil prices won't recover for 1.5 years - too far off to step in.

Mixed signals in the insurance sector

- Quite a few core and value managers own insurance companies for financial exposure and as an alternative to banks, but insurers with variable rate business will see profit pressure due to low-interest rates. Large swaths of their guaranteed book will likely lose money.

Precious metals

- Gold investors are watching (and hoping) that worldwide stimulus produces inflation. Other precious metals remain cheap relative to gold.

Japan equities

Uncertainties on pace of recovery

- Mixed views with regard to pace of the economic recovery.
- Many managers avoided autos and/or machineries, expecting slower demand recovery and supply chain disruptions. Most managers expect the recovery of small-ticket items to be faster.
- Overall, managers are paying close attention to business survivability, while risk tolerance has differed among styles.

Value managers' transactions were mixed

- Some added beta following valuation signals, while others showed a more cautious stance and made shifts without changing their overall value and cyclical exposures.

Growth managers buying beneficiaries of social distancing

- Momentum growth managers, in particular, showed strong interests in buying online-related stocks. Meanwhile, consistent growth managers reduced cyclical exposure, while broadly maintaining existing positions.

COVID-19 manager insights

Opportunities from accelerating reforms in work practices

- Many managers preferred defensives, while trying to capture the opportunities of a rebound. Growth managers are focusing on identifying opportunities in online-related and healthcare stocks as a result of the current market environment. The expectation is that this pandemic will lead to faster reform of Japan's work practices, potentially having a positive impact on information-technology spending and a possible negative impact on office leasing.
- The positive view on 5G-related stocks remained intact due to higher visibility of demand growth.

Second-wave risks

- Some managers initially sought to capture China's recovery, but have recently become more concerned with the risks associated with a second wave of infection in the short-term, as well as production shifts in the longer-term.

Uncertainties still lingering

- Given many unknown factors, such as duration of the virus outbreak and the contents of economic stimulus packages, managers have largely avoided overly relying on their macroeconomic views. At this stage, expectations are that the market will bottom out in the first half of the year.

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Real asset equities

Global property managers

- On price-to-NAV (net asset value) basis, all three regions are trading at significant discounts to NAV. Japanese and Hong Kong property companies are trading at the steepest discounts.
- Managers are tilting toward property sectors which are poised to benefit from social distancing/lockdown restrictions. These include data centres (increased internet usage) and industrial (e-commerce), as well as apartments (historically well-supported by the government). Meanwhile, managers are maintaining underweights to hotels, retail and senior housing.

Global infrastructure managers

- Midstream energy has been negatively impacted by the OPEC+ oil price war and coronavirus-related demand destruction.
- In utilities, the global decarbonisation trend should continue to drive strong growth in wind, solar, battery storage and transmission investments.

COVID-19 manager insights

Focus on quality

- In the listed market, strong capital structure, visible cashflows and management teams are key. Managers are spending time analysing the sustainability of dividends, trying to avoid dividend suspensions.
- Real estate investment trusts (REITs) de-levered post-GFC, with the exception of Europe. This has generally left company balance sheets in a much better position. However, they were not designed to withstand several quarters of no cash flows.

Beneficiaries of shift to online

- Social distancing measures accelerated the channel shift to online everything, benefiting industrial (e-commerce) at the expense of retail.

- Data centres and towers are critical infrastructure for shelter-in-place restrictions.
- The secular impact on office (utilisation, densification reversal) and hotels (business travel as people shift to virtual solutions under the current restrictions) remains to be seen.

Bifurcated impact on healthcare

- The COVID-19 impact is most acute in senior housing, but medical offices and hospitals are more resilient to the crisis (notwithstanding a drop in the highly profitable elective procedures).

U.S. large-cap equities

Managers in all styles are emphasising financial quality

- Regardless of philosophy, managers are shifting away from highly leveraged stocks in cyclical industries, with the energy sector a prime example.

Growth managers trading up for growth

- Growth managers are increasing allocations to stocks with higher revenue and earnings growth potential.

Babies thrown out with bath water in value

- Managers are looking in groups that have traded down heavily, such as industrials, for stocks that have better relative earnings visibility.

Opportunity in consumer discretionary?

- While consumer spending is at risk, managers are seeing opportunity for future stock selection alpha in the consumer discretionary sector, as the impact of the COVID-19 crisis will vary greatly across its many sub-industries.

COVID-19 manager insights

Re-evaluation of risks and balance sheet strength

- While managers in all styles are emphasising financial quality, value managers are being especially diligent about balance sheets, given the preponderance of cyclical stocks in their universe. Value managers are analysing liquidity, type and terms of debt covenants to ascertain the sustainability of cash flows through a prolonged economic slowdown with depressed corporate revenues. Managers are also concerned about the sustainability of dividends.

Opportunities in healthcare

- Many managers feel that improving investor sentiment toward healthcare will continue, although the sector has been challenged during past election years as investors mull the possibility of increased regulation. While certain healthcare segments are challenged in the current crisis - such as medical device manufacturers that provide inputs for elective procedures - overall, the sector is being perceived more positively amid the backdrop of the COVID-19 crisis.

Uncertain times for energy

- Managers have reduced exposure to the energy sector. While large-cap energy stocks have more survivability than their smaller cap counterparts, the horizon for a positive payout has been extended meaningfully due to the poor supply-and-demand dynamics of oil prices.
- Value managers and others that incorporate valuation are considering scenarios in which current year earnings are zero and/or significantly depressed, in order to assess the margin of safety.

U.S. small-cap equities

Growth managers lighten exposure to fastest growers

- With technology and healthcare generally holding up relative to the broad market, the growth managers who benefited recognised stretched valuations and trimmed the two sectors, but still remain overweight. Opportunistic growth managers added to cyclical growers - (e.g., industrials, transportation).

Value managers lose conviction in energy sector

- With a combination of both supply and demand collapsing for oil markets, value managers who have long held energy overweights have reduced their exposures. Managers without existing energy exposure have not expressed interest in the space, despite the collapse in valuations.

Managers opportunistic at the margin

- Managers across growth and value styles expressed some level of opportunism in industries hit hard by COVID-19, namely well-capitalised restaurants and consumer stocks.

COVID-19 manager insights

Survival of the fittest

- Small-cap managers broadly focused on survivability of their portfolio holdings over a two-to-three-quarter period of economic shutdown. Managers are emphasising balance sheet quality, favourable debt covenants and reducing exposure to companies with high financial leverage. Even managers with expertise in high yield credit analysis are less willing to own stocks with debt rated below BB.

Continued uncertainty for energy

- Managers almost unanimously reduced or eliminated exposure to the energy sector. Many characterised the sector as un-analysable, citing poor supply-and-demand dynamics of oil prices. Even among deep value managers, most have reduced or have not added to energy, despite the widening valuation discounts.

Fallen mid cap stocks

- Managers are broadly finding new ideas that were former mid cap names previously too large in market capitalisation to own. Some managers have cited the higher quality of previously larger cap names as more attractive than small/micro cap names that may not survive a prolonged downturn.

Hungry for opportunities

- Among the hardest hit sub-sectors within consumer discretionary, growth and value managers have been willing to buy opportunities in the restaurant industry, but in selective fashion - by investing in companies with enough cash to weather a temporary economic shutdown. Deeper value managers were willing to invest in harder hit industries such as specialty retail, theme parks, and airlines.

Dividend cuts priced in?

- Dividend cuts are widely expected, but the views from managers on market implications vary. Deeper value managers are willing to look past dividend cuts and argue that the first-quarter selloff largely priced in dividend cuts. Quality-oriented managers were quicker to eliminate stocks that are at risk of dividend cuts.

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The bottom line

The coronavirus pandemic has flipped the world economy on its side, but a gradual reopening and return to semi-normal conditions should translate into brighter days ahead. As the globe slowly emerges from lockdown, we believe there will be no shortage of opportunities in equity markets - but these opportunities may look very different than they did in a pre-pandemic world. Identifying these possibilities for outperformance will require keeping a vigilant watch on the views of specialist managers as the world navigates through uncertain times. We maintain a firm commitment to keeping you apprised of all the latest observations from across the manager universe.

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