December 2020 — Over the Horizon Market Commentary by David Offer

December was another positive month for our share market, with the All-Ordinaries index closing up 1.8% to finish the calendar year at 6,976 points. Our share market finished the year in the black, generating a marginally positive return of 3.6% with the inclusion of dividends. The benign full year return masked a year of huge underlying volatility, with our market falling 35% in the first three months as we experienced the most rapid bear market in history; to then subsequently recover in full over the subsequent 9 months.

As vaccines start to be rolled out around the world and humanity collectively strives for a return to pre COVID-19 normality, a key variable still to be addressed is the extent to which the new vaccines will reduce the transmission of COVID-19.

According to the World Health Organisation, there is presently insufficient evidence on any of the vaccines to be confident they will actually prevent people from getting infection and therefore prevent people from being able to pass it on.

The most likely scenario will be that the vaccines reduce the severity of COVID-19 symptoms and, as a result, may reduce transmission and the rate of adverse progression of the disease. It is unlikely they will stop the spread of the disease in entirety. If this outcome eventuates this will pose some big questions for Australia, where most States have sought a strategy of eradication. Eventually we will need to re-join the rest of the world and, in doing so, enable people to move more freely through our borders. When this happens, it will be likely that COVID-19 will enter the country and start to circulate. As such, while Australia's tough border stance will have kept us safe until the implementation of vaccines, it is unlikely to keep COVID-19 at bay indefinitely.

A big topic in 2021 will be whether COVID-19 vaccines will be made mandatory. We suspect that Australia's current wait and watch approach will be part of a broader Federal Government strategy to ultimately persuade as many Australians as possible to get immunised before such a decision is made. Given the extent of restrictions imposed on our freedoms over the last year, to the extent that people have been jailed for not isolating when required, we suspect that immunisation will be, for all intents and purposes, ultimately made mandatory at some point. For example, employers may be required to ensure all staff are immunised as part of meeting occupational health and safety requirements.

Other unanswered questions relating to the vaccines include the duration of time that they will remain effective once administered and just how effectively the vaccines will deal with the different strains of the virus that are emerging.

Regrettably, COVID-19 looks set to continue to dominate news-cycles and have a material impact on our lives throughout 2021.

Now that we have enjoyed a significant recovery in investment markets in the second half of calendar 2020, as to how 2021 plays out is frankly anyone's guess. Never before in my career have competing forces been so strong. Both share market Bulls and Bears can make compelling arguments. The Bulls highlight;

- There is unprecedented government stimulus being provided around the world to support economies.
- Central Banks have never done more to support economies with the printing of money having gone mainstream and interest rates generally close to zero or negative.
- Domestically consumer confidence is high thanks to asset values appreciating and, on balance, substantial funds having been saved over the year thanks to government payments and limited spending options.
- Due to low interest rates, investment options are limited with share markets offering the prospect of comparatively higher returns when compared to other forms of investment.
- High technology valuations are justified given how profoundly these businesses are impacting on our lives.
- On a historical basis, large pockets of the share market offer value and therefore reasonable prospects to generate an acceptable risk adjusted rate of return going forward.

Equally, the Bears have compelling points.

- The mainstream underlying assumption now underpinning share markets is that globally economies will continue to experience a V shaped recovery. This is not a certainty. Particularly if vaccines do not work as well as intended, more potent strains of COVID-19 emerge and as government stimulus starts to wind back.
- Large sectors of share markets globally such as the technology sector are unquestionably operating within a bubble. The Nasdaq is trading at 40 times earnings, comparable to its high in 2000 before the index crashed nearly 80%. This is typified by Elon Musk, now the richest person on the planet. Last year, each Tesla vehicle sold was worth over $1.25 million in value for the Company in terms of market capitalisation. This compares to just $9,000 for each car sold by GM. Likewise, that domestically Afterpay is now a top 20 company despite never having turned a profit. This means many fund managers (including all index funds) are presently being forced to buy the Company, *after* it has appreciated in value simply because of Afterpay's value, and not because of its investment merits. Many fund managers will also be forced to sell should Afterpay's market value start to materially decline and it subsequently drops out of the major indexes. With respect to the current bubble in technology shares, I encourage you to read the attached article by respected fund manager Jeremy Grantham – **Waiting for the last Dance**.
- The world is becoming increasing indebted with global debt markets now three times the size of global share markets. Should interest rates rise, due to inflation or the risk attributed to holding debt instruments is repriced, this will result in a loss of capital for debt holders and make the servicing of loans more expensive for borrowers.
- The relative peace and stability the world has enjoyed for the last 30 years may be coming to an end with the emergence of a more assertive China and ever widening cracks appearing within America's democracy.

As to how we address the above bull and bear points we are largely taking a middle road approach. The risks are simply too great to sit at either end of the pendulum. For example, going all out for growth could result in high short term returns but ultimately risk exposure to a serious share market crash and permanent loss of capital. Equally, with real cash returns negative after taking into account inflation, taking a defensive stance will *guarantee* a permanent loss of capital. Within our portfolios we are trying to achieve the following;

- Maintain the majority of portfolio funds (50% – 70%) invested in growth assets but within this space to focus on the more defensive (value orientated) investments. While the share prices of such companies would be impacted in the event of a broad-based share market sell off, ultimately, they will recover. There is also valid justification as to why the share prices of many such companies should ultimately track higher in the longer term. Namely, that from abnormally low profit levels this year due to COVID-19, company profits should now start to increase and, in turn, the dividends that they can afford to pay should rise.
- Maintain 10% – 40% invested in assets that will not track the broader share market. This includes unlisted property, long/short funds and alternative assets.
- Retain 10% – 30% in cash and other defensive assets (hybrids) so that when we do experience an inevitable share market correction, we are in a position to take advantage.
- Avoiding all areas of speculation. Examples here include the current technology orientated high flyers, cryptocurrency and speculative mining penny dreadfuls.

We have no doubt 2021 will serve up at least one curve ball during the year; it would not be a normal year if this was not the case. However, the above approach should ensure that any potential downside is minimised while retaining the opportunity to capitalise on the potential upside that exists both now and should a curve ball present in the future.

If you would like to discuss the above or any aspect of your portfolio, please do not hesitate to contact our office.

David Offer
Investment & Financial Advisor
phone: 08 9791 9188
fax: 08 9791 9187
email: david.offer@horizonis.com.au
website: www.horizoninvestmentsolutions.com.au

UNIT 4, 2-4 JETTY ROAD,
BUNBURY WA 6230