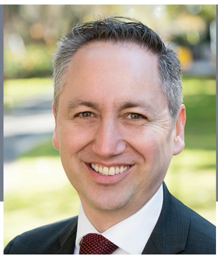

From the desk of James Abela

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A stark risk reminder

Well, what a difference six months can make... I can remember thinking just a few short months ago that if the global strategists were right and the consensus was correct, 2020 was shaping up quite nicely and, although stretched, the bull market might just ride out another year.

Today, we're staring down the barrel of a very different and sobering new reality, with the prospect of recession or depression – conditions not seen since the last World War. Capitalism, credit markets and humanity have suffered a stark risk reminder, this time biological, and we've all been humbled by the economic and human loss COVID-19 has caused over the last three months. At this stage, it's very difficult to estimate the fallout from the pandemic as death tolls, job losses and global debt levels continue to climb around the world. There are just so many unknowns.

Early on in the crisis, we saw impacts to travel, retail and airlines, but that quickly spread to value chains as lock-downs, closed factories and border closures disrupted logistic channels. By March, the economic impacts were becoming much more visible. The pandemic was changing our whole system of living as schools and businesses closed and social distancing measures were widely implemented. It's been a harsh 'reality bites' moment worldwide and with it has come the repricing of risk in equities and bonds.

If we look back to 2019, 'momentum' extremes were already fading. Concept stocks, unicorn boom valuations such as Uber or WeWork were much more challenged over the last 12 months. But in the current environment, the shift back to fundamentals (balance sheet strength, cash flow certainty and liquidity) has moved from a low priority to a top priority in a matter of months.

Long duration drivers of success are today beginning to matter much more – viability, sustainability and credibility are for some a driver of earnings and valuation, while for others, a factor determining survival.

When it comes to stock selection, I tend to use a framework of grading stocks through the Viability, Sustainability and Credibility (VSC) process lens, as per below. Currently I'm seeing some good opportunities in grade B and C, but remain cautious of companies in grade D.

VSC Lens through economic downturn of COVID-19
Stock lens through the VSC

	A grade	B grade	C grade	D grade
Character	Survive and thrive	Economic leverage	Economic and high financial leverage	Earnings, balance sheet risk and poor market structures
Earnings risk				
Balance sheet risk				
Cash flows, refinancing a major risk				
Market structure risk				
VSC	High	Medium	Low	Avoid
General examples	Healthcare	Technology	Tier 1 cyclicals, consumer and financials	Leveraged cyclicals, leveraged 'defensives', unregulated financials, concept stocks

Source: Fidelity International, April 2020.

Winner of the 2020 Morningstar Australia Fund Manager of the Year – Domestic Equities Small Cap Category for the third year in a row

Going forward, I think there will be valuation opportunities that arise in the traditional long-term clusters of future leaders – global healthcare, global technology, tier 1 global cyclicals and global consumer brands.

Navigating through the current environment

I'm having a lot of conversations with clients about how best to navigate through the current environment. In my view, now is not the time for complacency, as I don't think we're through the worst. Over the next four to six weeks, we'll likely see a bottoming-out as the balance sheet recapitalisation process continues, unemployment numbers begin to rise and the tests of lifting social distancing rules provide a firmer guide of the path toward normalisation.

Navigating corporate Darwinism* in 2020

Stage	Characteristics	Caution & action
Stage 1 **Complacency**	■ Low risk spreads ■ Weak valuation discipline ■ Caution on complacency beneficiaries	**Caution** – leverage, concept stocks, unfunded projects, momentum, equity or debt dependence
Stage 2 **Momentum failure**	■ Bullish sentiment fades ■ Rising risk premia ■ Balance sheet concerns emerge	**Caution** – economic leverage, financial and operating leverage, weak balance sheets, refinance refugees, weak cash flow, highly competitive market structures
Stage 3 **Bottoming out**	■ Market supported by cash yields ■ High point of hysteria ■ Record valuation extremes	**Action** – quality structural growers that have sold off to attractive valuations **Action** – Review strong balance sheet companies, Tier 1 global cyclicals
Stage 4 **Recovery**	■ Worst case scenario dissipates ■ Companies refinance or recapitalise ■ Market leadership, correlation changes	**Action** – Consider buying recapitalising names, structural growers and global cyclicals with more confidence. Reconsider expensive defensives
Stage 5 **Normalisation**	■ Leverage, risk and some beta become more normal ■ Valuations moving from extreme towards mean	**Action** – When comfortable, begin to add some more beta as fear and refinance risk dissipates.

Source: Fidelity International, April 2020.

*The 'survival of the fittest' is commonly attributed to Charles Darwin's book *Origin of the Species,* but was also termed in the Herbert Spencer (British economist) book in 1864 titled *Principles of Biology.* Corporate Darwinism is the narrative around survival applied to the world of companies that are most willing or positioned for adaptability.

Surviving a correction

If some of the concerns of the last few years, (emerging market debt, high yield bonds, unfunded pension funds, European banks, to name but a few) are realised into a global liquidity event or economic recession, then risk will quickly re-price and sustainability will become the central question for financial markets, but also for governments.

The anatomy of survival through a market correction

Managing a portfolio through a correction, recession and financial crisis

Stage 1: Buy and hold high quality and defensives. **Sell** high risk/financial or operating leverage/beta/complacency beneficiaries.

Stage 2: Buy Tier 1 global cyclicals with balance sheet strength, structural winners. **Trim** expensive defensives.

Stage 3: Buy value style/recapitalisation. **Trim** excessive valuation.

Stage 4: Buy beta, financials, Tier 2/3 cyclicals. **Sell** low volatility.

Source: Fidelity International, April 2020.

As some of my Fidelity colleagues have noted, 'History doesn't repeat, but it does rhyme', and so the lessons of previous corrections and market dislocations can help in navigating these very difficult times. Cash is king. Quality matters. Sustainability is critical.