MARKET INSIGHTS

March 2020 Quarter

A MORE ROBUST FUTURE – LESSONS FROM A CRISIS

Frank Jasper, Chief Investment Officer

We have things to learn as we battle through the coronavirus crisis. I hope as a result of this experience we build more robust companies, with less reliance on debt. I hope we build more robust social institutions ready to respond to future challenges and I hope we learn to accept that long-run returns will be lower and build portfolios that reflect reality.

I went for a run on Saturday afternoon. As I ran slowly past shuttered shop after shuttered shop, my mind wondered: what would the world look like after the coronavirus crisis?

It almost feels too early to think like that. But this is exactly the time to think about the world we want when this is all over, and to start driving change.

The word that kept jumping into my head, borrowing from writer and thinker Nassim Nicholas Taleb, was "antifragile."

As Taleb noted: "This is the central illusion in life: that randomness is a risk, that it is a bad thing. Much of modern life is preventable chronic stress injury. The fragile wants tranquillity, the antifragile grows from disorder, and the robust doesn't care too much."

The coronavirus crisis is not normal and was not the sort of shock Taleb was referring to – this is no societal "chronic stress fracture" – but it has exposed weaknesses. While we need to be careful drawing future guidance from an unexpected shock event, from a "black swan" event, to quote Taleb again, there are still lessons we can take.

We need a more robust world post-coronavirus. That means making trade-offs; being prepared to trade current consumption or returns for future strength. It's like insurance. Paying the bill every year requires sacrifice but invariably there will come a time you need it.

There has been a lack of 'insurance' in how some businesses are managed, in some of the choices we have made in society and it is evident in the risk-seeking behaviour of some investors.

The consequences are being keenly felt. This is a chance for a reset.

Awash in a sea of debt

Debt creates fragility. It can mean borrowers lose control of their destiny. It creates a timetable they don't control – when is the next loan payment due; if profits fall, even temporarily, can they meet their objectives, and what happens when the debt falls due? Normally this is manageable. But not always.

As we are seeing now, many businesses are facing an existential crisis because of the debt they are carrying.

The dangers of too much debt is a lesson we should have learnt after the global financial crisis. We didn't.

Global debt has continued to build, now, according to the Institute of International Finance, topping $US250 trillion, or 322% of global GDP – a record level.

Some debt is not a bad thing. Modest borrowing to fund productive assets that will generate high future returns on capital is one of the key ways we create economic growth.

But two things have happened in the past 10 years that challenge this healthy arithmetic. More debt has been used to acquire expensive assets, rather than on developing productive capacity. And, with low interest rates, it has been possible to borrow more, leading to more debt and less equity being deployed to buy these assets. We have lived beyond our means.

The composition of the global bond market paints a picture of this dynamic.

Triple B-rated companies are the lowest rung on the investment-grade debt ladder. In 1999, BBB's made up a quarter of the global corporate bond market. The market was dominated by higher-quality borrowers.

By December 2007, BBB's had grown to about a third of the market. Fast forward to today and they comprise of 50% of the investment-grade corporate bond market. Poorer quality borrowers have been borrowing more and more.

In the coming months there will be a rebalancing.

That means debt defaults. And there will be forced equity recapitalisations of some businesses. This trend has already started, with capital raisings in Australia earlier in the month at Cochlear and Ooh Media. Expect to see more, including some New Zealand companies.

Robustness or anti fragility often involves trading off present returns for future strength. Companies with more equity and less debt might generate lower returns but they are stronger.

We forgot this after the GFC. Maybe this time we won't.

Innovation is great, a market dominated by loss-making companies isn't

Like heavily indebted companies, firms that don't generate profits are reliant on the kindness of strangers for survival. They need to routinely raise equity. That is fine when investors are exuberant but when investors are nervous it will mean business failures.

New and innovative companies are an important growth engine in an economy. And some of the investment in loss-making, innovative companies in recent years is entirely rational. It has led to some of the great companies of this century – just think Google and Amazon. Unfortunately, there is a flip side. Some of this investment looks more like pipe dreams and collective Kool-Aid drinking.

Like many trends that start well, this has gone too far. According to the Wall Street Journal, close to 30% of all listed companies in the US were lossmaking over the past 12 months. The Journal also highlights that, at its recent peak, more than 75% of new companies in the US coming to the market in initial public offerings were lossmakers.

Too much capital and chasing too few genuinely good ideas invariably means that businesses that should never have got off the ground did. There will be failures. A slimmed down and more capital-rationed venture capital industry, and listed market investors pickier about what they will fund, will result in fewer companies but better, innovation-funded and a more robust market.

Social policy and investing in the future

More than sixteen million Americans lost their jobs in the last three weeks. The US was not alone, with unemployment rising around the world. Many of the people losing their jobs are in the most vulnerable parts of our society, living a paycheck-to-paycheck existence.

Similarly, healthcare systems in many parts of the world have been caught short by this crisis, with years of chronic underinvestment dramatically limiting the ability to respond. Countries such as Singapore, which did invest heavily in pandemic response strategies post-SARS, have shown that being prepared saves lives.

Fiscal authorities around the world are doing and will do more to respond to this crisis. In the short term this involves a vast array of programmes to support people, particularly the newly unemployed, and smaller businesses.

Longer term, this should result in changes in how we think about our vulnerable communities, on how we use good times to prepare for the inevitable tough periods, on what we need to do to deliver more sustainable economic growth and, then, how we ensure the spoils of that growth are shared.

Returns and reality

In the depths of the crisis, it's hard to be certain about future investment returns.

There are, however, some things we already know.

Share prices are lower, great insight there. Valuations have now fallen to average levels in the US and to generationally cheap levels in Europe.

That means prospective returns from shares have improved although there is one caveat in my view.

The post-coronavirus world will be different. It is likely companies will focus more on robustness, doing more to insure their business against the bad times, rather than just optimising for the good times.

Doing this adds cost and means lower through-the-cycle earnings. This ultimately flows through to lower, albeit not massively, fair value for companies. But, by diversifying supply chains, funding through more equity and less debt and investing in more business continuity initiatives, companies will be more robust. That is a good thing. It might even lower their cost of capital.

Prospective returns in fixed income are more troubling. While credit spreads for corporate debt have exploded and look appealing, yields on safe haven government debt have collapsed.

There is a lot of conjecture over where government bond yields head from current low levels. None of the scenarios look particularly appealing. Either yields remain anchored at low levels meaning returns are poor or, principally as a result of the outsized and justified, in my view, monetary and fiscal policy response to the coronavirus, we have let the inflation genie out of the bottle. That would be bad for fixed interest returns.

After the crisis, investors need to embrace the reality of lower returns, particularly for less risky investments. Some of the excesses we are now seeing in debt markets, the leveraged loan market, hedge funds and in parts of private equity are a result of investors hunting for returns in what has been, post-GFC, a lower prospective returns environment.

The common factor in these areas of excess is the use of debt to juice returns on low-return assets to make them look better than they are. This may look smart when things are going well but, eventually, the environment changes and companies get caught out.

Embracing the reality of lower returns, unfortunately, is like eating Brussels sprouts but we all intuitively know the prescription – save more, take on thoughtful risk and be patient.

Hopes for the future

I am optimistic that we will learn as we battle through this crisis. I hope anti fragility or robustness is an idea we talk about more as investors, as company executives or board members and as a society. It will make us stronger.

And if we don't learn those lessons, and history suggests we don't always, at least with the number of people I saw out running on Saturday, we will emerge from this fitter. That's one small step toward becoming more robust.

Frank Jasper | **Chief Investment Officer**

NEW ZEALAND SHARES

Sam Dickie, Senior Portfolio Manager

When we have a hard circuit breaker, all previous modelling goes out the window. Now, our process is more critical than ever before.

I will leave the hyperbole to the newspapers. Our thoughts are with those acutely affected by the COVID-19 crisis.

We have spoken to our NZ portfolio companies, their competitors, their suppliers, their customers and industry experts on 120 occasions in the past 6 weeks - more than 8 times per company. Our process has gone into overdrive! We ask 4 questions:

1. How are you ensuring the safety and security of your team, your customers and your suppliers?

2. How is your liquidity position?

3. What is a bear, base and bull case outcome for your revenues and profits?

4. How do you ensure you emerge from this better positioned than your competitors?

Our portfolio companies fit into four broad buckets:

Companies that should trade well through the COVID-19 crisis

a2 Milk has fared well, taking market share as mothers have shored up their infant formula supplies, often through the online channel where a2 is very strongly positioned. We have spoken with a2 several times, received feedback from channel contacts, and monitored real-time demand indicators.

Our analytical process during the last quarter has been quite different for Fisher & Paykel Healthcare. COVID-19 is a respiratory illness and Fisher & Paykel Healthcare are respiratory and humidification experts. The company is ramping production in its hospital division as rapidly as possible to treat COVID-19 patients with both its invasive ventilation and market-leading high flow oxygen devices and consumables. Most of our analysis has centred around sizing the amount of extra volume the company will sell in this crisis. We have learned that it pays to have flex capacity on hand as a manufacturer – Fisher & Paykel Healthcare have been able to ramp up 30% extra hospital product capacity within 2 weeks.

Companies that have more defensive earnings streams

The bulk of Infratil's portfolio is well-positioned to endure COVID-19, namely data and communications investments Canberra Data Centres and Vodafone NZ, plus electricity investments Trustpower and Tilt. Although Wellington Airport is operating well below capacity, this only comprises 12% of Infratil's net asset value and is actually much less reliant on international travel than Auckland Airport. The balance sheet is in a solid position. We think Infratil has more than twice as much in sources of capital as it is likely to have uses for capital over the next 12 months.

We have been talking to Xero, its competitors, its customers and industry experts to try and understand how Xero's small business customers will fare during the COVID-19 crisis. In the Global Financial Crisis the number of small businesses fell in aggregate from peak to trough by -6%. The current growth shock will shrink new business growth and will impact the growth of new subscribers for Xero. However Xero subscriber growth should fare better than overall small business numbers because: 1. the business model is more about adoption e.g. cloud accounting penetration in the US is less than 5% and in the UK less than 20% so while the overall small business pie may shrink, Xero will continue to take a bigger piece of that pie; 2. typically 50% of new businesses fail within 5 years but only 15% of businesses that use Xero fail within 5 years. Xero has almost $700m dollars of liquidity available so can weather any downturn and can take advantage of attractive valuations to acquire companies that complement its product suite.

Companies that have more economically sensitive earnings streams

Mainfreight has over $300m of liquidity available with no debt refinancing requirements for the next two years so will be able to withstand a protracted downturn. We have added to our position amid the uncertainty as the company will make good long-term decisions and emerge well-positioned to outperform competitors and take market share. Mainfreight's aim is to pull through without letting go its most valuable assets; its people. The company is seeing its team members reciprocate its loyalty to them - they are proud to be providing an essential service to keep New Zealand and the globe functioning during the crisis.

We have run stress tests on our retirement operators Ryman and Summerset, testing liquidity, cash flow, and balance sheet strength. Ryman has $300m headroom on its debt facilities and Summerset has over $400m, both with no meaningful expiries for 2+ years. Both can withstand large falls in new sales and resales without breaching covenants. Long wait lists and residents often having medical events that necessitate moving into a village or into care mitigates the risk that sales are weak for an extended period of time. This is a time when both operators will provide assurance and comfort for their residents and further build their brand strength.

Companies that are in the eye of the storm

Auckland Airport is a very long duration near monopoly asset, and is priced near our long-term bear case valuation, so we added to the position. People will travel again.

Cinema software provider Vista is in a difficult position. Almost every cinema globally is shut - Vista's customer base is acutely hurting. We have spoken to Vista's management and board a number of times and also had calls with multiple global cinema chains. We have modelled the monthly liquidity position to test if the company can survive a prolonged crisis situation. The long-term story and moat around Vista's core cinema business is intact.

AUSTRALIAN SHARES

Robbie Urquhart, Senior Portfolio Manager

When asked to name the greatest difficulty facing a Prime Minister, legend has it that Harold MacMillan replied "Events, dear boy, events."

Events relating to the spread of the COVID-19 coronavirus have certainly created challenges for the world in the past quarter. As the tragic human toll has risen, government actions to contain the virus have increased. This has created tremendous strain on the global economy and sent equity markets lower.

The ASX200 fell -23.2% (70% hedged into NZ$) over the quarter.

Managing a portfolio through a crisis such as this presents a range of challenges. It also offers opportunity. Our investment team has focused our energies in 3 key areas.

- Firstly, we have had regular dialogue with our portfolio company management teams. With over 50 calls in the last few weeks alone we've sought to gauge how their businesses are faring. We've explored the steps they are taking to mitigate the effects of the economic shutdown. We've focused particularly on the strength of their balance sheets.

  We have continued to be reassured and impressed by the calibre of portfolio company management teams and the actions they have taken to date. They are calmly moving fast to adapt to this environment and are setting their companies up well for the future.

- Secondly, we have selectively increased our weightings in some of our highest quality companies as share prices have fallen a lot because near-term earnings are expected to fall. However these companies are well placed to weather this storm and to strongly benefit when the economy does recover.

- Thirdly, as a team we have been determined not to waste this crisis. There are a number of high-quality companies that we've admired and followed for a long time, but have found to be too expensive in the past. In March we were given a rare opportunity to add one such company to the portfolio, online real estate advertising company REA Group Ltd. As this crisis evolves, we will keep an eye out for other opportunities such as this.

Balance Sheet, Balance Sheet, Balance Sheet

"To win the game you need to stay in the game" is a mantra of our CIO, Frank Jasper. The COVID-19 crisis has been a prescient reminder of this sentiment.

Companies have found their revenues falling fast in response to measures such as lockdowns, designed to contain the virus. Dominos can't sell pizzas in NZ if their stores are shut. Yet they still have costs which are being incurred. Having sufficient cash to pay these costs is paramount. In our calls with our companies we've therefore been focussed on the strength of their balance sheets. How much cash do companies have on hand? How much do they have in available debt facilities to meet their cash outgoings? Without it, they won't be able to stay in the game, much less win it. Incidentally Dominos has a strong balance sheet. In our discussion with them they are rightfully focussed at the moment on helping their franchisees navigate near-term challenges.

The management teams of our portfolio companies have pleasingly been on top of this. Importantly, they are also doing an admirable job balancing both the short and long-term needs of their businesses. As discussed below for example, Next DC is continuing to grow and invest through this slowdown. They're not making short-term decisions such as cutting back on key investments that would likely impair their long-term performance.

oOH!Media ("OML") the leading outdoor advertising (think of billboards on roadsides) company in Australia & NZ was our portfolio company with the most acute need of raising cash. OML's debt levels were fine for most environments, but it had too much debt for a 1 in 100 year event. Balance sheet concerns resulted in the share price falling -70% (in A$) within a few weeks. We had a number of conversations with the company about this and to its credit, it acted fast. By the end of March it had raised $167m in equity and substantially reduced its debt. We participated in the equity raising. OML also improved the terms of its existing bank debt. Amongst other initiatives it is also renegotiating leases on billboard sites to give it more leeway to manage through this period of 'hibernation'. OML is a well-run, albeit cyclical business. Its longer term competitive position remains sound. OML's capital raising keeps it in the game.

Data centre operator Next DC is a rare company benefitting from this crisis. Its share price rose +13% in March. With ample access to money through cash on hand and debt facilities in place, Next DC is well placed to fund its growth through this period. Data Centres are deemed an essential service in Australia so it can keep investing and expanding through the economic hibernation.

What's more, as CEO Craig Scroggie reiterated on a number of calls we had in the month, demand for data centre services has risen throughout March. Companies have had to embrace the 'working from home' model. This has accelerated the structural shift from having computing data stored on servers in offices to having it stored in the 'cloud', which is exactly what Next DC provides at its data centres. Companies have been scrambling to speed up this transition during the crisis to better enable employees working remotely. We think this shift is structural. When business gets back towards normality, companies are not going to revert to office servers. Those that still have them will likely move to them to data centres as fast as they can. Next DC is well placed to benefit from this trend.

Portfolio Changes

As the crisis unfolded in March we began re-weighting some of our positions. Share prices of most of our portfolio companies fell sharply in the month, including our highest quality companies. This has given us the opportunity to add to our higher quality company shareholdings at materially lower valuations. We have helped fund these changes by reducing our weightings in companies that have narrower competitive advantages and/or that do not offer the same return potential. These changes strengthen the overall mix of the portfolio.

To this end we increased our weightings in the Australian banks, ANZ, CBA, NAB and Westpac in the middle of March. The banks valuations have fallen as low as they have been since the recession in the early 1990s. The banks enter this crisis with the strongest balance sheets they've had in decades and are well positioned to weather the storm.

We have also increased our weighting in pallet manufacturer Brambles and have added selectively to positions including Credit Corp, and Wisetech. After initially decreasing our weighting in online employment advertising company Seek in February before the market fell, due to our rising concerns about the COVID-19 economic fallout, we have subsequently added to our position.

To help fund these moves, we have exited our shareholding in retirement accommodation provider Ingenia. We also reduced our weighting in Rio Tinto, Dominos Pizza Enterprises, ARB Corporation and Link Group.

Every crisis breeds opportunity

We have been following REA Group Ltd for a long time. It is Australia's dominant online real estate advertising business. Almost all real estate agents across the country advertise houses for sale on the site.

REA's near term earnings will be impacted as the economy enters hibernation. However the long-term prospects and REA's competitive positioning remains really strong. People will resume buying and selling houses at some point in the future. When they do, REA stands to benefit.

REA has a strong balance sheet enabling it to weather the storm. The drop in REA's share price in March offered us a rare opportunity to buy shares in the company at a reasonable valuation, and we are pleased to have added such a high quality company to the portfolio.

SELECT INTERNATIONAL SHARES

Ashley Gardyne, Senior Portfolio Manager

With coronavirus bringing much of the global economy to a sudden halt, the pandemic has quickly escalated from a health crisis to one of the most dramatic economic and market events in decades. Healthcare workers, governments and central banks have sprung to work to tackle both the pandemic and the economic ramifications, however uncertainty reigns in markets as investors grapple with the ultimate path to resolution.

Global markets plunged in the first quarter, with the US S&P 500 Index falling -20% - its worst quarterly performance since 2008. Major global markets followed suit, including Europe (-23%), Japan (-20%), and emerging markets (-24%). While falling markets have pulled most stock prices lower, the impact has not been uniform across all businesses - with those in the travel & hospitality, banking and energy sectors hit hardest.

Safety first, with an eye on new opportunities

Our primary focus at the moment is on safety and capital preservation. This means updating our work on the financial strength and liquidity position of each of our companies, and assessing how they will weather a protracted economic downturn. After spending the last month on this exercise we are as confident as ever in the financial strength of our portfolio companies. A large number of our portfolio companies have significant cash holdings (like Alphabet, Facebook and PayPal), and all of them are highly profitable. Those with some debt have relatively low gearing and limited repayment requirements in the next few years.

Our secondary focus, which will become a higher priority in the weeks ahead, is to use the market declines to identify the most compelling new investments to add to the portfolio. We have a watch list of companies we have long admired, and the recent market sell-off now means many of these are trading at significantly more attractive valuations.

Performance and the impact of coronavirus

The biggest contributors and detractors to portfolio performance this quarter were companies that were impacted (both positively and negatively) by coronavirus or its impact on the economy.

Starting with the negative side of the ledger, the two worst performers in the portfolio this quarter were aerospace supplier Hexcel and Signature Bank. We have spoken with both of these companies in recent weeks. While they are in industries feeling the brunt of the coronavirus impact, we feel confident in their ability to weather the storm and outgrow their respective industries longer term.

Hexcel is one of only three providers of carbon fibre composites to aircraft manufacturers like Boeing and Airbus. While aircraft production will be reduced significantly in the near term, Hexcel managed well through prior periods of weakness in the aviation sector (9/11, SARs and the global financial crisis) and a lot of the company's cost base is variable and can be reduced quickly in response to falling demand. With no debt repayments due until 2024, and undrawn credit facilities available, we believe the company has ample liquidity. Longer term Hexcel's growth story remains compelling - aircraft manufacturers will continue to add more carbon fibre to new aircraft to reduce weight, fuel costs and carbon emissions.

Signature Bank fell with the broader banking sector on concerns that lower interest rates will reduce bank net interest margins. While Signature Bank is not immune to this interest rate environment, we like the business because of its conservative lending standards and strong growth profile compared to peers. A large portion of its lending is backed by real estate (at conservative loan-to-value ratios of c.60%) and during the financial crisis the company reported loan loss rates that were a fraction of large US banks like Wells Fargo and Bank of America. Signature Bank were viewed as a relative safe haven in the global financial crisis and it saw deposit growth jump significantly in 2008 and 2009. We see Signature Bank weathering the storm well and ultimately benefiting from strong deposit and loan growth as they continue to hire new commercial banking teams.

On the positive side of the ledger, Amazon and Dollar General contributed significantly to our performance.

We added Dollar General to the portfolio last year due to its defensive nature and the fact that its sales hold up well in weak economic environments. They have been an unexpected beneficiary of coronavirus, with high consumer demand for basic food and household items ahead of lockdown driving a jump in sales. While this is just a short-term spike, we would expect Dollar General to benefit from the broader economic fallout and higher unemployment – with many consumers trading down and shopping at lower priced discount retailers.

Amazon's e-commerce business has also been a significant beneficiary of high demand for household necessities and a preference for delivery. Demand has been so high that Amazon are trying to hire an additional 100,000 workers in fulfilment and delivery. Longer term we see the potential for these recent changes in consumer behaviour to accelerate the trend towards online shopping. Particularly for categories like groceries, which until recently have gained limited traction online. Amazon's cloud business is also likely to be a long-term winner as coronavirus has highlighted the benefits of companies having their IT infrastructure and software hosted in the cloud.

Strategy and recent portfolio changes

The current environment is presenting more compelling investment opportunities than we have seen in quite some time. To capitalise on this environment we are methodically reviewing our existing holdings and working our way through our watch list of investment ideas - to ensure we are invested in the companies we think will deliver the best returns for clients over the next five to ten years. While in many cases these will be the companies we already hold – like PayPal and Alphabet – we are likely to add fresh companies to the portfolio in the coming months.

We added to a number of our high conviction holdings during the quarter, including Amazon, Edwards Lifesciences, Facebook and PayPal, and we also added two new companies to the portfolio – Gartner and Starbucks. We funded these new investments by exiting our holdings in Ecolab, Fresenius Medical Care and Electronic Arts.

Gartner is a leading research, consulting and advisory company. Its information technology research service is seen as a must-have at most large corporates and is used by 75% of Fortune 1,000 companies. Gartner provides IT industry research to help businesses make critical decisions (such as the selection of new software vendors), or to simply better understand current best practice in areas like cybersecurity or cloud deployment. The company has a strong track record of growth, with its earnings per share growing by 13% per annum over the last decade. We see this growth continuing, with over 100,000 businesses globally that could use Gartner's services, of which just over 13,000 are current customers.

Starbucks is the undisputed global leader in specialty coffee. It has over 30,000 coffee stores globally, to which it is adding another 2,000 stores each year. Starbucks has a strong brand, as well as high customer loyalty and repeat purchase behaviour. Despite being a 50 year old chain, they continue to rollout new stores globally and have extremely good store economics - with high profit margins and returns on new store openings. Starbucks also has a compelling growth story in China, where they currently have 4000 stores but believe they can ultimately have as many stores as they do in the US (15,000).

We invested in Starbucks in the midst of the market falls in March. The company's operations have been temporarily impacted by coronavirus, with Starbucks recently closing its US stores, having previously closed most of its Chinese stores for a number of weeks. The company's share price was hit hard by the closures, and when we added it to the portfolio in March it had fallen almost 40% from its highs. We believe the market is overreacting to these short-term developments. They have ample liquidity to cover store closures for a significant period of time, and they have already managed through coronavirus in China, with 95% of stores already back in operation. While it may take the US longer to get back on its feet than China, most of us will still have our coffee addictions when this is all over.

Final thoughts

Coronavirus is a frightening pandemic that also has serious economic and market ramifications. But society has faced other serious challenges before. Pandemics, world wars, oil and inflationary shocks and financial crises. Every time we are in the midst of these events the path to normality is highly uncertain. During the global financial crisis no one knew what the path to recovery looked like, or what actions would be needed by governments and central banks. But eventually we got there - through trial and error - until the right solutions were found. It will be the same with coronavirus. The path from here is uncertain, but we will get through this crisis like the ones before it.

We remain confident in the prospects of our portfolio companies. The portfolio contains a hand-picked collection of the world's best businesses, which we believe will ultimately weather the storm and continue to grow strongly in the years ahead.

PROPERTY & INFRASTRUCTURE FUND

Sam Dickie, Senior Portfolio Manager

Markets

There is no starker reminder that the COVID-19 crisis morphed from concern about revenue holes to a concern about balance sheet holes than the relative performance of our benchmark indices. Australian property (-35%) and NZ property (-21%) are considered defensive in a normal equity market correction but sharply underperformed global equities (-13%). This happened in the GFC too when property was considered defensive until it became clear that tenants couldn't afford to pay rent and then the focus became almost solely about their balance sheets.

Companies that should trade well through the COVID-19 crisis

American Tower and Crown Castle have learned from the early 2000's tech bust and have appropriately geared balance sheets with good liquidity and tenor of funding, plus the businesses continue to be highly cash generative. This is also true of their mobile carrier customers, who still have capacity to invest in their networks, benefiting the tower companies. This critical cellular network infrastructure is worth its weight in gold more than ever with millions of Americans working from home.

Companies that have more defensive earnings streams

The bulk of Infratil's portfolio is well positioned to endure COVID-19, namely data and communications investments Canberra Data Centres and Vodafone NZ, plus electricity investments Trustpower and Tilt. Although Wellington Airport is operating well below capacity, this only comprises 12% of Infratil's net asset value and is actually much less reliant on international travel than Auckland Airport. The balance sheet is in a solid position - we think Infratil has more than twice as much in sources of capital as it is likely to have uses for capital over the next 12 months.

Companies that have more economically sensitive earnings streams and heavier debt burdens

The New Zealand property sector generally has contracted rental income but many tenants are under pressure and this impacts their ability to pay rent. We spoke to all our companies and recognised the risks especially to the retail sector (Kiwi Property and Stride Property) and trimmed our positions in advance of NZ moving beyond Alert Level 2. We learned in the Global Financial Crisis that even sectors normally considered defensive can still become exposed in a crisis.

Australian property has similarly been impacted with its retail mall-heavy index suffering big losses. Our childcare landlords Arena and Charter Hall Social Infrastructure have also been impacted as their operators' centres feel the pinch from parents moving their children home (although centres have actually been encouraged to remain open). The Australian Government is supporting the centres by relaxing the conditions for its Child Care Subsidy, to ease the strain on operators and allow them to continue to earn income. This Government does not want to see the sector overly weakened as it will need it to support an economic recovery. Our landlords have strong balance sheets and have focused on high-quality operators but they may need to share some of their tenants' pain in the short term.

We have tested Union Pacific's and Norfolk Southern's liquidity and ability to ride out a cyclical economic downturn. Fortunately, they are better prepared than most companies for two key reasons. Firstly, they are good at adapting to cyclically changing demand conditions, having seen an industrial economy recession in the US in 2016 and have been dealing with softer volumes since late 2018. Secondly, they have been in cost-cutting mode after both implementing Precision Scheduled Railroading for the last year and so have the mentality of periodically redesigning the network with a "clean sheet" of paper and doing more with fewer resources. They are high-margin businesses and so will remain cash flow generative and also have large amounts of cash and undrawn credit lines.

Companies that are in the eye of the storm

Auckland Airport is a very long duration near monopoly asset, and is priced near our long-term bear case valuation, so we added to the position. People will travel again.

Our conversations with Vienna Airport and Zurich Airport show both are receiving government support for their employees' wages. Both companies have sufficient liquidity to ride the crisis out, provided traffic partially recovers in the second half of the year. Airports are far better positioned than most airlines that also have large fixed cost bases, but operate on thin margins and don't have the benefits of owning property or other more stable revenue streams. We expect most airlines will survive but some will need government bailouts and see value permanently destroyed for existing shareholders.

FIXED INCOME

David McLeish, Senior Portfolio Manager

Market Recap

The rapid pace at which the COVID-19 outbreak spread across the globe and the countering social, monetary and fiscal policy responses were the defining events for global financial markets, causing a bout of volatility unrivalled since 1931.

The level of both fiscal and monetary policy accommodation is unprecedented but so too is the economic fall-out from mass global lock-downs.

The Official Cash Rate was cut to 0.25% and Quantitative Easing (QE) was launched by the Reserve Bank of New Zealand. This caused floating rate notes, which have a 3-month resetting interest rate (or coupon) based off the 3-month Bank Bill Index, to underperform equivalent fixed rate bonds

In response to the country-wide lockdown, the perceived risk of non-payment of interest and / or principle from borrowers across the fixed income market rose strongly in March. This credit (or default) risk is low in a high-grade investment portfolio. But given the extreme uncertainty surrounding the impact of the virus, the ability of all bond issuers to make good on their financial commitments is being questioned. As a result of this, investors now demand a higher expected return to compensate for the higher perceived risks of an investment. This has resulted the price of most investments falling.

The impact of rising credit spreads was most acutely observed in bank-issued bonds during March as banks face both a rise in bad loans and falling profitability. That said, we believe New Zealand's major banks are well capitalised and should be able to weather the ensuing storm.

We also see them playing an important role in the dispersion of fiscal and monetary aid during this down turn. They are therefore likely to benefit from meaningful support themselves. In short their continued strength is of paramount importance.

We believe the recent sell-off in the bank-issued bonds has markedly improved their value and as such now look attractive over a medium term perspective.

Uncertainty surrounding the economic impact of the virus also caused secondary market trading activity to fall dramatically during March. Consequently, bond prices of even the highest rated, and previously most liquid assets, such as New Zealand Government bonds experienced intra-month volatility which has never been seen before. This has caused investors to (temporarily) assign a higher "liquidity premium" to fixed income investments across the market.

In addition, we also observed investors liquidating portfolio holdings of high-grade fixed income investments in order to raise cash to meet immediate cash flow requirements. This acted to further amplify the sell-off in such investments during March.

Mid-Month Update: April

Global fixed income markets have stabilised during the first two weeks of April. The greatest contributor to this was undoubtedly the US Federal Reserve's decision to combine forces with the US Treasury to intervene in the corporate bond market (for the first time in history).

The decision to not only begin purchases of Investment Grade corporate debt but to include recently downgraded (fallen angels) borrowers and High Yield exchange traded funds was highly unexpected. Decisions such as these are likely to be extremely hard to unwind, at least in the near term. It is for this reason many believe a strong backstop to corporate defaults in now in place.

Domestically, the Large Scale Asset Purchase (LSAP) programme initiated by the RBNZ in March has also had a strong and calming influence on fixed income markets. The RBNZ has also expanded the scope of the LSAP to include debt issued by the Local Government Funding Authority (LGFA).

General risk appetite outside the parts of the market which are being directly influenced by central bank actions remains muted.

Outlook & Strategy

This extremely rare and difficult to predict event, a true black swan, has caused widespread disruption to financial markets. We see this as both a challenge and an opportunity.

The OCR has now likely reached its lower bound. While yields remain this depressed, ultra-high-grade fixed income returns are likely to be constrained. However, higher credit spreads on bank and corporate paper now offer investors, with a longer-term focus and capital to deploy, historically attractive entry points.

Since late March, credit spreads on local bank and other high-rated corporate bonds have retraced some of their recent widening. But with economic uncertainty remaining high, trepidation is to be expected.

We are cautiously adding credit risk in our portfolios through very select company exposure at present. Our strategy is to slowly deploy capital during periods of particular weakness in what we believe could be a 12-18 month process.

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MARKET MOVEMENTS

As at 31 March 2020

Stock Markets*	Closing Values	Changes over: 1 Mth %	3 Mths %	6 Mths %	12 Mths %
S&P Developed LargeMidCap - (Local Curr)	706	-12.4	-19.6	-13.5	-8.9
S&P Developed LargeMidCap ($NZ)	N/A	-12.4	-12.6	-12.6	0.2
S&P Global LargeMidCap ($NZ)	N/A	-9.2	-10.2	-9.0	2.9
USA - S & P 500	5269	-12.4	-19.6	-12.3	-7.0
USA - Nasdaq	9068	-10.0	-14.0	-3.2	0.7
Japan - Topix	2168	-6.0	-17.5	-10.4	-9.5
UK - FTSE100	5317	-13.4	-23.8	-21.8	-18.4
Germany - DAX	9936	-16.4	-25.0	-20.1	-13.8
France - CAC40	11995	-17.0	-26.1	-22.1	-15.0
HK - Hang Seng	68685	-9.5	-15.9	-8.9	-15.7
Australia - S & P 300	54885	-20.8	-23.4	-22.9	-14.5
NZ-S&P/NZX 50 Gross Index (inc imp credits)	11945	-12.8	-14.5	-10.0	0.4
NZ-S&P/NZX 50 Gross Index (excl imp credits)	9797	-13.0	-14.8	-10.3	-0.5
Market Volatility - VIX	53.5	33.5	288.5	229.7	290.5

New Zealand Property		%	%	%	%
S&P/NZX All Real Estate (inc imp credits)	1510.3	-20.6	-20.3	-20.6	-2.9
S&P/NZX All Real Estate (exc imp credits)	1443.5	-20.7	-20.4	-20.9	-3.7

Ten Year Bonds	%	Yield Changes			
USA	0.62	-0.51	-1.30	-1.06	-1.79
Japan	0.02	0.16	0.04	0.25	0.12
United Kingdom	0.33	-0.09	-0.49	-0.13	-0.76
Australia	0.76	-0.06	-0.62	-0.20	-1.02
New Zealand	1.08	0.03	-0.58	-0.01	-0.72

90-Day Interest Rates	%	Yield Changes			
USA	0.11	-1.16	-1.44	-1.77	-2.29
Japan	0.07	0.00	0.00	0.00	0.00
United Kingdom	0.60	-0.08	-0.20	-0.16	-0.25
Australia	0.36	-0.44	-0.57	-0.58	-1.42
New Zealand	0.49	-0.57	-0.80	-0.66	-1.36

Bond Indices	Closing Values	Changes over: 1 Mth %	3 Mths %	6 Mths %	12 Mths %
S&P/NZX Bank Bills 90-Day	732.22	0.15	0.38	0.68	1.55
S&P/NZX NZ Government Bond Index	1898	-0.10	3.47	0.46	5.28
Barclays Capital Global Aggregate Index (Hedged NZD)	N/A	-1.67	1.37	0.72	6.02

Hedge Funds & Commodities		%	%	%	%
HFRX Global Hedge Fund Index (USD)	1204	-5.9	-6.9	-4.5	-1.4
DJ-UBS Commodity Index Total Return	132	-12.8	-23.3	-19.9	-22.3
Gold (US$/ounce)	1583.40	1.2	4.2	8.0	22.5
Oil (US$/barrel)	25.94	-49.4	-61.7	-57.5	-61.8

Currencies		%	%	%	%
NZD / USD	0.5928	-4.4	-12.1	-5.5	-13.1
NZD / EUR	0.5403	-4.3	-10.1	-6.1	-11.0
NZD / GBP	0.4781	-1.5	-6.1	-6.0	-8.6
NZD / AUD	0.9686	0.7	0.9	4.2	0.9
NZD / YEN	64.00	-4.3	-12.7	-5.6	-15.2
Trade Weighted Index	68.77	-3.6	-5.4	-2.8	-7.4

**Total Return Indices. Indices are net of offshore tax.*
Source: Thomson Reuters Datastream