Financial market volatility

19 March 2020

Financial market volatility

The past few weeks we have witnessed some of the most difficult conditions in financial markets since the global financial crisis. As at 19 March (5pm South Australian time):

- The Australian sharemarket has fallen over 30% from its peak on 20 February 2020.
- The US sharemarket has fallen 29% from its peak on 19 February 2020.

Share markets around the world have continued to fall materially in reaction to the global spread of coronavirus (COVID-19).

Economic impact

From a financial markets perspective, the pandemic has particularly caused concerns around interrupted supply chains and the negative impact of the virus on global economic growth.

In response, over the past week central banks and governments from around the world have intervened to provide significant liquidity, interest rate cuts, and fiscal stimulus to assist businesses and households in dealing with this highly disruptive event.

- In the US, the Federal Reserve has cut interest rates to near zero and announced a $700 billion stimulus program.
- The Eurozone, UK, Japan, Canada, Switzerland, and New Zealand have also undertaken initiatives to increase liquidity in the financial system.
- In Australia, the RBA Cash Rate has been cut to a historic low of 0.25%. The Australian Federal Government also announced a fiscal stimulus package of over $17 billion to address the potentially significant economic consequences of the virus. State governments too are complementing these initiatives with stimulatory packages.

More actions and announcements from central banks and governments around the world are expected as the impacts of the virus unfold.

The flow on effects of the virus to business revenues, employment, income and consumption are being closely watched. While the full effects of the virus are yet to be determined, equity markets are likely to remain volatile.

Funds SA is constantly monitoring and reviewing the appropriateness of the investment strategies and managers. Changes to the strategy are made to achieve the best outcome for members.

How is this volatility impacting the superannuation options?

The fall in share markets will have a negative impact on the unit prices of all investment options, with the exception of Cash.

Although portfolios are not immune to the volatility stemming from share markets, the asset mix, including high quality bonds, property, private equity and other unlisted assets, have helped to lessen the gyrations and deliver a smoother return profile for members.

Notwithstanding the negative impact on investment returns of the past few weeks, the best long run guide to the investment outcomes of the options is their investment objectives. For example, the Growth option is targeting a return averaging 4% above the inflation rate when measured over long-term periods (of at least 10 years).

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The expectation of negative returns

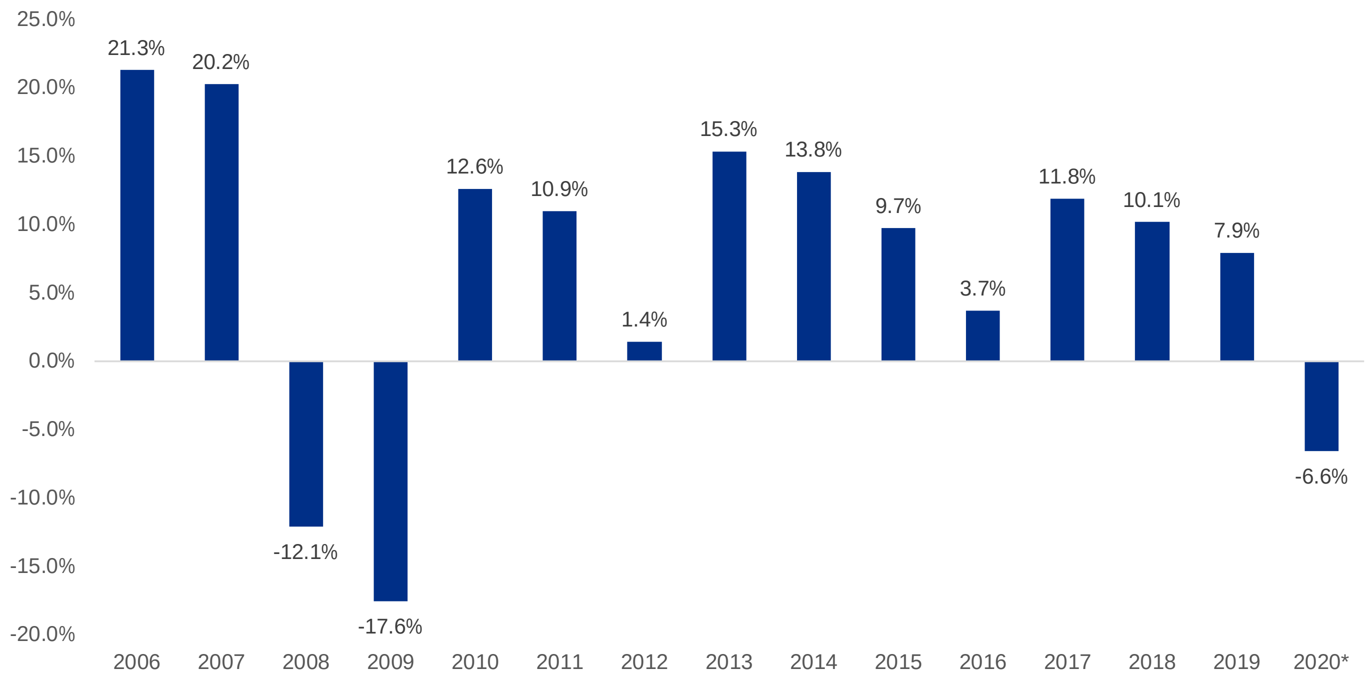
One of the most important concepts to consider when making an investment decision is that of risk and return. All investments, including super, have some level of risk.

Members should be aware that capital losses are possible, depending on the investment option(s) chosen and their performance over time. Fluctuations in investment markets will have on-going impacts on performance. This volatility is a normal part of investing and can occur with money you may have in other super funds, the share market and other types of investment.

Each option's investment objective provides an indication of risk by stating the number of negative annual returns likely to be experienced over any 20-year period. For example, for the Growth option it is expected that the investment strategy will result in between four to six negative annual returns over any 20-year period. This means that the risk of a negative return in any single year is between 20% and 30%.

The Chart below illustrates the annual returns of the Growth option since inception in 2005.

Chart 1: Growth option annual returns to 30 June*



* 2020 FYTD ending 17 March 2020

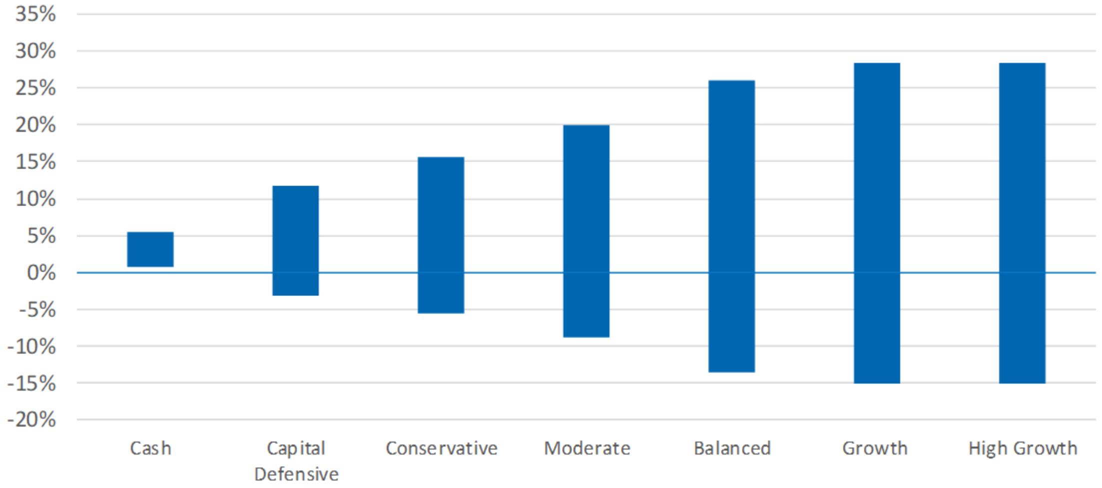
Looking back over the 14-year history of the growth fund, it has recorded a negative return for financial year periods 2 times, with a third negative bar currently showing for the 2019-20 financial year to date. This experience is broadly in line with expectations (4 to 6 years in 20).

However, the magnitude of loss for the 2019-20 financial year is as yet unknown.

The expected range of annual return outcomes also provides an indication of risk. This varies between the options. Generally, the options that offer the highest potential long-term returns also come with the widest range of returns including the possibility of negative returns. Options that offer the lowest potential long-term returns come with the narrowest range of returns and greatest likelihood of positive returns.

Each of the investment options has a different level of risk and return, as shown in the graph below.

Chart 2 Expected range of returns over a 1-year period*



* Note there is approximately a 5% chance that the return could lie outside of this range.

Understanding your attitude to risk is important. Note that this may change over time. Members may wish to periodically review their investment strategy to make sure it still meets their needs.

Switching investment option is an important decision

It's not easy to time entry to, or exits from, markets. Selling out of more risky options (i.e. those options with larger allocations to assets such as shares and property) and switching into less risky options (such as cash and options with higher allocations to fixed interest) can be costly over the longer term as it effectively locks in the losses which result from poor investment markets. As well, it is possible to miss out on future growth by being out of the market when it recovers.

We understand members may be concerned about the impact of market movements on their super. We encourage members to think about their super as a long-term investment generating a return over multiple years. We suggest members don't focus narrowly on short-term results.

Many members seek professional financial advice, especially those members approaching or in retirement.

There are a number of investment options offered to suit members with differing risk appetites and time horizons.