Financial market update

Fortnight ending 5 June 2020

Over the past few months we have witnessed some of the most difficult economic and financial market conditions. Given the extent of the market volatility, we are providing the following update.

Financial market volatility

Sharemarkets fell significantly between 20th February 2020 and 23rd March 2020 (falling over 30% in most global markets) and have since made a meaningful recovery.

The most important sharemarkets for Australian superannuation investors are Australia and the United States.

As at the close of business on Friday 5 June 2020:

- The Australian sharemarket is now 16% below its peak recorded on 20th February 2020.
- US sharemarket is now 6% below its peak recorded on 19th February 2020.

Sharemarkets world-wide are likely to remain volatile as each economy manages the social and economic impacts of the coronavirus.

Key themes impacting markets

The recent strong recovery in sharemarkets has been driven by the push to re-open economies by progressively relaxing economic and social restrictions in the short term. This has come earlier than investors were previously expecting, and they are currently prepared to look beyond the very low expected company earnings over the remainder of 2020.

A belief that Government support will continue for as long as required has been a key factor in allowing investors to focus on the recovery in economic outcomes beyond COVID-19, or at least until such time as a vaccine or superior treatments for the disease have been developed.

US employment figures released on 5 June, whilst very high, proved to be far less dire than expected and have provided additional impetus to the Equity market recovery.

The key watch points for investment markets over the coming months are the path to economic recovery and the ability to reduce the numbers of confirmed COVID-19 cases and/or avoid a second wave of infections.

- The impact of the COVID-19 virus has caused a synchronised contraction across the global economy. Economic data for some time will reflect the extremely weak environment. In Australia, GDP figures showed negative economic growth for the March quarter. June quarter data is also expected to be negative, seeing Australia in a ‘technical recession’ (two quarters of negative growth) after a 29-year run of economic growth. In the US and UK contractions in economic growth are expected to be significantly larger (contractions of 20% to 30% plus vs around a 10% or less contraction in Australia).

- The phased re-opening of economies is highlighting sectors that may take longer to recover or are at greater risk of continuing as a going concern: such sectors include retail, hospitality, leisure, travel and the higher education sector. At the same time, organisations are thinking through what the ‘new normal’ may mean for their business models – the trend to on-line shopping, employees working from home and how to localise/diversity supply chains being key considerations.

- Globally, government initiatives are aimed at hastening the pace of recovery and supporting specific industries in need. Unprecedented levels of fiscal stimulus continue to be announced. Central banks are also providing support to businesses and households, maintaining historically low interest rates and introducing measures aimed at the smooth functioning of financial markets. In Australia the cash rate is at an historic low of 0.25% and the Reserve Bank of Australia has said it will do whatever necessary to ensure bond markets remain functional.

- The number of confirmed COVID-19 cases now numbers over 7 million with key hotspots being the US, Brazil, Russia and the UK.

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

How movements in share markets impact your superannuation option?

Movements in share markets (up and down) impact the unit prices of all investment options, with the exception of Cash. As unit prices change so does the overall value of your superannuation balance.

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 short-term fluctuations in share markets, 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).

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*

Returns net of fees and gross of tax

* 2020 FYTD ending 30 April 2020

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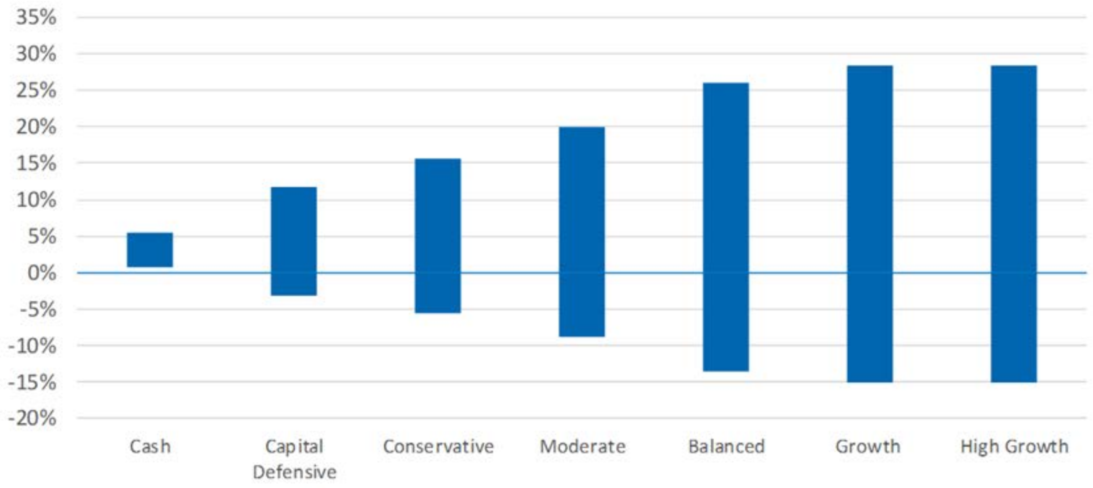
Looking back over the 14-year history of the growth fund, it has recorded a negative return for financial year periods 2 times, with a third bar currently showing for the 2019-20 financial year to date. This experience is broadly in line with expectations (4 to 6 years in 20).

However, the magnitude of loss for the full 2019-20 financial year is yet to be known and won't be determined until after 30 June 2020.

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 investment option 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. You may wish to periodically review your investment strategy to make sure it still meets your needs.

Switching your 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 that you may be concerned about the impact of market movement on your super. We encourage you to think about your super as a long-term investment generating a return over multiple years. We suggest that you 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.

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