Financial market update

Fortnight ending 8 May 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 partial recovery.

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

As at the close of business on Friday 8 May 2020:

- the Australian sharemarket has risen 3% since its close two weeks ago on Friday 24 April. The Australian sharemarket is now 25% below its peak recorded on 20 February 2020.
- the US sharemarket has risen 3% since its close two weeks ago on Friday 24 April. The US sharemarket is now 13% below its peak recorded on 19 February 2020.

Key themes impacting markets

For the two-week period ending Friday 8 May 2020 the main events impacting on investment markets included:

- The dichotomy between the optimism surrounding the opening up of economies and support provided by the very large government stimulus measures versus the negative sentiment relating to the release of shorter term economic data/forecasts.
- Steps have been announced in Australia and a number of other countries to ease restrictions on the economy and social activity, all while maintaining a ‘COVID safe’ environment.
- Countries are very conscious of the process and pace at which economies re-open, keen to avoid a second wave of COVID-19 infections. Social distancing, strong hygiene and international travel restrictions remain in place indefinitely.
- The impact of the COVID-19 virus has caused a synchronised contraction across the global economy, and in some countries (such as the UK), this looks to be an economic shock larger than the Great Depression of the 1930’s. Budget deficits, debt to GDP ratios, jobs, productivity and retail spending data show signs of this outcome. A key concern is the potential for structurally lower demand across many sectors as we move into the ‘new normal’.
- In the US, GDP fell by an annualized 4.8% in the first quarter of 2020 while the number of Americans filing for unemployment benefits since the beginning of the coronavirus rose to 33.5 million, representing 22% of the working age population.
- In the UK, the Bank of England estimates GDP will reduce by 25% this quarter, with unemployment rising to 9%.
- In Australia the Treasurer announced the economy will lose $4 billion for every week the coronavirus restrictions stay in place and estimated the economy is likely to shrink 10% in the 3 months ending June. Close to 1 million people have lost their jobs due to the impact of the virus during the 5 weeks to 18 April.
- Central banks around the world continue to provide support to businesses and households, maintaining historically low interest rates and introducing measures aimed at the smooth functioning of financial markets. The Reserve Bank of Australia left interest rates at an historical low of 0.25% in May and expanded its lending program to include corporate bonds, a move aimed at improving trading conditions in the corporate bond market.
- The number of confirmed COVID-19 cases now numbers close to 4 million, with just over 30% of these confirmed cases reported in the US.

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Economic impact of COVID-19

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.

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.

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

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 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.

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Chart 1: Growth option annual returns to 30 June*

Returns net of fees and gross of tax

* 2020 FYTD ending 30 April 2020

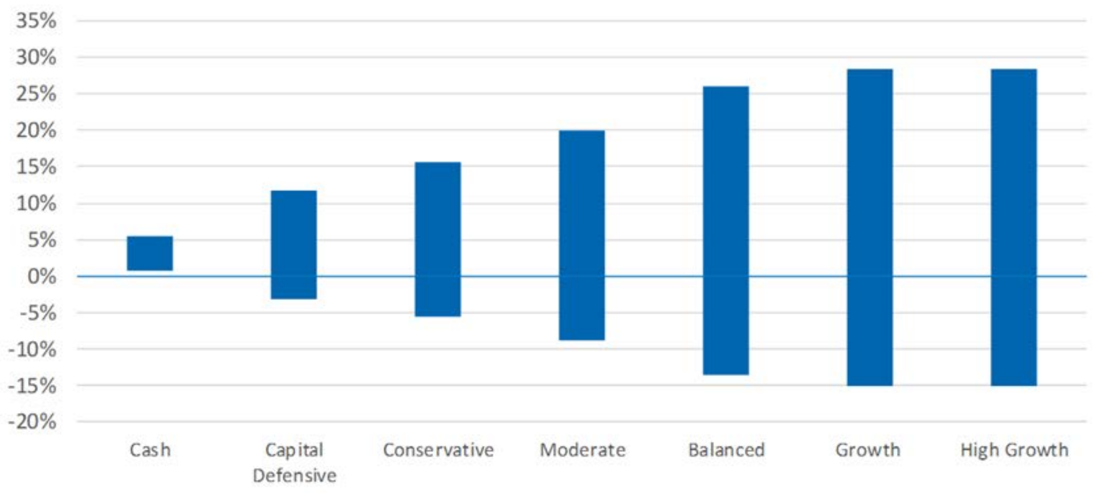
Looking back over the 14-year history of the growth fund, it has recorded a negative return for financial year periods 2 times, with a third bar currently showing for the 2019-20 financial year to date. This experience is broadly in line with expectations (4 to 6 years in 20).

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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