Financial market update

Fortnight ending 22 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 22nd May 2020:

- the Australian sharemarket has risen 2% since its close two weeks ago on Friday 8th May. The Australian sharemarket is now 23% below its peak recorded on 20th February 2020.
- the US sharemarket has risen 1% since its close two weeks ago on Friday 8th May. The US sharemarket is now 13% below its peak recorded on 19th February 2020.

Key themes impacting markets

For the two-week period ending Friday 22nd May 2020 the main events impacting on investment markets included:

- Optimism surrounding the phased re-opening of economies and hopes of a vaccine to stimulate an immune response against the coronavirus buoyed the market.
- The impact of the COVID-19 virus has caused a synchronised contraction across the global economy, weighing on markets. Economic data continues to reflect this extremely weak environment.
    - In Australia, the jobs market data for April revealed the largest monthly fall in employment since the period following WWII. Close to 600,000 jobs were lost in April and hours worked fell 9.2%. The JobKeeper program stopped many people registering as unemployed and prevented the unemployment rate rising above 6.2% in April (from 5.2% in March). More than 3.5 million people across 860,000 businesses are now on JobKeeper payments which are currently planned to end in September 2020. It is estimated the jobless rate would have been 11.7% were it not for the program.
    - Australian retail sales recorded its worst ever monthly decline in April, down -17.9%, following an +8.5% increase in retail sales in March which reflected pandemic hoarding, particularly the stockpiling of food.
    - In the US, 38 million Americans have filed for unemployment claims to date because of the impact of the coronavirus pandemic.
- Governments have been grappling with how to restart business activity in a 'COVID-safe' way and whether additional government support is needed.
    - The Chinese government abandoned the practice of setting an annual target for economic growth and said it would increase stimulus to support employment and investment. Their economy is reliant to some extent on other countries controlling the spread of the virus and the re-commencement of global trade.
- 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. In Australia, the RBA commented that it would be unlikely that the cash rate would fall below zero, saying the policy may not benefit the economy. The Australian cash rate, at 0.25%, is at an historic low.
- Meanwhile organisations globally 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.
- Trade tensions between Australia and China escalated due to the blocking of beef exports from 4 Australian abattoirs, movement towards 80% tariffs on barley and new inspection regulations for iron ore imports.
- The number of confirmed COVID-19 cases now numbers over 5 million, with just over 30% of these confirmed cases reported in the US. Along with the US, Russia, Brazil and the UK are all recording large numbers of COVID cases.

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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

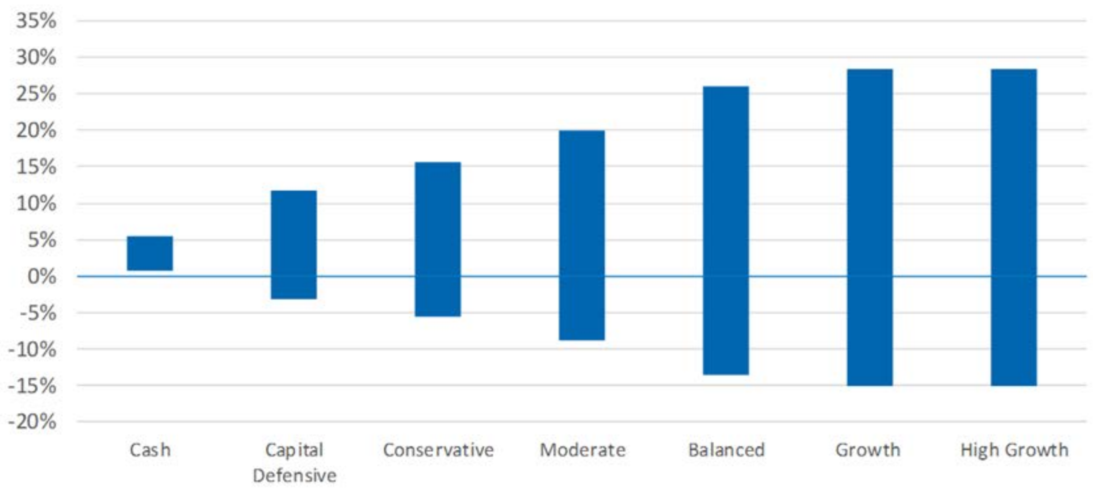
Looking back over the 14-year history of the growth fund, it has recorded a negative return for financial year periods 2 times, with a third bar currently showing for the 2019-20 financial year to date. This experience is broadly in line with expectations (4 to 6 years in 20).

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.