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Asset Management

The Coronavirus: Asking the right questions

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Emotionally reacting to any situation inevitably leads to regret. When I used to coach hockey I would insist that parents wait 24 hours before talking about their child's situation. Using a cooling off period would help not only parents, but also coaches, put things into perspective. This approach is also important in investing. Rarely do you get a once in a lifetime opportunity to buy or sell. If you do either of these swayed by emotion, you are likely to get it wrong. The key question for investors is, if the Coronavirus infections were to expand, how does this impact a particular company's valuation?

The answer to this question is certainly not zero, nor is it necessarily what it was worth two weeks ago. How do we value companies given this period of uncertainty? For us, the value of a stock is the discounted value of its future cash flows. By adjusting our typical approach, we can incorporate the potential impacts of Coronavirus into our valuation. This enables us to determine whether we should be concerned, or at what price we would be interested in buying those companies.

For a given company, let's assume that for the next two years, they have zero earnings and then resume normal activity without any catch up. If you believe that this scenario is very likely, then you have about another 10% downside from where we are today.

You can also assume a more moderate scenario of flat earnings for two years and then business returns to normal. In this outcome, the downside risk is about 5% or so from current levels. Of course, you can calculate the results using different scenarios but the key point is that for an individual to be aggressive and sell a significant amount of their equity position, we are quickly getting to levels where you need to believe the earnings will be wiped out for years to come – certainly not something we expect.

Ultimately, it is difficult to see a decline similar to what we saw in 2008 or 2000 unless there is a systemic problem that bankrupts part of the economy much like how the 2008 financial crisis impacted financial institutions. The increased regulation of the entire financial system has made the likelihood of such an outcome unlikely. That said, the fear of such an outcome is causing investors to flee the equity market.

What could make the Coronavirus situation better or worse will be the response of the central banks and governments. Unlike other crises, this situation will unlikely be helped by simply lowering interest rates or cutting taxes. Both of these responses are meant to stimulate demand in the marketplace. Unfortunately, a rate cut today will not lure people out of their homes to buy a car or go to a restaurant.

The Coronavirus crisis, if it continues, will require central banks working with regulators to grant credit on favourable terms to businesses to allow them to survive. The implications of the current state includes disruptions to supply chains and reduced demand. As a result, businesses might see their inventories of incomplete goods increase as they wait for key parts or materials. In addition, they may need liquidity to buy time until customer demand returns. The companies in our portfolios have strong balance sheets and are not as vulnerable to problems with working capital as others may be. We will be monitoring closely to see how central banks respond should the situation escalate.

The bottom line is that to aggressively move investments from equities to fixed income, you need to believe that earnings will not just decline, but disappear for a number of years and that governments and central banks will not respond. As we do not believe this is a likely outcome, we are not actively looking to adjust our exposure to equities.

As of Thursday, February 27th