March 20 Insights

20 April 2020 | Mark Beardow, Darling Macro

- Looking ahead
- Dynamic vs Static risk management
- Reviewing 1 year of the Darling Macro Fund
- Managing liquidity risk
- Contractual uncertainty

Looking ahead

In February we wrote "In periods of acute uncertainty, investors find it difficult to make forecasts and form expectations, while events will easily surpass current expectations. Large price moves can occur as investors build in a new margin of safety into new forecasts and expectations. Recovery in prices can occur when new more conservative expectations have been established and “positive” surprises occur."

Uncertainty was extreme and pervasive in early March as investors had no model to determine the spread of infection, the impact on economies or the timeliness of support by governments and central banks. However the quick implementation of fiscal and monetary support truncated some of the more dire scenarios, and equities have retraced. The implementation of social distancing policies became the best lead indicator for estimating the peak in infections. Going forward the repeal of these policies will be the best indicator for the slope after the peak and the length of the economic drawdown.

Analysis now shifts to the necessary social distancing policies to keep the virus contained before a vaccine is widely available. Upside occurs from here if governments repeal social distancing progressively from late April, a credible ceasefire on oil supply emerges and emerging market economies somehow escape the worst. There is downside if infections re-emerge in Wuhan, economic data for March and April is more negative than currently forecast and damage to banking systems emerges.

Dynamic vs static risk management

The Darling Macro Fund dynamically blends equities, bonds and commodities with the aim of producing superior risk adjusted returns compared with a static blend of equities and bonds.

The last 3 and 12 months is a potent example of the case for our dynamic risk management. The table below compares the fund with global and Australian equities and several indices measuring blends of bonds and equities.

Fund/Index	3 months	12 months
Darling Macro Fund	-1.8%	12.0%
MSCI World (A$ unhedged)	-9.3%	4.0%
Morningstar Multisector Aggressive	-14.4%	-4.5%
S&P Blended high growth	-18.9%	-10.7%
S&P Daily risk control 15% vol	-22.3%	-10.9%
Vanguard Diversified High Growth Index ETF	-17.0%	-11.0%
S&P/ASX 200	-23.1%	-14.4%

Source: S&P, MSCI, Morningstar, Vanguard

1 year track record for Darling Macro Fund

The Darling Macro Fund has been operating for 1 year, while the business and managed accounts have operated for almost 3 years. The fund was established with a goal of managing both return and risk, and therefore we established clear objectives for both.

Across each of the 5 objectives, the fund has achieved its objectives.

Darling Macro Fund objective	Objective	DMF	
Performance after fees	9.60%	12%	✓
Volatility	15%	14.6%	✓
Low to moderate correlation with a SAA blend of equity and bond.	Low to Moderate	14%	✓
Materially lower drawdown than equities (ASX/200 -36% during 12 months)	Materially lower	18%	✓
Easily observable valuations, low transaction costs and high liquidity	Liquid	Liquid	✓

Source: Darling Macro, 12 months as at 31 March 2020

Managing liquidity risk

Through managing portfolios in past crises we have both learned the value of liquidity and that is why liquidity is a key objective of the Darling Macro Fund. We made deliberate choices about the markets the fund trades, specifically excluding those that have not been proven through past crises. We also chose to invest cash in the highest quality at call cash accounts, rather than "turbo" returns with enhanced cash.

Charlie Jamieson of Jamieson Coote Bonds (JCB) reminded investors this week about the costs of illiquidity as many bond funds have shifted their buy/sell spreads wider to cope with the higher costs of trading. For redeeming investors, these costs come on top of capital losses due to wider credit spreads.

Like JCB, our buy/sell spreads remain unchanged, and are 0.1% for buying or selling.

	Previous sell spread	New sell spread
Active Funds		
Composite Bond Fund	0.10%	0.90%
Absolute Return Fixed Income Fund	0.10%	1.95%
Investment Grade Credit Fund	0.00%	1.00%
High Yield Income Fund	0.55%	0.80%
Passive Funds		
Australian Composite Bond Fund	0.08%	0.50%
Australian Investment Grade Credit Fund	0.15%	1.72%

Source: Morningstar, data as at 23 March 2020.

Contractual uncertainty

Governments and Central Banks have moved quickly to provide certainty to society - e.g. liquidity, income support, health services, data on infection. Governments are now further regulating or intervening in contracts and other commercial arrangements. Some examples below show the scope of this. These arrangements are intricately linked to debt obligations and we believe that governments must resist intervention that may lead to borrowers questioning their obligation to service debt, whether or not they have the capacity.

- Deferral or abatement of rent
- Deferral of other contractual payments and premiums
- Deferral of eviction
- Government forced equity injections
- Limits on pay and bonuses
- Limits on dividends

- Limits on buybacks
- Relief for disclosure obligations
- Relief for trading while insolvent
- Freezes on class actions

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