

## WHAT IT MEANS FOR SUPER FUNDS

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The coronavirus, COVID-19, continues to dominate the news. Share markets, which always respond more rapidly than governments, have reacted by turning the Bull market (which started in 2008) into a Bear market within a few weeks – with the latest oil crisis not helping. Despite initial hope that the virus would be a temporary dislocation, the market falls (and increased daily volatility) suggest that the global economy is going to have a more severe dislocation that could last for some time.

### Impact of COVID-19

There is still confusion about the likely outcome of this virus. Initially, it was thought the Chinese could contain it with drastic quarantine measures, and this appears to have worked for China so far. The problem has been that governments outside China have been focused on also trying to manage the short term impact on already stretched health systems as well as the potential impact on their economies and businesses, which has made decision making more difficult.

It must be remembered that we are still largely in uncharted waters and decision making always looks easier in hindsight. It is said that more than 80% of patients with COVID-19 will experience mild to moderate symptoms and recover quickly. While the overall case fatality rate (2-4%) is much lower than that of SARS in 2003 (around 10%) and MERS since 2012 (34%), COVID-19 has already killed more patients than SARS and MERS combined (1,632 people in total), and the elderly or those with existing disorders or comorbidities are particularly vulnerable with case fatality rates well above 10% for those above age 80 or with pre-existing cardiovascular disease.

In the first instance, global travel took the virus to other regions which were not already taking the same preventative actions as China was taking at that stage. This was partly due to inadequate understanding of the disease parameters like symptomology, the incubation period, the period for which sufferers are infective and the ease of contagion. It appears that carriers can be infective for several days before showing symptoms and, by then, they can have infected many others. Containment for infectious diseases can and has worked in the past, but sufficiently rigorous containment was not applied early enough.

The problem has grown in steps:

1. Chinese authorities knew about the problem in mid-December 2019, but were slow in publicly disclosing it until early January.
2. Once it became public, panic set in and the authorities, with the memory of SARS firmly in mind, started to take drastic action. They went scorched earth and shut down everything everywhere.

3. The rest of the world then adopted an approach that had proved unsuccessful in China, talking positively and doing little, except for trying to block people travelling from China.
4. This has been the approach since the end of January with the hope that the Chinese efforts would kill the virus off in China. Governments tried to block *high risk* travellers from *high risk* countries trusting, or hoping, that it would limit infection to isolated pockets which would then run their course without impacting on business or wider society.
5. The World Health Organisation (WHO) inadvertently facilitated this approach by being reluctant to declare a pandemic until 11 March, due to technical reasons related to the formal definition of a pandemic under their protocols. However, the most important reason would appear to have been a level of acquiescence with Western governments' desires not to unnecessarily disrupt their economies, with a lot of uncertainty at the time about how the virus would spread and develop, combined with a need to avoid panic and enable already stretched health systems to cope with the increased burden in a measured way.

The incremental approach from governments outside China is understandable. No one wants to crush the economy by actions that may be excessive. Nonetheless, the eventual closing down of business is now starting to hurt the economy badly. The early casualties have been those businesses relying on foot traffic, such as cafes, restaurants and retail, and all travel businesses including airlines. However, the multiplier effect means that all businesses will slow down, and their investment will dwindle.

Governments have developed different strategies as they all struggle to keep their economies afloat whilst also saving as many lives as possible. Some show more foresight than others. For example, the UK tried to contain it but soon realised that that was impossible given it was moving quickly through the population. It changed its strategy from Contain to Delay, with a view of pushing back the period of peak infection (when it goes wildly through the population). The delay will mean they know more about it when the crunch comes, the weather will be warmer as they enter the summer months (and viruses are less prevalent at higher temperatures), there may be a vaccine, and they can spread the workload for their hospitals. The problem they face though is that the number of infected patients will balloon, and international borders will probably be closed to Britons.

Italy has somewhat belatedly recognised the severity of their problem and has now adopted the Chinese approach. The delay means their health system is already overloaded.

In Australia, we have not managed our borders well and infections are now ramping up –unfortunately just as we are about to enter into the winter flu season! The government has announced financial measures to support both the economy and the public health system but has been consistent only in providing somewhat confused and contradictory messaging at times. Attendance at mass sporting events was initially considered low risk but, once deemed risky, took some time to be halted.

Unfortunately, situations like this require authorities to decide whether they are prioritising public health or prioritising the economy. Virtually all governments have instead taken an unconvincing middle ground. Their pleas for patience are being ignored because the public can see that these approaches have not worked, and the situation everywhere is clearly deteriorating.

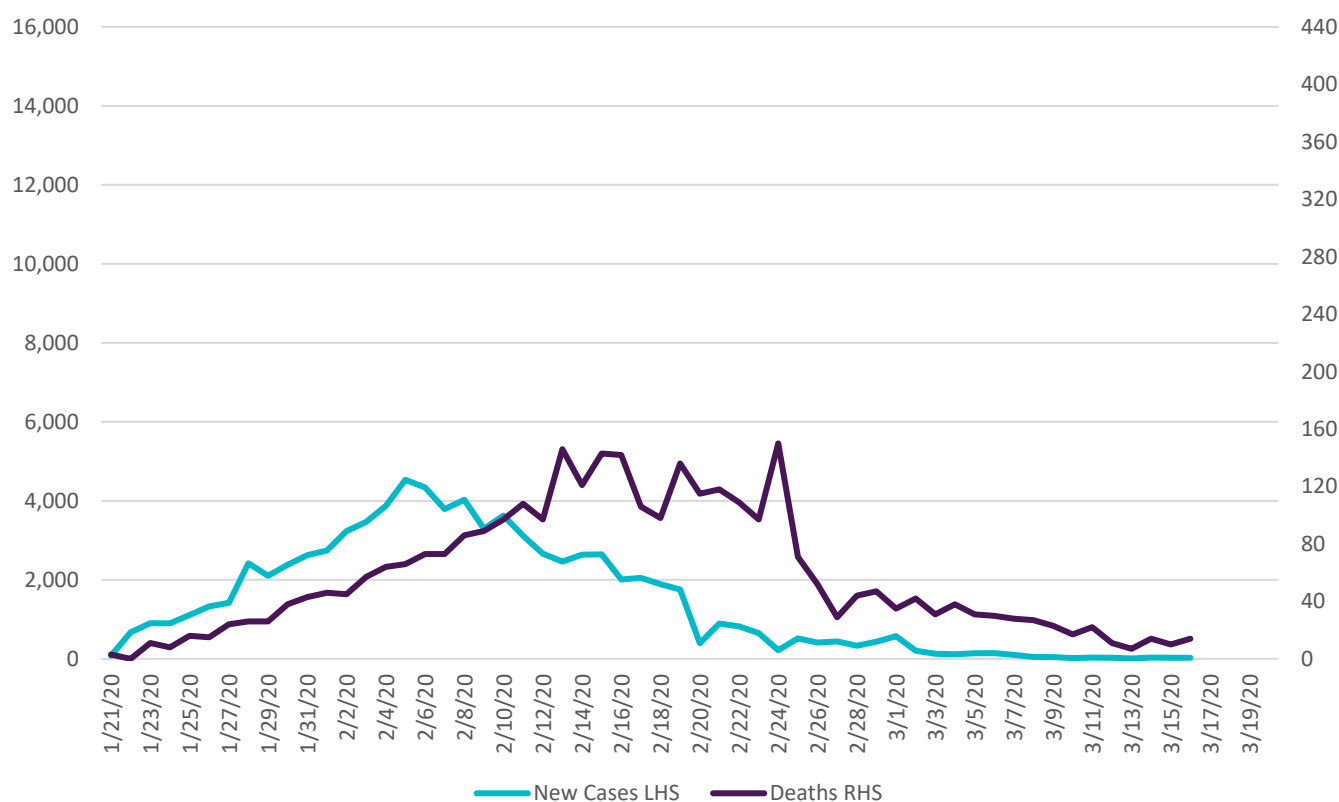
## Is the impact temporary?

The impact on the population's health will be temporary, but how long will this be? The trends indicate that there is likely to be a major outbreak in Australia and at least two to three months of mass infection. All age groups are susceptible, but older age groups experience more severe symptoms and deaths are significantly skewed to people aged over 65 and especially over 80. Death rates amongst males are also higher probably due to poorer lung health resulting from past smoking habits of this cohort.

This major tragedy will absorb the nation's resources but there will be an end as young people and the healthy aged recover, and levels of new infections diminish (as is happening now in China). The challenge is to ensure that the total infected pool does not overwhelm our hospital system. In Italy, where the hospital system is overwhelmed, elderly patients with severe symptoms are being given minimal palliative care in order to allow facilities to be devoted to those (younger) patients who have a good chance of recovering. This is exacerbating the Italian death rate.

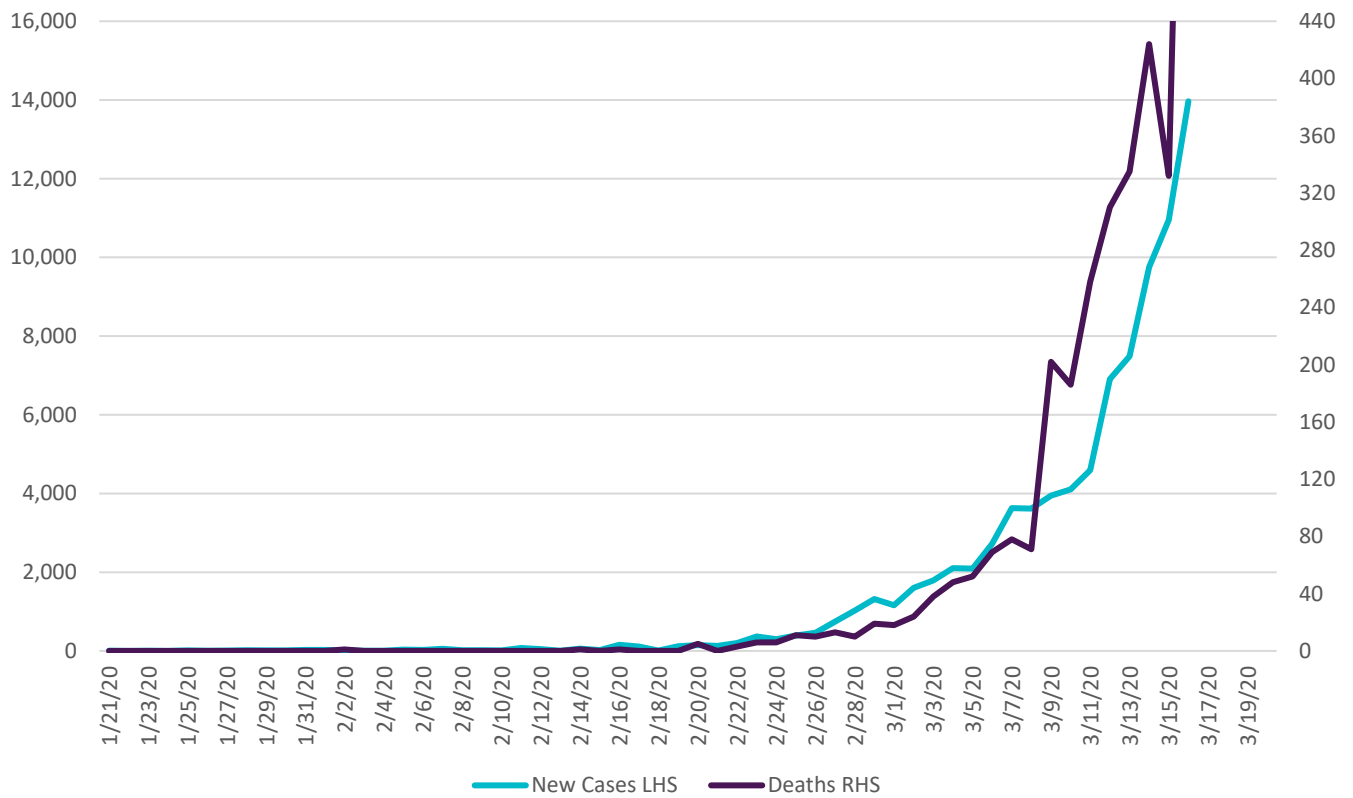
The Chinese experience shows that the virus can be contained. The following graphs are derived from WHO statistics that have been available since 21 January 2020<sup>1</sup>. The graphs are plotted on the same scales to illustrate the relativities between China and the rest of the world. It is possible that there is under-reporting of cases and deaths in China from the early days of suppressing publicity of the problem.

**Graph 1. China – new cases and deaths**

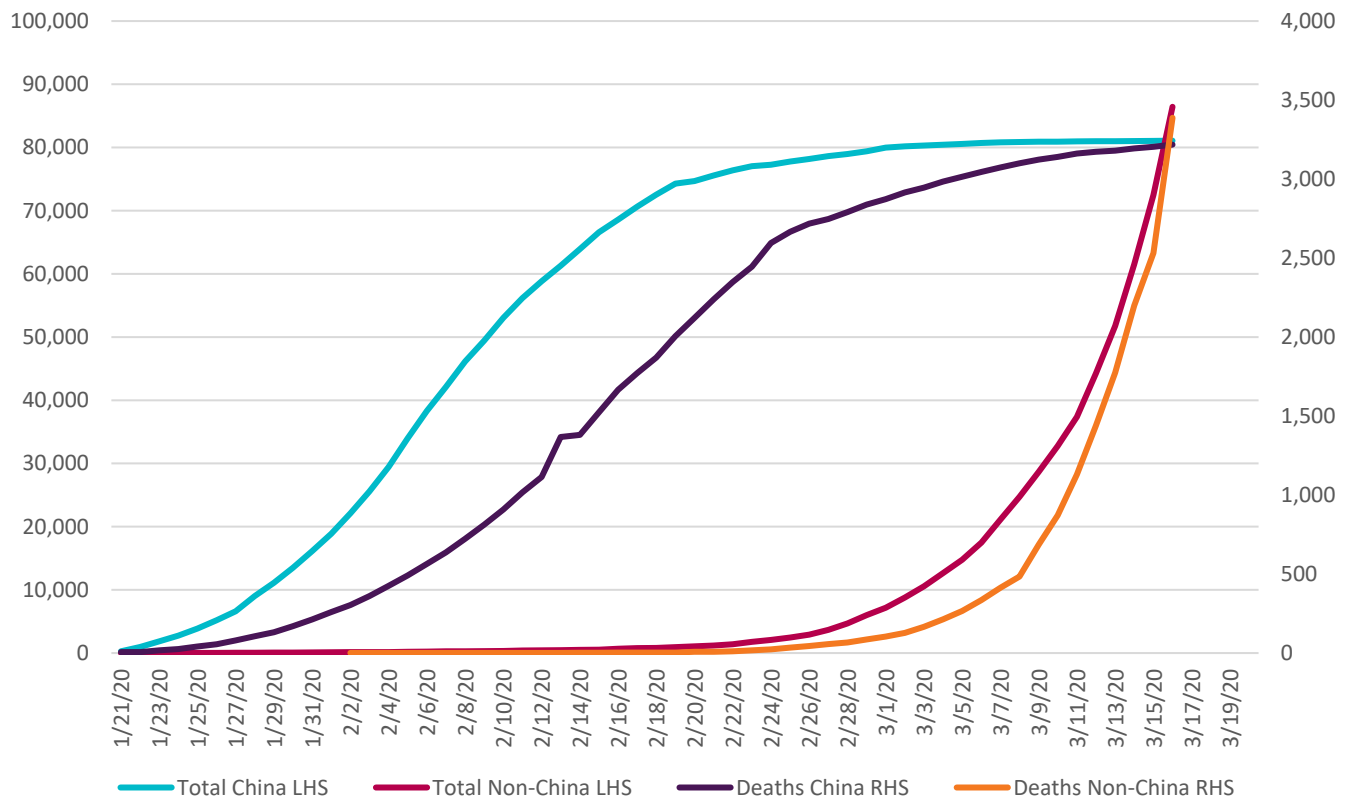


<sup>1</sup> World Health Organization, Coronavirus disease (COVID-2019) situation reports, <https://www.who.int/emergencies/diseases/novel-coronavirus-2019/situation-reports>

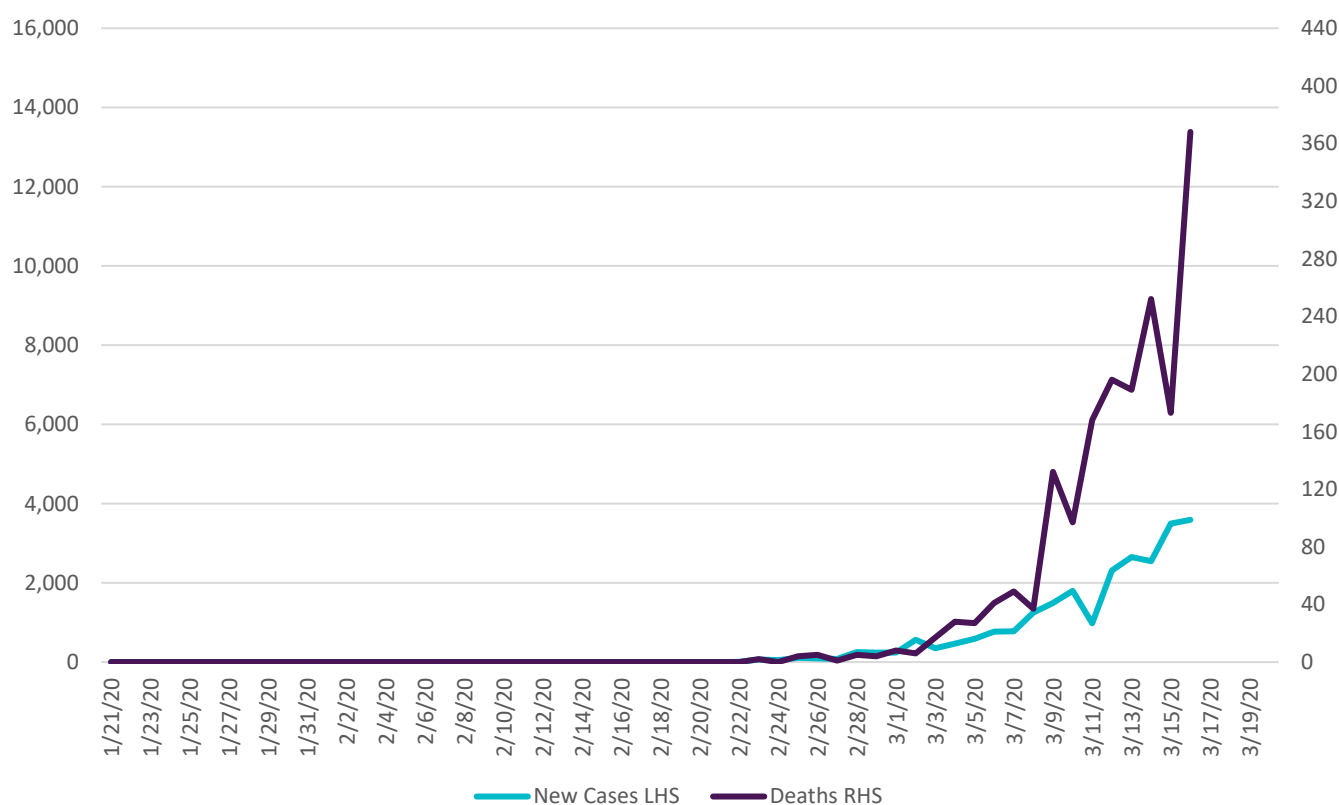
**Graph 2. World Ex-China – new cases and deaths**



**Graph 3. Cumulative Cases – China and World Ex-China**



**Graph 4. Italy – new cases and deaths**



The Chinese managed to contain the growth in new cases within two weeks with deaths peaking about two weeks after that. Full containment of the virus in China is now close and has taken about eight weeks. But this has required significant, draconian even, quarantine and containment measures.

New cases outside China are growing much more rapidly than they did in China and deaths are growing even faster. There is no indication as to when new infections will be contained outside China, but it is likely to take much longer because containment measures are much less robust. Given the Chinese experience, the world-wide containment of the virus is at least three months away and then only if containment measures are strengthened. A better estimate is probably four to six months – and it could be longer. Only then, will the start of a sustainable economic recovery be possible.

## Impact on economy

Whilst the health impact on the health system will be temporary, the impact on the Australian economy will continue for longer. Tourism and travel have already been hammered. The significant restrictions on international travel cannot be compensated with increased domestic travel and tourism, despite calls from the Government to this effect. It is likely that tourism will die out for at least six months and even if the virus is contained world-wide in that period, the slump could well extend for many months more due to the logistics of booking and travelling and needing to convince potential customers that it is safe to travel. This will put a huge strain on a major part of the economy and bankrupt most small businesses in the industry.

Retail sales, especially Main Street retail, will also stay stagnant as people keep their distance from other people. The reductions in disposable income will also extend the slump well beyond the point of containment of the virus and the curtailment of spending will extend beyond the restoration of disposable incomes as consumers deal with accumulated debt. Many retail businesses will succumb before spending recovers.

Primary production is unlikely to be significantly impacted as the demand for produce won't change. Some sections, such as seafood, have suffered from the downturn closure of exports to China, but these should recover soon as China is slowly coming out of its shut-down - people are being allowed to move around more and businesses are re-opening.

Production in China is ramping up again, and the Chinese government will be stimulating their economy. This will increase demand for Australian products especially primary production like iron ore that has not been greatly affected to date. Supply chains should also recover quite quickly, and commercial construction will get back to normal. The immediate emphasis in China will be on domestic stimulus as exports will be stagnant for some time.

The big sleeper in the world economy is the US. Their apparent control of the virus has been due almost entirely to under-reporting. Up to 9 March, the US had tested some 8,500 individuals out of a population of over 320 million while South Korea with a population of around 50 million had conducted 210,000 tests. The US, in fact, has no idea of how severely their country is affected by the virus and without significantly more test kits and testing, no way of finding out. Testing is now being expanded and confirmed cases have gone to 9238 by 18 March (44% up in a day). With the relaxed border controls the US has had in respect of the virus (only recently tightened), it is likely that the true number of cases is at least ten times what is being reported now and possibly even higher.

Rather than wait and rely on the Federal Government, several US State and city governments have implemented measures of their own. Washington State, Oregon and New York City have declared states of emergency and have started curtailing gatherings and travel. These restrictions and those coming from other jurisdictions will undoubtedly cool the US economy.

There are some bright areas. Governments around the world, including our own, are implementing emergency fiscal, monetary and other financial measures to prop up their economies and provide vulnerable people with the financial wherewithal to keep functioning. The efficacy of the various measures is open to question, but they will provide some cushion to the local and world economies.

We can eventually expect Chinese students back at our universities and restoration of Chinese tourists. The challenge though is that China will be wary about allowing its students and tourists to travel to Australia unless we have the virus contained (and this won't be for some time). They will not want to re-infect their country after working so hard to eliminate it domestically.

Whilst the timeframe is uncertain, the downturn will be temporary but will shake out businesses with insufficient cash reserves to ride it out and we could see takeovers of businesses at depressed values. We are also likely to see further growth in online retailers at the expense of their bricks-and-mortar competitors.

## Will markets recover soon?

Some fall in markets was not unexpected as prices had reached record levels. However, prices have fallen sharply, exacerbated initially due to closure of short-selling and margin lending positions, but the absence of any institutional buyers and negative sentiment has prevented any short-term rally. As happens with momentum, the losses are across the board – even the prices of funeral companies and medical businesses have fallen.

It looks like China will be back to business as usual soon, but its trading partners will all then be in the peak of the pandemic. Realistically, we will have a few months of pain, and financial year returns will be low or even negative.

The inherent uncertainties of a pandemic, the varied and rapidly changing approaches by governments around the world to the pandemic and to their economies, the resulting confused messages they are producing, the increasing level of fear world-wide and the hammering the markets have suffered, mean that extreme volatility will continue at least for several weeks and possibly months.

Sudden movements on the downside are more likely than on the upside. Wall Street, as a bellwether for the world markets, is likely to be especially volatile as the Centres for Disease Control and the various State governments increasingly gain a proper understanding of the extent of the problem they face.

Any recovery is likely to be subdued and prices might settle at new (lower) levels. It could take two years to get back to normal, and during this time we will see many businesses taken over or pushed into administration.

## So, what does this mean for super funds?

### Equity falls

With many members working from home and media publicity about the share market crash, superannuation funds have started receiving increased levels of member inquiries. This might be challenging if the fund's own staff are also working largely from home and outsourced service providers are operating less effectively than usual.

One of the critical queries will be about reduced asset values. Members will want to know what they should do. For most, the correct answer is to hold still and wait it out. Funds have diversified investment pools and the share market falls are not reflective of the position for the whole portfolio.

Portfolios with high domestic and overseas equity percentages go down rapidly when markets fall, but history shows that they recover when those equity markets recover – which they will. This was demonstrated quite starkly during the GFC. The All Ords Index fell 54% during the GFC and took 18 months to recover (October 2007 to March 2009).

Members should be cautious of selling out of these portfolios after the big falls we have seen as they could be caught, like many were during the GFC, of selling out at the bottom and missing out of the sharp rebound. Unfortunately, there is already evidence that many have panicked and moved money to cash – the early movers might feel vindicated but history tells us that the panickers don't revert back to growth assets, at least not quickly enough, and they all will miss the upturn (probably starting next year).

### Infrastructure

A feature of the GFC was the performance of Infrastructure and other portfolios with high percentages of unlisted assets. At that time, several funds did not revalue their unlisted assets to reflect the new realities until forced to do so by APRA. The result is that some members switched their investments into portfolios which were subsequently revalued downward sharply after the equity markets had rebounded.

This experience led to more robust and transparent processes for the valuation of unlisted assets being put in place. Funds will need to ensure that these processes are followed effectively to avoid a recurrence of these issues.

The high levels of unlisted assets will smooth the reduction in unit prices for some funds. The unlisted assets will likely fall in value too, though the extent will depend on levels of economic activity. As the annual valuations of airports, toll roads and conference centres are made, they will be reduced to reflect lower revenues.

## Fund costs

Most funds supplement their operational costs, at least to some extent, from asset-based fees or through Indirect Costs charged to their investment portfolio. These contributions to fee income will have fallen considerably, and several funds will now be in a position where they will need to cut services or increase member fees or their Indirect Costs. At the same time, demand from members for some services is spiking due to the current volatility and uncertainty.

We expect this might tip some of the smaller funds into merger negotiations – but they may find the climate a lot less amenable than a year ago.

## Financial advice and retirees

Everyone approaching retirement and those who are already there will want some guidance. Investment returns on all classes will be low or negative. They will need advice on asset allocation, how much to withdraw as pension payments, and how much to spend.

Unfortunately, our outdated legislation means that advice is costly and very slow to deliver. Funds will do the best to educate their members, but most messages will be necessarily bland and unrelated to personal circumstances.

Those funds which use bucketing strategies with their retirement products are better placed. Members can continue to draw pensions from cash and not panic about the fall in the rest of their portfolio at least for the next 6-12 months.

We might find the normal frugality of retirees tightened further due to increased uncertainty.

## Redundancies

Members losing their jobs will also need advice. Some of these will be forced into early retirement at a time when their super balance has fallen.

We might find the level of hardship withdrawals from funds grows quickly – and the rules might need to be made more lenient to put cash into the hands of consumers.

## Recovery

Although assets values will recover, they are unlikely to recover quickly to the record levels they reached immediately prior to the latest plunge. The Price/Earnings ratios were at historically high levels, largely due to the record low interest rates.

We should return to more realistic valuations based on prospective earnings. That will be a shock for many start-ups and tech businesses which were valued on the promise of global growth rather than profit.

## Business as usual

For large funds and consultancy businesses, it will be business as usual. While the nature of the work and some priorities have changed, the industry has a list of requirements to comply with new and pending laws. Focusing on getting this done efficiently will benefit funds as they emerge from the gloom late this year.

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