AberdeenStandard Investments

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# Flexibility needed to counter COVID-19 impact

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**RISK WARNING**
The value of investments, and the income from them, can go down as well as up and you may get back less than the amount invested.

**We highlight three courses of action for investors to navigate portfolios through the second half of 2020.**

As the coronavirus pandemic drives the global economy into recession and compounds heightened geopolitical tensions, we anticipate continued market volatility in the second half of this year.

We see three courses of action for investors to navigate the near-term challenges: be dynamic in asset allocation; diversify into non-traditional investments; and capitalise on market dislocations opportunistically.

Investors need the flexibility to move into defensively positioned assets, while at the same time be able to seize on opportunities to buy undervalued investments. This will leave them better placed to protect their portfolio from large drawdowns and also to capture upside gains.

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As we look ahead over the next six months, we see return potential for credit on the back of improving liquidity and monetary support by major central banks.

The impact of lockdowns on global growth led default expectations to rise and spreads to widen in the first quarter. However, the scale of support provided makes for appealing risk-adjusted returns. If the global economy starts to recover, we see potential for both capital and income appreciation.

Although investors will have limited visibility on company earnings in the near term, our expectations for equity returns are also improving as we see welcome signs of virus containment across key global economies.

Over the longer term we believe that quality stocks with strong balance sheets and good governance will be best positioned to sustain growth. As nations exit recession, we expect quality companies operating in sectors that have been heavily sold down to rebound the most.

Typically, cyclical sectors – financials, materials, industrials and consumer discretionary – suffer the largest drawdowns at the onset of recessions, but thereafter recover more strongly than defensive sectors such as consumer staples, health care and utilities.

We would also expect more companies to suspend or cut dividend payments as the economic impact of the crisis unfolds. Investors might want to consider shifting dividend exposures to longer-dated contracts.

## Being opportunistic

Weakness in the global economy and the slump in commodity prices point to elevated volatility ahead. We see value in using cost-effective put, put spread and put spread collar options to hedge against downside risks, while maintaining moderate risk-on exposure.

We would also urge investors to look beyond short-term noise to identify structural opportunities with a longer investment horizon. As valuations in some segments begin to diverge, investors might look to position their portfolios to benefit.

In the US, for example, we prefer large-cap over small-cap stocks. Both have rebounded strongly since March, leaving investors to chase returns at historically high valuations. But small caps are fundamentally weaker and more vulnerable to late-cycle market dynamics.

To address this, investors can enter into a relative-value trade where they go long the large-cap index and short the small-cap index. This approach is non-directional and can shield investors from volatility even when both markets fall.

If a global economic recovery takes hold, we would also expect the US dollar to weaken. That would be supportive of commodities, emerging market local currency bonds and EM currencies in general.

Asian stocks also appear attractively priced following the recent sell-off. We favour Chinese, South Korean and some Taiwanese names due to better containment of COVID-19 in those markets, combined with strong structural growth prospects in consumption and technology.

We expect the pandemic to accelerate development of 5G and cloud computing and drive continued spending in areas such as health care and insurance.

## Increased diversification

Equity and bond markets won't be able to deliver the high rates of income and capital growth they have delivered in the past, when interest rates, dividend and rental yields were far higher.

The marketplace confronting investors today is one of structurally slower growth, record low bond yields and companies struggling to maintain meaningful earnings growth.

Moreover, stock and bond markets plunged in tandem during the peak of the pandemic as investors made a dash for cash – highlighting a correlation trend that is eroding the diversification benefits of traditional multi-asset portfolios.

To gain diversification benefits, investors should consider non-traditional asset classes. Listed investment trusts – REITs are the earliest example – offer access to a range of investments including infrastructure, specialist credit, financial leasing, private equity and other assets.

What drives their revenues is different to what drives traditional equities and bonds, enabling them to deliver recurring income streams less directly affected by the macroeconomic environment. Infrastructure revenues are often fixed and inflation-linked, so should remain relatively unscathed. Because this universe of non-traditional assets is so broad, investors need the depth of knowledge to make good active investment decisions.

We are also positive about the prospects for companies that offer streaming services. Consumption of music streaming has continued to grow despite the pandemic-induced economic slump, offering stable cash flows that can act as a catalyst for future growth.

Similarly, investors might want to consider a segment such as social housing, where long-term, inflation-linked contracts with local authorities mean income tends to remain stable – appealing in an environment where companies are suspending or cutting dividend payments.

In summary, we anticipate low visibility into the near-term impact of COVID-19 on businesses. Investors who retain cash can capitalise on any return opportunities that arise amid volatility.

At the same time, investors might look to diversify into alternative asset classes with durable revenue streams less tied to the health of the global economy. They can help to provide portfolio resilience as investors attempt to navigate market turbulence in the second half.

Full article can be found here:
https://www.aberdeenstandard.com/en/singapore/investor/insights-thinking-aloud/article-page/flexibility-needed-to-counter-covid-19-impact

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