kardinia capital

The Long and The Short #1

The yield hunt

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With winter in full swing, investors are going on a yield hunt.

Central banks are increasingly controlling volumes and prices as they attempt to set the shape of yield curves.

In the US, investment grade 10-year corporate bonds typically offer more than a 2% yield, significantly higher than the 10-year Treasury yield of approximately 70bps. It was therefore a curious move by the US Federal Reserve to target corporate bonds. What is the Fed seeing that spooked it to take such action? Restoring liquidity to credit markets was one cited reason, but regardless of the motivation the end outcome is clear – corporate bond yields are going to fall, potentially closing off an additional asset class offering income to ever-hungry investors.

It's a similar theme at home, where the Reserve Bank of Australia (RBA) has pushed interest rates so low that as an asset class, term deposits are no longer an option for investors requiring income.

In response to COVID-19, on 19 March 2020 the RBA announced a cut in the overnight cash rate target to a record low of 0.25%. In fact, the RBA went one step further and announced it would also target a yield on three-year Australian Government bonds of 0.25%, purchasing across the yield curve to achieve the target.

This unconventional measure is set to remain in place until progress is made towards the RBA's goals of full employment and the inflation target (2-3% on average, over time).

Given the spike in unemployment due to COVID-19 and the risks of further increases once the government's stimulus measures (JobKeeper and JobSeeker) are wound back, as well as the RBA undershooting its 2-3% inflation target for more than four years, this does not appear likely anytime soon. In fact, at the ANU Crawford Leadership Forum on 22 June 2020, RBA Governor Philip Lowe said that due to the pandemic and an excess of global savings relative to investments, interest rates would remain at their current record lows for years to come.

To us at Kardinia, yield-producing equities are increasingly looking like the last asset class standing. We believe investors will continue to move capital into equities to chase yield in a world seemingly devoid of such opportunities. The need for income is a powerful force – particularly for those transitioning to or already in retirement. At some point, we believe this need will tip bond investors into the equities market. Consequently, we have increased our exposure to this thematic.

Share trading at an all-time high

At a time when investors are grappling with unprecedented uncertainty, a new phenomenon is taking hold in equity markets which is causing quite a stir. Retail investors are setting up accounts and trading securities with enormous enthusiasm. A range of online trading platforms, such as Robinhood, are being embraced by a new generation of retail investors and the impact on markets has been noted.

Populist investment forums are encouraging investors to participate and with a lack of sport, gambling and other entertainment options available, combined with increased free time, many have turned to share trading. The Australian Securities and Investment Commission's recent report, *Retail investor trading during COVID-19 volatility*, highlights the doubling of average daily securities market turnover by retail brokers; between 24 February 2020 (the first trading day after the market peak) and 3 April 2020, it rose from $1.6 billion to $3.3 billion.

Whether this retail trend has truly divorced fundaments from asset prices, or whether the professional investment community is clutching at explanations for the recent market moves, is open to much debate. Either way, Kardinia believes central bank actions remain the most powerful driving force behind market returns.

Kardinia's strategy

Since inception over 14 years ago, Kardinia has deliberately restricted its maximum net exposure to the market (that is, long positions minus short positions) at 75%. This ceiling has proven itself time and time again in its ability to limit the drawdown of the fund. This has been the case again this year during the COVID-19 pandemic, when the fund's drawdown was 3.93% versus the market drawdown of 36.17%.

The true value of this key structural element of the Kardinia fund comes to fruition when markets fall. Drawdowns of more than 5% in the Australian market tend to occur at least once every year, and our capital protection is invaluable during these periods. As the current swift rally in the market takes hold, the chances of a sell off will only increase with time. With volatility likely to remain elevated, we truly believe the Kardinia fund is a strategy for the times.

Kardinia Capital is a boutique asset manager investing in Australian equities via an absolute return, variable beta, long/short strategy which was incepted in 2006. Kardinia aims to generate consistent positive returns through an investment cycle, and not lose money in falling markets. Rather than trying to generate the highest possible returns which tends to result in heightened risk and volatility, the team strives to provide growth via superior risk-adjusted returns.

For more information visit kardiniacapital.com.au