State Street Australian Equity Fund

Vaccine Drives Massive Rotation

STATE STREET GLOBAL ADVISORS

- Vaccine news boosts equity markets but the real story lies beneath the surface.
- Massive rotation as the years underperformers shine on vaccine developments.
- Vaccine news sees low quality and high risk stocks outperform.

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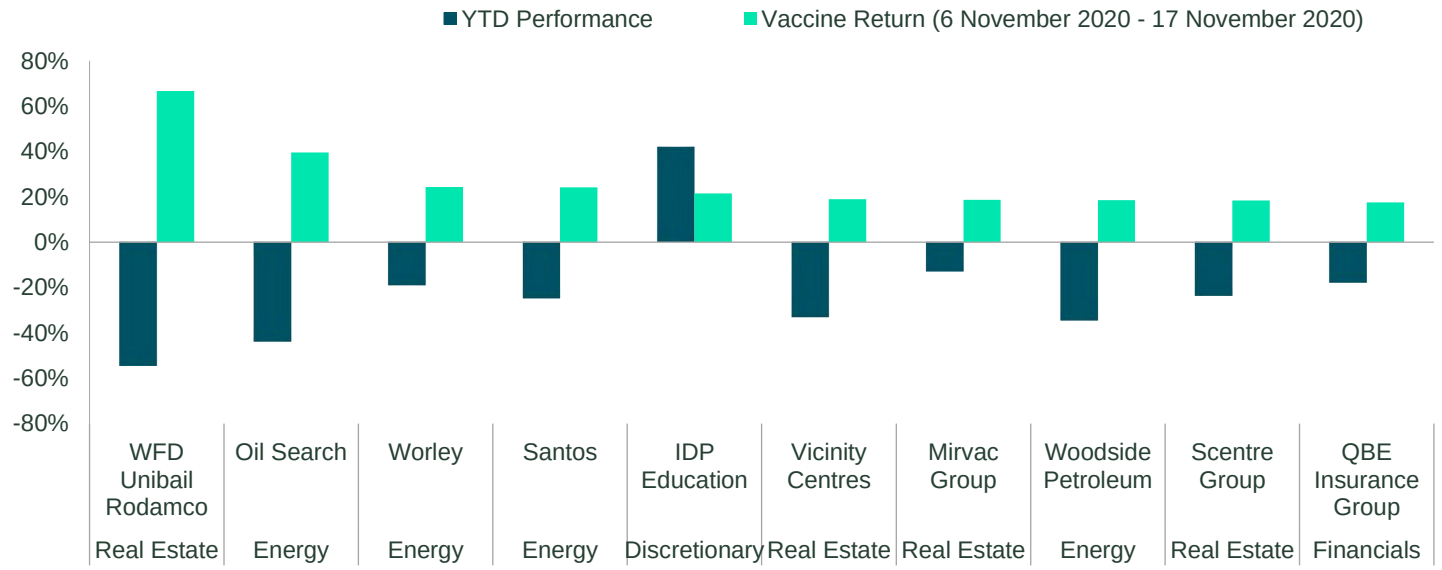
The positive news regarding the effectiveness of both Pfizer and Moderna's vaccines against Covid-19 are exceptionally good news for the world. With many more companies working in parallel we can likely expect more positive developments on these fronts in the coming months and over the course of 2021. While success is unlikely to occur in a straight line, the vaccine is a much needed light at the end of the pandemic tunnel. Equity markets have rallied on the news as you would expect but the real story lies beneath the surface. In this monthly note we take a closer look at the large rotation within equity markets.

Vaccine rally reverses many year to date trends

Since the latest positive vaccine developments were released to the market, we have seen the MSCI World Index rally to 7.43% and the S&P/ASX 300 Index has rallied 9.79%. We have seen a significant jump in some of the most beaten up stocks within the market. Figure 1 below lists the best performing stocks from the top 100 market capitalized stocks within the S&P/ASX 300 Index from Friday the 6th of November to Tuesday the 17th of November. Also noted alongside this performance has been the year to date (YTD) performance of these stocks.

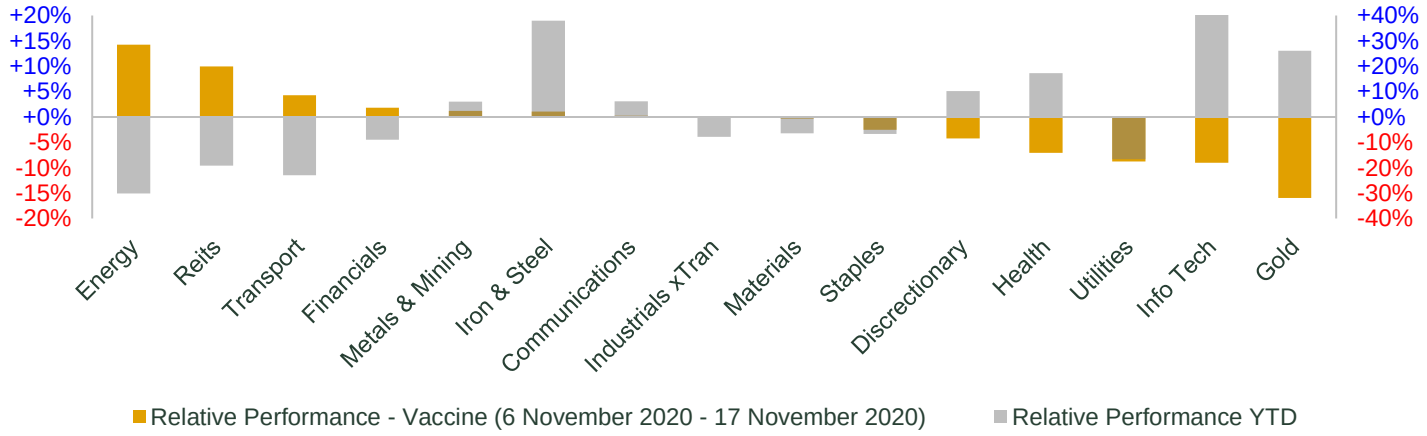
Figure 1. Top ten stock performances post positive vaccine developments as at 17th November 2020



Source: Thomson Reuters, State Street Global Advisors as at 17 November 2020. Universe is the largest 100 market capitalized stocks from within the S&P ASX 300 Index. Past performance is not a reliable indicator of future performance. Performance returns for periods of less than one year are not annualized. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.

As shown in Figure 1 we have seen a reversal of fortunes for those companies that have been impacted the most. They are now the companies with the most to gain from a vaccine. From a sector perspective you can see that both Energy and REITs are the biggest beneficiaries of a vaccine as illustrated on both Figure 1 and 2.

Figure 2. Some of the worst performing sectors YTD have rallied the most on the positive vaccine news



Source: Thomson Reuters, State Street Global Advisors as at 17 November 2020. Performance of the largest 100 market capitalized stocks from within the S&P ASX 300 Index. Past performance is not a reliable indicator of future performance. Performance returns for periods of less than one year are not annualized. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.

The 2020 back story

During 2020 investors de-rated the companies that were the most impacted by the pandemic including Travel, Energy, Real Estate and Financials. In contrast investors positively re-rated the few companies expected to do better in the pandemic world. Examples included Information Technology, Health Care and some Consumer companies. Over the course of 2020 the gap between the Covid-19 winners and Covid-19 losers became extreme. The recent price reaction to the positive vaccine news partly reflects the extreme pricing caused by the pandemic.

As shown in Figure 2, Energy, REITS and Transport have outperformed the most on the vaccine news while some of the best performing sectors like Information Technology, Healthcare, Gold and Consumer Discretionary underperformed the most. Iron ore and some of the Metals and Miners have managed to buck this trend outperforming both during the positive vaccine developments and YTD.

Figure 3 below outlines the returns associated with different groups of stocks during the vaccine rally. We group stocks by different characteristics and look at the return differences between these groups. During the period from the 6th November to the 17th November when the dominant news was the positive developments of the vaccine we observed a number of interesting rotations. The returns to these different stock characteristics are captured in Figure 3 below.

Figure 3. Quintile spread returns to various themes during the vaccine rally and rotation

Company Characteristic	Quintile Spread Return** (6th November 2020 to 17th November 2020)	Comments
Highest YTD performance	-14.8%	Worst YTD performers outperformed
Beta Three Year / Weekly	-13.8%	High Beta outperformed
YTD EPS revisions (FY1&2)	-16.0%	Poor revisions outperformed
Long Term Growth	-4.9%	Lower growth outperformed
ROE (5 Year Average)	-7.6%	Less profitable companies outperformed
Net Debt / EBITDA	-6.6%	Higher gearing outperformed
Div Yield (NTM)	-1.3%	Lower expected yield slightly outperformed
Free Cash Flow Yield (NTM)	+3.5%	Higher Free cash flow yield outperformed

Source: Thomson Reuters, State Street Global Advisors as at 17 November 2020.
**"Quintile Spread Return" is calculated as the equal weighted return of the top 20% of stocks in the S&P/ASX 300 Index ranked by the relevant "Company Characteristic" minus the equal rated return of the bottom 20% of stocks ranked by the same "Company Characteristic". Past performance is not a reliable indicator of future performance. Performance returns for periods of less than one year are not annualized. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

Most of the relationships observed in the vaccine risk rally are atypical.

- Companies that had performed the best YTD underperformed the most.
- Companies with the great risk as measure by beta outperformed.

- Companies with the worst YTD earnings revisions outperformed.
- Companies with the lowest levels of profitability outperformed.
- The only quality that was more typical was that companies that were cheaper outperformed.

The top 20% of stocks that outperformed on the vaccine news were up 22.6% from the 6th to the 17th of November and whilst this is impressive, remember this cohort is still down -12.5% YTD. Other than having positive returns during the positive vaccine news how might we characterise these stocks?

Figure 4: What are the key characteristics of the vaccine winners

Characteristic	Average of the Best 20% of Vaccine Performers	Comments
Beta Three Year / Weekly	1.5	Higher risk
YTD EPS revisions (FY1 & FY2)	-35%	Earnings downgrades
ROE (NTM)	2.6	Lower operating margins
ROE (5 Year Average)	7.2	Lower operating margins
Net Debt / EBITDA	4.0	Higher gearing
Div Yield (NTM)	2.4	Lower dividend yield
Free Cash Flow Yield (NTM)	5.5%	Higher Free cash flow

Source: Thomson Reuters, State Street Global Advisors as at 17 November 2020.

The Vaccine beneficiary cohort can be characterised as;

1. Higher risk with an average with beta of 1.5.
2. Greater downgrades to earnings (-35%) in 2020.
3. Lower quality in terms of gearing and lower levels of profitability.
4. Slightly better value especially in terms of expected free cash flow yields.

The vaccine rally has many similarities to a classic junk rally.

In contrast the State Street Australian Equity Fund has stocks that on average have the opposite characteristics. The State Street Australian Equity Fund portfolio has exposure to companies which have had lower volatility, with improving earnings prospects, higher operating margins and which we believe offer better value (see Figure 5 below).

Figure 5: Key characteristics of the State Street Australian Equity Fund

Characteristic	State Street Australian Equity Fund	Comments
Beta Three Year / Weekly	0.7	Lower risk
YTD EPS revisions (FY1 & FY2)	5%	Earnings upgrades
ROE (NTM)	22.3	Higher operating margins
ROE (5 Year Average)	18.3	Higher operating margins
Net Debt / EBITDA	2.8	Higher gearing
Div Yield (NTM)	4.4	Higher dividend yield
Free Cash Flow Yield (NTM)	5.5%	Higher Free cash flow

Source: Thomson Reuters, State Street Global Advisors as at 17 November 2020.

The Bottom Line

The recent outperformance of the lower quality more distressed securities with higher volatility is atypical. Historically we find these bouts of outperformance are often short lived and hence we caution against over extrapolating this recent development. Over the longer term we prefer higher quality businesses with improving earnings prospects, higher operating margins and lower volatility.

Portfolio attribution and performance[1]

The S&P/ASX 300 Index rose +1.9% in October, outperforming developed market equity returns. As the European and US second waves intensify and geopolitical risks mount (US election, Brexit, trade), the picture down under was, in contrast, looking up. Importantly, confidence began to rise amongst consumers and corporates, which is manifesting in improved earnings and dividend expectations. During the month, IT, Financials and Staples outperformed while Industrials and Utilities underperformed. In contrast to global themes, Value stocks outperformed Growth stocks in October, a move that was driven principally by the rally in Australian banks.

The State Street Australian Equity Fund underperformed its benchmark during October after fees. From a sector perspective, our lower than benchmark weight in Financials (not holding big 4 banks) and negative stock selection within Industrials (Brambles and Aurizon) were key detractors. On the other hand, good stock picking within Health Care (Fisher & Paykel and Resmed) and Staples (Coca-Cola and Coles) were key contributors towards relative performance. YTD, the fund's outperformance can be largely attributed to our lower than benchmark weight in Financials (not holding big 4 banks, AUB Group) and good stock picking within Health Care.

[1]Bloomberg Finance, L.P. SSGA as at 31 October 2020. Past performance is not a reliable indicator of future performance. Performance returns for periods of less than one year are not annualized. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. This information should not be considered a recommendation to buy or sell any security or sector shown. It is not known whether the securities or sectors shown will be profitable in the future. Characteristics are as of the date indicated, subject to change, and should not be relied upon as current thereafter.

Disclosure

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