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The case for adding some defensive exposure

Our weekly view on Australian Equities

20 May 2021

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Defensive exposure

A +13-month rally in Australian equities since markets bottomed in March 2020 has taken place without any meaningful price correction (>5%). The rally in the All Ordinaries has been one of the strongest on record, assisted by a low starting point and the strongest upward EPS revision cycle in over a decade.

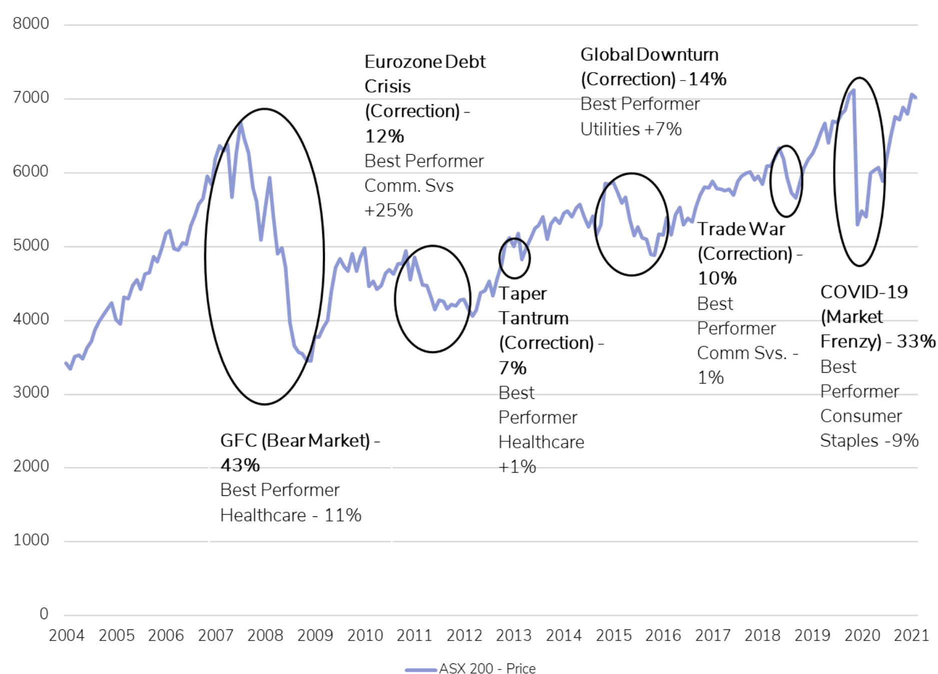
Market rallies don't die simply because of old age, they need a reason to sell-off. Last week's much stronger-than-expected US inflation print increased the list of potential reasons for a market pull-back.

In prior market pull-backs (over the last 15 years), the strongest performing sectors have been consumer services, consumer staples, healthcare, and utilities. The worst performing sectors have been real estate energy, materials, and consumer discretionary.

Inside we take a look at what companies could be considered defensive in 2021.

Our preferred defensive names include: **Amcor (AMC), Coles (COL), CSL (CSL, Focus List), Northern Star (NST, Focus List), Medibank (MPL), Ramsay Healthcare (RHC) and Telstra (TLS, Focus List).**

Exhibit 1: The market has seen 2 bear markets and 4 corrections since 2007



Source: Refinitiv, Wilsons.

The case for defensive exposures

It seems odd to be talking about defensive exposures when the outlook for global growth and corporate earnings is one of the strongest we have seen in years.

See: The coming global growth revival

While our core view on markets remains that of multi-year recovery in which equities perform well, we are becoming more sensitive to the fact that equity markets have done very well over the last 12 months.

Whether a pull-back of 5-10% will emerge is unclear, but it is certainly possible given the almost straight-line rally of the past year.

In our view, the most likely rationale for a pull-back in equities is short-term inflation/the Fed tapering worries, which will be in part driven by the scale of stimulus and inability for production/industry capacity to change in the short-term.

See: Weighing up the US inflation spike

Other potential reasons could include, delays in COVID-19 reopening, geo-political events, an energy price spike (oil is currently at 2019 highs), or failure of corporate earnings to live up to expectations.

While the 'significant correction' scenario may not necessarily transpire, at a minimum a period of more normal returns from equities is likely. This base case scenario alongside the risk case of a significant correction bolsters the case for examining a short list of quality defensives that have been overlooked in the tech and value/cyclical rallies of the last 12 months.

Bull market corrections: A case study (Taper Tantrum 2013)

During the 'Taper Tantrum' episode in 2Q2013, the Australian equity market fell 7%. 10-year bond yields rose from 3.0% to 4.5%. Investors during this period worried about the speed at which the Federal Reserve was going to withdraw QE stimulus and lift rates. Most of the price action happened in the first 4-5 weeks of the quarter.

While market narratives differ between periods, in relatively short/sharp pull-backs many sectors tend to cluster around the performance of the market.

Financials performed in line with the market, despite the rising bond yields. The large market caps and deep liquidity tends to work against the major banks in market pull-backs.

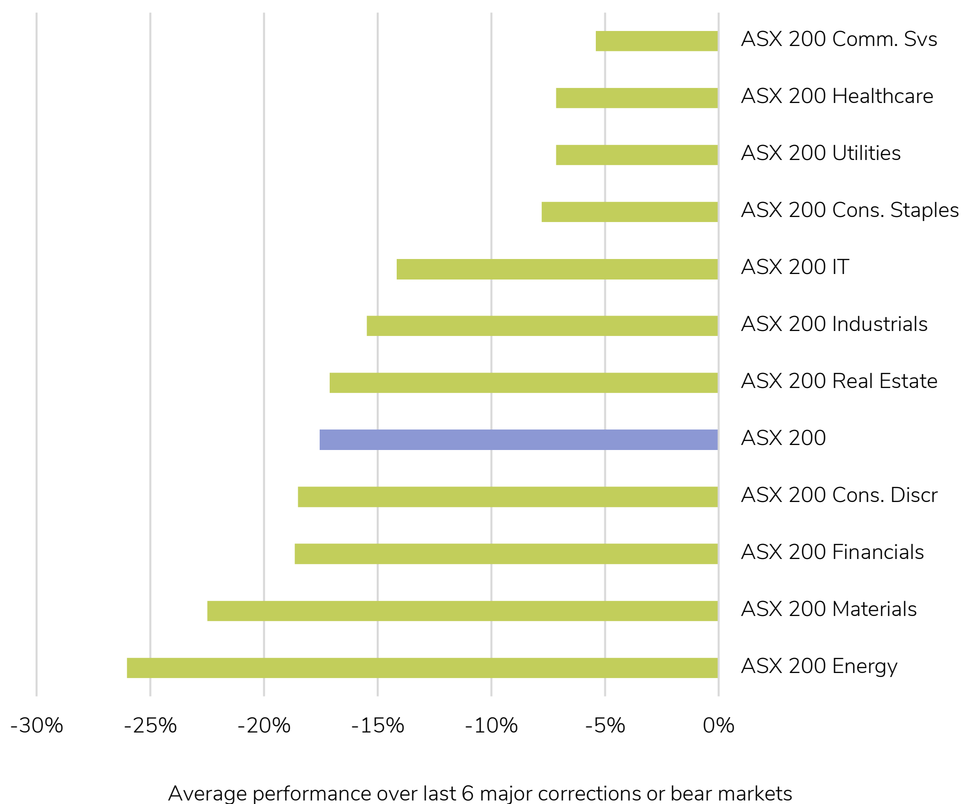
Materials underperformed as investors worried that higher rates would kill off global growth. Most commodities were in plentiful supply post the large-scale mining CAPEX build in prior years.

Unsurprisingly, the more interest rate-sensitive sectors like real estate/utilities offered very modest relative protection versus the market.

Only healthcare (growth in any environment) and IT (just) outperformed.

While this period provides a guide for how a potential equity market pull-back in 2021 could look, sector and stock performances over multiple market pull-backs since 2005 varies dramatically. The context of both the pull-back and the market is a critical consideration when looking at defensive companies.

Exhibit 2: S&P/ASX 100 sector performance during market sell-offs



Source: Refinitiv, Wilsons.

Searching for quality defence

Looking at individual stock market betas (price sensitivity of a stock relative to the S&P/ASX 100) can provide some ideas on where to hide during a market sell-off.

Under this scenario, the higher beta stocks are more likely to underperform the market, while the low market beta stocks tend to perform more strongly.

Betas are just one way of looking at price sensitivity (based on historical relationships) of companies to the market. Because betas are dynamic, they don't always provide the best guide to price movements during a market sell-off. Additionally, low beta does not always equal low volatility in share prices.

A dozen quality defensive exposures

We have screened the S&P/ASX 100 for what we consider defensive names in 2021. These companies have:

- Equity market beta of less than 1.
- Flat/up consensus earnings revisions on both a 1 and 3-month basis.
- Positive 3-year EPS CAGR.
- No significant balance sheet leverage (rules out infrastructure, utilities and REITs).
- No significant short- to medium-term structural concerns.

Healthcare companies are strongly represented with low beta and positive earnings momentum. The underperformance across healthcare (-25% relative to market over the last 12 months) adds to the case. **Ramsay Healthcare (RHC)** should see an earnings acceleration as hospitals reopen post-COVID-19.

Consumer staples have little earnings risk in market pull-back. **Coles Group (COL**) appeals given a wide relative PER discount to the market, while **Woolworths Group (WOW**) adds a structural break-up story, with the pending spin-off of Endeavour Drinks.

Industrial like names like **Amcor (AMC), Brambles (BXB), and Telstra (TLS)** have little downside earnings risk, and are often seen as relative safe-havens. TLS proposed asset break-up with a spin-off of its mobile towers business, which should also help underpin the share price.

AMC continues to benefit from top-line sales momentum and operational leverage, while **BXB** has a post-COVID earnings recovery story with the share price ~20% below pre-COVID levels.

Exhibit 3: Top 10/bottom 10 S&P 100 market betas

	AU 10 yr Yield Beta	Market Beta
Afterpay	-0.12	2.87
Oil Search	0.29	2.47
Worley	0.21	2.37
Santos	0.25	2.24
Beach Energy	0.27	2.23
Boral	0.06	2.07
Scentre Group	0.12	2.02
Vicinity Centres	0.15	1.96
Downer	0.13	1.82
IDP Education	0.22	1.74
Dominos	-0.05	0.44
APA	-0.08	0.44
CSL	-0.10	0.44
ASX	-0.07	0.42
Spark Infrastructure	-0.11	0.39
Evolution Mining	-0.26	0.33
A2M	-0.08	0.26
ResMed	-0.20	0.22
Ausnet	-0.09	0.19
Next DC	-0.15	0.05
Fisher & Paykel	-0.19	-0.07

Source: Wilsons, Refinitiv. Market Beta is 5yr monthly rolling equity market beta to S&P/ASX 100 Index.

Northern Star (NST) covers the gold exposure, which is typically seen as a safe-haven asset, particularly under a higher inflation/higher bond yield-related sell-off.

In financials, **Insurance Australia Group (IAG)** is low beta and has underperformed the market by over 30% over the last 12 months, with the share continuing to factor in the poor outcome on business interruption insurance against a firming insurance price.

Medibank (MPL) despite offering low prospective EPS growth, has a highly defensive earnings base, which shows early signs of an acceleration in customer growth post-COVID-19.

Exhibit 4: A dozen quality defensive exposures

Ticker	Company	Beta 5-Year	PE 12mth FWD	Div Yield FY1	EPSg CAGR (FY1-FY3)	30 day EPS Revision (FY2)	90 day EPS Revision (FY2)	ROE NTM	Price Performance (01/11/2020-18/05/2021)	Wilsons Comment
Communications services										
TLS	Telstra	0.7	24.3	4.6%	7%	0%	1%	12%	18%	De-rated since COVID-19, improving earnings and break-up story.
Consumer Staples										
WOW	Woolworths	0.5	25.0	2.7%	6%	-1%	-1%	21%	18%	Earnings benefit from higher inflation, asset break- up story.
COL	Coles	0.5	21.0	3.8%	5%	-1%	-1%	36%	8%	Significant price derating, earnings benefit from higher inflation.
Financials										
IAG	IAG	0.5	16.8	3.9%	31%	0%	-2%	11%	-13%	Significant price derating, core insurance earnings are defensive.
MPL	Medibank	0.7	19.7	4.0%	1%	0%	0%	22%	12%	Consumer staple earnings quality, improving earnings environment
ASX	ASX	0.4	29.4	3.0%	3%	0%	0%	13%	-8%	High quality near monopoly like infrastructure earning.
Healthcare										
RHC	Ramsay Health Care	0.8	24.5	1.8%	17%	1%	0%	14%	2%	Significant price derating, emerging earnings recovery on pent-up demand.
CSL	CSL	0.4	41.7	1.0%	11%	0%	0%	27%	-7%	Significant price derating, emerging signs of base in earnings
RMD	ResMed	0.2	34.8	0.8%	12%	2%	2%	26%	4%	Significant price derating, COVID-19 earnings recovery, long-term structural growth.
Industrials										
BXB	Brambles	0.8	20.3	2.6%	9%	-1%	-2%	23%	1%	Consumer staple earnings quality, more LT upside.
Materials										
AMC	Amcor	0.6	15.7	3.8%	5%	1%	1%	25%	17%	Consumer staple earnings quality.
NST	Northern Star	0.6	14.9	1.6%	38%	-3%	-8%	22%	-2%	Our pick of the gold miners.

Source: *Refinitiv, Wilsons. *Highlighted rows indicate a Focus List member*

A building case for defensives

Our overall view on Australian equities throughout 2021 remains constructive. We anticipate markets will end 2021 higher than where they are today, driven by the global vaccine led reopening and earnings recovery.

We are conscious of the strong price performance we have seen in markets over the last 12 months. This backdrop has meant that defensive names have not stood a chance against the very strong moves in the share prices of cyclical companies.

Whether we see a pull-back in markets or just a normalisation of returns from the market, the case for building exposures to defensives has improved. Our list of a dozen quality defensive names provides some ideas on where to build exposure.

Australian Equity Focus List

The Focus List presently has exposure to four of the 'dozen quality exposures' – CSL, RMD, NST and TLS.

Telstra was added recently to reduce the beta and dampen potential share price volatility of the Focus List. A pre-emptive move ahead of what could be a bumpier ride for markets near-term.

See: Banks Results: Sizing up the capital management opportunity

65% of the Focus List's exposures will directly benefit from the cyclical recovery (down from 70% at the start of May).

If we do become more concerned about growth, inflation or other risk scenarios, our list of a dozen quality defensive names provides a go-to shopping list for investors into those periods.

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