# Don’t blame COVID-19

## Cash flow quality was poor to begin with

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Author: Robert M. Almeida, Jr., Portfolio Manager and Global Investment Strategist

### In brief:

- Asset valuations were above average or higher as the coronavirus outbreak worsened.
- We doubt actions by policymakers can improve the below-average-quality cash flow being generated by the run-of-the-mill asset today.
- The coronavirus outbreak revealed to all that investors have been paying an above-average price for below-average return potential.

Investor apprehension over the coronavirus outbreak peaked during the last week of February. As a result, assets de-rated while sovereign bonds, despite many carrying negative yields, re-rated. During the volatile week and throughout the following weekend, there was a surplus of market opinion and prognostication about what would come next, ranging from lowered economic and profit estimates to calls for central bank stimulus and a coordinated fiscal response from world leaders. I, unfortunately, lack the clairvoyance that others seemingly possess in forecasting these events. I can, however, offer our perspective on the situation, rooted in corporate fundamentals and derived from our global research platform.

Before the market drawdown began, U.S. equity valuations, on a simple price-to-earnings basis, neared the top quintile historically. Similarly, global investment-grade and high-yield corporate bond spreads, on a yield-to-worst basis, were in the top quartile. It was the same across multiple richly priced asset classes. I would characterize these as above average, if not high, valuations.

While valuation is a critical component of successful investing, it’s only part of the calculus. Investing is allocating capital to a company or institution in exchange for a return stream commensurate with the risk taken. In other words, investors must weigh the quality and probability of the cash flow stream that the business or project promises to generate against the potential for an undesirable outcome.

As I have argued, while every capital cycle is unique, cycles follow consistent patterns. As a cycle matures and confidence grows, the supply of investment opportunities is at some point unable to meet the demand from return-hungry investors. At that point, on balance, investors overestimate market liquidity, underestimate risk and overpay for cash flows.

We can debate whether pre-selloff valuations levels in mid-February were excessive. But valuation is more of an art than a science. It reflects what someone is willing to pay, and everyone’s framework is different. More important, our perspective has been that the quality of cash flows investors have been receiving in exchange for the use of capital has been below average. Our equity and credit analysts have been concerned by the decreasing durability of cash flows globally (margin, profits and EBITDA, for example) given that much of this cycle’s apparent profit strength has been generated by cost cutting, balance sheet financialization and working capital enhancements. More businesses have been employing creative accounting, and fewer have been driving margin and cash flows via normal business operations, such as selling more widgets or raising prices.

Our view has been that the approach to portfolio construction should shift from one that does not discriminate to one that is selective, specifically, by seeking to avoid companies whose deteriorating earnings quality can no longer be hidden. We think there will be scarcity value for the stocks and bonds of companies that are able to deliver consistent cash flows.

Those are the securities we want to own. I don’t know how central bankers or politicians will react to COVID-19, lowered economic projections and other looming headwinds. But can any action by policymakers improve what we believe is the below-average-quality cash flow being generated by the run-of-the-mill asset today?

The markets are blaming the recent shift in market sentiment on the coronavirus. But is that the whole story? Or has the virus outbreak revealed to all what we’ve been pointing out for some time: that investors have been paying an above-average price for below-average return potential? Asked another way, did the market underappreciate the risks companies were taking until they were tested by adverse conditions? We believe it did.