Optima Wealth Winter Update

April – June 2024

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Against this backdrop, the US share market extended its bull run that began in late 2022, with the S&P 500 Index reaching all-time highs during the quarter.

Market Commentary

Positive global share market momentum carried into the second quarter of 2024 for the USA, although share market returns in other regions were variable.

The outlook for interest rates remained unchanged, however there is growing expectation for a general reduction in interest rates around the globe. In June, the European Central Bank and the Bank of Canada became the first of the major banks to begin cutting rates. With local inflation heading in the right direction, it looks as though the Reserve Bank of New Zealand may soon follow suit.

In the key US market, the Federal Reserve held the federal funds rate steady at 5.25% throughout the quarter, with officials there citing the need to cool persistently high inflation.

Against this backdrop, the US share market extended its bull run that began in late 2022, with the S&P 500 Index reaching all-time highs during the quarter. This performance was led, once again, by the strong performance from a handful of large capitalisation companies in the information technology sector. Unfortunately, the New Zealand share market continues to lag many of its global peers with weak economic growth, and stubborn inflationary pressures, continuing to challenge local policymakers.

On the global political stage, uncertainty and change seems to be in store in 2024. After a relatively brief campaign, the Conservatives have just relinquished Downing Street after 14 years in power in the UK. Emmanuel Macron's snap election resulted in no clear winner, leaving France without a new prime minister or government and in political chaos just weeks before they welcome the world for the Olympic Games. Meanwhile, the lead-up to the US presidential election has been even more volatile than pundits expected, including the shocking attack on former president Donald Trump in early July. The race between Biden and Trump will no doubt include many twists and turns before the nation votes in November.

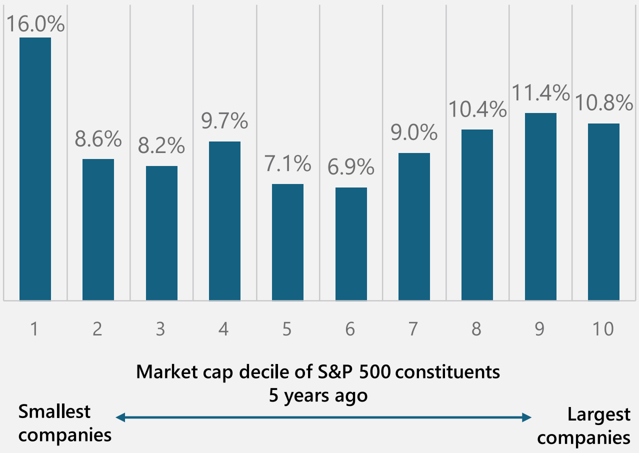
Bigger isn't necessarily better

Over recent months, share market news has been dominated by the strong returns of some of the largest companies in the world, including several of the technology giants based in the USA.

If we look at the leading US share market index – the S&P 500 – we can break it into ten different company groupings (or deciles) of 10% each, according to company size. In other words, we can group together the largest 10% of firms in the index all the way down to the smallest 10% of firms. If we calculate the past five year returns from each of these groups, we can see that the largest 10% of firms have beaten all other size segments. This seems consistent with the reported strong performance of many large technology companies.

However, concluding that the largest companies have performed the best would be incorrect. What the analysis as described above only tells us is how the current largest companies have performed looking backwards in time, not how the largest companies five years ago performed over the subsequent five years. If we use company size as they were five years ago as the starting point and then calculate the forward-looking returns of each size grouping, the analysis changes quite significantly.

Median 5 year forward annualised S&P 500 return by market cap decile 5 years ago[1]



The largest companies from five years ago have still performed well (+10.8% pa), but the top performer over the period, by a healthy margin, has actually been the smallest decile of companies (+16.0% pa).

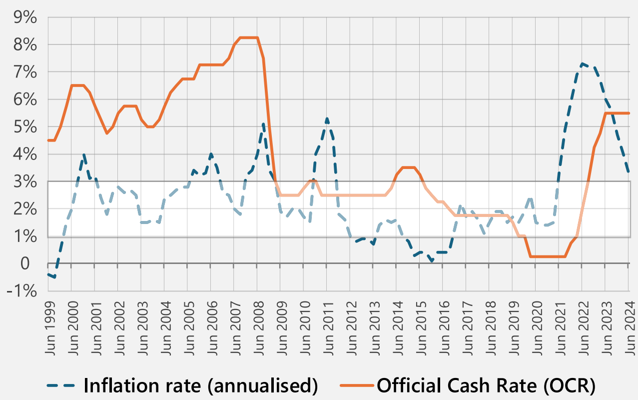
This is the case because some of the big companies today were actually much smaller five years ago and some of the smaller companies today were also much bigger.

It's generally unusual for the largest companies in an index to continue to outperform all others, and history tells us the best time to buy these companies is before they become large, not after.

New Zealand interest rates - the wait goes on

The chart below shows the annualised inflation rate (dotted blue line) plotted against New Zealand's Official Cash Rate (OCR) which is the short-term interest rate set on a periodic basis by the RBNZ (orange line).

New Zealand interest rates versus inflation



The RBNZ aims to keep inflation within the range of 1% to 3% over the medium term (the area shaded in white). For the most part they have achieved this fairly consistently over the last 25 years. Up until 2021, there had been only occasional deviations of inflation outside this band, and most had returned back to the target range within 12 months.

However, the cost-of-living crisis has been a different story. The significant 'spike' in inflation that commenced in 2021 has so far not returned to the target band. This is why the orange line is not budging yet. The length of time that inflation has stayed above target (now three years and counting) has backed the RBNZ into a corner. They are highly reluctant to reduce interest rates until they see inflation back inside their target band. This caution has resulted in the OCR being stuck at 5.5% since May 2023.

The good news, as you can see from the chart, is that inflation is heading in the right direction, and many commentators consider that we could see interest rate reductions later this year (ahead of the RBNZ's own forecasts). Whenever it begins, it will mark the end of the most restrictive interest rate settings New Zealand has experienced in 15 years.

Does the US election matter?

We are readying ourselves for Biden vs Trump 2.0 in November and, from afar, the view doesn't look flattering. This time around, it is an incumbent who is facing increasing questions of his competency, including from within his party, versus an often divisive and controversial challenger whose run is likely to include significant time in the court rooms as well as on the campaign trail. It is surely an indictment of the US political system that these are two 'best' candidates for leadership of the most influential nation in the free world.

Does it matter who wins?

In some ways, probably not. Both the Democrats and Republicans will aim to be expansionary and will keep issuing bonds and printing money. While the Democrats might spend more, the Republicans will aim to reduce taxes more.

In some ways, almost certainly. In matters of foreign policy, we can expect a Republican presidency to renew stronger rhetoric around Europe's contributions to NATO, possibly not supporting efforts to arm Ukraine, and likely promoting greater trade protectionism, particularly in respect to China. Conversely, President Biden has indicated he will propose extending tax breaks for those on low incomes while raising corporate tax rates, and potentially further promoting renewable energy development. Clearly the outcome in November will have a significant impact on some sensitive corners of the economy.

How investment markets might perform is much less predictable, although history says that patient investors will be rewarded regardless of which political party controls the White House.

One of the reasons why is because the president has no direct control over the share market. While the president influences fiscal policy to varying degrees, it is Congress that ultimately creates the federal budget, and government spending is only one of many variables that affect the share market. Also, when considering events like the dot-com bubble, the Great Recession, and the COVID-19 pandemic - no president caused those events, but all three events caused share market crashes.

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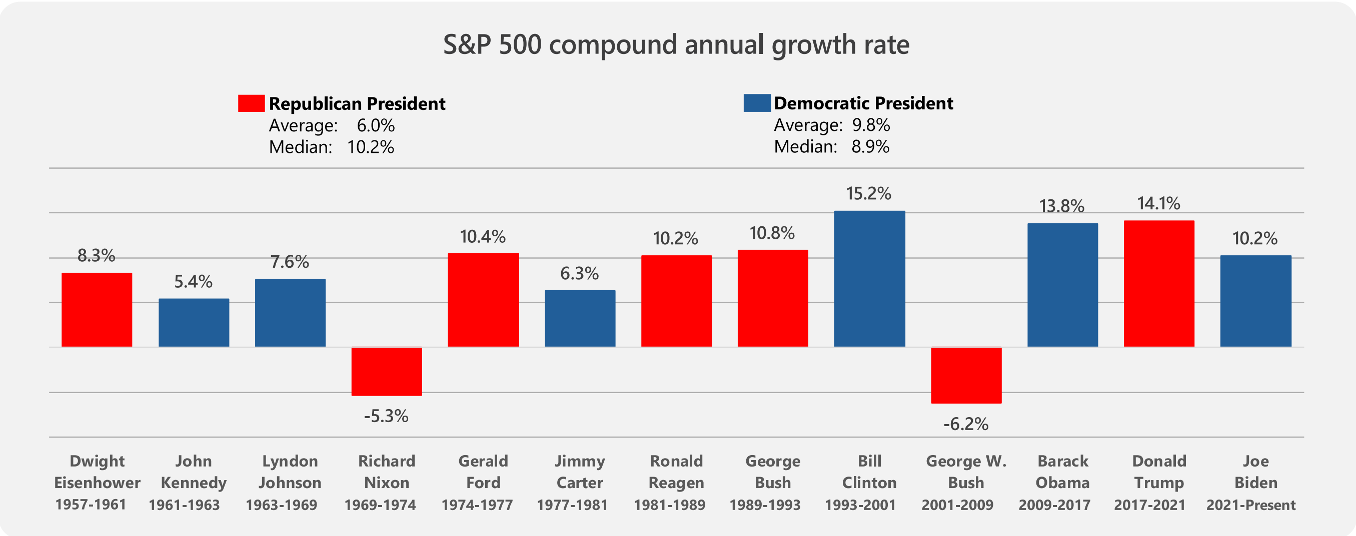
Since the inception of the S&P 500 share market index in 1957, the respective market performance under different presidencies is highlighted below.

Given the ability for statistics to be easily manipulated, Republicans (higher median return) and Democrats (higher average return) could both try to claim the share market has performed better when they controlled the presidency.

However, investors should ignore such comments. Share prices, determined by business fundamentals like revenue and earnings growth, are merely influenced (not controlled) by a president's fiscal policies.

While the winner in November may not have much of an impact on eventual market returns, this will nevertheless be a point of considerable global attention over the next 4-5 months.



> The best response a long-term investor can have to uncertain events is to tune out the persistent noise about everything that is unknown or could go wrong and focus instead on the consistent behaviours that have been proven to add value over time.

Tune out the noise

There is a near constant swirl of speculative opinion both in the general news media and in the financial press about a range of factors or events for which the outcome is, and always will be, uncertain.

Not a day goes by without a big, scary headline professing at least some level of consternation about one or more of the following:

- the timing and size of future interest rate changes
- the long-term impact of AI
- the consequences of a changing global political landscape
- whether inflation is really back under control
- whether technology companies are forming the next market 'bubble'
- when the conflict in Ukraine or the Middle East might end
- the ongoing impacts of climate change

Unfortunately, reading (or watching) the guesses of different pundits about an unknown future provides no useful benefit to long term investors.

Markets, in aggregate, are aware of the prevailing uncertainties and, to the greatest extent possible, that uncertainty is already factored into asset prices today. Yes, as information changes, prices will move to reflect that new information. But, as the exact nature of future information is usually unguessable in advance – even by so-called experts – this speculation is nothing more than an unwelcome distraction and investors should exclude it from their strategic decision-making.

The best response a long-term investor can have to uncertain events is to tune out the persistent noise about everything that is unknown or could go wrong, and focus instead on the consistent behaviours that have been proven to add value over time.

Unlike the list of potential issues, which is always concerning and always changing, the list of great investor behaviours never changes.

These are – in no particular order:

- ✔ allocate strategically (not tactically),
- ✔ keep costs low, stay diversified, rebalance periodically to manage risk,
- ✔ don't engage in panic buying (or selling),
- ✔ and always consult your adviser if your circumstances or requirements change.

Mastery of these relatively simple steps means you will dramatically improve your chances of achieving your long-term investment goals and objectives.

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(1) Data sourced from Ritholtz Wealth Management as at 18 June 2024

Key market movements for the quarter

International share markets gained overall in the second quarter of 2024, although individual country returns were mixed.

Politics was a key focus for the quarter. European Union parliamentary elections registered gains for right-wing nationalist parties, the UK built towards a general election on 4 July and an inevitable change in government, while the first US presidential debate sparked questions about whether President Joe Biden would even remain in the race for re-election in November.

Outside of this, the artificial intelligence "theme" continued to lead markets, while policymakers continued to wrestle with how much (and when) to reduce interest rates.

With a slowing in economic activity in the US and weakening economic indicators in the Eurozone and UK, the case for interest rate reductions remains broadly intact. The only element not playing its part is inflation which is remaining a little higher and 'stickier' in some regions than the central bankers are generally comfortable with.

Emerging share markets outperformed developed share markets over the quarter (excluding any currency hedging impacts) as softer US macroeconomic data helped ease concerns about the timing of US interest rate cuts, and a welcome rebound in Chinese shares helped propel emerging market returns overall.

International shares

+3.2% *(hedged to NZD)*

+0.7% *(unhedged)*

Share markets in the developed economies generally delivered gains in the second quarter.

The US market was again led higher by the information technology and communication services sectors. Ongoing enthusiasm around artificial intelligence continued to boost related companies, such as microprocessor manufacturers and AI software developers, amid some strong earnings and outlook statements.

European share markets were mixed in the second quarter amid uncertainty caused by the announcement of parliamentary elections in France and dwindling expectations for steep interest rate cuts (with euro area inflation actually increasing from 2.4% in March to 2.5% in June).

The FTSE 100 achieved all-time highs as UK shares rose over the quarter. After delivering relatively strong economic growth in the first quarter, data early the second quarter pointed to a slowdown with the economy shedding 140,000 jobs in April.

Against most major currencies, the New Zealand dollar was stronger through the quarter which meant higher reported returns for investors holding hedged foreign assets.

The MSCI World ex-Australia Index returned +3.2% for the quarter hedged to the New Zealand dollar and +0.7% for the unhedged index.

Source: MSCI World ex-Australia Index (net div.)

Emerging markets shares

+3.1%

Emerging markets shares delivered more solid returns than their developed counterparts, although the stronger New Zealand dollar was a factor in reducing the size of the reported gains.

Shares in China rallied strongly over the quarter as low valuations for many Chinese companies encouraged investors to return. Optimism about the authorities' support for the housing sector and President Xi's reform rhetoric was also beneficial.

Indian shares delivered robust gains, driven by continued positive investor sentiment. Indian benchmark indices reached record highs at the end of the quarter, with media and banking stocks leading the way. Taiwan also posted a strong return against a back-drop of continued investor enthusiasm for technology companies, particularly those benefitting from the positive sentiment linked to AI-related businesses.

Brazil and Mexico were amongst the worst performers for the quarter. Flooding in Brazil's southern state of Rio Grande do Sul prompted investor concerns about economic growth, spending and inflation. Meanwhile, in Mexico, Claudia Sheinbaum's election as president and her Morena party's super majority in the lower house of congress raises the prospect of institutional weakening if Morena is able to pass constitutional reforms, including judicial reform. The associated risks here were poorly received by the market.

It was a useful quarter overall for the underlying emerging markets group. While the MSCI Emerging Markets Index produced a quarterly return of +6.3% in local currency terms, the stronger New Zealand dollar reduced the gains to unhedged investors.

Source: MSCI Emerging Markets Index (gross div.)

New Zealand shares

-3.1%

The New Zealand share market, as measured by the S&P/NZX 50 Index, delivered a negative return for the second quarter, generally lagging global peers.

Hanging over the performance of the local share market has been persistent weakness in economic indicators. Forward economic activity indicators point towards a potential contraction in New Zealand's GDP for the second quarter, running with a notable decline in GDP per capita and a contraction in the services industries. The labour market is also showing signs of loosening, with a decline in job advertisements and an anticipated acceleration in the unemployment rate.

The Reserve Bank of New Zealand (RBNZ) continues to be faced with the delicate task of balancing the risk of managing current high inflation against the possibility that inflation may decline much more rapidly than expected over the medium term.

From within the top 50 companies, good results were recorded by Fisher & Paykel Healthcare (+18.2%) following the announcement of a 6% gain in annual net profit, and Meridian Energy shares (+6.4%) gained on the back of solid retail sales volumes. On the downside, Fletcher Building Ltd (-31.3%) reduced its profit guidance citing difficult housing market conditions, and SkyCity Entertainment (-29.8%) declined steadily through the quarter.

Source: S&P/NZX 50 Index (gross with imputation credits)

Australian shares

-0.6%

The Australian share market (S&P/ASX 200 Total Return Index) recorded a small decline in the second quarter, falling -1.1% in Australian dollar terms.

Returns tended to be slightly better in the larger capitalisation companies over the quarter and, in breaking ranks with global peers, it was the utilities sector which was easily the strongest performing sector of the Australian market. The energy, real estate and materials sectors were the weakest in a quarter where losing sectors outnumbered winners by six to five.

Within the largest 50 firms, which is where the bulk of the ASX 200 index return generally comes from, there were notable performances from healthcare software provider Pro Medicus (+38.1%) and gold mining company Newmont Corporation (+18.7%).

However, in a period where the overall returns were weak, there were at least as many firms that struggled, including financial technology firm Block Incorporated (-25.5%) along with James Hardie Industries (-23.2%). James Hardie is the world's largest fibre cement maker and have forecast a fall in profits over the next year due to reduced demand for its products.

With the Australian dollar very slightly stronger against the New Zealand dollar over the quarter, the reported returns to unhedged New Zealand investors rose to -0.6%.

Source: S&P/ASX 200 Index (total return)

International fixed interest

+0.9%

The second quarter of 2024 commenced on a disappointing note for global bond markets, with renewed concerns about US inflation causing investors to reassess the likely timing of interest rate cuts. However, later in the quarter a more favourable market environment was driven by the emergence of softer labour market conditions, and encouraging news on inflation.

With US inflation easing slightly from 3.5% in March to 3.0% in June, the latest "dot plot" showing the rate forecasts of Federal Reserve policymakers indicated just one interest rate cut this year. The European Central Bank proceeded with a 0.25% interest rate cut in early June, although scope for further cuts appear limited by 'sticky' inflation readings in the region. While in the UK, despite slowing growth and encouraging inflation trends, the Bank of England left its base rate unchanged over the quarter.

The US 10 year bond yield climbed from 4.21% to 4.41%, with the two year bond yield moving from 4.63% to 4.75%. Germany's 10 year bond yield rose from 2.29% to 2.49%, while the UK 10 year yield moved from 3.94% to 4.18%.

The FTSE World Government Bond Index 1-5 Years (hedged to NZD) returned +0.9% for the quarter, while the broader Bloomberg Global Aggregate Bond Index (hedged to NZD) was up +0.1%.

Source: FTSE World Government Bond Index 1-5 Years (hedged to NZD)

New Zealand fixed interest

+1.2%

The Reserve Bank of New Zealand (RBNZ) left New Zealand's Official Cash Rate (OCR) unchanged at 5.50% at 10 April and 22 May announcements, extending the sequence to eight 'hold's since May 2023.

While the RBNZ acknowledge weaker capacity pressures and an easing labour market are reducing domestic inflation, they also point out that certain sectors of the economy are less sensitive to interest rates. For example, higher rents, insurance costs, council rates, and other domestic services costs are contributing to New Zealand's overall inflation figure still above the RBNZ's target band.

As they have signalled for some time, the RBNZ reiterated that they want to see inflation back in the target 1% to 3% band before they move to reduce interest rates. With unemployment having risen post the election and evidence of reduced spending across the economy, the only open question now is - how long will it take for inflation to fall back into the target band? The latest reading, for the 12 months ended June 2024, was 3.3% suggesting it could be sometime soon.

On the back of the general trend of rising bond yields internationally, the New Zealand 10 year bond yield increased from 4.61% to 4.75% over the quarter.

The S&P/NZX A-Grade Corporate Bond Index gained +1.2% for the quarter, while the longer duration but higher quality S&P/NZX NZ Government Bond Index gained +0.5%.

Source: S&P/NZX A-Grade Corporate Bond Index

Table 1: Asset class returns to 30 June 2024

Asset Class	Index Name	3 months	1 year	3 years	5 years	10 years
International shares	MSCI World ex Australia Index (net div., hedged to NZD)	3.2%	21.6%	7.8%	11.7%	10.7%
	MSCI World ex Australia Index (net div.)	0.7%	21.2%	11.9%	14.1%	13.3%
Emerging markets shares	MSCI Emerging Markets Index (gross div.)	3.1%	13.8%	-0.2%	5.5%	7.0%
New Zealand shares	S&P/NZX 50 Index (gross with imputation credits)	-3.1%	-0.8%	-1.7%	3.0%	9.7%
Australian shares	S&P/ASX 200 Index (total return)	-0.6%	13.1%	7.1%	8.3%	8.2%
International fixed interest	FTSE World Government Bond Index 1-5 years (hedged to NZD)	0.9%	4.7%	0.3%	0.9%	2.1%
	Bloomberg Global Aggregate Bond Index (hedged to NZD)	0.1%	3.8%	-1.9%	0.0%	2.6%
New Zealand fixed interest	S&P/NZX A-Grade Corporate Bond Index	1.2%	6.3%	0.3%	1.1%	3.4%
New Zealand cash	New Zealand One-Month Bank Bill Yields Index	1.4%	5.8%	3.7%	2.5%	2.4%

Unless otherwise specified, all returns are expressed in NZD. We assume Australian shares and emerging markets shares are invested on an unhedged basis, and therefore reported returns from these asset classes are susceptible to movement in the value of the NZD. Index returns are before all costs and tax. Returns are annualised for time periods greater than one year.

Warren Buffett and the miracle of compound wealth

It was 1942 and America was still reeling from the attack on Pearl Harbour. They had also recently entered the war in Europe where the Nazis had reached the height of their power. The future looked decidedly bleak.

Nevertheless, an optimistic young boy of 11, with a habit of looking at the financial pages, took the money he had saved from doing odd jobs like shovelling snow, $114.75 in total, and invested it. What in? A natural gas company called Cities Service which no longer exists today.

That boy was Warren Buffett who now at age 93, has a net worth of $136 billion.

We may conclude, rightly enough, that we'll never be Warren Buffett. We could never match his investing aptitude or success. But to dismiss this outright would mean missing one vital factor that we all share in common with Buffett that has played a much bigger part in his success than is generally appreciated.

What's the vital factor?

Time.

It's almost impossible to overestimate the importance of time on Warren Buffett's success in growing wealth. If you need any proof, look at the chart below showing how Buffett's net worth has changed over time.

You'll notice that Buffett's wealth seems to take off from age 66 onward. By our calculations, approximately 88% of Warren Buffet's wealth has been generated since he turned 65, retirement age for many in the United States. Moreover, that number would be 94%[1] except for Buffett's significant philanthropy in recent years.

As evidenced below, time in the market has been incredibly powerful for Buffett, complemented by a fierce determination to own shares starting at age 11.

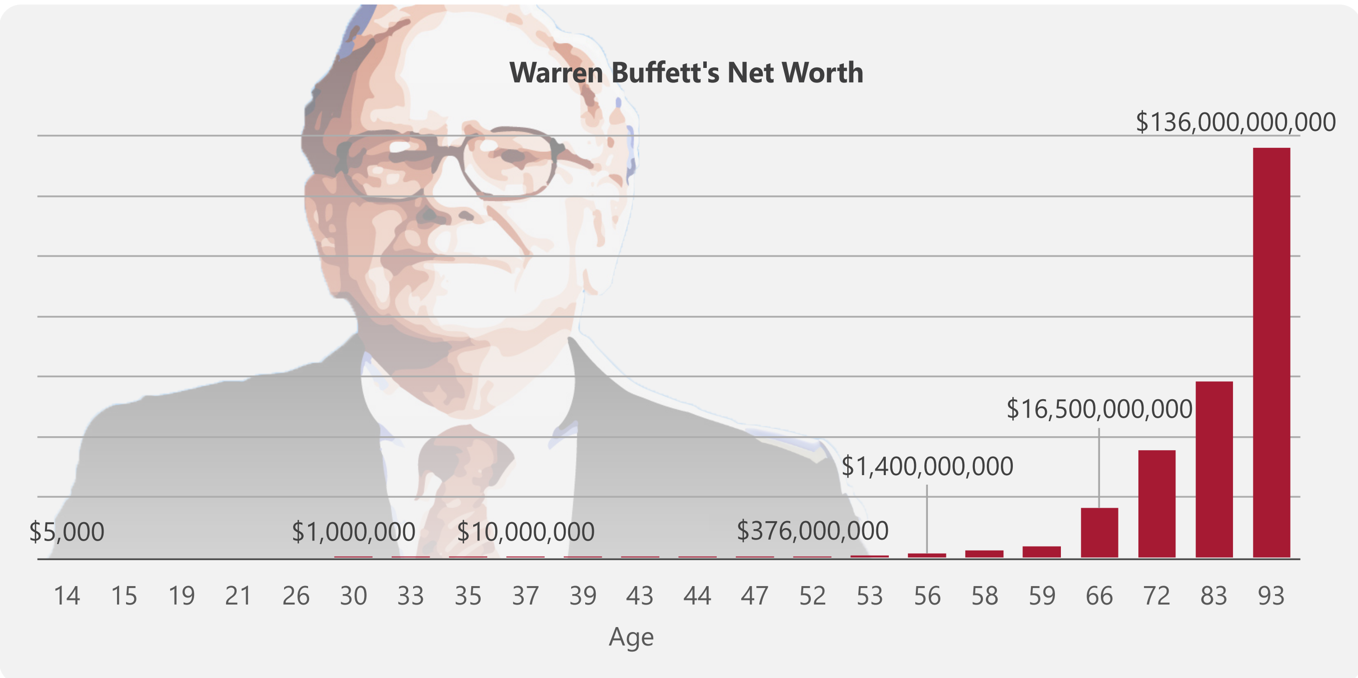
However, most people would attribute Buffett's wealth solely to investment prowess. It's easy to understand why. Before age 65 the average return of Buffett's business, Berkshire Hathaway, was a little over 34% a year, which is truly remarkable. By contrast, his returns since turning 65 have only been 12% a year.

Yet Buffett has earned 88% of his wealth since age 65 even while his average yearly returns have been much lower. How is that possible?

Time, and the miracle of compound wealth.

You see, those 34% per annum returns were on a much smaller asset base. For example, a 34% return on $10,000 will increase your wealth by an additional $3,400. A 12% return on $1,000,000 will increase your wealth an additional $120,000.

By the time Buffett turned 65 he was earning lower returns but on a much larger base of wealth.



Source: https://finmasters.com/warren-buffett-net-worth/

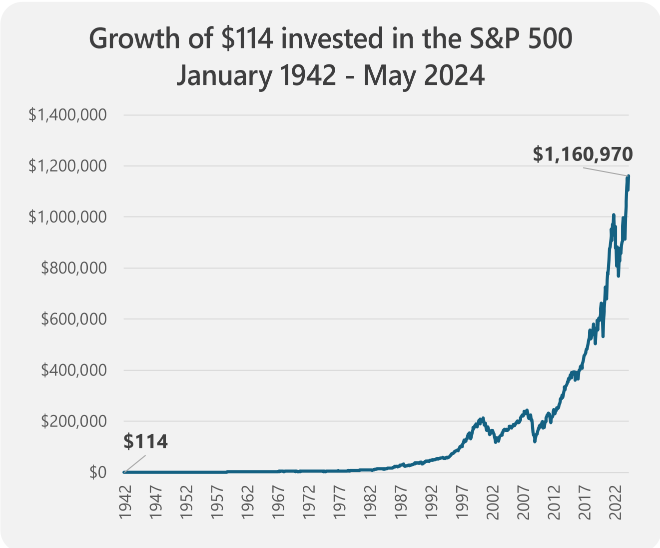
Whilst we're perfectly aware that most clients reading this aren't aged 11 with $114 to invest, you are likely still at a time where the power of markets and compound wealth can help grow substantial wealth.

Whilst you may consider this interesting, perhaps you think you have to be Buffett to get a stunning lifetime return on your portfolio. Well, Buffett himself disagrees. In a 2018 interview with Yahoo Finance he shared this,

> ***"If I put that $114 into the S&P 500 at that time, and reinvested the dividends, think of a figure as to what it would be worth today? The answer is about $400,000. So, if I as a little kid had taken that 114 bucks I'd saved shoveling snow or whatever I'd done — $400,000 today. One person's lifetime. That's America."***

We've updated Buffett's figures to 2024. As at May 2024, his original $114 investment if it had gone into the S&P 500 would be worth about $1,160,000.

It's hard to get your head around this, so we've detailed what this growth looks like in the chart below. An investment of $114 in the S&P 500 including dividends reinvested from January 1942 until May 2024 grows into over $1,000,000.



(1) Based on the cumulative return of Berkshire Hathway shares

The line on the chart looks like it barely moves from the 1940s to the 1990s but then goes up sharply over the last 30 years. In that way, it isn't dissimilar to the growth of Buffett's overall wealth.

Warren Buffett wants you to conclude is that the miracle of compound growth isn't merely for the few with the skill, experience and expertise that he has. Anyone can grow wealth, as long as they have time and discipline, because Buffett finished his 2018 interview this way -

> ***"You don't want to buy to hold for a year, and you don't want to buy with the idea that you could sell it in two years or three years necessarily and make money. You could lose money that way."***

Whilst we're perfectly aware that most clients reading this aren't aged 11 with $114 to invest, you are likely still at a time where the power of markets and compound wealth can help grow substantial wealth.

We hope this article encourages you to maintain optimism, resilience and discipline in your long term plan. But you may also have a younger person in your life you can share this with. For them, this is potentially a lesson in creating true financial independence.