Optima Wealth Winter Update

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While the first quarter of 2020 will long be remembered for the global emergence of Covid-19 and an unprecedented market downturn, the second quarter may well be remembered for the extraordinary resilience of investment markets.

Throughout most of February and March, it felt as though the world had almost been knocked off its axis. There was a rapidly developing global pandemic delivering a rising tide of uncertainty and fear, plummeting investment markets, and world leaders who were struggling to identify an adequate response. In New Zealand, we had to try and make sense of it all from the detachment of our living rooms, as we commenced a nationwide lockdown that ultimately lasted seven weeks.

By the end of March, with economic growth rates slashed and global unemployment rising sharply, the deteriorating health situation looked like it might cast a gloomy shadow over investment markets for a considerable period.

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In the second quarter we witnessed a significant rebound from the first quarter's decline. This turnaround was remarkable not just because of the size and breadth of the investment returns delivered (more on that shortly), but also because the global pandemic that drove markets downward with such force in February and March, had not receded. In fact, by almost any measure, the global health crisis triggered by Covid-19 had only intensified.

When the World Health Organisation issued its first Covid-19 global situation report on 21 January, they advised a total of 282 confirmed cases and six deaths. By the end of March, those numbers had jumped to 750,000 cases and more than 36,000 deaths. By the end of June, a staggering 10 million cases and over half a million deaths were reported, with the rate of new confirmed cases climbing by more than 1 million a week.

Given this backdrop, how is it possible that investment markets could perform strongly?

Readers with a keen memory will know the answer. We alluded to this precise point in our last quarterly report when we wrote "medical statistics will surely - and tragically - get much worse from here, before they get better" and "whatever shape the recovery ultimately takes, the performance of the share market will be a leading indicator. In other words, share markets will be extremely likely to have commenced their rebound well before any improvement in medical or economic data is evident".

This has unquestionably been the case.

As things stand at the time of writing –

- Far from being defeated, Covid-19 is escalating globally. Some countries (thankfully not New Zealand) are experiencing second and third wave outbreaks, while others are still trying to control their first wave.
- There is still no vaccine on the horizon, although there is continued optimism about the progress of vaccine research.
- Economic growth rates everywhere have turned negative, at least temporarily.
- Global unemployment rates have risen sharply. In the US, the number of unemployed jumped from 4.4% in March to 14.7% in April, an increase of over 20 million people out of work. In New Zealand, unemployment is projected to rise from 4.2% in March to 9.8% in September. However, with hundreds of thousands of jobs still being supported by Covid-19 wage subsidies, there is significant uncertainty attached to such estimates.

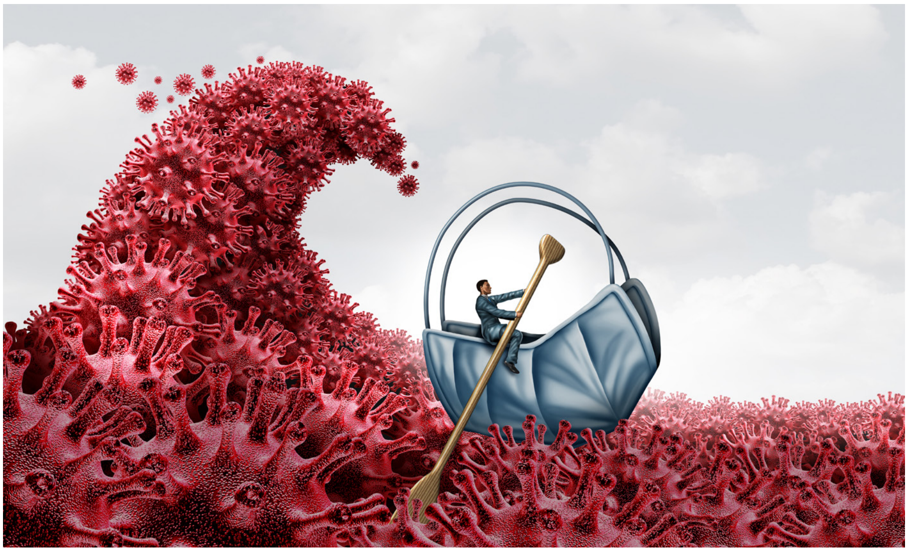
Apart from stories relating to Donald Trump and America's fraught and fragmented management of Covid-19, these were amongst the items that dominated international news flows from April to June. But markets seemed disinterested in them.

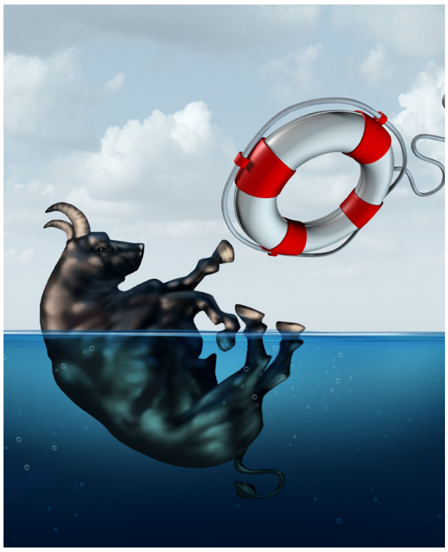
Instead, the market response was far more directly linked to these five elements:

1. Even though we still cannot see an immediate end to the Covid-19 pandemic, there is an underlying expectation that, at some point, this will be controlled (or eliminated) and that business as usual will return.
2. The general easing of Covid-19 lockdowns internationally, and associated pick-up in economic activity in the second quarter, helped improve investor sentiment and risk appetites.
3. By the end of March, prices had dropped so far that future expected returns (despite increased short-term uncertainty) began to look increasingly attractive.
4. Central governments have committed to providing unparalleled fiscal and monetary support (via wage subsidies, spending initiatives, interest rate controls, tax breaks, etc) to help engineer an economic recovery.
5. Interest rates are going to be held at extremely low levels for as long as necessary to ease the debt burden on individuals and businesses, and to encourage increased spending and investment.

In other words, markets "looked beyond" all the prevailing bad news stories and focused instead on the longer term outlook. When viewed through that lens, investing in risky assets changed from looking unnerving (March) to looking increasingly appealing (April to June).

This explains how the US share market, after declining -19.6% during the challenging first quarter of the year, rebounded 20.5%[1] in the last three months. Across international developed markets it was a similar story, with Japan rallying 11.6%[2], Europe (excluding the UK) recovering 15.1%[2], and the UK advancing 8.2%[2]. In a relative sense, UK shares have disappointed again this year, continuing a broader trend of underperformance that extends back to the Brexit referendum in 2016.





With investor sentiment swinging back in favour of higher risk assets, the bounce back in the returns of many of the larger, emerging market countries, was similarly impressive. China posted an increase of 15.3%[2], Korea 18.2%[2], Taiwan 18.6%[2], India 20.4%[2], Brazil 30.1%[2], and Russia 9.7%[2]. In aggregate, the emerging markets asset class returned 18.2%[3].

Closer to home, New Zealand and Australian markets also charged back to life following a tough first quarter. The New Zealand share market gained 16.9%[4] from April to June, while the Australian share market added 16.5%[5].

The size and relative consistency of these different market returns highlighted the unique nature of this Covid-led event. The widespread and rapid sell-off in the first quarter, was replaced by an extraordinarily synchronised global rebound in the second quarter.

Similar effects, but on a much lesser scale, were also visible in bond markets. The first quarter ended with considerable uncertainty, as investors became extremely concerned about the potential of increased default risk.

However, substantial efforts by central banks to facilitate bond market liquidity and calm market participants, helped restore market order and confidence.

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This had a positive effect on the second quarter returns from bond markets. Although interest rates remained relatively steady and at extremely low levels throughout the quarter, bonds performed well as fears of default began to diminish.

With this backdrop, the World Government Bond Index delivered 0.6%[6] for the quarter while the Global Aggregate Bond Index, with greater exposure to investment grade corporate bonds, gained 2.4%[7]. In New Zealand, where yields declined slightly over the quarter, the New Zealand Corporate A Grade Bond Index rebounded 3.4%[8].

When Covid-19 emerged in the early weeks of 2020, it was a giant domino that triggered a series of unimaginable events:

- The grounding of planes
- The closing of borders
- Social distancing and national lockdowns
- Escalating confusion and fear
- An unprecedented market correction
- Massive fiscal and monetary support by governments and central banks

Air New Zealand provides a case study for how unexpected this was and how quickly it evolved. On 27 February, Air New Zealand announced a six month after tax profit of $101 million and expressed confidence they would be able to effectively manage their way through the emerging Covid-19 outbreak. By April, it had been forced to reduce its network capacity by more than 95% and required an emergency loan facility of $900 million from the New Zealand government. Extraordinary.

Air New Zealand of course wasn't the only business to suddenly encounter significant Covid-related problems. But the point is, if these firms couldn't easily foresee the impact on their businesses, it highlights something we know only too well - just how difficult it is to correctly forecast the future.

In the first quarter, investors weathered the financial fallout from all of this. In the second quarter, they benefited from their resilience and the forward-looking nature of markets. In many cases, investor resilience was fortified by communicating with their financial adviser.

Access to good advice is a critical component of achieving good investment outcomes, and it is never more valuable than when uncertainty and fear are the dominant emotions influencing markets. Good advice is the life jacket that might seem unnecessary when seas are calm. But when a freak storm hits and waves start crashing over the bow, it's the first thing you reach for.

In KiwiSaver, where many investors are forced to take a DIY approach, the market upheaval of the first quarter led to a sizable increase in the number of investors wanting to switch out of a growth strategy, into a more conservative portfolio.

It's an understandable behavioural response to an extremely challenging and confusing environment. Unfortunately, it's almost always a sub-optimal strategy. Investors exiting growth assets in March, then had to endure the added discomfort of watching most share markets rebound by double-digit amounts over the next three months.

Pleasingly, the vast majority of investors with access to advice, took the opposite route and made the rational, but emotionally more confronting, decision to stick with their plan. A decision that only with the benefit of hindsight now seems all too obvious.

Good advice (and smart investing) isn't based on trying to defy the odds. We know that events like Covid-19 will very occasionally come along and, thankfully, we don't need to be able to predict how or where they will strike or exactly what impact they might have. Instead we need to focus on making sure that we have a sound, long term strategy that investors can continue to hold, even when the going gets tough. Because bailing out of a plan at the wrong time and missing the inevitable rebound, is a setback that can have far more devastating long term consequences.

A key component of any sound long term strategy is to:

- Always be well diversified (minimising your exposure to company-specific risks, or to a single industry or asset class);
- Always take risk in amounts you can tolerate (so you can hold on through periods of heightened uncertainty), and
- Always keep your life jacket handy.

> Good advice is the life jacket that might seem unnecessary when seas are calm. But when a freak storm hits and waves start crashing over the bow, it's the first thing you reach for.

We don't know what the future holds. Given what we've seen so far this year, it would be a brave person who said that they did.

What we do know is that 2020 has already thrown up considerable challenges and investors have had their mettle well and truly tested. So far, although a little bruised and a little weary of the added emotional strains, most investors have passed this test with flying colours.

1 S&P 500 Index (total return in USD)
2 MSCI Country and regional indices (gross dividend in local currency)
3 MSCI Emerging Markets Index (gross dividend in USD)
4 S&P/NZX 50 Index (gross with imputation)
5 S&P/ASX 200 Index (total return in AUD)
6 FTSE World Government Bond Index 1-5 Years, hedged to NZD
7 Bloomberg Barclays Global Aggregate Bond Index, hedged to NZD
8 S&P/NZX A-Grade Corporate Bond Index

Key market movements for the quarter

Following the remarkable price action of the first quarter, the investment roller coaster that is 2020 continued from April to June. Markets responded very strongly to ongoing financial stimulus (central banks buying securities), accommodative monetary policy (low interest rates) and an upward revision in expectations about the impact of Covid-19.

Economic data released in April confirmed the severe impact of the lockdown, but as economies re-opened (to varying degrees), many businesses and employees began to get back to work. This led to an improvement in economic and corporate news. Compared with the outlook during the peak of the Covid-19 uncertainty in March, company earnings were generally revised upwards, and unemployment projections were revised downwards. This reduction in uncertainty, and (relative) increase in expected long term global output was positive for almost all risky assets.

The speed of the market recovery was slowed late in the quarter with a second wave of Covid-19 cases in the US, forcing some states to consider reinstating lockdown restrictions. With social unrest and an increase in confirmed cases of Covid-19 globally, an improving sharemarket seemingly highlighted a disconnect between Wall Street and the main street.

However, markets are truly forward looking. Market participants are pricing in long term expectations of global economic growth and each and every firm's participation in that growth. When the quarter began, expectations of economic recovery were frail and weighed down by valid fears of the potential catastrophic impact of Covid-19. But, as social restrictions began to 'flatten the curve' and economies began to slowly reopen, the very worst fears began to be priced out.

Today's bad news isn't nearly so bad when yesterday's news was worse.

+18.2% *(hedged to NZD)*

+10.2% *(unhedged)*

International shares

In sharp contrast to the cacophony of negative returns in the first quarter, most developed market equity indices posted double-digit gains. The US led the charge with the S&P 500 Index (total returns in USD) advancing +20.5% for the quarter. This is only the fourth quarterly gain over +20% in this index since the Great Depression, almost a century ago, and the first since 1998.

In general, smaller capitalisation companies outperformed after lagging the market earlier in the year. Information technology firms continued to outperform with many firms' cashflows unaffected, or even benefiting from the health crisis. Consumer discretionary, materials, and energy sectors also enjoyed good quarters as economic activity picked up. Defensive sectors such as utilities and consumer staples lagged, although these sectors were amongst the better relative performers in the first quarter. The real estate and financial sectors' recoveries were also subdued, and after being among the worst hit in the first quarter, they are now the lagging US market sectors for the year to date.

There was some dispersion among the returns of European nations as each had varying success at containing the virus. In aggregate, the MSCI Europe ex UK gained +15.1%. The recovery for members of the European Union was aided by the European Central Bank expanding its Pandemic Emergency Purchase Programme by a further €600 billion until June 2021 (or until the bank believes the crisis is over).

Britain suffered some of the highest infection rates and endured some of the longest and most severe lockdowns, which weighed on their domestic market, as the UK's FTSE 100 made 'just' +9.1% (in GBP) for the quarter.

In a reversal of the price action in the first quarter, the New Zealand dollar strengthened as foreign investment flowed back into New Zealand. This diminished New Zealand investor gains on unhedged foreign assets.

In New Zealand dollar terms, the MSCI World ex Australia Index delivered a quarterly return of +18.2% on a hedged basis and +10.2% unhedged. Whether looking at hedged or unhedged performance, the returns for this index are again positive over 1, 3, and 5 year periods, while the annualised 10 year returns comfortably exceed 10% p.a.

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

+9.3%

Emerging Markets shares

Emerging Markets also made strong gains through the quarter, albeit in the face of increasing infection rates in many emerging nations such as Brazil and India. Markets with higher levels of foreign debt did best, with a relative weakening of the US dollar helping to ease their debt servicing obligations.

After a relatively more robust first quarter performance, gains from China were below average in the second quarter, despite the nation's economic recovery continuing and the government delivering further fiscal stimulus. Geopolitical concerns remain, with US-China relations strained by Donald Trump's continued insistence that the blame for the pandemic can be laid at China's door, and hinting at further trade sanctions. China didn't help its cause imposing a law in Hong Kong on 30 June that will empower the arrests of anyone in Hong Kong (citizen or visitor), who has criticised the Chinese Communist Party.

Technology-heavy exporting economies such as South Korea and Taiwan did well in the hopes of a normalisation in global demand, while India was supported by ongoing stimulus from their central bank. Brazil recorded a strong gain, while Russia lagged after reaching an agreement with OPEC to temporarily reduce oil production.

The MSCI Emerging Markets Index produced a quarterly return of +9.3%, for a +0.9% return over the last 12 months.

Source: MSCI Emerging Markets Index (gross div.)

+16.9%

New Zealand shares

Immediately after posting its worst ever single quarter, New Zealand's S&P/NZX 50 Index posted its largest single quarter gain since 1998, advancing +16.9%. New Zealand's three largest listed companies (Fisher & Paykel: +27.2%, a2 Milk: +27.5% and Meridian Energy: +29.3%) were all very strong. Tourism related firms like Air New Zealand (+69%), Tourism Holdings (+97%) and Auckland Airport (+43%) all bounced back significantly from their late March lows, as the relaxing of lockdown restrictions at least restored the ability for kiwis to enjoy domestic tourist activities.

Similar to global trends, firms in the energy sector didn't participate as strongly in the recovery due to compressed prices and profit margins. Listed real estate companies also struggled, in particular those with assets tied to retail space. The economic downturn and increased levels of unemployment will reduce discretionary spending and may compromise some retail outlets' ability to renew leases.

Overall, the S&P/NZX 50 Index advanced in all three months for a +16.9% quarter and leads all asset classes over 1 year (+9.9%) and 10 years (+15.8% per annum).

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

+20.8%

Australian shares

The Australian share market was amongst the strongest in the second quarter with the S&P/ASX 200 returning +16.5% in Australian dollar terms. Small capitalisation companies performed even better with the S&P/ASX Small Ordinaries Index rising +23.9%, although still down -9.2% year to date.

Dominated by the materials and financials sectors, it was the miners in the materials sector that led the rebound, as global demand for industrial metals returned. BHP (+24%), Fortescue Metals (+39%) and Newcrest Mining (+37%) were amongst the top performing shares for the quarter. The banks were more subdued with the four largest (Commonwealth Bank, Westpac, NAB, and ANZ) all advancing in the order of +10%.

Former market darling, Telstra, continued its struggles with only a small gain. Large biotech company CSL declined through the quarter, but remains one of the few positive performing large cap stocks on the ASX over the last 12 months.

Returns to New Zealand investors, were further enhanced by a relatively strong Australian dollar over the quarter, as the NZD / AUD foreign exchange rate pulled back from parity.

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

+0.6%

International fixed interest

With central banks continuing to provide market liquidity, through asset purchasing programmes, and holding interest rates at or near zero, the yields on high quality government bonds were relatively unchanged. The US 10-year government bond traded in a narrow range and ended the quarter effectively unchanged yielding 0.66%. With the Federal Reserve "not even thinking about, thinking about raising rates", this low interest rate environment looks likely to continue.

Conversely, corporate bonds enjoyed a strong quarter. With economic activity showing signs of greater resilience, the prospects of widespread corporate default reduced, enabling the prices of many under stress securities to rally.

In general, it meant a partial reversal of many of the declines seen in March, with the lower credit quality segments of the market outperforming. Even so, credit spreads (the additional yield on bonds backed by riskier issuers) remain elevated.

In aggregate, corporate bonds outperformed higher quality sovereign bonds, and longer duration bonds outperformed shorter duration. The FTSE World Government Bond Index 1-5 Years (hedged to NZD), posted a +0.6% gain, to take its 12 month return to +3.6%, while the broader Bloomberg Barclays Global Aggregate Bond Index (hedged to NZD), returned +2.4% for the quarter, and +5.7% for the last 12 months.

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

+3.4%

New Zealand fixed interest

New Zealand's fixed interest market delivered more action than was generally seen in global markets, with the 10 year New Zealand government bond yield pushing as low as 0.51% in May; with levels never seen before in New Zealand. Through the second half of the quarter, yields increased again and closed the quarter at 0.96%, for a -0.15% decrease since March 31.

This point to point decline in yields meant a price rise for most underlying bonds and, when combined with narrowing credit spreads, resulting in a +3.4% return for the S&P/NZX A-Grade Corporate Bond Index. This is one of the better quarters for this asset class in recent history. The longer duration, but higher quality S&P/NZX NZ Government Bond Index, gained +2.3%.

The Reserve Bank of New Zealand held the Official Cash Rate at the record low 0.25% at all three meetings in the quarter and significantly expanded the Large Scale Asset Purchases ("LSAP") programme on May 13. The LSAP now includes a commitment to purchase up to $60 billion of New Zealand Government bonds, Local Government Funding Agency bonds, and now, Government Inflation-Indexed Bonds in the secondary market. The LSAP aims to keep borrowing costs low and to improve the functioning of the credit markets to help support New Zealand firms navigate the economic uncertainty resulting from the Covid-19 pandemic.

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

Table 1: Asset class returns to 30 June 2020

Asset Class	Index Name	3 months	1 year	3 years	5 years	10 years
New Zealand shares	S&P/NZX 50 Index, (gross with imputation credits)	+16.9%	+9.9%	+15.7%	+16.1%	+15.8%
Australian shares	S&P/ASX 200 Index (total return)	+20.8%	-5.5%	+5.9%	+4.6%	+6.3%
International shares	MSCI World ex Australia Index (net div., hedged to NZD)	+18.2%	+1.9%	+6.7%	+7.7%	+11.9%
	MSCI World ex Australia Index (net div.)	+10.2%	+7.4%	+11.5%	+8.0%	+10.8%
Emerging markets shares	MSCI Emerging Markets Index (gross div.)	+9.3%	+0.9%	+6.7%	+4.3%	+4.3%
New Zealand fixed interest	S&P/NZX A-Grade Corporate Bond Index	+3.4%	+5.8%	+5.7%	+5.2%	+5.8%
International fixed interest	FTSE World Government Bond Index 1-5 Years (hedged to NZD)	+0.6%	+3.6%	+3.0%	+3.1%	+3.7%
New Zealand cash	New Zealand One-Month Bank Bill Yields Index	+0.1%	+0.9%	+1.5%	+1.8%	+2.4%

Unless otherwise specified, all returns are expressed in NZD. Australian shares and Emerging Market shares are invested on an unhedged basis, and therefore 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.

The year smart investing was not so smart

Maybe you remember 1998. Several wonderful things happened that year. Google was founded for one. The *Spice Girls* were going off. And the first episode of *Who Wants to Be a Millionaire* was aired.

And if you wanted to be a millionaire, there were a couple of very clear rules to follow.... don't be a value investor and don't invest in emerging markets.

As we are value investors with a philosophy to diversify internationally, for us 1998 was a year with some significant lessons attached.

At the time, if you invested the "smart" way, bought low priced companies, smaller companies or profitable companies, and took a global view of markets, you got crushed.

Investment trends at the time favoured large growth companies, defined as a company that is generally larger and more expensive than the average listed company. Small value companies are just the opposite. They are smaller and tend to be less expensive to invest in than the average.

Buying small and value companies is often a prudent investment, as they have historically earned higher returns. It's a smart way to beat the market over time. But not in 1998.

In 1998, the returns of large growth companies outperformed small and value companies by 46%.

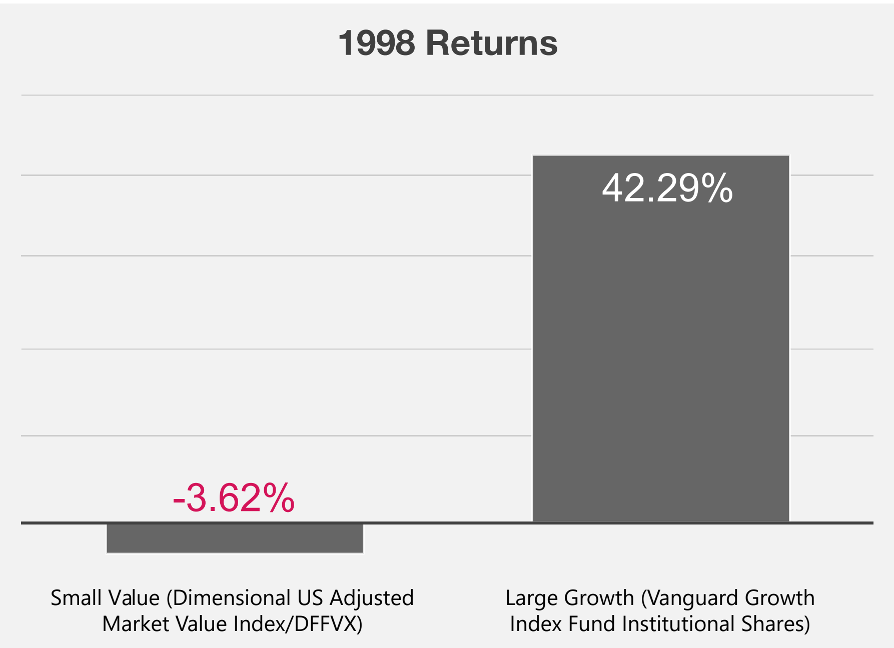
Small and value, represented by the Dimensional US Adjusted Market Value Index, had a negative -3.62% return, whereas the large growth index, represented by Vanguard Growth Index Fund Institutional Shares (VIGIX), had a positive 42.29% return.

The reason to invest in small and value companies is because there is compelling long term evidence of earning higher returns over time.

Imagine your adviser showed you this evidence in 1997 and you acted on it, and at your family Christmas party the next year your brother-in-law outperformed you by 46%. Would you still believe your adviser? Would your adviser even believe himself? In 1998, the internet/computer age was in full swing. Common knowledge was that these new tech companies had different economics which didn't involve tangible assets or require making a profit.

If you confronted your adviser with this "common knowledge" what would he/she say?

1998 was also the year of the Russian currency default and subsequent Asian Financial Crisis. Investing internationally, specifically in emerging markets, resulted in big losses. The MSCI Emerging Market Index was down -9.43%[1]. Now imagine that, again, your financial adviser told you to invest in emerging markets because they had higher expected returns.



Source: Investment Fund Advisers calculator

That seemed reasonable in 1997. But by 1998 what would you think of that "smart" advice?

In almost every way imaginable, 1998 was a year where the smart portfolio that tried to get higher returns via tilting towards shares with higher expected returns, crashed and burned.

If you were invested in a "smart" portfolio in 1997, by 1998 what would you do? Would you sell? Would you buy into the "new economy" funds? Would you go full tech? Would you forego international diversification because the world outside local borders was too risky?

If so, you would have missed the financial good times to come. The compound returns over the next 10 years, which included the start of the GFC, are shown in the table.

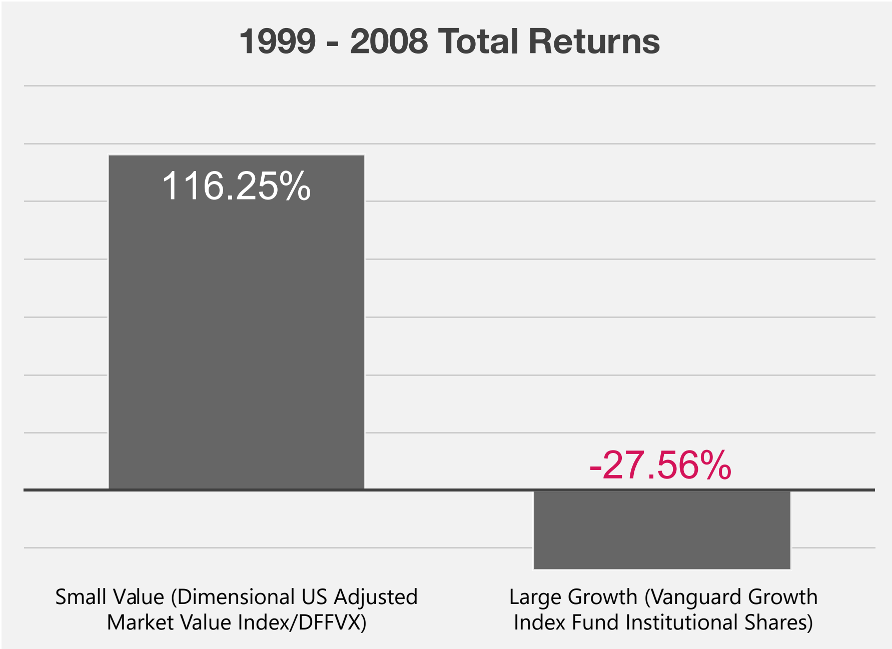
Over the next ten years, a small value portfolio earned a total return of 116.25% but a large growth index earned -27.56%. Emerging markets earned 147.67%[2]

"The 1998 Effect", is a term we use to describe a situation in which all your best "smart" advice appears, well, not as smart as it should. When faced with such a situation, investors must decide to hold on or, without even knowing why, feel compelled to make the ridiculous decisions described in this sketch.

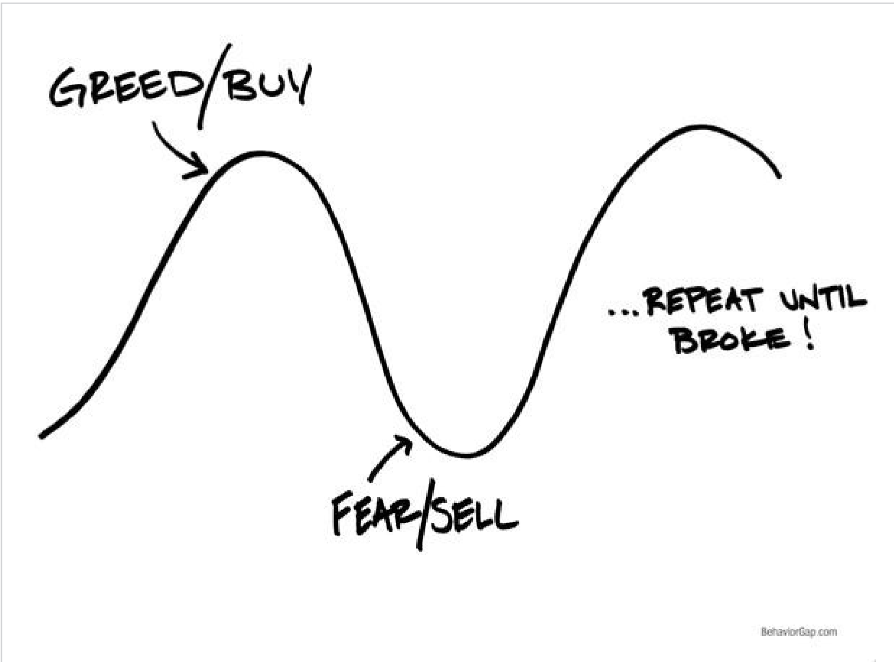
This is why knowledge of the history of capital markets is so important.

There is no strategy that will outperform every year. And when it underperforms, sometimes it will underperform spectacularly.

In the first quarter of 2020, "smart" strategies which diversified internationally, which bought inexpensive value companies, which bought smaller than average companies, underperformed a stay-at-home, large, expensive company strategy. It's as simple as that.



Source: Investment Fund Advisers calculator



The question is, what should we do about it? Should we buy expensive companies, which are now more expensive than they were before? Should we buy large companies because they are larger than they were before? Has the economics changed? Is it reasonable to abandon the strategy?

Every investor has to answer that question for themselves. But if 1998 is any example, a decision to change from a "failed strategy", could very well be a strategy destined to fail.

1 https://www.ifa.com/calculator/?i=em&g=100000&s=1/1/1998&e=12/31/1998&aorw=true&perc=true

2 https://www.ifa.com/calculator/?i=em&g=100000&s=1/1/1999&e=12/31/2008&gy=true&aorw=true&perc=true