Optima Wealth Autumn Update

Optima Wealth
23 Rochdale Street
Christchurch 8014
027 249 8955
hamish@optimawealth.co.nz

Three months ago, after a disappointing quarter in investment markets, we reminded readers that quarterly returns can be extremely volatile, and that long term investors are generally best served by resisting the urge to overreact to short term setbacks. It's pleasing to now be able to report that, over the most recent three months, diversified model portfolios achieved their highest quarterly returns for seven years.

It is also not without a shade of irony that we note these exceptionally strong returns were delivered in a period where most major economies – including China, UK, the Eurozone, Australia, Japan and, more recently, the USA – have all been experiencing a cooling in their economic growth rates.

> As we have remarked before, the relationship between economic growth rates and share market returns is nowhere near as strong as media articles often try to have us believe.

Most of the blame for this cooling has been levelled at the USA for their initiation of a tariff-driven trade war with China, as well as their persistent efforts to renegotiate other significant trade relationships. The slow motion train wreck that has been the UK's bungled attempts at achieving a clean Brexit has no doubt added an additional cause for economic concern, at least in the UK and Eurozone.

However, as we have remarked before, the relationship between economic growth rates and share market returns is nowhere near as strong as media articles often try to have us believe. In fact, lower economic growth rates are not necessarily bad for share markets at all, as it is often a key catalyst for central banks to consider reducing interest rates as a means of providing greater economic stimulus. The rationale is that the lower the cost of money, the more likely it is that businesses and individuals will consider borrowing to invest or spend, both of which are likely to have a positive impact on future economic growth.

In the first quarter of 2019 this is precisely what we saw – a series of measures and actions undertaken by a number of global central banks designed to encourage borrowing, investment and growth.

A short list of some of the banks taking more stimulatory measures included:

- The USA suspending their interest rate hiking cycle much earlier than previously forecast
- The European Central Bank indicating their lending rates would not rise this year
- China, which is actively introducing measures to encourage business borrowing
- The Reserve Bank of Australia appearing to be on the cusp of two interest rate reductions this year
- And last, but not least, our own Reserve Bank of New Zealand (RBNZ) surprising the market with comments indicating a movement towards an easing bias which promptly sent domestic residential mortgage rates to fresh lows

With lower interest rates rewarding investors in both riskier assets and government bonds during the quarter, it is no surprise that diversified portfolios enjoyed a healthy three months of returns.

And last, but not least, our own Reserve Bank of New Zealand (RBNZ) surprising the market with comments indicating a movement towards an easing bias which promptly sent domestic residential mortgage rates to fresh lows.

Looking back over the quarter the New Zealand share market[1] delivered a healthy 12.1%, just ahead of neighbouring Australia[2], which returned 10.9%. Internationally there were also very strong returns coming from developed equity markets, propelled by the USA[3] with an impressive 13.7% return for the quarter. Emerging market[4] countries generally provided a wider spread of individual returns and advanced 10% for the quarter in aggregate. Within these emerging market regions, the sizable Chinese market performed with distinction, while a rally in the price of crude oil was also reflected in strong performances from net oil exporting nations such as Russia and Colombia.

On the back of strong equity market performance, listed property assets also performed extremely well. Domestically, even though the RBNZ's indications about lower interest rates would have been applauded by most property investors, the New Zealand listed property sector[5] rose 'only' 8.7%. While this was still a very strong quarterly performance, it nevertheless lagged the domestic equity market return by a little over 3%.

Internationally we saw the reverse, with the Australian listed property sector[6] gaining 14.4% and international listed property securities[7] delivering 14.6%. Both performances were above their respective equity market returns and represented exceptionally strong quarterly results for this asset class.

Interestingly, it also highlights a growing disconnect between commercial or listed property assets and residential housing assets. Residential property prices are under pressure in a number of major cities around the world. Prime real estate in London has experienced price falls of around 20% since 2016, Sydney prices have fallen by around 13% from their peak, Dubai's residential prices have dropped 25% over the last five years, Hong Kong is down 10% since August 2018 and Manhattan apartments have eased by around 5% over the last year.

It's a concerning trend and likely caused by a combination of factors – a general slowing in the global economy, the bubbling trade conflict between the USA and China, geopolitical problems in Europe, a general tightening in global credit, and increased anti-money laundering crackdowns on funds from countries such as Russia and China. The net effect is that foreign buying has reduced considerably.

The International Monetary Fund drew the same conclusions in their November 2018 working paper titled "House Price Synchronicity, Banking Integration, and Global Financial Conditions". They observed that house price movements have become increasingly correlated across the world, and that the link is stronger between big cities than it is between countries. In effect, housing is becoming more of a global asset class than a purely local one and, as such, the winds of the international marketplace are affecting prime residential property as much as they do shares and bonds.

In New Zealand we haven't been so directly impacted by this global residential correction, although the Auckland market was relatively sluggish throughout most of 2018. Respective New Zealand governments have highlighted concerns about housing affordability and have been implementing strategies aimed at taking some of the heat out of the domestic property market. This includes the relatively recent implementation and extension of the bright line test for residential property, as well as the foreign buyers ban.

The next cab off the rank could potentially be in the form of a new tax policy the government might seek to implement as a result of the Tax Working Group's recommendations, with the most obvious contender being the hotly debated idea of some form of capital gains tax. However, the strongly negative public reaction to these recommendations suggests we may not need to be overly concerned right now about what might eventually find its way into government policy.

The final element of portfolio returns for the quarter was the performance of the fixed interest asset classes.

With the RBNZ in late March announcing a surprise shift towards an easing interest rate bias, domestic bond yields hit record lows by the end of the quarter, which was very positive for local bond returns. This was reflected by the performance of the New Zealand Corporate A Grade Bond Index[8], which gained 2.3% in the quarter.

It was a similar story overseas, with major foreign central banks all taking a notably softer stance on interest rates amidst a weakening global growth environment. In both the USA and Germany, the respective 10 year government bond yields fell close to 30 basis points (0.3%) each, which was again very beneficial for international bond investors. In this environment the returns of the World Government Bond Index[9] and the Global Aggregate Bond Index[10] were up 1.0% and 2.8% respectively for the quarter.

When we entered 2019 - on the back of a difficult quarter to end the 2018 year - we couldn't have predicted such a strong start to this year. It is also highly likely that none of the more active investment managers who might now be congratulating themselves on having helped deliver strong returns from January to March were predicting it either.

As we have stated many times before, the future is complex and unknowable. Yes, we can guess about certain things happening, and if we get enough of these guesses right and markets move up, we could even pretend that these guesses were somehow valuable windows into the future. Well, we'd like to categorically dispel that myth. If anyone, us included, could see into the future with special and consistent predictive ability, we'd probably be sitting on an island somewhere - our own island - working on our suntans.

Thankfully we know our limitations, but we also know our strengths. And one thing we do extremely well is to block out all of the 'noise' that is largely unrelated to investment market performance, and to strategically take targeted risk factor exposures within well diversified and low cost investment portfolios. We think this approach, above all, is what gives investors their best chance of successfully achieving their clearly articulated goals and objectives.

Part of the reason that works so well is because we are never tempted to trade based on hunches or guesswork. And sometimes, as was the case three months ago, when the immediate environment around you looks challenging, the best strategy of all is to just stay calm and stick to your plan.

1 S&P/NZX 50 Index (gross with imputation)
2 S&P/ASX 200 Index (total return in AUD)
3 S&P 500 Index (total return in USD)
4 MSCI Emerging Markets Index (gross dividend in USD)
5 S&P/NZX All Real Estate Index (gross with imputation)
6 S&P/ASX 300 A-REIT Index (total return in AUD)
7 S&P Developed REIT Index (gross total return in USD)
8 S&P/NZX A-Grade Corporate Bond Index
9 FTSE World Government Bond Index 1-5 Years, hedged to NZD
10 Bloomberg Barclays Global Aggregate Bond Index, hedged to NZD

Key market movements for the quarter

+12.09%

New Zealand shares

After a testing finish to 2018, the new year started strongly across most equity markets worldwide. The domestic market participated in this rally and had recovered from the Christmas low by early March. The NZX top 50 went on to set several new all time highs, and by the end of the quarter it was 12.09% higher than the 2018 close. Large companies led the recovery, with the two largest stocks on the index – a2 Milk and Meridian Energy – gaining in excess of 25%, and many more in the top 25 posting double digit returns. Air New Zealand's share price hit some turbulence following a warning its annual earnings may fall by as much as 37%, while Spark similarly announced reduced profits which led to a loss for the quarter. Vista Group was the strongest stock in the NZX top 50, with the film industry software solutions firm reporting impressive growth and profitability stats across its businesses. *Source: S&P/NZX 50 Index, gross with imputation credits*

+2.30%

New Zealand fixed interest

The Reserve Bank of New Zealand (RBNZ) held the Official Cash Rate (OCR) at 1.75% at both their 13 February and 27 March updates. However, the surprising aspect of the March announcement was the clear signal that "the more likely direction of our next OCR move is down". This helped push New Zealand government stock yields to record lows by the end of the quarter. Local bond investors benefitted from the associated reduction in corporate bond yields, with the New Zealand A Grade Corporate Bond Index returning a very healthy 2.30% for the quarter. With the market now pricing in an OCR of just 1.30% in February 2020, down from 1.75% at present, it seems apparent that the very low yields currently on offer in the New Zealand bond market can be expected to persist for some time to come. And, if current market pricing is accurate, the prospect of even lower yields into 2020 is an increasing possibility.
Source: S&P/NZX A Grade Corporate Bond Index

+8.69%

New Zealand property

The New Zealand listed property asset class enjoyed the rising tide of the equity market resurgence by delivering a gain of 8.69% for the quarter. Although this was lower than the gain in the wider equity market, it was perhaps only a reflection that the property sector was more resilient than the equity sector during the tough final quarter last year. The prospect of an enduring low interest rate environment in New Zealand continues to underpin strong investor support for listed property assets.
Source: S&P/NZX All Real Estate Index, gross with imputation credits

+10.18%

Australian shares

The Australian share market also enjoyed the swing back in favour of higher risk assets during the quarter as the ASX 200 gained 10.89% in Australian dollar terms. Whilst the gains were relatively evenly dispersed across the Australian market, it was within the small company space that the greatest average gains were posted, with the ASX Small Ordinaries Index gaining 12.59% in Australian dollar terms. Small companies outperforming large companies is typically also consistent with investors displaying a generally increased appetite for investment risk. The leading Australian equity sectors in the first quarter were information technology, materials and communications services, which posted sector returns of between 17.0% to 20.7%. Healthcare, financials and consumer staples firms, on average, delivered 'only' mid-single digit gains. Reported returns to unhedged New Zealand investors were slightly reduced by the Australian dollar weakening by approximately 0.6% relative to the New Zealand dollar over the quarter. *Source: S&P/ASX 200 Index (total return)*

+12.53% (hedged to NZD)
+10.89% (unhedged)

International shares

International equity markets rebounded strongly during the first quarter of 2019 as concerns over the China/USA trade dispute showed some signs of moderating and major central banks signalled more accommodative monetary policy intentions. These factors, along with an end to the Government shutdown in the US, helped drive US equity market returns. The UK and Eurozone markets also responded positively to the prospect of looser monetary policy settings and both managed to perform well in spite of ongoing Brexit-related uncertainties. Japanese shares also gained, but the advance was somewhat muted compared with other developed markets. Overall, quarterly gains were impressive across most developed nations including USA +13.9%, UK +9.4%, Europe +11.7% and Japan +7.8%, making it the best quarter for this asset class since the first quarter of 2012. *Source: MSCI World ex-Australia Index (net div.)*

+8.37%

Emerging markets shares

Emerging market equities registered a strong return in the first quarter. This was led by a sizable rally in the Chinese share market. The Federal Reserve's announcement of a pause in interest rate hikes, the USA's decision to suspend tariff hikes on US$200 billion of Chinese goods and ongoing government support for the Chinese domestic economy were all very supportive. A recovery in the price of crude oil from around US$55 per barrel to around US$70 per barrel was also favourable for net oil exporting countries such as Russia and Colombia. Bucking this trend, though, was Qatar, which was the weakest index market during the quarter as Qatari equities fell back after a particularly strong rally in 2018. *Source: MSCI Emerging Markets Index (gross div.)*

+0.96%

International fixed interest

The first quarter of 2019 saw a notable change in tone from the US Federal Reserve. In January they confirmed they would adjust planned interest rate hikes to compensate for deteriorating economic momentum. By March, they had officially lowered projections for USA growth and inflation and similarly reduced their expectations for future interest rate hikes. Their revised expectation is for no further rate hikes in 2019 and only one in 2020. The adjusted growth outlook caused the US Treasury yield curve to invert – a signal historically associated with a pre-recessionary environment. However, in the current environment the economic counter-argument is that central bankers have successfully reduced market risks and helped ease financial conditions which should be supportive of the current growth cycle. With other global central banks also joining the accommodative-monetary-policy-party, we generally saw long government bond yields fall, which was a favourable environment for bond returns. The FTSE World Government Bond Index 1-5 Years (hedged to NZD) gained 0.96% in the quarter and the longer duration Bloomberg Barclays Global Aggregate Bond Index (hedged to NZD) delivered 2.77%. The return of the Bloomberg index was also assisted by its higher average credit exposures.
Source: FTSE World Government Bond Index 1-5 Years (hedged to NZD)

+12.92%

International property

Contrary to the domestic performance, international property securities in general outperformed their respective equity markets. With a significant proportion of the asset class linked to financial conditions in North America, the surprise change in stance from the Federal Reserve provided a sizable tailwind for the sector during the quarter. The S&P Developed REIT Index gained 14.57% in US dollar terms and the Australian S&P/ASX 300 A-REIT Total Return Index gained 14.38% in Australian dollar terms. A slightly stronger New Zealand dollar (relative to the US dollar) reduced reported returns to New Zealand investors holding unhedged investments in this asset class.
Source: S&P Developed REIT Index (total return)

Unless otherwise specified, all returns are expressed in NZD. We assume Australian shares and international property are invested on an unhedged basis, and therefore returns from these sectors are susceptible to movement in the value of the NZD.

Why we never sell during down markets

We know you've heard this before - in fact, you possibly heard it the last time you were in our offices - but we thought it useful to take a moment to again state very clearly why we never sell portfolios during down markets.

Hopefully you didn't notice, but the end of 2018 presented such a market.

You might have come across headlines such:

"The stock market is on pace for its worst December since the Great Depression."[1]

Now that sounds pretty scary. Here's another one:

"Are you ready for the financial crisis of 2019?"[2]

You might be surprised to know that the 2019 Q1 return for the S&P 500 was +13.65% (USD). Hardly a crisis.

And that's the trouble with headlines. News headlines are meant to sell papers and advertising space. Even in our part of the world, doom has been forecast for a while. We've learned to be cynical.

When markets do actually fall, though, it's very natural for any investor to get nervous.

So, in this article, we thought we would remind you of the reasons why we will never suggest you sell your shares before or during down markets.

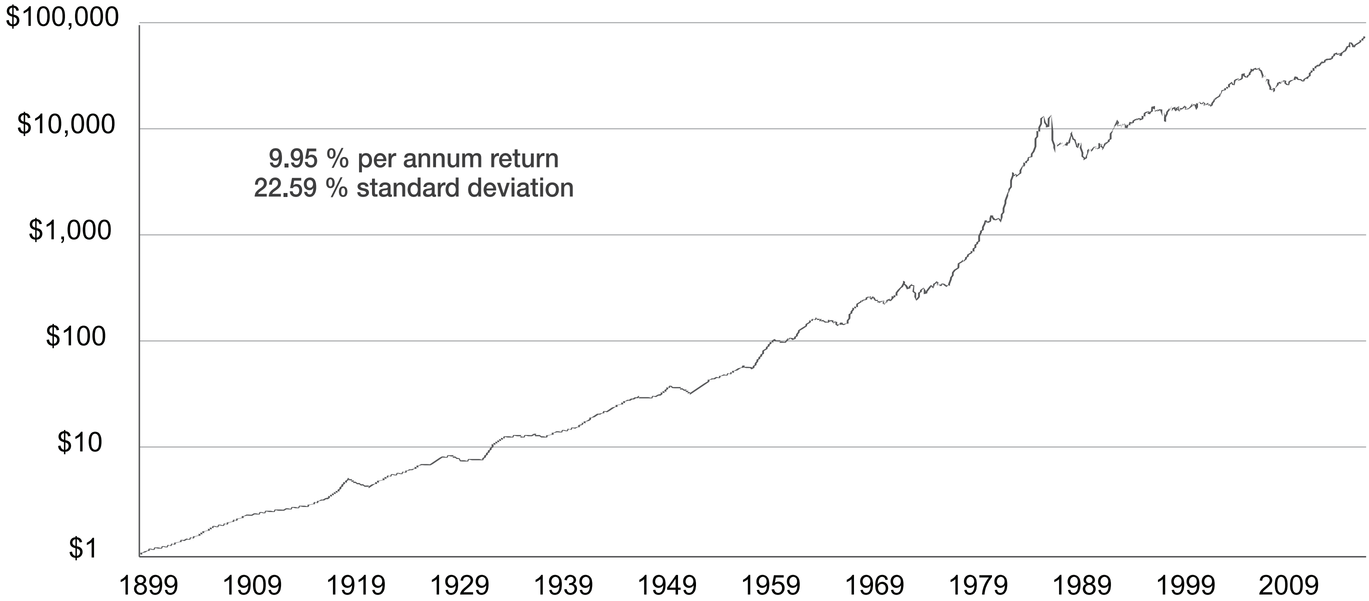
- Buying high and selling low just doesn't make sense. We avoid it at all costs. We can't really think of a worse reason to sell than the fact that the price went down. Can you?

Headlines vs Reality	Yearly return
"Middling year Expected" Otago Daily Times, 1 Jan 2012	NZX50 Index rose 24%
"Economic headwinds lurking" Dominion Post, 29 Jan 2013	NZX50 Index rose 16%
"We're probably fully valued" NZ Herald, 1 Jan 2014	NZX50 Index rose 18%
"Bull run near end of tether" NZ Herald , 3 Jan 2015	NZX50 Index rose 14%
"End of the golden run" NBR, Jan 2016	NZX50 Index rose 9%
"The easy gains for share investors appear to be over" Noted, Jan 2017	NZX50 Index rose 22%

Source: Standard & Poors

- Looking at New Zealand shares since 1899, average returns were 9.95% per annum. One dollar returns tens of thousands of dollars before taxes and inflation. There's almost no possible way to mess this up…unless you try to time the market. (Fig 1)

(Fig 1) NZ SHAREMARKET GROWTH OF WEALTH 1899 - 2017



- Often the money you invest with us is being put aside for very long term goals stretching out 20 or 30 years. Did you know the worst consecutive 20 year return for the S&P 500 over the last 50 years (a time period that included the GFC) was that the value of shares tripled?[3] And that in the worst period over the last 30 years, the total return was over 1,300%?[4]
- We've already factored temporary drops into your plans. When we recommend a portfolio, we know full well there will be up and down markets. When determining if your portfolio will achieve your goals, we count on down markets. Frankly, if we don't get down markets, you'll so overwhelmingly overshoot your financial goals that we'll need to have other conversations. So, if temporary down markets come, your first instinct should be, "my adviser already factored this in", because we have.
- If you really need the money and your time horizon is short, you will already have a substantial position in cash and bonds that have far more stable prices than shares. And that's not by accident. We would have recommended that portfolio because we knew you would need the money over the shorter term.
- We monitor your plan regularly as we meet with you. If you need to do something to get back on track, we'll tell you. That's our job. If necessary, our advice will likely be some combination of saving more, spending less, increasing shares in your portfolio, reducing estate plans, or something else depending on the point you're at in life. All those things, you can control. The markets, you cannot.
- We've built a margin of safety into your plan, because we generally calculate on the market delivering a rate of return lower than what we actually expect. This margin of safety gives you flexibility during down times to ride it out, without your plans being negatively impacted.
- We're not aware of any credible academic evidence (and we've looked) that suggests there is a methodical way to time markets. Without evidence, you are left with hunches and guesses. We don't manage money based on hunches and guesses.

- The past gives us a rich understanding of markets. One question we can ask after the market has fallen X amount is what is the median return over the next 12 months? As you can see below, the data never allows you to comfortably say the market is 'falling'. You can only know the market has 'fallen' (past tense), because the majority of cases after it has fallen, it has subsequently risen.[5]

Average market performance following downturn	
Loss of	**Average 12 month return after loss**
-5%	+12.55%
-10%	+8.19%
-15%	+15.91%
-20%	+6.45%
-25%	+17.36%
-30%	+9.80%
-35%	+10.65%
-40%	+25.39%

The reality is that after markets have fallen, not only are we unlikely to tell you to sell shares (short of you needing the money for a specific purpose), but we are likely to tell you to buy shares.

We do this with our normal rebalancing exercise. If, for example, your portfolio is 60% shares and 40% cash and bonds, when shares fall in value the ratio will change. Perhaps it tips closer to 55%/45%. When that happens, we sell down bonds and cash in order to purchase shares and rebalance the portfolio back to its target ratio.

We know that when markets have fallen like they did in the last quarter of 2018, it can feel like a cause for concern. But we also want you to know that it's our job to be concerned for you. Down markets are inevitable. When they do occur, our advice will be there to keep you on track, but our real hope is that you have a sense of peace knowing we've already factored these markets into your plans.

1 https://www.cnbc.com/2018/12/17/worst-start-to-december-for-the-stock-market-since-great-depression.html

2 https://www.nytimes.com/2018/12/10/style/2019-financial-crisis.html

3 20 years - from Jan 1999 to Dec 2018, annualised return 5.62%. https://www.ifa.com/calculator/?i=sp500&g=100000&s=1/1/1999&e=12/31/2018&gy=true&aorw=true&perc=true

4 30 years Sep 1987 to August 2017, annualised return 9.37%. https://www.ifa.com/calculator/?i=sp500&g=100000&s=8/1/1987&e=2/28/2017&gy=true&aorw=true&perc=true

5 Based on the monthly returns of the S&P 500 Index (gross) and in US dollars. Monthly returns current to 28 February 2018 provided by Standard & Poor's Index Services Group.

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