Optima Wealth Spring Update

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It's been another interesting quarter.

Diversified portfolios continued to perform very well despite the media's best efforts to have us all running for the hills.

It's true there continues to be some large uncertainties in the world. We are reminded of them every day in print and on television. But that's not always relevant when it comes to investment performance.

Even though we don't yet know how or when Brexit will eventually occur, or how the China/USA trade war will play out, market participants around the globe accept that these issues are real and have priced in the elevated risks they represent.

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Why is this relevant? Well, let's consider an example based on the mid 2016 vote in the UK, which resulted in their surprise decision to leave the EU.

Immediately after the vote, UK shares and the value of the British pound both took a hit. In the short term, market prices reacted quite sharply to this previously unanticipated news. Markets reacted because they had only priced in a low probability of the 'Leave' vote winning.

Fast forward to today, and the idea that the UK is leaving the EU is not new information. We've known about it for more than three years, but even today no one can be entirely sure of how Brexit will happen and what the precise consequences will be.

The ongoing speculation today is mainly about whether it will be a hard Brexit (no deal with the EU) or a soft Brexit (a negotiated deal). Perhaps there is even still a very remote chance that the UK might have a new election, a new referendum, and not ever leave. But after three years of uncertainty on this issue, the markets are highly sceptical that Boris Johnson (the new UK Prime Minister) can pull a rabbit out of a hat and negotiate a leave deal acceptable to both the EU and the UK. This scepticism is factored into the market prices of UK securities in particular, and global securities more broadly.

But, for the purposes of this thought exercise, let's imagine what would happen if there was a rabbit residing in Boris Johnson's hat. If the UK could somehow reach a favourable leave agreement with the EU, then this would probably be regarded as a much better outcome than market participants currently expect. In that scenario, the UK would leave the EU and UK securities prices, and share markets in general, might actually go up.

And that's the point we need to continue to remind ourselves. Bad news or uncertainty is quickly factored into market prices as soon as we know about it. Even our collective expectations about the future are priced in.

In the Brexit example, the issue is no longer that the UK leaves the EU. That part is highly anticipated. The issue now is how it will happen, and will it be better or worse than the market expects? And, if what eventually occurs turns out to be better than expected, markets are more likely to respond favourably.

In the face of uncertainty, we just have to be vigilant and continue to look through the noise. Whether that noise is Brexit uncertainty, ongoing trade wars, the US president potentially being impeached, climate change activism, drone attacks on Saudi Arabian oil fields, Fonterra making sizable write-downs or Hong Kong democracy demonstrations, all of these issues are well known and very real. And all of them are already factored into market prices.

That's why, in spite of a relatively lengthy list of unknowns, we saw fairly consistent returns from most developed equity markets in the third quarter. Australasian share markets again performed well, with the New Zealand share market up 4.36%[1] and Australia gaining 2.37%[2].

The important USA economy also continues to look fairly solid, with ongoing jobs growth and low interest rates leading to buoyant confidence surveys. American companies also demonstrated reasonable resilience in their latest earnings season and the USA share market advanced 1.70%[3] as a result.

It was a similar story across key developed markets in Europe and Asia, with European equities posting a 2.09%[4] gain, UK up 0.72%[4] and Japan gaining 3.61%[4] over the quarter.

The results in emerging markets were unfortunately more negative than positive. This is something we see from time to time when investors decide to reduce their risk appetites a little bit more than usual. It's part of what makes an allocation to the emerging markets a more volatile ride in the short term, but with the potential to be highly rewarding over the long term.

Within the leading emerging market countries, we note that within the higher profile BRICK quintet (Brazil, Russia, India, China and Korea), only Brazil (+3.75%[4]) and Russia (+1.53%[4]) delivered positive results for the quarter. It was somewhat surprising that these two oil producers should do well in a quarter where crude oil prices were generally weaker, except for a sharp price spike in mid-September following an attack on oil facilities in Saudi Arabia. Unfortunately, these positives were outweighed by the negative returns from China (-4.25%[4]), India (-2.62%[4]) and Korea (-1.02%[4]), as emerging markets overall delivered -4.11%[5].

The bond markets also performed well over the quarter. Central banks internationally were contemplating a generally weaker global growth outlook and the stage was set for some of the most concerted monetary policy stimulus since the global financial crisis (GFC).

Ironically, the circumstances couldn't be any more different than the GFC. Rather than trying to avert a collapse in the world financial system, accommodative monetary policy today is aimed at breathing life into a decade-old expansion. Nevertheless, with the world turning firmly towards monetary stimulus, bond yields declined markedly over the quarter.

USA and Australia both cut rates by 0.25% in July, and both followed up with a further 0.25% cut in September/early October respectively. The US 10-year Treasury yield declined by 0.35% over the quarter and, in late August, even dipped briefly below the prevailing 2-year Treasury yield. This inversion (where shorter duration Treasury yields are higher than longer duration yields) is unusual and has since corrected.

Some commentators point to an inversion as an indicator of a future recession. That's certainly not a guaranteed outcome, but at a minimum it does signify significant pessimism amongst bond investors. With this pessimism primarily centred on a weaker economic outlook, at least it is not irrational that central banks are attempting to stimulate economic activity.

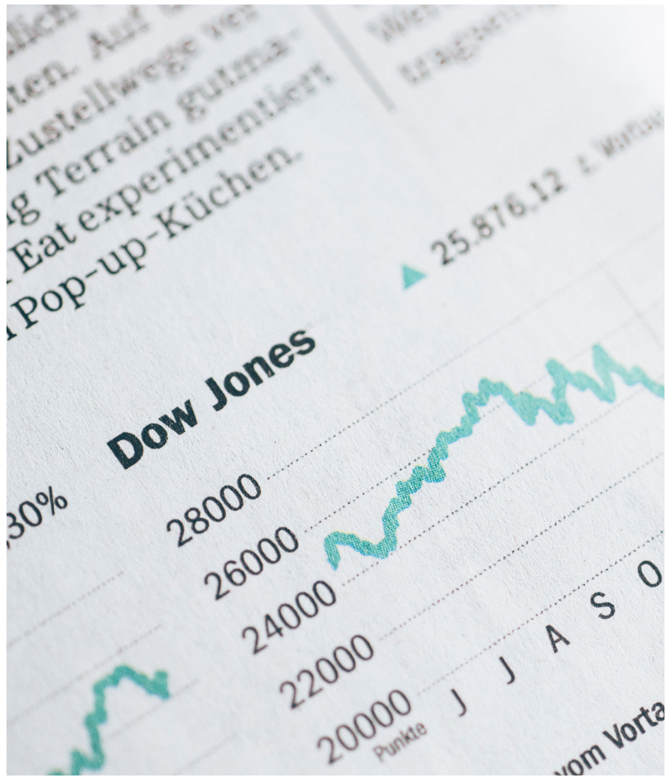
New Zealand joined the party by surprising the market with a 0.50% rate cut in early August. The European Central Bank also cut rates by 0.10% in September (perhaps more notable given their interest rates were already negative), and announced a new bond buying programme as an additional stimulatory measure.

Its widely thought that monetary policy effectiveness wanes when rates that are already very low, head even lower. And with interest rates already low in Australasia and the USA, and below zero in Japan and much of Europe, it will be interesting to gauge the effectiveness of these lower rates in time. After all, if interest rates at 1% don't already tempt individuals and businesses to borrow and invest, will a move to 0.5% or lower really make a difference?

In the interim, the global reduction in bond yields was generally very positive for bond strategies. This was reflected in the returns of the World Government Bond Index and the Global Aggregate Bond Index gaining 0.77%[6] and 2.47%[7] respectively for the quarter. It was a very similar picture in New Zealand, with the New Zealand Corporate A Grade Bond Index returning 2.23%[8] for the quarter.

This quarter provided another clear reminder that events unfold, and markets move in ways that we cannot accurately foresee. When new information becomes available, it is priced in quickly by market participants. In fact, if you hear something new on the evening news or from reading the morning papers, you are already too late. That 'new' information has already been disseminated, digested and translated into securities prices all over the world.

Does that make effective investing too difficult? No. If we need to take some measured investment risks in order to achieve our long term goals (and most of us do) then there are some simple things that we can do consistently, and well, that will always have a positive impact on our investment returns over time. Trying to second-guess markets isn't one of those things. In fact, there is plenty of evidence to say that is entirely the wrong thing to do!



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Uncertainty and market volatility are an inescapable reality of being invested. Reducing your exposure to these risks reduces your portfolio's expected return and, in a world where global interest rates are at historic lows already and heading lower, that could have a catastrophic impact on your long term plans.

The best way to handle uncertainty is by looking through the noise and sticking to your plan. That means staying diversified, keeping costs low, not allowing your strategy to be dictated by the media, and by maintaining an asset allocation that is appropriate to your risk level and investment needs.

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 regional indices (gross dividend in local currency)
5 MSCI Emerging Markets Index (gross dividend in USD)
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

International shares

+1.37% (hedged to NZD) +7.91% (unhedged)

Amid another quarter of ongoing uncertainty, most developed equity markets delivered more positive returns for investors. US-China trade relations regularly lurched from positive to negative, with a resolution remaining elusive. Uncertainty spiked further with the launch of an impeachment inquiry against President Trump late in September. Through this, the US economy remained resilient with unemployment at just 3.5%, a level not seen since the early 1970s. Accommodative monetary policy looks to support businesses (more on that below), although consumer confidence (a measure of consumers' intention to spend) did weaken. Ultimately the S&P 500 gained +1.70% through the quarter (in USD). Brexit continued to dominate headlines in the UK, with Boris Johnson replacing Theresa May as Prime Minister in late July. In his first speech as PM, Johnson promised the UK would leave the EU on 31 October 2019 with or without a deal, and even enlisted the help of the Queen to prorogue parliament (although this recess was ultimately overturned). If nothing else, it proved Mr Johnsons commitment to Brexit, at all costs. The market's reaction was for the FTSE 100 to gain 1%. In the face of such seemingly serious headwinds, this shows how the market had perhaps already priced the likely outcome of a no-deal Brexit some time ago. Europe also gained in the quarter with news of the European Central Bank restarting quantitative easing outweighing underwhelming economic data. The only developed market to post a significant negative return was Hong Kong which declined in excess of -10% amid ongoing protests as Hong Kong residents attempt to resist increased controls from the mainland. The New Zealand dollar was weak through the quarter significantly enhancing returns in unhedged securities. *Source: MSCI World ex-Australia Index (net div.)*

Emerging markets shares

+2.88%

Emerging market shares generally lagged their developed market counterparts in the quarter. China in particular (which accounts for over 30% of the index) was poor declining by -4.25% in local currency terms as US trade tariffs on $300 billion of goods took effect. Further increases in tariffs were announced by the US to take effect in October, as were retaliatory tariffs on US goods. The presence of a strong US dollar was also a headwind as many firms in emerging markets borrow in US dollars and any strength in that currency directly increases their interest costs (in local currency). Taiwan was the pick of emerging nations driven by strong performance from technology firms that represent a large portion of this economy. In aggregate, this asset class was negative in local currency terms however the relatively weak New Zealand dollar meant unhedged investors made gains. *Source: MSCI Emerging Markets Index (gross div.)*

New Zealand shares

+4.36%

The New Zealand share market continued its strong returns with another positive quarter and is up almost +25% year to date. A combination of lower interest rates and reduced rate expectations continued to enhance the attractiveness of many of our domestic firms, with interest coming from both local and foreign investors. In a coup for headline writers, Kathmandu looks set to ride a wave of success with their takeover of Rip Curl helping advance their share price by over 44%. Fellow consumer discretionary company The Warehouse Group also enjoyed a strong quarter advancing +23% on the back of a surprise increase in profit of over 25% for the year ending June. It was a difficult quarter for the dairy industry with Fonterra (-9%) announcing a net loss of $605m for the year which also impacted partner a2 Milk (-10%). Higher yielding sectors such as utilities and property did well with their stable dividends proving attractive in this lower interest rate environment. *Source: S&P/NZX 50 Index, gross with imputation credits*

Australian shares

+5.58%

The Australian share market delivered another gain with the S&P/ASX 200 appreciating by +2.37% in AUD terms, and remains on track for its best year since 2009. There was relatively low dispersion by market capitalisation with the large caps (S&P/ASX 100: +2.48%) just behind the small caps (S&P/ASX Small Ordinaries +3.11%). The two consumer sectors led the way with consumer staples advancing +11.56% led by Woolworths Group, and consumer discretionary gaining +8.20% led by Bunnings' owner Wesfarmers and media conglomerate News Corp. Communications services (Telstra: -6.75%) and materials (BHP -8.02%, Rio Tinto: -7.72%) were both down, the latter feeling the pinch from a potential slowdown in China in particular. Returns to unhedged New Zealand investors were enhanced by a relatively strong Australian dollar. *Source: S&P/ASX 200 Index (total return)*

International fixed interest

+0.77%

The September end quarter delivered increasingly accommodative monetary policy from most central banks leading to a decline in yields across the board. The US Federal Reserve cut rates twice through the quarter contributing to a 0.35% reduction in the US 10-year yield. This key rate temporarily dipped below that of the 2-year bond signifying the first 'yield curve inversion' since the GFC. Yield curve inversions have been linked with recessions in the past and this was a common talking point for journalists during August (although unsurprisingly not accompanied by a discussion of the frequency of false positives). Short term rates have since declined returning the yield curve to a 'normal' upward slope. The European Central Bank also made increasingly supportive policy decisions including a restart of the quantitative easing programme. This will see them buying €20bn of bonds a month on the open market in an effort to keep the cost of borrowing low which is hoped will help reignite borrowing, investment and growth. The 10-year German Government Bond yield fell 0.24% to finish even deeper in negative territory at -0.57%. UK and Australia also saw falling yields, with the latter making two rounds of rate cuts through the quarter, while the Bank of England held steady at 0.75%. In this declining yield environment fixed income investors benefited, and returns were generally higher for exposures with longer duration or more corporate credit exposure. The FTSE World Government Bond Index 1-5 Years (hedged to NZD) gained +0.77% in the quarter and Bloomberg Barclays Global Aggregate Bond Index (hedged to NZD) rose +2.47%. *Source: FTSE World Government Bond Index 1-5 Years (hedged to NZD)*

New Zealand fixed interest

+2.23%

On 7 August the Reserve Bank of New Zealand (RBNZ) lowered the Official Cash Rate (OCR) to 1.00%; a surprise 0.50% reduction to levels not seen since the OCR was adopted in 1999. Consistent with the rhetoric in May, the change was driven by concerns about the weaker global growth outlook and the risks of ongoing subdued growth in New Zealand. Yields have been compressing since 2017 and the quarterly change continued this trend (the New Zealand 10-year Government bond yield finished the quarter at 1.09% down from 1.57% at the end of June). Local bond investors benefitted from the reduction in yields, with the New Zealand A Grade Corporate Bond Index returning +2.23% for the quarter. At the RBNZ's 25 September meeting (where the OCR was held at 1.00%), they reinforced their intention to make further cuts to support the New Zealand economy if needed, and the market is currently pricing a high chance of another rate cut as soon as November. *Source: S&P/NZX A Grade Corporate Bond Index*

Unless otherwise specified, all returns are expressed in NZD. We assume 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.

Why your kids ask for financial help in their 30s

Recently, one of America's largest life insurers (New York Life) did a survey of over 2,000 people to find out what they considered to be their largest financial mistakes, and how long it took to recover from them.

The key mistakes can be summarised as:

- Not saving soon enough for retirement.
- Relying too much on a credit card.
- Not paying off credit card debt monthly.
- Taking on too much student loan debt.
- Not setting aside enough money for an emergency.

On average, these financial mistakes tend to occur in the 30s. That makes sense. The 30s seem to be the decade of life when many major financial decisions are made. We've graduated from university, have a big mortgage, we get married, we have children, and we buy a car less than ten years old (not always in that order). It's the time of life when we could really use financial discipline and guidance. Yet, ironically, it's also often a time of life when people seek help the least.

With so many major life events happening, the 30s can be a time when we spend almost every dollar we make. An income that comfortably supported two individuals now needs to stretch to three, four and even five people, and that can be compounded by the added pressure of one spouse moving out of the workforce - or at least cutting back hours - when children are younger.

Then a couple of financial surprises happen, like the car breaking down or a necessary home repair, and you solve it with a little credit card debt… We've all seen how this spiral can take hold.

It is often around this time when parents get a call for some financial support.

If we understand, and can anticipate, the concentration of multiple financial commitments and the associated stress at this life stage, are there steps we can take to relieve some of the pressure?

When dealing with your financial future, the most important element you can prepare for is to expect the unexpected. In other words, plan on the assumption that you'll get a couple of surprises a year.

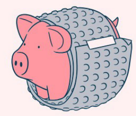
Setting up a savings account is one way to deal with any surprise expenses that may arise. An automatic payment can be set up so, as soon as you get paid, a portion of your salary goes directly into that account. Essentially, pay yourself first, before you pay for anything else. Let that money accumulate, knowing that it isn't there for holidays or household extras, but is set aside specifically for the unexpected. Once your account is larger than about three months' wages, reward yourself with something nice for the house, or consider additional retirement savings. Either way, you'll feel a lot better knowing that you have a 'just in case' fund available.

I did not start saving for retirement

11 years to recover

Average age of mistake: **34**

Average age of recovery: **45**

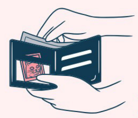


I did not maintain an adequate emergency fund

9 years to recover

Average age of mistake: **32**

Average age of recovery: **41**



I relied too much on my credit card

8 years to recover

Average age of mistake: **36**

Average age of recovery: **44**

I didn't pay off my credit card balance each month

5 years to recover

Average age of mistake: **35**

Average age of recovery: **40**

Source: NYLife

It's important to note that making financial mistakes is part of life. We've all made them. But while they are a normal part of life, the goal is learning from them. In fact, it's learning by experience when you're young, that can be the key to assuring a financially successful future.