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Snapshot

Market insights for investment professionals from Fisher Institutional — February 2018

Embracing volatile markets

Frank Jasper
Chief Investment Officer

What happened?

A goldilocks economy is the best of all worlds; a supportive economy, growing company profits and higher share prices. If the economy is too cold companies don't make enough money and share prices struggle. Too hot and central banks step on the brakes to slow growth and reduce inflation. This means company profits again come under pressure and share prices also struggle.

We have been in a Goldilocks environment over the past year. Every country in the OECD is growing and growth rates have been picking up. Companies have been growing profits strongly and this has resulted in very strong share price appreciation.

On Jan 26 US payroll data was released that was stronger than the market had anticipated. This cast doubt on the Goldilocks theory. Investors wondered if the economy is getting over heated and central banks would act more aggressively to slow things down.

That got the sell off started.

The fundamentals were exacerbated by technical factors

One feature of market psychology is that investors have a tendency to think things will continue along their current trajectory forever. In recent years markets have been remarkably stable. This is measured in financial market terms by the volatility or variability of returns.

Many investors started to believe that this low volatility environment would continue for ever and bet billions of dollars that markets would continue to stay stable and/or that volatility would even fall. Jan 26 was a wakeup call. Volatility spiked going from below 10% to over 50%. Investors who bet on this took a bath. To protect their position many become forced sellers of shares exacerbating the move to the downside.

To give a sense of how crazy some of these strategies were one Fund betting on lower volatility, the VelocityShares Daily Inverse VIX Short-Term ETN, had a market value over $2 billion in late January — significant investor support. As volatility spiked it fell in value by 93 percent and has been wound up.

This pressure of forced selling from highly geared investors betting low volatility would last forever greatly exacerbated the markets moves over the past few weeks.

What happens next?

Despite the surprisingly strong US jobs data and the recent market volatility we still think Goldilocks wins for now. The global economy will continue to grow, companies will increase earnings and shares will generate sound returns with that backdrop despite the fact that are no longer cheap.

That is why we remain around our typical long run exposure to shares in diversified portfolios. But we are watching this closely with our Chief Investment Strategist Mark Brighouse and the team very focussed on when we need to move to a much more defensive position in portfolios.

There are five things all of us need to remember in more difficult times

1. Moves like this in markets happen

We may not remember at this point, but stocks fell more than 12% in the US summer of 2015 and 13% in early 2016. These corrections are all but forgotten because stocks recovered relatively quickly. Volatility is a normal feature of markets and we should never assume that periods of low volatility will last forever.

2. Your response to the recent moves tells you a lot about your DNA as a risk taker

If you feel really nervous, can't sleep and feel the need the check the value of your investment daily it might be a sign you are taking too much risk. It might be time to rethink your investment strategy. The right strategy is one you can live with in difficult as well as buoyant times. Fisher Funds is here to help with this.

3. Where you are at in your investment journey makes all the difference

Many of our KiwiSaver and Managed Fund investors who make regular contributions should embrace falling prices. Falling prices means the investment you make today will likely reap better rewards over the long run. You are invariably richly rewarded for embracing risk at the right times. If you are nearer the time you need access to your money your investment strategy ought to embrace less risk.

4. Active investors use volatility to their advantage

Fisher Funds is an active investor. We have the ability to use volatile markets to make changes to portfolios that we believe will add value over time. For instance, our fixed interest portfolio manager David McLeish has been positioned in shorter maturity bonds so protected clients during the rise in interest rates. Similarly, Sam Dickie our New Zealand equity portfolio manager has been using weaker prices to build our position in new portfolio investment A2 Milk.

5. Fundamentals are all that count in the long run

For me personally this is what I fall back on in tough market environments. Just because a bunch of investors lost money betting on the markets continued stability and were forced to sell shares, the demand for Fisher and Paykel Healthcare's infant Optiflow nasal hi flow oxygen cannula did not change one iota. Luckily for mums worried about their babies, hospitals don't look at whether the Dow was up or down before purchasing life-saving equipment like this. Similarly, Americans are still getting CSL's flu medication regardless of the share market. These companies, as well as the others in Fisher Funds' portfolios, are fundamentally sound, high quality and are growing. The chance to buy shares in world leaders like theses at lower prices is one we should all embrace.

Bruce McLachlan
Chief Executive

2018: Is GFC2 really coming?

Davos is a ski resort in Switzerland where the worlds business and political elite gather each January to discuss world economic affairs. Me, I would rather be on a New Zealand beach at that time or watching the tennis, however for many, Davos is the centre of world attention at that time rather than the other Swiss newsmaker Roger Federer.

This year though there were a number of high profile presentations and interviews that grabbed the world's attention. From early feedback from Fisher Funds clients my guess is they have captured your attention as well. In particular, the claim that *"All the market indicators right now look very similar to what we saw before the Lehman and GFC crisis, but the lesson has somehow been forgotten"* from Swiss-based head of the OECD's review board and ex-chief economist for the Bank for International Settlements **William Whites**. This comment caused some alarm and consternation with some New Zealand investors. At Fisher Funds, we witnessed the odd instance of bizarre and irrational investor behaviour to this early New Year coverage; namely poor investment decisions being based on very little rational thought and almost panicky in its nature.

For many years now and long preceding my time here at Fisher Funds, great effort has gone into making investment understandable, enjoyable and profitable for Fisher Funds clients. Much of that communication has emphasised the differences between investment and speculation, the value of risk management and long term thinking, and the notion of not trying to predict the future, but preparing for it. There is no need for irrational and panicky behaviour if investors have followed the basics.

Even though not any of us can predict the future with any degree of certainty, our very own Chief Investment Officer Frank Jasper addressed this very topic at the end of 2017. In it, Frank spoke to the fact it is widely known that many market valuations are stretched, however Frank also noted that the lead indicators that highlight the prospects for international company earnings were mainly positive. This led Frank to conclude there was unlikely to be any major market correction in the immediate future, however fund managers like ourselves would have their work cut out to find pockets of value and opportunity in this environment.

More recently, we have seen sharp sell offs in global markets triggered by risks of higher inflation and rising interest rates. Volatility is very much on the rise. These corrections have been healthy for markets that have been very overvalued, and proves once again markets are never a one-way bet.

This is where active management of your investments is important. Low fee passive funds are getting some coverage right now given they have ridden the positive investment environment over the last few years. For many New Zealanders these passive investments do not offer support and peace of mind which increases the risk of irrational investor behaviour in dark times. The real benefit of being with a reputable active manager like Fisher Funds is in the more complex and difficult investment environments like that we have ahead of us. There is no need to act irrationally or panic if you have selected your investments carefully, and your investment manager even more carefully. William White may not be wrong and GFC2 is around the corner, however you can rest easy at the beach or at the tennis. Let Frank and his team do the worrying for you.

Mark Brighouse
Chief Investment Strategist

Balancing risk and return

Our Chief Investment Strategist explains how our investment team balance risk and return to benefit your KiwiSaver portfolios — in a way that ensures the portfolio composition is appropriate for both your circumstances and the market environment.

In your kiwisaver portfolios we are able to include in a wide range of different types of assets ranging from shares to bonds to property and infrastructure.

How we mix these together depends on the requirements of the KiwiSaver member (people closer to retirement tend to need a more conservative mix) but also on the risk and return prospects of each type of assets.

I am often asked: "Why don't we just pick the assets with the best returns and own lots of them and none of the others?" However, such "market timing" (especially over short time periods) is likely to be a frustrating exercise most of the time.

Why is this? Why is market timing so difficult? It is partly because financial markets can keep going in a direction that defies logic for a lot longer than people expected. Our research shows that while fundamental valuations have a powerful influence on 5-10 year returns, the range of possible short term returns is still very wide.

Also, the catalysts that trigger turning points in markets are not always evident, even after they have happened. History shows that many of the pivotal episodes in markets lacked a single explanation for why they happened at that particular time.

However, we do know that economies do go in a cycle, moving through periods of recovery, boom, slowdown and recession. And we know that markets swing between relative euphoria and relative fearfulness.

> "At Fisher Funds we can adjust the mix of assets in a KiwiSaver's portfolio as the prospective risk & reward changes"

These swings mean that even though long term investors get well rewarded for bearing the risk of fluctuations in their returns, the scale of this reward varies over time.

For example in the late 1990s investors in the US sharemarket enjoyed above average returns and low market volatility. In the late 2000s they endured lower returns but twice as much volatility. Ten years ago in New Zealand bank deposit rates were double what are they now and the risk hasn't changed that much over that time.

Clearly we live in a changing world where what the financial markets are offering investors is definitely not a fixed payoff.

So the question is how can we adapt to these changing payoffs?

At Fisher Funds we can adjust the mix of assets in a KiwiSaver's portfolio as the prospective risk and reward changes. While these portfolios will still remain appropriate for a member's circumstances, we try to ensure that they also remain appropriate for the market environment. We believe that this approach is superior to a set and forget approach where markets are assumed to offer up a constant level of return and risk.

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Frank Jasper
Chief Investment Officer

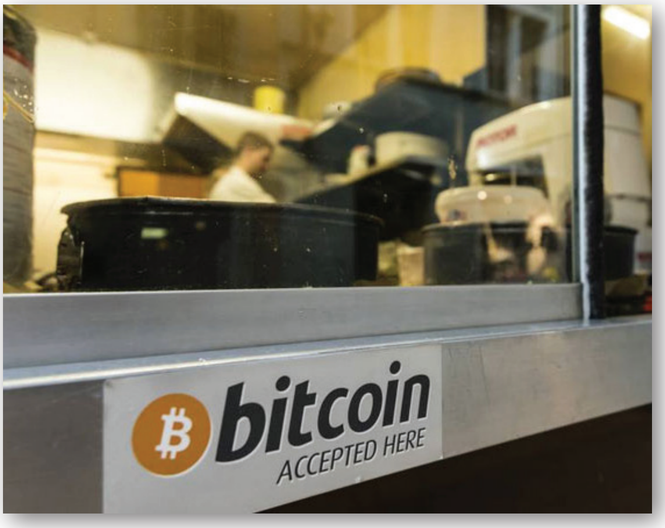
Bit too soon to tell about Bitcoin

Cryptocurrencies will be mainstream in time. But will it be Bitcoin? Or one of 1000 other versions?

It's the summer of Bitcoin. The media, Twitter and blogosphere have been peppered with articles on whether cryptocurrencies will head higher or if it's just a giant delusional bubble.

Much of what is written has been close to idle speculation on what the future might hold. Thoughtful long term perspective is rare. One article, though, shone through in my summer reading.

Viktor Shivets of investment bank Macquarie shared a perspective that makes his work my favourite Bitcoin article. He makes the important observation that money is not like other assets. Money is based on a promise and on trust.



The promise is that the central bank won't just randomly print more, for instance, New Zealand dollars — forcing a decline in its value. Similarly, as owners of New Zealand dollars, we trust the Reserve Bank won't do this, so we are comfortable keeping our money in the bank and using those dollars as a medium of exchange — a benchmark for the value of the goods and services we buy every day.

The 2008 global financial crisis rocked people's confidence and trust in that system. Confidence was not helped by the extensive programme of quantitative easing undertaken by central banks around the world. This meant more and more "dollars" were created in an attempt to save the global economy.

Printing more dollars risks making those currencies less valuable and leading to inflation.

The fact cryptocurrencies like Bitcoin can't be created on a whim by a central bank and take time and expense to produce means, according to Shivets: "They already reflect the essence of money better than existing money."

He sees a long term role for a cryptocurrency independent of global central banks and immune from the influence of politics.

There is a "but". One way of illustrating it is by comparing the rise of crypto currencies to the history of the automobile industry.

This is less of a stretch than it appears. In 1900 there were 2000 car makers globally. Despite the fact cars changed the world, making the horse and cart virtually extinct, it was impossible to have predicted which automobile manufacturers would survive.

By 1920, those 2000 producers had narrowed down to 200. Today it's well below 50.

This is precisely the challenge facing investors in cryptocurrencies in 2018. Even if we accept the role of an independent cryptocurrency, and believe the blockchain technology underpinning them is a car-like step forward, it is all but impossible to predict the winners.

Like the automobile industry of 1900, there are over 1000 crypto currencies in existence today. The least brave prediction I have ever made is that things won't end well for all of them!

There lies the dilemma for genuine investors interested in diversifying currency exposure away from central banks and towards cryptocurrencies. It's simply too early to pick the winners and the costs of backing the wrong cryptocurrency could be disastrous.

To finish with the words of Mr Shivets, and using the automobile manufacturing analogy, "we are still closer to the 1900s than the 1920s."

Our view is the same. There is genuine promise in cryptocurrencies and in blockchain technology but right now this is a speculators' market, not ready for serious investors.

I suspect by the summer of 2038, spanning the 20 years of the automobile example, the winners of the cryptocurrency wars will have well and truly emerged and this will be a mainstream currency.

I wonder what articles Twitter will be swamped with then ... flying cars?

Contact us

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Market Movements

As at 31 January 2018

Stock Markets*	Closing Values	Changes over: 1 Mth %	3 Mths %	6 Mths %	12 Mths %
S&P Developed LargeMidCap - (Local Curr)	769	3.7	6.5	12.2	22.2
S&P Developed LargeMidCap ($NZ)	N/A	3.7	2.6	18.2	26.0
S&P Global LargeMidCap ($NZ)	N/A	1.5	1.4	16.0	27.1
USA - S & P 500	5511	5.7	10.2	15.4	26.4
USA - Nasdaq	8523	7.4	10.4	17.4	33.4
Japan - Topix	2674	1.1	4.2	14.6	23.3
UK - FTSE100	6392	-2.0	1.1	3.9	10.4
Germany - DAX	13189	2.1	-0.3	8.8	14.3
France - CAC40	13968	3.2	-0.1	8.1	19.1
HK - Hang Seng	88756	9.9	16.6	21.9	46.3
Australia - S & P 300	59491	-0.4	3.2	8.2	12.4
NZ-S&P/NZX 50 Gross Index (inc imp credits)	10067	0.5	3.8	10.4	21.3
NZ-S&P/NZX 50 Gross Index (excl imp credits)	8442	0.5	3.6	9.7	19.7
Market Volatility - VIX	13.5	22.6	33.0	32.0	12.9

New Zealand Property		%	%	%	%
S&P/NZX All Real Estate (inc imp credits)	1270.7	-1.5	5.4	6.3	9.4
S&P/NZX All Real Estate (exc imp credits)	1238.2	-1.5	5.1	5.9	8.3

Ten Year Bonds	%	Yield Changes			
USA	2.72	0.32	0.36	0.40	0.29
Japan	0.08	0.04	0.02	0.01	0.00
United Kingdom	1.51	0.32	0.18	0.28	0.10
Australia	2.79	0.16	0.12	0.11	0.08
New Zealand	2.90	0.18	-0.02	-0.08	-0.46

90 Day Interest Rates	%	Yield Changes			
USA	1.46	0.12	0.37	0.37	0.94
Japan	0.07	0.00	0.00	0.01	0.01
United Kingdom	0.52	0.00	0.08	0.24	0.17
Australia	1.76	-0.04	0.06	0.06	-0.02
New Zealand	1.89	0.01	-0.05	-0.06	-0.10

Bond Indices	Closing Values	Changes over: 1 Mth %	3 Mths %	6 Mths %	12 Mths %
S&P/NZX Bank Bills 90-Day	704.69	0.16	0.49	0.98	2.00
S&P/NZX NZ Government Bond Index	1663	-0.50	0.67	1.73	4.85
Barclays Capital Global Aggregate Index (Hedged NZD)	N/A	-0.64	-0.15	0.95	3.59

Hedge Funds & Commodities		%	%	%	%
HFRX Global Hedge Fund Index (USD)	1307	2.4	3.3	4.9	8.0
DJ-UBS Commodity Index Total Return	184	2.0	4.5	7.1	3.6
Gold (US$/ounce)	1339.00	2.5	5.7	5.7	10.8
Oil (US$/barrel)	68.86	3.2	12.2	32.4	24.6

Currencies		%	%	%	%
NZD / USD	0.7401	4.1	8.0	-1.3	0.9
NZD / EUR	0.5941	0.3	1.0	-6.6	-12.4
NZD / GBP	0.5204	-1.0	0.9	-8.5	-10.7
NZD / AUD	0.9140	0.5	2.3	-2.7	-5.4
NZD / YEN	80.79	0.8	3.8	-2.5	-2.1
Trade Weighted Index	74.91	1.9	0.2	-4.5	-4.6

**Total Return Indices. Indices are net of offshore tax.*
Source: Thomson Reuters Datastream

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