fisher institutional

# Snapshot

Market insights for investment professionals from Fisher Institutional — May 2018


**David McLeish**
Senior Portfolio Manager — Fixed Interest


## The Awakening of the Sleeping Tiger

We have long admired the potential India possesses. But until recently, the once aptly named "Sleeping Tiger" economy appeared to be hamstrung by structural issues most believed were insurmountable.

That was until the arrival of Narendra Modi. The BJP's party crushing victory in the 2014 general election provided the ideal springboard for new Primer Minister Modi to launch his ambitious reform agenda.

Looking back over these last four years, this once digitally regressed and highly corrupt economy with dilapidated infrastructure and an almost non-existent rule of law has undergone truly transformational change. Aimed squarely at addressing these previously mentioned deep-seated handbrakes on the economy, Modi's progress has been nothing short of astonishing.

### On the ground in India

Eager to appreciate the opportunities these reforms might offer, we undertook our first on-the-ground research trip in March. As I zig zagged my way across this huge country the sense of opportunity was overwhelming.

The demographic changes taking place in India are profound. Powered by a rapidly rising middle class, which is expected to double from 270 million people to 550 million people by 2025, the potential growth consumption is astounding. Over the next 7 years the purchasing power of the economy is estimated to rise by a whopping US$3 trillion.

In a predominantly cash-based economy, the fruits of this mega-trend may seem a long way off. But with the introduction of a state-of-the-art, digital biometric identification and electronic payments system called Aadhaar, 95% of India's population now have bank accounts. This mobile-driven bank account is sophistication no other country in the world has on this scale. It allows people to transfer money and purchase services directly from the users' phone. This is truly revolutionary stuff and the banking and insurance industries stand squarely in the centre of this new financial eco-system.

A modern infrastructure network has always been an integral part of any countries economic progress. This is a fact clearly not lost on Prime Minister Modi and ambitious plans are already in the pipeline, pun intended.

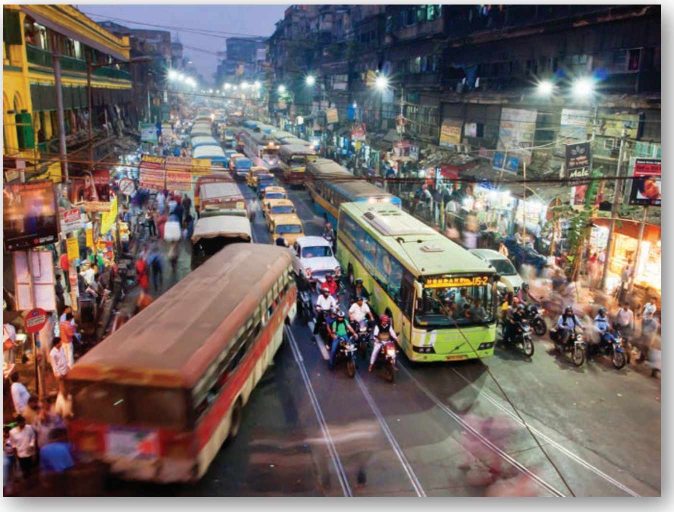
### The Outlook for Growth

Over the next five years the plan is to build 84,000kms of new roads. That's enough roading to circumnavigate the world, twice. Public Private Partnerships are already moving this plan forward and, following the ironing out of some major wrinkles around the tender process for these contracts, it seems that the returns on offer for industry participants now look to have turned favourable.

Airports are another key part of the required infrastructure. It was evident throughout my travels that Indian tourism is booming. So too is domestic business travel. Having met with the management of India's two largest and award-winning airports, Delhi and Mumbai, during my trip it is clear this an industry deep in expansionary mode. Strategically important assets are being created here and we believe partnering with the companies that are building these makes great investment sense.

Another area of focus is India's depleted haulage network which required urgent attention. With this competition amongst state governments for the resources required to carry out all this infrastructure work has begun to grow. At the centre of this struggle are the steel and energy sectors.

During the trip, I spent time with key players within both of these industries and while the outlook has vastly improved a series of capacity, environmental, and trade-related issues saw a number of smaller, over-leveraged players end up in the countries recently established bankruptcy tribunal. These industries are in the process of consolidating and more robust companies



will emerge. Once this is complete, the investment opportunity will be clear.

India is undoubtedly the most exciting opportunity in the world right now.

# Fletcher Building: A Rare Opportunity Under Construction

**Sam Dickie**
Portfolio Manager
— New Zealand

Fletcher Building's woes over the past couple of years have been widely reported. The company has made too many newspaper headlines with delays on major construction projects and the significant losses reported by its building and interiors unit. It is fair to say this has been a company with a chequered track record facing a number of challenges. We believe the headlines, and the fallout from some of Fletcher's poor strategic decisions, are hiding a business that has healthy prospects. New management is the catalyst for change.

Fletcher Building is a company we know well and have followed for many years. I began covering it as a sell-side research analyst back in 2000 and at the time liked the fact it had 5-6 simple divisions, most of which dominated the market.

Despite its challenges, Fletcher Building's key New Zealand operations; Golden Bay Cement, Winstone Wallboards and PlaceMakers dominate their respective markets. These core businesses have, in my view, clear moats and help the company to deliver solid cash flow.

This fact hasn't changed in all the years that I have followed the company. What changed was a number of poorly considered acquisitions and forays into other business lines that clearly did not work.

### So what changed?

What's attracted our attention to the Fletchers of today is the strategic review that has been guided by the new management team. Fletchers has committed to a "back to the future" strategy — selling its overseas business and re-focussing on the strong NZ and Australian core. Fletcher Building is getting back to what it does best.

I am particularly encouraged by Fletcher's new management team. I have met with new CEO, Ross Taylor, several times over the past few months. Ross has a straightforward demeanour, a clear vision and a keen sense of Fletcher's strengths as a business. Ross is committed to seeing it return to its former glory. Based on these conversations and feedback from former Fletcher's executives and industry experts I believe the strategy makes real sense.

There are two key planks to Ross's strategy — refocussing the business on areas of strength and taking out cost and complexity.

After years of distracting international acquisitions and diversification away from key operations, Fletcher's decision to sell its overseas businesses (Formica and Roof Tiles are currently up for sale) makes sense. This is likely to generate in excess of $1bn for the company and may result in it being able to return capital to shareholders.

Fletcher Building also announced a comprehensive restructure of its business. This presents both cost savings and potential revenue growth opportunities. All up we think these initiatives could add $30-$50m to its core earnings.

Bruce McLachlan
Chief Executive

# The Court of Public Opinion

Australia's Royal Commission on Financial Services is going to have a material long term impact on financial services on both sides of the Tasman, but not likely for the reasons currently getting publicity. Yes, there have been examples of very poor behaviour exposed in the Australian industry over an extended period of time.

These examples will be dealt with swiftly and severely by authorities and there will be personnel changes at some organisations at all levels as a result. This process has already started. New personnel will come in and there will be major rectification programs relating to both culture and process implemented at many if not all institutions. In two years or so this will be the new normal.

The impacts from the Commission will go far deeper however. What has now changed forever is the trust of the public. The power and expectation of public opinion is something every institution invests heavily to gain, but once lost is very difficult to rebuild. Notwithstanding the examples of bad behaviour, what has been exposed more than anything else is that meeting the letter of the law with regards financial regulation is nowhere near good enough. The ultimate judge of appropriate corporate behaviour is public opinion and their expectations have been well ahead of the bar that lawmakers and regulators have set. Many Australian Financial Services companies may have not broken any laws, but that is not the criteria by which many will now be judged.

This is why the impacts will be more far reaching and longer term that many may be expecting. It is also the reason why the impacts will be felt heavily in New Zealand. Regulators may have difficulty identifying similar examples of bad behaviour here, but that ignores that public opinion has moved. Meeting the minimum legal standards is a given. Meeting client's expectations with regards independence, quality of advice, fairness, transparency and value for money is way more challenging.

Our processes are very transparent and client friendly. Public opinions of these matters though are changing and we will have to ensure Fisher Funds stays ahead of your expectations.

**Harry Smith**
Senior Investment Analyst

# Retail: it's not all doom and gloom

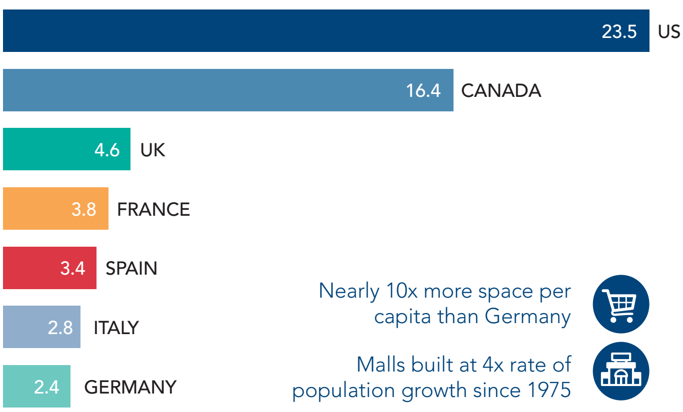
Almost daily we see articles discussing store closures and retail being doomed in the US, pronouncing the death of the US mall. The cause is often attributed to the formidable force, which is Amazon.com. So given this environment, which has most recently seen Toys-R-Us liquidate, does it make brick and mortar retailer's uninvestable?

In short, our answer is no. In fact, we see pockets of growth in the current environment. For example, TJX, the Briscoes of the US (but in branded apparel). But before we get into specifics, let's take a step back and take a look at what is actually happening with US retailers at a time when consumer confidence and spending has been robust.

Pressured by Wall Street expectations, many retailers have expanded their store foot print well beyond sustainable levels. For example, US malls have grown four times faster than population growth since 1975. As a result, there is a significant amount of overcapacity in many segments of retail, especially given the rise of many other pressures since the Global Financial Crisis (GFC), which we list below.

Consumers, particularly millennials, are increasingly valuing experiences over physical things. Therefore, spending on services has been outpacing spending on physical goods, which doesn't bode well for traditional retailers.

**Retail Square Footage per Capita**




*Source: Cowen Research*

There has been a steady increase in subscription-based services (examples are Netflix and Spotify), which means a greater proportion of weekly disposable income is already committed before a brick and mortar retailer has an opportunity to entice a consumer to spend in their store.

Inequality has increased. The majority of the US working population has not seen their inflation-adjusted incomes increase. These same individuals have seen the cost of non-discretionary expenditures (such as health care, housing, child care, and education) rise.

Lastly, there is no doubt e-commerce has had a large impact on traditional retailers. We estimate that when a brick and mortar store closes, one-third of its sales moves online. Also, e-commerce is taking a disproportionate share of retail sales growth.

So, we are left with a paradox. Consumer spending and confidence is strong and consumers are benefitting from low interest rates. At the same time, though, retailers are closing stores at historic rates.

This paradox, and the explanatory factors cited above, create an increasingly tricky environment for investors in consumer stocks. On the flipside this complexity creates opportunity, which brings us back to TJX an 'off-price' retailer, which has benefitted from an oversupply of inventory as stores close, rising inequality making consumers more value conscious and a business model that is hard to replicate online.

TJX sells branded clothing, such as Nike and Ralph Lauren at a 20%-60% discount to a full-price retailer. They can sell inventory cheaper than other retailers as it sources stock from store closures, order cancellations and manufacturer overruns, which have been plentiful since the GFC, allowing them to sell at a significantly lower price.

In store, a wide assortment of inventory turns over quickly, but there is little depth in terms of sizes etc. This creates a 'treasure hunt' experience, encouraging customers to visit stores regularly as new and different brands arrive almost daily. It is also a model that is hard to replicate online given your ability to view numerous items.

# Market Movements

## As at 30 April 2018

| Stock Markets* | Closing Values | Changes over: 1 Mth % | 3 Mths % | 6 Mths % | 12 Mths % |
|---|---|---|---|---|---|
| S&P Developed LargeMidCap - (Local Curr) | 741 | 2.1 | -3.7 | 2.6 | 11.6 |
| S&P Developed LargeMidCap ($NZ) | N/A | 2.1 | -1.2 | -2.6 | 6.2 |
| S&P Global LargeMidCap ($NZ) | N/A | 3.4 | -0.4 | 1.0 | 11.9 |
| USA - S & P 500 | 5193 | 0.4 | -5.8 | 3.8 | 13.3 |
| USA - Nasdaq | 8147 | 0.1 | -4.4 | 5.6 | 18.1 |
| Japan - Topix | 2612 | 3.6 | -2.3 | 1.8 | 18.5 |
| UK - FTSE100 | 6464 | 6.8 | 1.1 | 2.3 | 8.5 |
| Germany - DAX | 12612 | 4.3 | -4.4 | -4.7 | 1.4 |
| France - CAC40 | 14147 | 7.2 | 1.3 | 1.2 | 8.2 |
| HK - Hang Seng | 83553 | 2.5 | -5.9 | 9.7 | 30.0 |
| Australia - S & P 300 | 59639 | 3.8 | 0.2 | 3.4 | 5.7 |
| NZ-S&P/NZX 50 Gross Index (inc imp credits) | 10106 | 1.5 | 0.4 | 4.2 | 15.8 |
| NZ-S&P/NZX 50 Gross Index (excl imp credits) | 8444 | 1.5 | 0.0 | 3.6 | 14.4 |
| Market Volatility - VIX | 15.9 | -20.2 | 17.7 | 56.5 | 47.2 |

| New Zealand Property | | % | % | % | % |
|---|---|---|---|---|---|
| S&P/NZX All Real Estate (inc imp credits) | 1259.1 | 1.3 | -0.9 | 4.4 | 8.0 |
| S&P/NZX All Real Estate (exc imp credits) | 1225.2 | 1.3 | -1.0 | 4.0 | 7.0 |

| Ten Year Bonds | % | Yield Changes | | | |
|---|---|---|---|---|---|
| USA | 2.95 | 0.21 | 0.23 | 0.59 | 0.65 |
| Japan | 0.05 | 0.01 | -0.03 | -0.01 | 0.04 |
| United Kingdom | 1.43 | 0.08 | -0.09 | 0.10 | 0.34 |
| Australia | 2.78 | 0.20 | -0.01 | 0.11 | 0.20 |
| New Zealand | 3.02 | 0.09 | 0.11 | 0.10 | -0.03 |

| 90 Day Interest Rates | % | Yield Changes | | | |
|---|---|---|---|---|---|
| USA | 1.87 | 0.14 | 0.41 | 0.78 | 1.06 |
| Japan | 0.69 | 0.00 | 0.62 | 0.62 | 0.63 |
| United Kingdom | 0.71 | 0.00 | 0.19 | 0.27 | 0.39 |
| Australia | 2.03 | -0.02 | 0.27 | 0.34 | 0.29 |
| New Zealand | 2.02 | 0.06 | 0.13 | 0.08 | 0.04 |

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| Bond Indices | Closing Values | Changes over: 1 Mth % | 3 Mths % | 6 Mths % | 12 Mths % |
|---|---|---|---|---|---|
| S&P/NZX Bank Bills 90-Day | 707.94 | 0.16 | 0.46 | 0.96 | 1.96 |
| S&P/NZX NZ Government Bond Index | 1676 | -0.19 | 0.80 | 1.48 | 3.54 |
| Barclays Capital Global Aggregate Index (Hedged NZD) | N/A | -0.38 | 0.28 | 0.12 | 2.07 |

| Hedge Funds & Commodities | | % | % | % | % |
|---|---|---|---|---|---|
| HFRX Global Hedge Fund Index (USD) | 1264 | 0.1 | -3.3 | -0.1 | 2.9 |
| DJ-UBS Commodity Index Total Return | 184 | 2.6 | 0.2 | 4.7 | 8.0 |
| Gold (US$/ounce) | 1316.20 | -0.5 | -1.7 | 3.9 | 4.0 |
| Oil (US$/barrel) | 75.92 | 10.0 | 12.0 | 23.7 | 53.5 |

| Currencies | | % | % | % | % |
|---|---|---|---|---|---|
| NZD / USD | 0.7046 | -2.3 | -4.8 | 2.9 | 2.6 |
| NZD / EUR | 0.5832 | -0.6 | -1.8 | -0.8 | -7.5 |
| NZD / GBP | 0.5116 | -0.5 | -1.7 | -0.8 | -3.6 |
| NZD / AUD | 0.9334 | -0.7 | 2.1 | 4.5 | 1.7 |
| NZD / YEN | 77.10 | 0.5 | -4.6 | -1.0 | 0.7 |
| Trade Weighted Index | 74.88 | 0.2 | 0.0 | 0.2 | -1.5 |

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



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