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Snapshot

Market insights from Fisher Institutional
December 2018

Frank Jasper
Chief Investment Officer

November: strong New Zealand dollar hides market rebound

It was another volatile month in what has been a volatile and trying year for investors. Despite the negative headlines, markets recovered off recent lows and ended stronger for the month. Unfortunately a sharply rising New Zealand dollar in November took the lustre off these returns.

To provide a sense of this, the S&P 500, a measure of the performance of the United States share market, was up 2.0% in US dollar terms for the month but when translated back into New Zealand dollars this turned into a fall of 3.0%. A stronger Kiwi dollar is great news if you are planning to go overseas or to fill the car up with petrol (lower prices are coming just in time for Xmas) but it's not so good for your investments overseas!

We build portfolios with the knowledge that fixed income helps cushion the blow when share markets fluctuate. This was the case in October although it was the fixed income issued by governments rather than companies that was the best performing. Company debt tends to echo stresses in the share market, and this was definitely the case in October especially for the more indebted companies around the globe.

Despite the stronger end to the month, it has been a challenging year. When markets are difficult, it pays to step back from the noise and go back to first principles.

Valuing the share market

Over time the value of any company or its share price reflects two things — how much profit it will make in future and what investors are prepared to pay for these profits.

One way that we look at what investors are prepared to pay for future profits is a price/earnings ratio, or PE ratio in market shorthand. A PE ratio is simply the value of a company divided by its earnings or profits.

While we often use a PE ratio for considering the value of an individual company we can use the same idea for looking at the share market in aggregate. Over the past five years the United States share market, as an example, has had an average PE ratio of 16.6x; for every dollar of earnings, investors have been prepared to pay $16.60.

The selloff in shares in the past two months has led to a material reduction in the US market's PE ratio. At the end of the last year the market PE was around 18.5x. This was above the average of the past five years. Based on current expectations for earnings, US shares now trade on a PE of 15.5x. This is cheaper than they have been in three years and comfortably below the five year average.

The Future Outlook

Does this make shares a stand out buy today? Not necessarily. The other factor that drives the value of shares is the outlook for company profits or earnings. Maybe weaker prices are telling us companies will grow profits less in the future than they have been recently?

We have some sympathy for this view. The global economy has been strong, particularly in the United States. We expect economic growth in 2019 to be lower than it was in 2018. This will undoubtedly mean that company profits don't grow as rapidly next year as they did this year. In short, some of the fall in share prices has been warranted.

Lower growth is not exactly a disaster and is vastly different than expecting future earnings in total to be materially lower. It's only if we saw the risk of an outright profit recession would we believe that further caution would be warranted. For now the investor expectations have been sensibly reset, the trade rhetoric between President Trump and Chinese Premier Xi has simmered down a little and interest rates are off recent highs. This is a recipe for lower volatility.

It's December, and so I can ask Santa for my Christmas present. This year I am asking for a little less volatility so that the long-term positive fundamentals in our companies can reassert themselves. It will be good for all of our nerves if the big guy delivers!

Have a wonderful lead in to your Christmas break.

The power of Xero

Sam Dickie
Portfolio Manager
— New Zealand

As Warren Buffet said, "The single most important decision in evaluating a business is pricing power. If you've got the power to raise prices without losing business to a competitor, you've got a very good business".

Pricing power comes in several forms — the purest form is the one Warren describes above. But it could be more nuanced, for example, when a competitor has been trying to take market share by deeply discounting its prices but later has had to raise its prices materially to remain economically viable.

Xero is a business with that type of pricing power and that was demonstrated recently when Xero's major competitor in the UK (and globally), Intuit, raised prices 8-33% for its range of Quickbooks Online products in the UK.

So where exactly are we in the Xero journey and how is it managing to still grow so rapidly?

Xero was the pioneer of cloud-based accounting solutions and has disrupted conventional desktop solutions since its launch in NZ in 2007. XRO now has over 1.6 million subscribers, and is the market leading provider of cloud based accounting software for small-to medium businesses (SMB's) and their accountants in NZ, Australia and the UK, with growing presences in the North America and other markets such as Southeast Asia and South Africa.

The potential market opportunity for Xero remains huge and the migration to cloud-accounting continues to gain momentum. We think total penetration of the total addressable market by all cloud based accounting players is less than 20% in the UK, the US and Canada (all key growth markets for XRO). We think global penetration outside of these growth markets and Xero's home markets of Australia and NZ is less than 5%, indicating a very long growth runway ahead.

Importantly, Xero is not just a cloud accounting software provider — it has expanded to become a small business platform with an ecosystem of more than 700 connected apps. In Xero's own language, its mission is to rewire the global economy, connecting millions of businesses to their advisors, banks and each other. Xero's MOAT is driven by powerful network effects and is increasing in strength given its ever expanding web of global financial data. As an example, 10 years ago a local Whangarei accountant who was advising the local Whangarei plumber on appropriate cash levels and the optimal level of pipe and fittings inventory might have only had a sample set of one! Meaning that the accountant could not possibly provide a great deal of insight into how the plumber could improve his or her business.

Today there are tens of thousands of plumbers on the Xero platform and Xero itself can advise the Whangarei plumber what the top 10% of plumbers globally have for cash levels and pipe and fittings inventory.

And importantly, every time another plumber starts using the Xero platform, the power of the platform for that original Whangarei plumber increases as he or she gets a bigger sample set to benchmark against.

This creates a self-reinforcing flywheel effect and makes it nearly impossible for a new entrant to build a software product good enough to compete with Xero.

When we think about a MOAT for a company, we are always looking for litmus tests of that MOAT. And one of the most obvious litmus tests of a MOAT is pricing power. When your competitor raises prices by many multiples of inflation, that can only mean good things for the competitive environment and the width of the MOAT.

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Market Movements

As at 30 November 2018

Stock Markets*	Closing Values	1 Mth %	Changes over: 3 Mths %	6 Mths %	12 Mths %
S&P Developed LargeMidCap — (Local Curr)	746	1.3	-4.8	-0.4	1.9
S&P Developed LargeMidCap ($NZ)	N/A	1.3	-3.3	7.0	7.1
S&P Global LargeMidCap ($NZ)	N/A	-3.4	-8.7	-0.3	-0.5
USA — S & P 500	5479	2.0	-4.4	3.0	6.3
USA — Nasdaq	8510	0.5	-9.4	-1.0	7.8
Japan — Topix	2476	1.3	-3.1	-3.6	-4.9
UK — FTSE100	6166	-1.6	-5.3	-7.2	-0.7
Germany — DAX	11257	-1.7	-9.0	-10.7	-13.6
France — CAC40	13135	-1.7	-7.2	-6.6	-3.8
HK — Hang Seng	74069	6.2	-4.3	-11.0	-5.9
Australia — S & P 300	58028	-2.2	-9.3	-3.8	-1.0
NZ-S&P/NZX 50 Gross Index (inc imp credits)	10627	0.9	-4.9	2.5	8.9
NZ-S&P/NZX 50 Gross Index (excl imp credits)	8824	0.8	-5.3	1.9	7.8
Market Volatility — VIX	18.1	-14.9	40.5	17.1	60.2

New Zealand Property		%	%	%	%
S&P/NZX All Real Estate (inc imp credits)	1404.1	4.0	2.9	8.1	12.3
S&P/NZX All Real Estate (exc imp credits)	1358.5	3.9	2.7	7.5	11.3

Ten Year Bonds	%	Yield Changes			
USA	3.01	-0.14	0.15	0.18	0.66
Japan	0.08	-0.04	-0.01	0.05	0.05
United Kingdom	1.35	-0.11	-0.08	0.12	0.03
Australia	2.59	-0.02	0.07	-0.06	0.09
New Zealand	2.56	0.03	0.03	-0.33	-0.17

90 Day Interest Rates	%	Yield Changes			
USA	2.37	0.03	0.26	0.44	1.12
Japan	0.05	0.00	-0.04	-0.05	-0.02
United Kingdom	0.89	0.08	0.09	0.28	0.37
Australia	1.94	0.03	-0.01	-0.04	0.20
New Zealand	1.98	0.07	0.07	-0.04	0.07

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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	716.04	0.15	0.46	0.97	1.94
S&P/NZX NZ Government Bond Index	1731	0.00	0.27	2.59	3.93
Barclays Capital Global Aggregate Index (Hedged NZD)	N/A	0.45	-0.16	0.37	0.66

Hedge Funds & Commodities		%	%	%	%
HFRX Global Hedge Fund Index (USD)	1213	-0.6	-4.4	-4.3	-4.2
DJ-UBS Commodity Index Total Return	172	-0.6	-0.8	-8.0	-1.8
Gold (US$/ounce)	1220.20	0.7	1.7	-6.1	-4.2
Oil (US$/barrel)	57.71	-22.9	-25.0	-24.5	-9.2

Currencies		%	%	%	%
NZD / USD	0.6869	5.2	3.5	-2.1	0.1
NZD / EUR	0.6067	5.3	6.4	0.9	5.4
NZD / GBP	0.5384	5.3	5.5	2.1	6.2
NZD / AUD	0.9406	2.1	2.5	1.4	4.1
NZD / YEN	78.00	5.8	6.0	2.3	1.6
Trade Weighted Index	74.10	3.4	2.5	1.5	1.4

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