Snapshot

Market insights from Fisher Institutional
January 2019

Uncertainty, time frames and 2019

Frank Jasper
Chief Investment Officer

We sounded a word of caution in previous commentary highlighting that the US share market was an outlier of positive performance in what had, to that point, been a weak 2018. Little did we know that share prices would fall savagely in the fourth quarter.

The fall in share markets over the quarter was dramatic. Using data from the United States the 14.0% sell-off in the S&P 500 was the 9th largest Q4 sell-off since the 1920's. In the last 90 years, only the most extreme circumstances have witnessed a sell-off greater than last quarter. Five of those episodes were during the Great Depression when the unemployment rate was over 15%, not the current 3.7%. One episode was the fourth quarter of 1941, when Pearl Harbour was attacked and the US entered WWII. The 1987 stock market crash was another episode. Finally the fourth quarter of 2008 saw a 23% collapse as financial markets essentially seized up amid multiple crises.

The fourth quarter of 2018 was notable in that the large fall was not the result of decisively poor macroeconomic data, or because of extreme political or geopolitical outcomes, but centred more on the fear of possible future outcomes.

There clearly are a number of reasons to be fearful of future outcomes ranging from slowing economic growth in the developed world, to weakness in the Chinese economy and concerns around trade negotiations between the US and China.

The challenge for investors is deciphering which, if any, of these risks will actually eventuate and the impact that they might have on the economy, company earnings and the share market.

While the future, by definition, is uncertain, 2019 feels unusually unclear, a sentiment that is shared by many investors and explains the wild fluctuations in markets over the past few months.

Learning to live with uncertainty

This is the time of the year when many investment specialists provide an outlook for the next year opining on what it might hold for shares, currencies and interest rates. These opinions often give the impression that these experts have a startlingly clear crystal ball with forecasts that are precise, right down to indications of which quarters might provide the best returns.

Reality could not be more different. As the fourth quarter showed, share prices, currencies and interest rates often move in ways that are very unpredictable. Forecasting the timing of these moves is nigh on impossible.

It is because of this short term unpredictability that the long term returns of riskier assets like shares are good. Long term investors are compensated for taking short term risk by earning higher average returns. No risk would mean cash-like returns. We should not be surprised by volatility, but oftentimes we are.

Over the holiday break I read a great book by, wait for it, poker player Annie Duke. The book "Thinking in Bets: Making smarter decisions when you don't have all the facts" is about uncertainty and how we can respond and manage risk, in an uncertain environment.

While many of the book's lessons come from poker (not a game I play!) its relevance is much broader. Uncertainty is a hallmark of not only poker, but financial markets and in fact life more broadly.

One of the key messages in the book is to think about the future more as a range of possible outcomes with an associated probability distribution. This involves thinking about not only what is probable, this is the subject of most of those yearly forecasts, but also what is possible. For investors this means thinking about the range of possible outcomes that will influence your portfolio over the next 12 months and over the longer term.

Time frame is a very important element in this thought process. Over the short term share markets are volatile with annual returns relatively unpredictable and widely dispersed. Over the long term this changes with the range of outcomes surprisingly tight.

Using returns for the US share market back to 1928, returns for individual calendar years have ranged from the best 12 month period with the market up 52.6% to the worst year where the market fell 43.8%. Clearly a wide range of outcomes! If we zoom out and look at 20 year returns, the best twenty year period returns were 18.7%pa with the worst period having a gain of 3.2%pa. Every twenty year period has enjoyed positive returns.

Over the long term we can be highly confident that shares will drive the return on your portfolio. Over any one year this is uncertain. Taking a long term view based on things you can be confident in is important when building a long term portfolio strategy designed to meet your financial needs.

How do we think about the shorter term?

While we can be confident about the long term outlook for shares, even if we are unlucky enough to live through a challenging twenty year period, short term fluctuations still matter, as much as anything because they are emotionally challenging!

We are humble about our ability to predict short term market movements. That said we think we have a reasonable basis to be able to identify environments that are likely to be consistent with sound market returns and environments where markets will be challenged. Where we have discretion we modestly tilt portfolios to reflect these views.

Why only modest tilts? In short, we are not convinced that we, or for that matter anyone, can be so confident in their ability to predict the short term that putting your long term financial security at risk would be wise. That is a bold statement. But imagine if we were too cautious and you missed out on a surprisingly strong year of share market returns. This would have a negative impact on long term wealth accumulation.

From a top down perspective we think about the short term through three lenses — the economic outlook, current valuations and investor sentiment.

Our cautious positioning has reflected the balance of risks on all three of these pointing to some downside. The global economy, and hence the outlook for company profits, was clearly slowing. Valuations, at least for some parts of the share market, were stretched and investor sentiment, in the US in particular, was overly buoyant.

Today some of this backdrop remains the same, while some has changed. Recent economic data supports our view that the global economy is slowing, although the number one question of how much is it slowing is very uncertain, with trade wars and the state of the Chinese economy making for a particularly cloudy outlook. A cloudy economic outlook doesn't bode well for company earnings growing rapidly. The outlook for company earnings is an important driver of share market returns. This points to the need for continued caution.

Valuations, on the other hand, have improved. Falling prices will do that! With share prices down a lot and earnings not as much the average valuation or, in market shorthand, the price earnings ratio (P/E) for many companies is down materially. Again using US data, 20 times in past 92 years the trailing P/E has fallen by 20% or more. In the following year 15 times the market posted positive returns. Of the five times when the market fell following a massive P/E derating, three of the negatives were in the Great Depression. The other two were the end of the nifty fifty period in the 1970's and end of the tech bubble in 2000. Valuations are beginning to be a positive for the outlook.

Similarly the ferocity of the market fall has destroyed the last vestiges of investor optimism. Fear is definitely the prevailing mood of the market right now. This is usually a time to think about buying.

So the market viewed through two out of our three lenses looks better than it did a few months ago. Despite dating myself with the following comment, "two outta three ain't bad[1]" it's not enough for us to fall in love with shares again. The plethora of downside risks to the global economy and to company earnings is enough to keep us cautiously positioned, holding less investments in shares than normal. Using Annie Duke's framework, the spread of possible returns is just too wide right now and the probabilities of positive versus negative returns too balanced.

Caution not panic remains our watchword.

[1] *With apologies to Meatloaf*

New Zealand Shares

Sam Dickie
Portfolio Manager
— New Zealand

- **The December quarter was extremely tough dragged down by poor October performance**
- **We took advantage of the volatility to add to high quality names Fisher & Paykel Healthcare, a2 Milk and Xero**

That was a tough quarter! The S&P/NZX50 had its worst quarter in two years and third worst quarter since the global financial crisis. The utilities sector (+3.4%), real estate (+2.0%) and the telco sector (+0.2%) were the only sectors up for the quarter and all sharply outperformed the market. These are not normally parts of the market where we find a lot of opportunities due to the low growth nature of these businesses.

The quarterly fall, and more, all came in the brutal month of October with the S&P/NZX50 index down 6.4%. Despite that fact that November (S&P/NZX50 +0.8%) and December (S&P/NZX50 -0.1%) returns were OK on the surface the New Zealand market still felt fragile, primarily given the extreme turmoil global markets were experiencing.

December especially was an unusual month, with the New Zealand sharemarket an island of calm in a storm, with flat performance and very low intra-month volatility compared to global stock markets that had extremely elevated levels of volatility and fell sharply. This caps off a wonderful period for New Zealand shares both in absolute terms, up 13% pa for the past decade, and against other global markets.

While challenging periods are never enjoyable the good news is that the valuations of some of our core portfolio holdings are now looking much more attractive. The question we always ask ourselves is: Has anything significant changed with the fundamentals of the company? Is this still a company we would be proud to own in 5 years time? If the answers to those questions is Yes, then Mr Market has just thrown up a wonderful opportunity to add to quality companies at more attractive prices.

We took advantage of the severe volatility in October especially to add to quality portfolio companies **Fisher & Paykel Healthcare**, **a2 Milk** and **Xero**.

Key portfolio movers

Mexican financial investor Finaccess made a partial takeover offer for 75% of **Restaurant Brands** (+7%) in October at $9.45 per share (24% above the previous close of $7.60). The offer is attractive as it is at a premium to our most optimistic valuation of the firm. Finaccess is a Mexican private equity fund that has a shareholding of almost 60% in AmRest Holdings SE, a large Polish-listed fast food operation. AmRest appears to be a credible player. At $8.29 (the share price at the end of the year), the market is implying a c50% probability of this transaction going through, which seems low in our opinion. An alternative way of looking at it is assuming 100% probability of success, the 25% Finacces is not bidding for (the rump) is trading at an implied price of c$4.80 which is attractive.

Infratil (+4%) had a very busy quarter. Notable events included the sale of its under-performing NZ Bus business, took investors around its high-quality data centres in Canberra, continued to negotiate the full take-over of Tilt, announced major value accretive transactions at its Longroad investment and reported a strong financial result. Phew!! There are many reasons why Infratil continues to be one of our largest portfolio holdings but the significant degree of upside optionality in Infratil's portfolio is the key. We travelled to Canberra during the quarter to visit Infratil's, Canberra Data Centre (CDC) and came away very impressed with management, CDC's cost advantage in deploying data centres and the ongoing growth in data centre demand. Demand for CDC's services is accelerating with CDC contracting space in unbuilt data centres faster than in the past.

Michael Hill (-34%) had a shocker of a quarter. The company announced 1Q19 sales, which revealed a sharp -11% decline in same store sales growth, as it cut back its practice of allowing store staff the autonomy to discount to close sales. This was only offset by a modest improvement in gross margin (63.1% to 64.6%). This move was part of the company's change in strategy to move away from price-based competition on generic products and towards offering more unique jewellry collections. We were very disappointed by the worse-than-expected sales decline which suggested a loss of share to competitors and loss of important volume and margin dollars. The company has flagged a greater promotional pipeline in the important December quarter, which is expected to improve results. We have almost halved our portfolio weighting in Michael Hill and we further cut our weighting in the December quarter as we are yet to be convinced that the new strategy is the correct one. The new CEO Daniel Bracken has an impressive CV and we look forward to meeting him in January.

Portfolio Changes

In October, we exited our position in **Abano Healthcare**. Abano has been on watch over the last year and we have progressively been decreasing our investment. Two of the key attractions of a roll-up story are the ability to take organic market share and the delivery of operating leverage via scale and Abano has struggled to deliver on both of these.

Global tech companies were savaged over the quarter and in the face of that, Xero reported a solid 1H19 result, demonstrating its pricing power in its core Australasian business with strong average revenue per user (ARPU) growth and is showing encouraging early signs of subscriber growth in its expansion into the Canadian market. A further demonstration of pricing power was evident when Xero's number one global competitor Intuit raised prices in Xero's most valuable market (UK) 8-33%. Xero is in the enviable position whereby its wide economic moat is becoming wider.

Australian Shares

Robbie Urquhart
Senior Portfolio Manager
— Australia

» **During the quarter we added Aristocrat to the portfolio, and participated in the equity raisings by AUB and Sonic Healthcare and increased our Resmed position**

What a December quarter to finish the year!

The December quarter was quiet from a company news perspective, as it is nestled between the data-heavy 30 June and 31 December financial reporting periods. In contrast share price moves across the quarter were anything but quiet.

In its worst quarter for the year, the ASX200 Index fell 8.3% in A$ across the quarter.

Led by a fall in the oil price, Energy led the declines with the sector falling -21.3% during the quarter. Concern over the outlook for advertising spending coupled with competition commission concerns over a proposed merger between two telecommunications companies dragged the Communication Services —14.5% sector lower.

A global sell-off in higher multiple 'growth' companies dragged down the Information Technology sector which fell —13.9% and also impacted a number of the (more cyclical) Consumer Discretionary names with the sector falling —13.8%.

In contrast, sectors seen as being defensive fared best with Utilities –3.1% and Consumer Staples –3.8% outperforming the market.

Company Focus: AUB Group Ltd

Insurance broker and risk management solutions provider, AUB Group Ltd was down -5.5% in AU$ for the quarter. We spent time with its management team,during what was an eventful quarter for the company.

Meeting with executives for both the Australian and NZ divisions reinforced our confidence in the personnel overseeing the growth and expansion of this company. Fisher Funds has been an investor in AUB for about twelve years. Since then we have watched the company approximately triple its earnings (and the share price has responded accordingly) via increasing the scale of its insurance broking and underwriting agency services operations in Australia. In latter years, under CEO Mark Searles' stewardship, it has expanded to NZ,and broadened its product offering to include people/ workplace oriented risk solutions for clients. In doing so, AUB has diversified its earnings base and reduced its reliance on the insurance premium cycle.

AUB has achieved this growth organically and through acquisition. We are generally cautious of companies growing through acquisition. However, we have always taken some comfort in AUB's 'owner-driver' business model. We believe this structure in which vendors (typically founder-owners) retain ownership in their local operation, is central to its culture of alignment and has been key to the success of its disciplined acquisitive-assisted expansion over more than a decade.

AUB raised just over A$100m in equity during the quarter which we participated in. This has bolstered its capacity to flex ownership in partner-businesses and to broaden its number of business partners across the Australian and NZ divisions. It is also in the process of finding a successor for CEO Mark Searles who is stepping down later in 2019.

We were reminded of a core component of AUB's culture on the Boardroom wall when we visited management's offices in December

While it remains to be seen who will pick up the reins, we take comfort in the orderly transition already underway and our faith in the wider management team. Importantly, we do not believe that a new CEO will herald a departure from the company's successful and well-trodden pathway of the last decade. We expect the network of business partners to keep increasing in coming years. We also expect collaboration across AUB's different divisions to increase which, although difficult to quantify, should in time add to shareholder value.

Key Portfolio News

Technology One (+11.8% in A$) A solid full year result in November saw Tech One return to mid double digit earnings growth after a weaker FY17. This was driven by strong growth in annual recurring revenues which now make up 57% of total revenues. The signing of new SaaS customers in addition to migrating existing desktop customers to the cloud also continues to be the key driver of margin expansion. Management remains committed to expanding their presence in the UK after a few years of teething issues in this market.

Sonic Healthcare (-11.2%) raised equity to fund the acquisition of a US based pathology business. In line with Sonic's expansion strategy, this acquisition elevates Sonic's beachhead in anatomical pathology in the US into a business with reasonable scale and extends its geographical presence and coverage across the US, broadening its platform for growth over the coming years.

Resmed (+0.7%) had a busy quarter which included the delivery of a strong Q1 2019 result with positive revenue momentum evident. Resmed also received a favourable regulatory outcome in the latest round of the competitive bidding process in the US which improves the earnings outlook for the company in the next few years. Resmed continued its push into 'connected care' in the quarter by adding further healthcare related software capability to its arsenal through the acquisition of MatrixCare (for US$750m) and digital therapeutics business, Propeller Health (US$225m).

New addition to the portfolio **Aristocrat Leisure** (-22.3%) missed market expectation in announcing its full year result in November. The result included double digit underlying earnings growth for the year and high cash flow conversion, driven by strong performance within its land-based gaming operations. This was offset by a messy result from the digital division in a transitional year which included the integration of two recently acquired digital businesses. Management's outlook for the group is for another year of growth. Crucially, management is maintaining its focus on investing in innovation, design and development which has historically underpinned its growth in profitability.

We attended a **Dominos** (-23.6%) investor day in Brisbane in October where the company shone further light on a range of store productivity and customer focussed technology initiatives, sharing more of their thinking around the economics and logic behind store-splits — central to the store roll-out strategy in Australia. While the success of the firm's growth strategy is dependent on execution, we came away from the investor day comfortable that management continue to explore ways to improve the customer proposition and put more distance between them and their competitors.

OOH!Media (-33.3%) was negatively impacted by concerns around the outlook for the advertising market. While it may be softer, we think outdoor advertising will continue to outperform other categories. Pleasingly, the company confirmed in November that a key contract with Brisbane City Council had been renewed, alleviating some market concern over its earnings outlook.

Portfolio Changes

During the quarter we increased our **Resmed** position on the back of further evidence of strong management execution and an improved earnings outlook. We participated in the **AUB** and **Sonic Healthcare** equity raisings and used share price weakness to selectively top up a number of positions across the portfolio.

During the quarter we initiated a new position in **Aristocrat Leisure**, the leading global provider of gaming machines and software to casinos, pubs and clubs. Well run, with a strong presence in the US and Australia it has a track record of earnings growth, management have a deep cultural focus on innovation, design and development within the company. This has been commercialised through the launch of a range of games that have developed a strong brand cache amongst consumers and gaming venues alike. Aristocrat has diverted some of the cash flow generated from its core, more mature land based division into higher growth opportunities in of digital and mobile games. Aristocrat entered the digital gaming market through acquisition in 2012, successfully growing earnings strongly from this division over the ensuing years.

Brent Buchanan
Head of Direct Property

What sectors of commercial property can be expected to outperform into 2019?

At the micro level, the main factors impacting investment returns of commercial property remain supply and tenant demand, asset type and of course location.

In terms of new supply, there are currently 140 tower cranes working on construction sites throughout the country, accordingly to RLB's recently released Annual Crane Index (the highest number in more than 10 years). This is a tangible example of a booming construction industry that is the experiencing high demand for skilled labour within an industry that is operating at near capacity.

There are 22 cranes in Christchurch primarily on public sector works, while the 10 in Queenstown are largely focussed on tourism projects. But it is Auckland, with a record number of 90 cranes on the sky line that remain the main centre of activity. Significant, long term projects currently underway in the city include Westfield's $790M Newmarket project, Kiwi's $223M retail expansion of Sylvia Park and Precinct Properties $941M Commercial Bay development.

Whilst individually these developments are reporting solid levels of tenant pre-commitment, the scale of these projects is a material increase in the volume of new stock being introduced into the market. This in turn will increase vacancy and soften rents in their respective asset categories on completion – at least for the medium term. Therefore, those sectors that will see a fall in rents in 2019 include Auckland CBD office (all grades), and Auckland retail — particularly large regional centres. This earnings dip may carry into valuation falls towards late 2019, depending on how long vacancy rates remain at elevated levels.

For other sectors however, the outlook is more positive. Restricted construction capacity, combined with the limited availability of land, means there continues to be a lack of industrial new builds and so expect continued rent increases throughout that sector and value growth particularly in the B and C grades.

Another significant influence on the Auckland market is Auckland Transport's $1B infrastructure plan over the next ten years, to support the $3.4B City Rail Link, due to be completed in 2024.

While high profile CBD developments are getting the majority of media attention, it is the surrounding non-CBD areas that stand to gain the most. Tenant demand for non-CBD locations, that will soon enjoy considerable improvements in worker transportation linkages, along with substantial advancement from investment by the public sector, is escalating rapidly.

Vacancy is falling and rents are already increasing in these suburban locations, particularly in the office sector, but also within supporting retail once the new transportation linkages become established. We expect this sector to outperform in 2019/20.

At the macro level, growth in the New Zealand economy has been slowing with housing, business, and consumer confidence ebbing away in late 2018. This does raise the prospect of overall property yields easing in 2019 given these headwinds and combined with lower domestic investor demand. However, while the New Zealand property market is small, it continues to offer global investors an investment alternative in an increasingly turbulent world.

2018 saw the arrival of a number of new international property investors to our shores, including Blackstone's $635M purchase of seven office buildings and Invesco taking a $181M stake in the ANZ Centre. This buying trend is almost certain to continue into 2019 given a scarcity of global investment opportunities and an increasing allocation to property from institutional investors, given the relative returns on offer other investment classes.

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Market Movements

As at 31 December 2018

Stock Markets*	Closing Values	Changes over: 1 Mth %	3 Mths %	6 Mths %	12 Mths %
S&P Developed LargeMidCap — (Local Curr)	689	-7.7	-13.0	-8.3	-7.0
S&P Developed LargeMidCap ($NZ)	N/A	-7.7	-16.0	-9.6	-3.7
S&P Global LargeMidCap ($NZ)	N/A	-4.7	-13.5	-7.8	-3.3
USA — S & P 500	4984	-9.0	-13.5	-6.9	-4.4
USA — Nasdaq	7710	-9.4	-17.3	-11.2	-2.8
Japan — Topix	2223	-10.2	-17.6	-12.8	-16.0
UK — FTSE100	5950	-3.5	-9.6	-10.2	-8.7
Germany — DAX	10559	-6.2	-13.8	-14.2	-18.3
France — CAC40	12451	-5.2	-13.6	-10.7	-8.0
HK — Hang Seng	72232	-2.5	-6.7	-9.1	-10.5
Australia — S & P 300	57896	-0.2	-8.4	-7.0	-3.1
NZ-S&P/NZX 50 Gross Index (inc imp credits)	10619	-0.1	-5.6	-0.9	6.0
NZ-S&P/NZX 50 Gross Index (excl imp credits)	8811	-0.1	-5.8	-1.5	4.9
Market Volatility — VIX	25.4	40.7	109.7	58.0	130.3

New Zealand Property		%	%	%	%
S&P/NZX All Real Estate (inc imp credits)	1430.9	1.9	2.3	8.3	10.9
S&P/NZX All Real Estate (exc imp credits)	1381.2	1.7	2.0	7.8	9.8

Ten Year Bonds	%	Yield Changes			
USA	2.69	-0.32	-0.36	-0.16	0.29
Japan	-0.01	-0.09	-0.12	-0.04	-0.05
United Kingdom	1.27	-0.08	-0.30	0.00	0.08
Australia	2.32	-0.27	-0.35	-0.32	-0.31
New Zealand	2.36	-0.20	-0.25	-0.49	-0.36

90 Day Interest Rates	%	Yield Changes			
USA	2.45	0.08	0.26	0.52	1.11
Japan	0.07	0.00	0.00	0.00	0.00
United Kingdom	0.91	0.02	0.11	0.24	0.39
Australia	2.09	0.15	0.15	-0.03	0.30
New Zealand	1.97	-0.01	0.06	-0.03	0.09

Bond Indices	Closing Values	Changes over: 1 Mth %	3 Mths %	6 Mths %	12 Mths %
S&P/NZX Bank Bills 90-Day	717.40	0.19	0.50	1.00	1.97
S&P/NZX NZ Government Bond Index	1749	1.04	1.48	3.06	4.65
Barclays Capital Global Aggregate Index (Hedged NZD)	N/A	1.42	1.65	1.61	1.82

Hedge Funds & Commodities		%	%	%	%
HFRX Global Hedge Fund Index (USD)	1190	-1.9	-5.6	-5.9	-6.7
DJ-UBS Commodity Index Total Return	160	-6.9	-9.4	-11.2	-11.2
Gold (US$/ounce)	1278.30	4.8	7.3	2.2	-2.1
Oil (US$/barrel)	53.83	-6.7	-34.9	-30.5	-19.3

Currencies		%	%	%	%
NZD / USD	0.6706	-2.4	1.1	-1.0	-5.7
NZD / EUR	0.5866	-3.3	2.8	1.2	-1.0
NZD / GBP	0.5265	-2.2	3.6	2.7	0.1
NZD / AUD	0.9525	1.3	4.0	3.9	4.8
NZD / YEN	73.57	-5.7	-2.3	-1.9	-8.2
Trade Weighted Index	74.73	0.9	4.1	1.7	1.7

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

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