Snapshot

Market insights from Fisher Institutional
October 2018

Frank Jasper
Chief Investment Officer

You simply can't have it both ways

One investor I have a lot of respect for is Howard Marks. He is the Co Chairman of US based investment firm Oaktree Capital and a deep thinker about money management. In his widely read memos[1], which are well worth looking up, he talks about having the judgement to know what kind of investing environment you are in. Is it time to focus on defence, be cautious and happy to generate lower returns? Or is it time to be aggressive and, in baseball terms, to swing for the fences and enjoy higher rewards?

Over the past year we have suggested that caution was right tone to adopt in this market. This caution meant that we have been positioned for rising interest rates and, where we have discretion, been holding less in shares than we typically would. We have been focussing on two main things to give us a sense of just how cautious to be; the pace of economic growth in the United States and on how other investor's attitudes to risk are unfolding. Developments both in the strength of the United States economy and investor behaviour continue to suggest that caution is warranted.

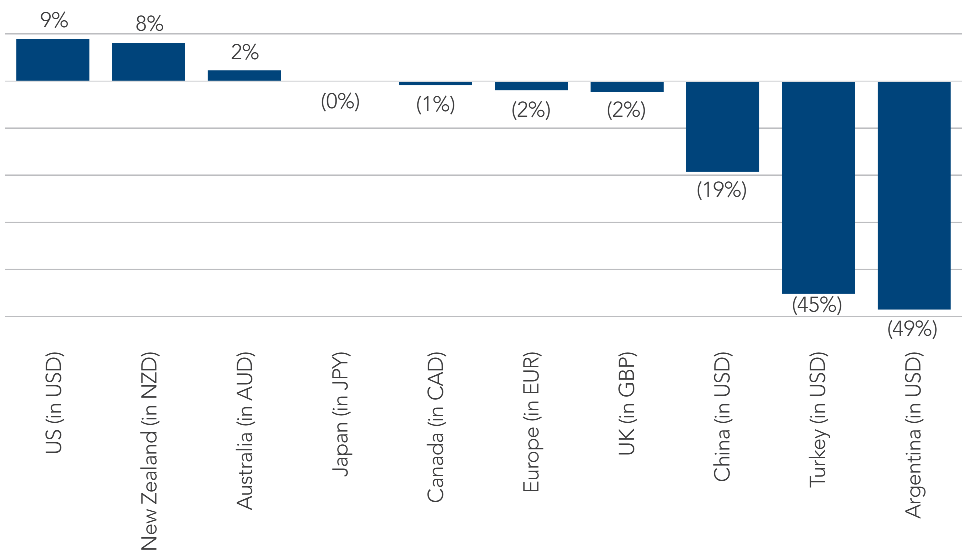
On the surface 2018 has been a strong year

While performance to date has been superb, and I hate to be a party pooper, all is not exactly as rosy as it seems.

1. **Without the US and New Zealand share markets being so strong things would look very different.**

   It is only a small handful of markets that have posted positive returns over the year with the US, and New Zealand the shining lights. Most other markets are down for the year and in the case of the emerging

Sharemarket Returns — Year to 30 September 2018



[1] https://www.oaktreecapital.com/insights/howard-marks-memos

markets 2018 has been very challenging with the market in countries like China, down 19.3% and Turkey and Argentina down 45.3% and 48.6% respectively.

2. **A weak New Zealand dollar has boosted returns for New Zealand based investors.**

   Over the year the New Zealand dollar has fallen against the major global currency blocs. 6.8% down versus a resurgent USD, 3.6% against the Euro, 6.0% against the Japanese yen, even against the Brexiting UK we are down 3.3%

   The fall in the value of the New Zealand dollar has not only boosted the returns of international shares for kiwi investors but has been beneficial for New Zealand companies that are either exporters or have significant offshore operations boosting the return of New Zealand shares.

   The weak Kiwi has both protected and enhanced returns so far this year.

So while we should be smiling about the returns this year it is not cause for rampant celebration. Nor is it reason for us to throw caution to the wind. In our view the catch cry of moving forward with patience and caution should be redoubled.

Why redoubled?

There are two factors we have focussed on to help gauge the appropriate level of caution when building portfolios – the strength of the US economy and investor risk appetites.

There is no doubt that the US economy has been strong this year and while a strong economy is good an overheating one isn't. Economic growth last quarter, admittedly flattered by President Trump's tax cuts, was a lofty 4.2% (real quarter on quarter). Unemployment has fallen to a cycle low of 3.7% and wage pressures are beginning to build. The US Federal Reserve is conscious of this strength and is normalising short term interest rates having increased them three times this year to 2.25%, now a full 0.5% higher than New Zealand's.

The financial markets have responded to this pushing up the value of the US dollar. Similarly US long term interest rates, which tend to reflect concerns of higher inflation, are now at seven year highs, a whole 1.9% above the level reached in July 2016.

The price of money, which is what interest rates are, is the most important variable in financial markets. Rising rates are rarely a good backdrop for investors if they continue to climb too high and for too long.

While this has yet to have had a major impact in the United States, the canary in the coal mine, the Emerging Markets, have suffered a sharp bear market correction this year. These less stable economies are often poorly positioned to absorb higher borrowing costs and this, coupled with a stronger US dollar, have led to precipitous falls.

Caution is warranted.

Similarly investor behaviour is showing signs of over exuberance. This is less evident in the share market; although manias in specific areas, like the cannabis stocks, will inevitably rob some investors of their hard earned savings.

We are seeing more issues in the lending markets. Howard Marks discusses this theme in his latest memo entitled, "The seven worst words in the world," referring to the phrase "too much money chasing too few deals". Over the past few years investors have responded to low interest rates by chasing more risk, companies have responded by being prepared to borrow more, and in some cases, arguably too much. That is a potent combination that has the potential to end badly.

Howard Marks ends his memo making the closing point far more eloquently than I can. I will leave the final word to him. "Investors should favour strategies, managers and approaches that emphasize limiting losses in declines above ensuring full participation in gains. You simply can't have it both ways."

Australian Equities

Robbie Urquhart
Senior Portfolio Manager — Australia

Our team spent a lot of time over the September quarter analysing the strong profit results and meeting with the management teams of the majority of our portfolio companies, both in person and via phone calls. A number of companies use their post results briefings as mini 'investor days' and provide investors access to a broader number of their management teams than is ordinarily the case when meeting with, usually the CEO and/or CFO. These meetings are useful in providing us with deeper insight into the overall businesses and amongst other elements, their culture, people and 'bench strength'.

An anecdote to share with you from one of these meetings relates to an overriding question we're always testing with our portfolio companies. That is, is the management team continually working to expand the 'moat' of their business? This can sometimes take the form of headline grabbing activity such as acquiring a major competitor to improve the market structure or bargaining power of the acquirer. Equally important to us though is whether the management and staff are consistently trying, through daily activity and business as usual initiatives to incrementally add to their customer proposition.

In our meeting with Carsales management, the head of their consumer business walked us through some initiatives specific to their 'Instant Offer' product which does exactly that. Instant Offer is a product offered to consumers who wish to sell their cars immediately rather than go through a process of advertising it online and/or negotiating with dealers. Carsales will have the car inspected and then typically an offer is made to the owner on the spot and Carsales takes on the administrative effort to re-sell the car later. Carsales syndicates the price risk to a third party.

This product has been well received however the logistical process is clunky for consumers. They have to take the car to a specific location to be inspected and once sold, the owner can be left needing transport back home or into town. Carsales is working on a solution that solves for some of these friction points. For example in some metropolitan areas it will soon have the ability to send an inspector to a person's workplace to inspect and make an offer for the car at their workplace and potentially providing transport assistance to the seller post sale as well.

Instant Offer is not an economically meaningful contributor to Carsales profitability. But products and practical initiatives such as this provide additional reasons for consumers to interact with Carsales' network when looking to sell their car. It adds to the customer experience and thereby incrementally adds to Carsales' moat.

Needless to say, we're supportive of Carsales management and the initiatives they have underway.

Retail Landscape

Ashley Gardyne
Senior Portfolio Manager
— International Shares

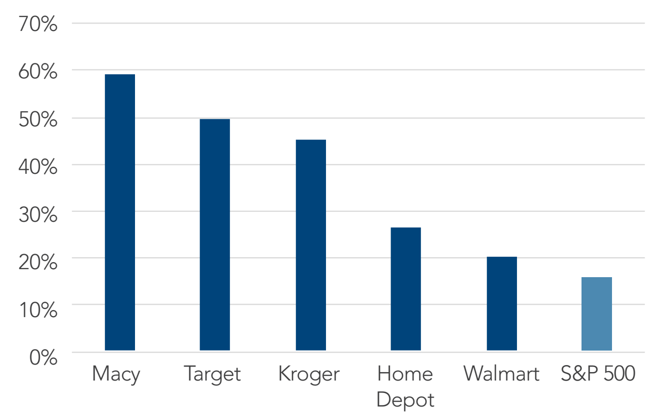
This time last year there was a lot of press coverage of the 'retail apocalypse' theme. Shopping malls were suffering from weak customer traffic, retailers were being boarded up at record pace, and Amazon was seen to be sounding the death knell for retailers. However, it seems that someone forgot to tell the retailers about this impending doom - and their shareholders haven't seemed to take much notice either. The chart below shows that many large US retailers have significantly outperformed the broader US share market over the last twelve months.

It hasn't just been the share market fortunes of these businesses that have improved, in the recent US reporting season many of these retailers saw sales growth accelerate. Shoppers are out and about and spending more than last year. US retailer Walmart recently reported same store sales growth of 4.5%, significantly above market expectations. Home Depot (the equivalent of Bunnings) did even better with 8% same store sales growth. The strong US consumer has been driven by low unemployment (now at 3.7%), increasing wages, and tax cuts that gave many US families more spending money.

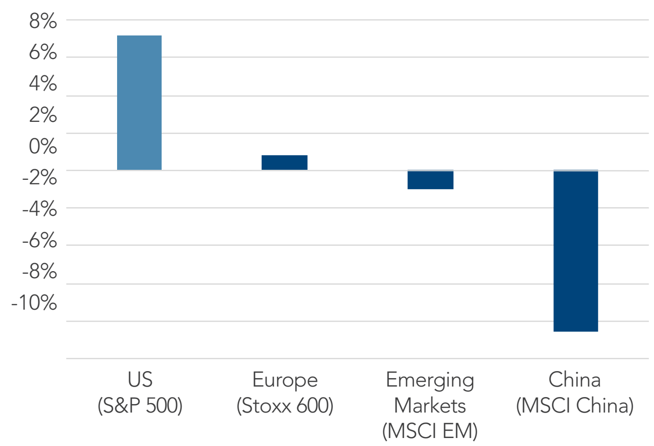
The pick-up in the US economy has driven two major themes that impacted the global investment landscape over the quarter. Firstly, it has seen the US share market outperform the rest of world quite considerably (see chart below), and secondly, it has resulted in outperformance of cyclical sectors like industrials and consumer discretionary, placing less reliance on the tech sector for market gains.

In the third quarter the US market surged 7%, while European markets gained 1% and emerging markets retreated, with China down 9%. This dispersion reflects diverging economic fundamentals, with recent data showing that Eurozone growth slowed in the June quarter. Emerging markets have been impacted by increasing interest rates, which has weighed on markets like Turkey and Indonesia with high external debt levels. Rising trade tensions also weighed considerably on the Chinese market.

Large US retailers - 1 year share price gain %



Quarterly index performance



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Fixed Income

David McLeish
Senior Portfolio Manager — Fixed Interest

- Despite strong risk appetite at present, full valuations and our cautious outlook justifies a more defensive stance
- Global central banks are likely to take their cue from robust current activity and will continued to remove monetary stimulus (i.e. hike interest rates and reduce asset purchases)
- Rising interest rates across some major developed economies are making a defensive portfolio position more attractive, at a time when the economic cycle is nearing its eventual end

Those who are regular readers will be aware of our growing cautiousness as the year has progressed.

This view is predicated largely on a combination of full valuations across much of the global corporate bond market and a deteriorating outlook for economic activity across much of the world into 2019. As we have stated on more than one occasion, risk appetite peaks when conditions are best and are only just starting to deteriorate, which is what we believe we could now be of the cusp of experiencing.

The most straightforward implementation, where we have discretion, of this cautious stance involves reducing the portfolio's allocation to corporate-issued debt and replacing it with higher quality, government-issued bonds.

However, in practice, it is not always as straightforward as that. Forgoing the higher yields offered by corporate bonds significantly reduces the income the portfolio will generate – thereby reducing its overall return in the absence of an offsetting rise in bond prices caused by falling interest rates. Armed with less than perfect foresight into when the trajectory of interest rates will reverse course and move lower, we have instead chosen to implement alternative strategies that aim to improve returns whilst waiting for the momentum behind risk appetite to shift.

The first is a measured 'upgrading' of the portfolio. In essence this is the first step towards a more predominantly government bond portfolio. Here our holdings in those assets which we have identified as most exposed to a cyclical downward and/or reduced risk appetite are replaced with higher quality, investment grade corporate bonds.

Contact us

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Market Movements

As at 30 September 2018

Stock Markets*	Closing Values	1 Mth %	3 Mths %	6 Mths %	12 Mths %
		Changes over:			
S&P Developed LargeMidCap - (Local Curr)	792	0.9	5.4	9.1	12.6
S&P Developed LargeMidCap ($NZ)	N/A	0.9	7.5	18.6	22.7
S&P Global LargeMidCap ($NZ)	N/A	0.7	6.6	14.3	20.3
USA - S & P 500	5763	0.6	7.7	11.4	17.9
USA - Nasdaq	9322	-0.7	7.4	14.5	25.2
Japan - Topix	2698	5.5	5.9	7.0	10.8
UK - FTSE100	6585	1.2	-0.7	8.9	6.1
Germany - DAX	12247	-0.9	-0.5	1.2	-4.5
France - CAC40	14403	1.7	3.4	9.2	6.4
HK - Hang Seng	77446	0.0	-2.5	-5.0	4.4
Australia - S & P 300	63210	-1.2	1.5	10.0	14.0
NZ-S&P/NZX 50 Gross Index (inc imp credits)	11249	0.7	4.9	13.0	19.1
NZ-S&P/NZX 50 Gross Index (excl imp credits)	9351	0.4	4.6	12.4	17.9
Market Volatility - VIX	12.1	-5.8	-24.7	-39.3	27.4

New Zealand Property		%	%	%	%
S&P/NZX All Real Estate (inc imp credits)	1398.2	2.5	5.9	12.5	15.7
S&P/NZX All Real Estate (exc imp credits)	1354.3	2.4	5.7	12.0	14.7

Ten Year Bonds	%	Yield Changes			
USA	3.05	0.19	0.20	0.31	0.85
Japan	0.12	0.02	0.09	0.08	0.06
United Kingdom	1.57	0.13	0.30	0.22	0.21
Australia	2.67	0.15	0.03	0.09	-0.17
New Zealand	2.61	0.08	-0.24	-0.31	-0.36

90 Day Interest Rates	%	Yield Changes			
USA	2.19	0.08	0.26	0.46	1.14
Japan	0.05	-0.04	-0.03	-0.05	-0.01
United Kingdom	0.80	0.00	0.13	0.09	0.47
Australia	1.94	-0.01	-0.18	-0.10	0.23
New Zealand	1.91	0.00	-0.09	-0.05	-0.05

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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	713.81	0.15	0.49	0.99	1.95
S&P/NZX NZ Government Bond Index	1723	-0.16	1.57	2.64	4.88
Barclays Capital Global Aggregate Index (Hedged NZD)	N/A	-0.38	-0.04	0.15	1.16

Hedge Funds & Commodities		%	%	%	%
HFRX Global Hedge Fund Index (USD)	1260	-0.7	-0.4	-0.2	0.2
DJ-UBS Commodity Index Total Return	176	1.9	-2.0	-1.6	2.6
Gold (US$/ounce)	1191.50	-0.7	-4.8	-9.9	-7.0
Oil (US$/barrel)	82.72	7.5	6.8	19.8	45.7

Currencies		%	%	%	%
NZD / USD	0.6630	-0.1	-2.1	-8.1	-8.3
NZD / EUR	0.5708	0.1	-1.6	-2.7	-6.7
NZD / GBP	0.5084	-0.4	-0.9	-1.1	-5.6
NZD / AUD	0.9162	-0.1	0.0	-2.6	-0.5
NZD / YEN	75.30	2.4	0.4	-1.9	-7.5
Trade Weighted Index	71.79	-0.7	-2.3	-3.9	-5.4

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

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