# MARKET INSIGHTS

## Fourth Quarter — 2019

# GOODBYE TO A GREAT YEAR FOR INVESTORS, WELCOME TO 2020

**Frank Jasper, Chief Investment Officer**

2019 was a wonderful year for investors. Markets were up strongly, and we were able to generate returns healthily above the market for most of our strategies.

Active management, trying to beat the market, is at the core of what we do at Fisher Funds. It is the sole focus of our investment team.

We believe that the extra return from active management is going to be even more important in the coming years than it has been in the recent past.

In the pages that follow we will share some of the active management stories from the past year and outline how we have positioned portfolios for 2020.

Before getting into the specifics of which companies we like, things that went well and investments that were tough, I wanted to reflect on the debate around active management and why I have confidence Fisher Funds will continue to flourish and deliver extra returns to our clients.

## Active management, beating the Average and Awards

Active management, done right, enhances long-term client wealth. In 2020, that has almost become a controversial statement. Deep into a prolonged bull market the perceived wisdom is increasingly that active managers can't add value.

I agree. They can't. In aggregate. But with the right team, the right process and a culture committed to excellence, the rules of the aggregate, the average, don't have to apply.

Over our 21-year history, Fisher Funds has added significant value to clients over and above the market. We are committed to continue doing this.

### The fallacy of the average

The passive versus active debate management is flawed. It is simple maths that active managers, in aggregate, can't beat the market. In the absence of an obvious losing market participant, active management is a zero sum game. For every active manager owning more of a stock that beats the market, someone must own less. They will lag the market.

The right question isn't, does active management add value? The right question is can a specialist investment manager be a consistent winner? We believe they can. Over our 21-year history we have proven this.

**We have done it**
Our longest standing fund is the New Zealand Growth Fund – a concentrated portfolio of our favourite Kiwi companies.

This fund has been managed with a core set of principles from day one. Take a long-term approach. Invest in quality businesses with clear competitive advantages. Look for a long runway of growth enabling the firm to compound earnings over time. And partner with visionary leadership, whose interests are aligned with shareholders. Simple. Not easy, but simple!

The process has worked. Over its 21-year history, the New Zealand Growth Fund has delivered a return of 12.4% which is comfortably ahead of the market over the same time.

To put it another way $100,000 invested in 1998 is worth over $1.2m today, after all taxes and fees.

That is materially better than the market. Over the same timeframe, market returns would have grown that $100,000 to $880,000. Active management put an extra $320,000 in the back pocket of our clients.

**Active Management is more important than ever**
While active management has been able to enhance returns for clients over the past couple of decades, we think it's going to be even more important in the next decade.

Interest rates are low. Global economic growth has been anaemic. Valuations are not cheap. This points to lower future market returns. This, in our view, means that the return from active management goes from being the cream on the cake to being the whole cake.

With that view, we are more focussed than ever on generating attractive active returns.

**Pond - People – Process – Passion**
Winning the active management game requires deliberate effort. In my view, it requires clarity in four areas:

» Pond – being very clear where the opportunities are, fishing for them in the right pond, is critical. Get this wrong and you waste a lot of energy for little return. We look for uneven gains where our insights and patience will pay off, and then put all of our attention there.

» People – a smart insightful team is the bedrock that success rests on. I am very proud of the Fisher Funds team. Yes they are smart, experienced investors but most importantly they are curious, hungry to learn and not afraid to do the hard work that it takes to become even better.

» Process – having a clear approach to identifying opportunities, building portfolios and managing risk is important. Our process has stood the test of time and been successful in different market environments. But it never stands still. We are always learning and enhancing our process. We can always get better.

» Passion – is not something investment managers typically talk about. I do. It is passion for excellence that drives an analyst to dig deeper, ask more questions, and not rest until they have the answers. It is passion that means honestly reflecting on what went well and not so well, so that we learn lessons and get better. And frankly it's passion that makes coming into work each day fun and rewarding.

Do these things well and I believe we will keep beating the market.

## Awards

If we add value it is sometimes recognised. Most importantly we hope that it is valued by our clients, but sometimes we do get industry recognition.

We were grateful to have been awarded Fund Manager of the Year in the Good Returns powered by Research IP awards in November.

We also won two sector awards. Our fixed team, headed by David McLeish, won the award for Australasian fixed income fund of the year. And Sam Dickie's New Zealand equity strategy, was successful in taking out the advisor's choice equity strategy award.

It was a great way to end the year and hopefully points to a successful 2020.

I trust you will enjoy the pages that follow. If you do have any questions or observations please give me a call, you can reach me on 021 398 886, or email frank@fisherfunds.co.nz.

Best wishes for the New Year.

Frank Jasper | **Chief Investment Officer**

# NEW ZEALAND SHARES

Sam Dickie, Senior Portfolio Manager

## The difference a moat makes

A moat is an attribute of a business that makes it very hard to compete with. Not losing your customers to competition is a very good attribute to have!! A genuine moat is near impenetrable and ideally gets wider over time. Companies with wide and widening moats are typically long-term winners in the market. Companies that struggle to keep their customers and have no moat, or a narrow moat often struggle to generate long-term returns to shareholders. The winners in the New Zealand share market in 2019 had wide moats. The losers did not.

## The winners

Xero has one of the widest moats in our investment universe. The over one billion dollars it has spent on its technology and the 2.2 million small and medium business customers it has amassed ensures it already has a wide moat. But it is the network effect that means its moat gets wider over time. Xero, a provider of small business accounting software, collects data on each of its customers. As an example, when a new plumber signs up to Xero, the network becomes more valuable to all of the existing plumbers using Xero as they have one more datapoint to benchmark their businesses against.

When Xero released its strong first half result, it was exciting to see some of its already high-growth businesses like the UK accelerating (fast revenue growth rates got even faster). In a world where the average financial analyst will reduce forecasted revenue growth rates in a linear fashion, it is extremely powerful when that trend is bucked.


Fisher & Paykel Healthcare's moat is based on over50 years of research and development work. That is extremely difficult to replicate and was reflected in the release of the Vitera - the firm's new Obstructive Sleep Apnea (OSA) mask - during the year. Customers seem to love it. This helped the company upgrade their own earnings guidance three times in three months and reminded us that this company is a long-term underpromiser and over-deliverer.

Despite significant noise (often misplaced in our view ) around a2 Milk this year, with the market worried about regulatory risk, the CEO change, and the firms investment in brand, the company outperformed a very strong NZ share market in 2019. a2 Milk's moat is based upon the very strong brand it has built, especially in China. It is also based upon the extremely passionate and dynamic team of people that run and operate the company. While we were disappointed by the short tenure of the last CEO, it is pleasing to see Geoff Babidge return to the drivers seat.

Geoff was responsible for assembling and mentoring many of the current a2 team and was responsible for driving much of the company's growth. a2's milk recent AGM allayed a lot of the market's fears. Profit margins were upgraded (following a downgrade at the 2019 result in August) due to price rises and stringent control of cost of goods sold. Sales growth of ~30% for the 6 months ended December 2019 was better than analysts had expected.

When you have been developing high-quality retirement villages successfully for as long as Ryman and Summerset have, you are going to develop a huge amount of in-house expertise. The expertise to secure a large parcel of bare land in a high-quality location and shepherd it through the difficult process of consenting and turn out consistently high-quality apartments and integrated care facilities has created wide moats around these companies. And then to have the ability to replicate that process dozens of times in both NZ and Australia means the moats continue to widen. Last month Ryman hosted an investor day in Melbourne which we attended. Awareness of Ryman in Melbourne is strengthening, resulting in strong demand for its product. The company is well positioned versus its Australian counterparts that don't cater to the increasing demand for a continuum of care model - independent retirement living all the way through to acute aged care and dementia care.

Mainfreight's moat is more esoteric than most but is one of the most powerful of all. It is largely based on Mainfreight's culture and Mainfreight's people. And it was great to see Don Braid who lives, breathes and drives the highly successful culture awarded the executive of the decade by Deloitte!

## The rest of the pack

Sky TV used to have a (near) monopoly in satellite delivery of Pay TV and had the most Pay TV subscribers in NZ. But we were reminded in 2019 that high market share is not necessarily a moat. Sky TV's technology is outdated, it is losing subscribers, it lost the cricket rights and didn't show the Rugby World Cup. All of these contributed to another horror year.

Metro Performance Glass has no moat. Its earnings were downgraded another 20-30% this year as it continues to face competition from all angles and it lost key management.

Gentrack has elements of a moat via its high market share and strong software. But we were reminded that you are only as strong as your customers, especially when you have a fairly concentrated customer base. The company was beleaguered by Brexit and its small, unprofitable UK electricity customers are under pressure. This saw analysts downgrade earnings by more than 50% during the year.

Comvita is the biggest Manuka honey producer in NZ and has a very strong brand. But those "moatish" elements are eroded by the reliance on horticulture which is the definition of relying on factors outside your control! The third poor honey harvest in a row and the departure of the CCO and CEO contributed to the company reporting a large and unexpected loss for the fiscal year.

Fonterra is one of the largest exporters of milk products globally. But scale alone is not a moat and the company reported a record annual loss last year.

The highest market share in corporatised dentists in Australasia was not enough of a moat for Abano. Despite being taken over during the year, the stock still underperformed the market by almost 40% in 2019.

# AUSTRALIAN SHARES

Robbie Urquhart, Senior Portfolio Manager

## 2019 was a good year

Nanosonics was one of our best performing companies, returning 124% (in A$) for the year. Retirement lifestyle community operator Ingenia (+71%) also had a great year, helped in part by falling interest rates. Credit Corp (+71%) and CSL (+51%) also delivered well against what were high expectations. Carsales (+58%) performed well in a soft domestic advertising market. Link Administration (-9%) was our only company with a negative return for the year.

## Responsible investing continues to be important

Responsibile investing was a major theme in 2019. The environment and society benefits from companies being run in a sustainable way. We think investors benefit from this as well. Environmental, Social and Governance ("ESG") considerations are core to our investment process, and governed by our Responsible Investing Policy.

Companies involved in activities that harm the environment, their customers or society may do well and profit over the short term. But over the long term, when pressure is brought to bear by consumers, regulators or investors, we think they will have a tough time sustaining their way of doing business. As the economist Herb Stein is reputed to have said "If something can not go on forever, it will stop."

### Responsible investing in action

As discussed in our March quarterly update, we sold our shareholding in the diversified miner BHP during the year. Since we first invested in BHP a few years ago, it has divested the majority of its thermal coal mines. But it has retained two thermal coal assets in Colombia and Australia.

We hold BHP's management and portfolio of businesses in high regard. However until BHP sells or shuts down its remaining thermal coal mines, we will not be a shareholder.

Thermal coal (used in electricity production) has plenty of environmentally friendly substitutes that could be used instead. Society is not reliant on thermal coal for electricity.

In addition to this, society's aversion to thermal coal has hardened over time. Funding new mines is more difficult than it was twenty years ago. As this trend continues, we think companies owning thermal coal mines will find it harder to sell them for good prices. They may find that these assets are economically as well as environmentally unsustainable.

### Holding Westpac to account

We have owned shares in Westpac bank for a number of years. In November, AUSTRAC (the anti-money laundering and counterterrorism financing regulator) took Westpac to court in relation to alleged contraventions of its obligations under the relevant regulations.

Westpac had previously disclosed that it discovered it failed to report a large number of international transfer instructions to AUSTRAC, which it was required to do. Westpac self-reported these breaches to the regulator, AUSTRAC sparking an investigation into Westpac's banking activities.

Surprisingly the claim filed in court by AUSTRAC was far more extensive than expected by the market. This claim went beyond the issues self-reported by Westpac. It included funds transfers that are characteristic of the type linked to child exploitation activities.

At Fisher Funds we have taken the AUSTRAC filing against Westpac very seriously. There seem to have been significant failings of governance across the company. We have engaged with Westpac management and voiced our concerns. We also echoed these concerns in how we voted our shares at Westpac's recent AGM. This included voting against the re-election of a longstanding director who has been a member of Westpac's risk and compliance committee.

Westpac has a long history. It has played a crucial role in providing mortgages for Australian families and funding Australian companies for 200 years. It is important that it addresses failings in governance of recent years to continue in this role for the next 200 years.

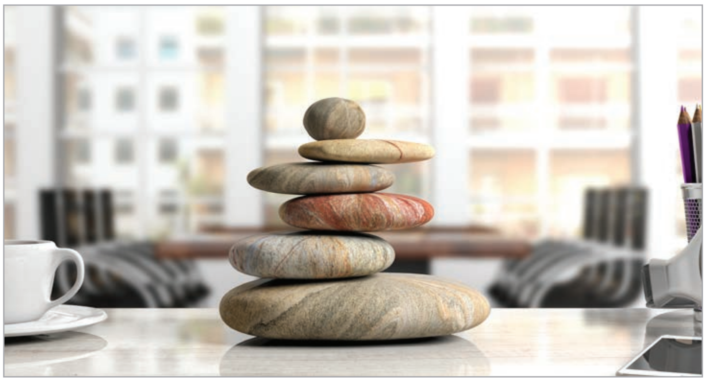
In the wake of AUSTRAC's filing, Westpac's CEO resigned and has been replaced. Westpac's chairman has brought forward his resignation into the first half of 2020. Westpac has started a number of workstreams to address the company's failings.

With these changes underway, we still own Westpac shares. In saying that, they are on watch; we have continued our dialogue with the company and will be monitoring the outcomes of these initiatives closely.

## Portfolio newcomer Limeade: improving well-being

Limeade provides organisations with software that helps improve employee well-being. It collects employee data from assessments & surveys, integrated third-party devices (like Fitbits), and blood tests. It uses the data to provide employees personalised recommendations to improve their physical, financial and mental well-being. Limeade has also developed activities and challenges that are implemented at a corporate, team and individual level to incentivise employees to achieve their goals.

Limeade's software is used by a wide range of (typically large) organisations. Its biggest customers include the State of Washington, Microsoft, American Airlines and Southwest Airlines.



As the benefits of improved employee well-being translate into higher, sustainable profits for these organisations, we expect Limeade to add many more organisations to this list in the future.

We are excited to have added Limeade to our Australian portfolios when it listed on the Australian Stock Exchange in December.

## SELECT INTERNATIONAL SHARES

**Ashley Gardyne, Senior Portfolio Manager**

Few would have expected 2019 to be a bumper year for equities, following a rocky end to 2018 when the US market plunged nearly 20% from its highs. Weak economic data, trade headwinds, the threat of rising interest rates and worries over Brexit pointed to an uncertain year in markets. These threats were sidelined when the US Federal Reserve halted interest rate hikes and changed tack. This Fed pivot and interest rate cuts propelled markets higher, which were further supported by a stabilisation in economic data and the unwinding of trade and Brexit related uncertainties late in the year.

Against this supportive backdrop the US S&P 500 Index soared 29% for the year, its biggest gain since 2013. Major global markets followed suit, including Europe (+22%), Japan (+18%), and emerging markets (+15%).

### Winners and losers for 2019

Despite the strong outperformance of the US share market, and technology stocks in particular, our top performing investment in 2019 was German sportswear giant Adidas.

Adidas (+61% for the year) continues to take market share in its strategic growth markets in the US and China. It's shifting sales mix towards the directto- consumer channel, including its own ecommerce initiatives, helped push gross margins to record highs and led to structurally higher profitability. The company's product innovation and success collaborating with influencers outside of sport, such as Kanye West and Beyoncé, has also helped broaden the brand's appeal and is resonating with customers. One weak spot in 2018 had been Europe where they saw strong competition from a resurgent Nike, although recent results have shown progress accelerating growth in this home market, further supporting Adidas's share price.

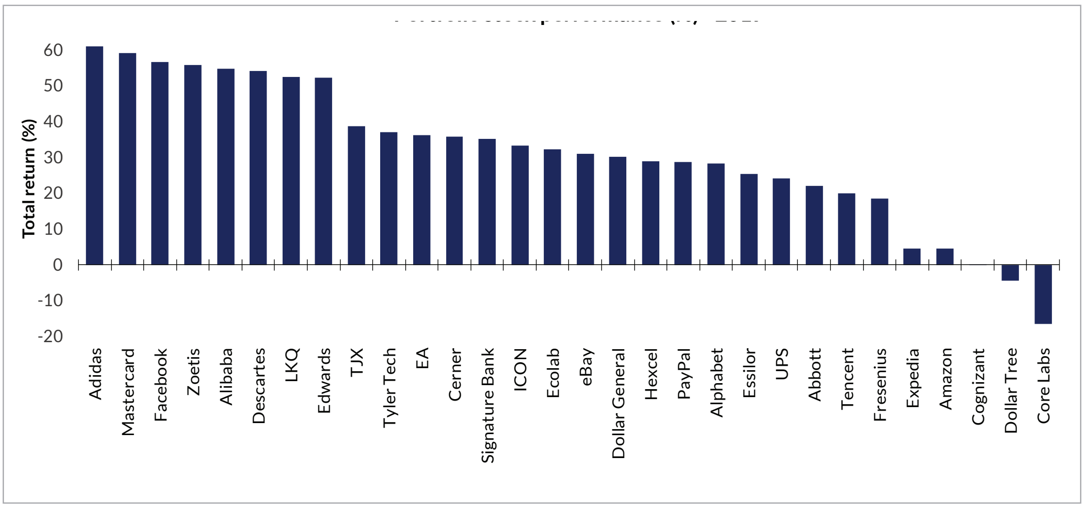
While we don't often invest in turnaround situations, Adidas is a company we first invested in late in 2014 when it was suffering from challenging trading conditions in emerging markets. This emerging market backdrop, combined with weakness in its TaylorMade Golf business (since sold), was dragging on its growth and suppressing profit margins. Adidas is a good example of how investors can exploit market mispricing if they are willing to invest despite short-term noise and market volatility. We believed Adidas had a strong brand and that the althleisure trend and shift to ecommerce would ultimately be positive for brand owners like Adidas. Looking through the noise in this case proved rewarding, with Adidas's share price climbing from EUR56 to EUR292 per share since we first invested (+420%).

Facebook (+57%) was another top performer for the portfolio in 2019. Many advertisers prefer and find digital advertising more effective, and during 2019 US digital advertising penetration marched steadily higher and finally passed through 50%. Digital advertising is now a bigger part of corporate ad budgets than TV, newspaper and radio combined. While we are positive of the outlook for the company, we are not blind to the challenges that it has. We believe Facebook must continue to address the issues associated with running a social network (privacy concerns, security, election interference etc). We have spent a lot of time with the company over the last 12 months discussing these issues and believe Facebook takes them seriously and is investing in smart solutions.

In terms of its business Facebook and Instagram continue to attract more users. Instagram's Stories format continues to grow in popularity with both users and advertisers. Despite Facebook's size, advertising revenues are growing at close to 30%. The firm's product teams continue to focus on innovating and making its products more useful for both users and advertisers. A good example of this is the new Checkout for Instagram, which allows users to shop, purchase and track orders directly in the Instagram app. While we believe Facebook must continue to address the myriad of issues associated with running a social network (privacy concerns, security, election interference), they continue to build a strong business with a lot of growth potential.

Facebook is another great example of how there are opportunities for active investors to achieve outsized gains – even in large and widely covered companies like Facebook. Good investment opportunities often present themselves when sentiment sours on a company, despite the underlying business strengths and growth drivers remaining resilient. We believe Facebook is still materially undervalued despite the jump in share price in 2019.

There were a number of companies that dragged on performance this year. As investors, we will get things wrong – mistakes are unavoidable in this business. The key to success is to get more decisions right than wrong (a good 'hit rate') and to continually learn from our mistakes. This has been a real focus for us in recent years and is something we continue to work on. In particular, we have been trying to get better at exiting stocks from the portfolio proactively - when we see first signs that a company's moat is narrowing, or when the dynamics that attracted us to the company or industry start to deteriorate. This is often a delicate balance and requires a lot of analysis and judgement - because selling a great business too hastily, if the problems end up being transitory, can result in significant foregone gains.



While there were no outright calamities in the portfolio this year, Cognizant (+0%), Core Labs (-17%) and Expedia (+5%) underperformed the market and dragged on our results. While there are specific lessons from each of these investments (which we have now exited), in hindsight we gave these businesses the benefit of the doubt longer than we should have. Exiting earlier, when question marks first developed around our investment thesis, would have improved our performance.

While there will be detractors from performance every year, we were pleased that there weren't any major blow-ups in the portfolio. We believe that the move to high quality companies in the portfolio, that we have undertaken over the last few years has helped in this regard. We were also pleased with our hit rate during the year, with two-thirds of our portfolio companies outperforming the market.

## Outlook and positioning

Central bank interest rate cuts provided a shot in the arm to global equity markets in 2019, but also pushed valuations significantly higher. In the US, the S&P 500 price-to-earnings ratio increased from 14x to 18x during the year, driving over 90% of the gain in the US share market, with corporate earnings growing only a few percent and contributing less than 10% of the gain. After a 10-year bull market and valuations near 20-year highs in the US, market returns will need to increasingly come from earnings growth. Given these elevated valuations and a subdued economic backdrop, we expect more moderate market returns in the years ahead.

Our investment style is well suited to this environment. We believe businesses with strong secular growth drivers like Alphabet, PayPal and Alibaba are well positioned in this world of lower economic growth, inflation and interest rates. Regardless of whether global economic growth is 1%, 2% or 3%, many leading businesses in ecommerce, digital payments, software and online advertising still have many years of double-digit earnings growth ahead. While high starting valuations for many of these companies muddy the picture, we think investors can still achieve good returns with a carefully constructed portfolio. But investors will need to be picky.

# PROPERTY & INFRASTRUCTURE FUND

Sam Dickie, Senior Portfolio Manager

## Wide moats are critical when the going gets tough

The US has been in a freight recession after a very strong 2018. Truck shipments as measured by the Cass freight index are down 10-15% from their highs in 2018. Rail shipments have been down mid to high single-digit percentages for most of 2019. Despite this, our US rail exposures are up ~30% over the last 12 months. The tough volume headwind has been more than offset by the companies' pricing power and costcutting. Our US rails have an inherent moat – no one is building a competing railway anytime soon! And rail remains by far the most cost-efficient way to transport bulk goods long distances over land. This has allowed the US rail companies to lift prices by around twice inflation on average for the past 15 years. In addition, both Norfolk Southern and Union Pacific continue to implement precision scheduled railroading (PSR). In short, this means running rail cars to an extremely well planned and tight timetable, reducing dwell times and significantly improving efficiency. This runs the risk of alienating customers as they might miss the train! It is a testament to the people and culture at both companies that customer satisfaction remains solid.

Despite a well-publicised trade war that has had flow-on effects to most trade lanes globally, our two port investments have continued to perform strongly. Napier Port, in particular, was up ~30% for the quarter. It not only met the 2019 fiscal year profits forecasted in its prospectus but it also reiterated its fiscal year 2020 profit forecasts. Some in the market feared that due to the well-publicised fall in log prices, we might see a deferral of log volumes or pricing pressure from customers. Napier Port's moat is based upon its captive customers – 85% of its volumes come from within 100km of the port. This means it has superior pricing power and this was reflected in it retaining its forecasts despite a weak backdrop. We increased our position in Napier Port during the quarter.

The future direction of the renewables market in Australia has been opaque to say the least. It has not been helped by having five different prime ministers in the last 12 years! Regardless, Tilt has built up a very strong pipeline of operating assets and development options. And it has started harvesting these options via selling into the very strong market for quality infrastucture. Tilt sold Snowtown II in December 2019 for 40-50% more than the market expected. This added significantly to not only the Tilt valuation but also the Infratil valuation (given Infratil owns 65% of Tilt).

American Tower and Crown Castle International, our US cellular tower investments, have a very concentrated set of customers. The four largest cellular carriers in the US make up the vast majority of their US based revenue. And two of them (T-Mobile and Sprint) have been trying to merge for the last year. There were concerns in the market that the merger would cause a rationalisation of especially Sprint's cellular Tower needs and that would be a negative for American Tower and Crown Castle International.

Rising above this distraction, the Tower companies were two of the best performers in the Property & Infrastructure Fund in 2019. This is because the Tower industry has very strong barriers to entry - only 1-2,000 new towers are consented each year versus an installed base of 125,000. This gives them very strong pricing power as their customers have very few alternatives to satisfy the strong growth they are seeing in their data networks.

While our NZ Gentailers Meridian and Contact Energy were strong performers over the 12-month period, they struggled in the final quarter. As interest rates collapsed in NZ, interest rate sensitive companies like the Gentailers became very crowded. And at precisely the time that interest rates stopped falling and the gloss started coming off the Gentailers, Rio Tinto which operates the aluminium smelter at Tiwai Point announced it was undertaking a strategic review of the asset. The worst case scenario would be Rio Tinto shutting the smelter as it consumes ~10% of NZ's electricity!

# FIXED INCOME

David McLeish, Senior Portfolio Manager

## The widespread use of prophetic licence at the dawn of a new year

As is typical for this time of the year, my inbox is overflowing with predictions about the year ahead. Those that know me will know that my cynicism stretches well beyond professionals offering me free predictions about the future. After all, if they really had the ability to consistently predict the future then I'm quite sure they wouldn't be sharing their prophecies with me.

That is not to say these predictions are worthless though. In fact, quite the opposite.

## The importance of knowing what is in the price

An important part of our investment process involves gaining insight into what the collective "market" believes is going to happen in the future. This insight comes from both how people act (this is what is embedded in the current price of assets) and what people say about the expected future price of assets.

Knowing what the market thinks is important. Without a clear picture of what consensus expects, how would you ever know if your view is any different? Moreover, how would you know if there was an opportunity for the value of the assets price to change in your favour as it begins to encompass your view?

December is a great time to retest our assumptions in this regard, because so much of the "market" is willing to share their views with us at the same time.

## Global corporate bonds remain expensive

Regular readers may remember that back in the middle of 2019 I wrote a tongue-in-cheek article about breaking up with the global corporate bond market. This was a light hearted spin on the decision we made to reduce the amount we would lend to companies.

This is a case whereby the message sent by the current price of the asset(s) tells us almost everything we need to hear. In short, the interest rates that most companies are able to borrow at is well below what we believe is fair for the risk – making most of our lending opportunities look unattractive at present.

## The grass is greener on our side of the fence

While we were of the view that lending to global businesses was less attractive than normal we are still finding attractive opportunities to lend at more attractive rates to good New Zealand businesses.

This is particularly true of first-time borrowers in the NZDX listed market of late. Two additions to the portfolio this quarter were Metlifecare and Synlait.

Metlifecare Limited represents our first debt investment into the retirement village sector in New Zealand. The company owns and operates 25 villages with a skew toward Auckland and the Bay of Plenty with both regions considered desirable locations for retirees.

The retirement village sector is benefiting from positive demographic tailwinds given New Zealand's ageing population and this trend will underpin the company's future earnings prospects. Metlifecare has also demonstrated a history of high and stable occupancy levels which suggest its staff are delivering a consistent quality of care which is important for existing customer satisfaction and ongoing referrals.

Moreover, the company has a prudent balance sheet which reflects management's conservative financial policy. To that end, the company has one of the lowest debt-to-asset ratios in the sector and this was a key reason why we chose to include it in the portfolio.

Since we initiated this position, the company has been subject to a number of takeover bids with the most recent $7.00 per share bid recommended by the board. As we await further information on the potential ownership change, we believe the senior secured position of our lending leaves us well protected.

During the quarter, we also established a position in Synlait Milk Limited which is a leading dairy processing group with a focus on nutritional products and other value-added dairy goods. The company has a history of efficient capital investment and impressive operational execution – especially regarding the construction of manufacturing facilities that have supported growth in domestic and export infant formula sales.

The business is a key supplier to the a2 Milk Company (regular readers will know this is a favourite stock of the Fisher Funds NZ Equity team) which has and should continue to underpin Synlait's cash flow generation. Its mutual partnership with a2 Milk and the company's strong balance sheet were key reasons we chose to participate in this deal.

Critics have questioned management's willingness to remain true to their publicly stated investment grade credit metric target. However, we believe much of this concern comes from a unique period in the company's history when they were building their aforementioned flagship, state-of-the-art processing facility. Therefore, we feel, these concerns are overblown as the improved earnings growth that has come from this asset now places the company in a far stronger position. As such, the bond coupon of 3.83% offered an attractive risk-reward balance.

# BANK CAPITAL REVIEW

**David McLeish**
**Senior Portfolio Manager, Fixed Income**

The top domestic financial news story from December was the final announcement of the Bank Capital Review by the Reserve Bank of New Zealand (RBNZ): in short, a large but manageable build-up of additional capital is now underway at the local banks. We suspect the impact of this will place only minor downward pressure on short-term interest rates over the next few years. On Thursday 5 December 2019, the RBNZ announced its final decision to push through one of the most profound capital reforms in history. Yes, there were some tweaks to the use and size of certain types of capital instruments. However, the only meaningful departure from their highly criticised 2018 proposal was granting banks a longer period in which to become compliant.

## Are these reforms required?

I hope we never find out. Because if we do, it will mean they were not enough. However, our estimates suggest they are appropriate for protecting against the assumed 1 in 200-year event. As we see it, they are as gold-plated as you would want them.

## What might this mean for interest rates?

The impact on borrowing rates remains the big unknown. It is very likely though the banks will move to protect their profitability as the phase in period starts on 1 July 2020. Given the strong competition for deposits in this country, I suspect much of the repricing required will result in higher mortgage rates rather than lower deposit rates.

## How has the RBNZ addressed the lack of competition?

They have gone some way. As proposed the RBNZ has reduced the benefit the large, systemic banks get from being able to calculate their own capital requirements. But today they went one step further, allowing the banks to raise cheaper forms of capital to meet their new targets. As we see it, competition rather than (over)regulation is only way to break the oligopolistic position of the over-earning Big 4 banks. These reforms are the first few steps in the right direction.

## How will the banks raise the money?

It depends on what actions the banks choose to take in protecting profitability. However, under most plausible scenarios, retail banking is still going to be an attractive business for the New Zealand banks. It is for this reason; we would be very surprised to see the Australian parents of our Big 4 choose to raise the required capital by divesting some of their stakes.

Our estimates suggest that by retaining approximately 70% of projected earnings over the implementation period, the Big 4 will have built up enough capital to be fully compliant by 2027. So instead of almost 100% of the Big 4's earnings being paid out to shareholders, as they have been in recent years, this money looks likely to stay onshore to fulfil these new capital requirements.

As previously mentioned, another olive branch offered by the RBNZ today was the allowance for other forms of capital to make up 2.5% of their new 16% Tier 1 requirement. Instruments such as redeemable preference shares are likely to be much cheaper for the banks to issue. So we would expect the banks will take full advantage of this – further diminishing the rationale for selling down their stakes to raise the capital.

## Who are the winners and losers?

A large portion of the industry's lending comes from low loan-to-value ratio (LVR) residential mortgages. This will remain an attractive business for the banks. It is therefore unlikely banks will materially pull back from this type of lending.

However, other borrowing cohorts are likely to feel more of a pinch. High LVR residential borrowers, such as first home buyers, farmers, and small companies are likely to be some of the hardest hit. This is because loans made to these higher risk borrowers require the lender to hold a larger amount of capital against them in case the loan goes bad. This could see either higher lending rates or reduced credit made available to these borrowers or both.

## Conclusion

Our Big 4 banks have been afforded a charmed position on a global banking context – earning outsized profits while benefiting from implicit government support due to their systemic importance to society.

It remains unclear how much of these capital changes will flow through as a cost to the clients of these banks. However, we view the actions taken by the RBNZ as an important step to levelling the competitive playing field and safeguarding our economy from future turbulence.

## CONTACT US

**Frank Jasper**
Chief Investment Officer
Phone 09 484 0344 | Email frank@fisherfunds.co.nz

**Kate Meyers**
Institutional Client Relationship Manager
Phone 09 487 2637 | Email kate@fisherfunds.co.nz

# MARKET MOVEMENTS

## As at 31 December 2019

| Stock Markets* | Closing Values | Changes over: 1 Mth % | 3 Mths % | 6 Mths % | 12 Mths % |
|---|---|---|---|---|---|
| S&P Developed LargeMidCap - (Local Curr) | 879 | 2.4 | 7.6 | 9.4 | 27.5 |
| S&P Developed LargeMidCap ($NZ) | N/A | 2.4 | 5.1 | 14.5 | 33.2 |
| S&P Global LargeMidCap ($NZ) | N/A | -1.5 | 1.4 | 8.7 | 26.2 |
| USA - S & P 500 | 6554 | 3.0 | 9.1 | 10.9 | 31.5 |
| USA - Nasdaq | 10539 | 3.6 | 12.5 | 12.7 | 36.7 |
| Japan - Topix | 2626 | 1.4 | 8.6 | 12.3 | 18.1 |
| UK - FTSE100 | 6981 | 2.8 | 2.7 | 3.7 | 17.3 |
| Germany - DAX | 13249 | 0.1 | 6.6 | 6.9 | 25.5 |
| France - CAC40 | 16242 | 1.3 | 5.5 | 8.3 | 30.5 |
| HK - Hang Seng | 81653 | 7.0 | 8.4 | 0.2 | 13.0 |
| Australia - S & P 300 | 71659 | -2.0 | 0.7 | 3.3 | 23.8 |
| NZ-S&P/NZX 50 Gross Index (inc imp credits) | 13978 | 1.6 | 5.3 | 9.9 | 31.6 |
| NZ-S&P/NZX 50 Gross Index (excl imp credits) | 11492 | 1.5 | 5.2 | 9.4 | 30.4 |
| Market Volatility - VIX | 13.8 | 9.2 | -15.1 | -8.6 | -45.8 |
| **New Zealand Property** | | **%** | **%** | **%** | **%** |
| S&P/NZX All Real Estate (inc imp credits) | 1894.0 | 2.8 | -0.4 | 8.3 | 32.4 |
| S&P/NZX All Real Estate (exc imp credits) | 1812.9 | 2.6 | -0.6 | 7.9 | 31.3 |
| **Ten Year Bonds** | **%** | **Yield Changes** | | | |
| USA | 1.92 | 0.14 | 0.24 | -0.08 | -0.77 |
| Japan | -0.02 | 0.06 | 0.21 | 0.14 | -0.02 |
| United Kingdom | 0.82 | 0.12 | 0.36 | -0.13 | -0.51 |
| Australia | 1.38 | 0.34 | 0.41 | 0.05 | -0.94 |
| New Zealand | 1.67 | 0.37 | 0.58 | 0.10 | -0.70 |
| **90-Day Interest Rates** | **%** | **Yield Changes** | | | |
| USA | 1.55 | -0.04 | -0.33 | -0.57 | -0.90 |
| Japan | 0.07 | 0.00 | 0.00 | 0.00 | 0.00 |
| United Kingdom | 0.79 | 0.00 | 0.03 | 0.02 | -0.12 |
| Australia | 0.93 | 0.05 | -0.01 | -0.27 | -1.16 |
| New Zealand | 1.29 | 0.06 | 0.14 | -0.35 | -0.68 |

| Bond Indices | Closing Values | Changes over: 1 Mth % | 3 Mths % | 6 Mths % | 12 Mths % |
|---|---|---|---|---|---|
| S&P/NZX Bank Bills 90-Day | 729.42 | 0.11 | 0.30 | 0.70 | 1.68 |
| S&P/NZX NZ Government Bond Index | 1834 | -1.89 | -2.91 | -0.11 | 4.89 |
| Barclays Capital Global Aggregate Index (Hedged NZD) | N/A | -0.24 | -0.64 | 1.81 | 7.48 |

| Hedge Funds & Commodities | | % | % | % | % |
|---|---|---|---|---|---|
| HFRX Global Hedge Fund Index (USD) | 1292 | 1.2 | 2.6 | 4.2 | 8.6 |
| DJ-UBS Commodity Index Total Return | 172 | 5.0 | 4.4 | 2.5 | 7.7 |
| Gold (US$/ounce) | 1519.50 | 3.7 | 3.7 | 7.8 | 18.9 |
| Oil (US$/barrel) | 67.77 | 5.1 | 11.1 | 0.4 | 34.0 |

| Currencies | | % | % | % | % |
|---|---|---|---|---|---|
| NZD / USD | 0.6746 | 5.1 | 7.6 | 0.4 | 0.6 |
| NZD / EUR | 0.6010 | 3.2 | 4.5 | 1.9 | 2.5 |
| NZD / GBP | 0.5093 | 2.6 | 0.1 | -3.5 | -3.3 |
| NZD / AUD | 0.9597 | 1.1 | 3.2 | 0.3 | 0.8 |
| NZD / YEN | 73.32 | 4.3 | 8.2 | 1.3 | -0.3 |
| Trade Weighted Index | 72.73 | 2.6 | 2.8 | 0.3 | -2.7 |

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