fisher funds

# MARKET INSIGHTS

September 2021 Quarter

## AN ECONOMIC GUESSING GAME

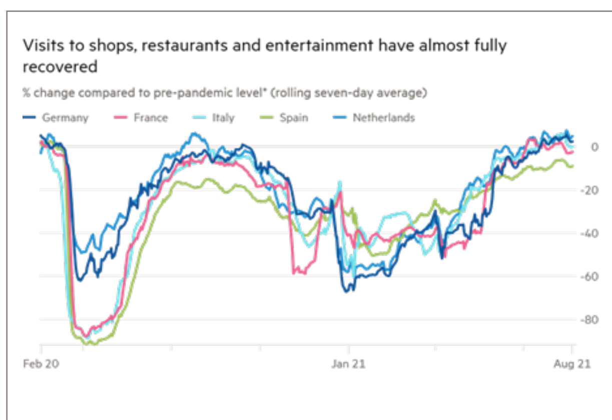
**Ashley Gardyne, Chief Investment Officer**

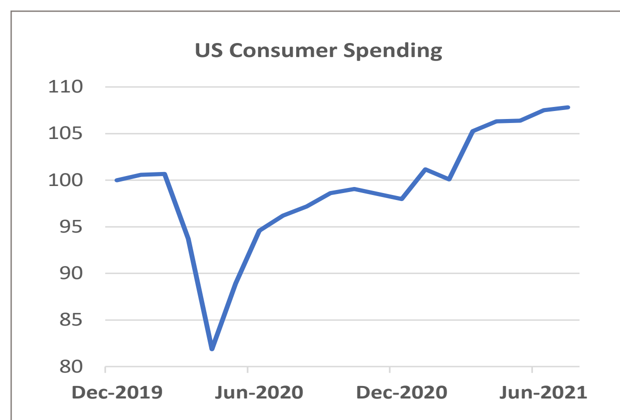
*While lockdowns continue in New Zealand, the global economy and financial markets have all but put Covid in the rear-view mirror. Consumer spending in most countries is back to pre-Covid levels, as is US industrial production, house prices, wages and employment. Two very different pictures are now being painted of what comes next. Are we in for high inflation (or even stagflation), or a return to the low inflation and growth world of the last decade? All of this is playing out in real-time and has broad implications for financial markets.*

### The economy marches on

Looking beyond our borders most countries are gradually learning to live with Covid. Lockdown rules have been rolled back, offices have reopened, and people are travelling and dining out again. Consumers are flush with cash and are now out spending. Even domestic travel volumes and hotel occupancy rates are back near 2019 levels in the US. As can be seen from the chart below, visits to shops and entertainment venues in Europe are almost fully recovered.

In the US, industrial production is now back to pre-pandemic levels and consumer spending is at all-time highs. This has all flowed through to rosy economic data, strong corporate profit growth, and share market indices hitting all-time highs.




But this strong economic momentum has also caught many industries off guard. The rapid surge in demand has led to product shortages, shipping bottlenecks, a shortage of labour – and as a result a level of inflation we haven't seen for over a decade.

The path from here is a guessing game. Will we see continued high inflation, or are these factors temporary? The answer here will determine the speed with which the US Federal Reserve tapers their quantitative easing and starts to hike interest rates - two factors that have had a major impact on markets in the past.

## Inflation returns from the distant past

The spike in inflation has also seen the return of a term many had thought relegated to economic textbooks - stagflation. Shipping costs have surged over 200% in the last year and oil prices have almost doubled - putting upwards pressure on the price we pay for everyday goods. Even used cars, an asset class I would have never really expected to experience inflation, have seen their prices jump over 40% compared to pre-pandemic levels.

All these price increases have links to supply chain issues driven by Covid. In the case of shipping costs, the boom in demand for goods (instead of services like dining out) has seen a spike in shipping from China to the developed world. This has led to a bunch of empty containers sitting in the US and Europe, with a smaller number returning full of exports due to lockdowns impacting production. The end result is a shortage of shipping capacity out of China and a spike in freight rates.

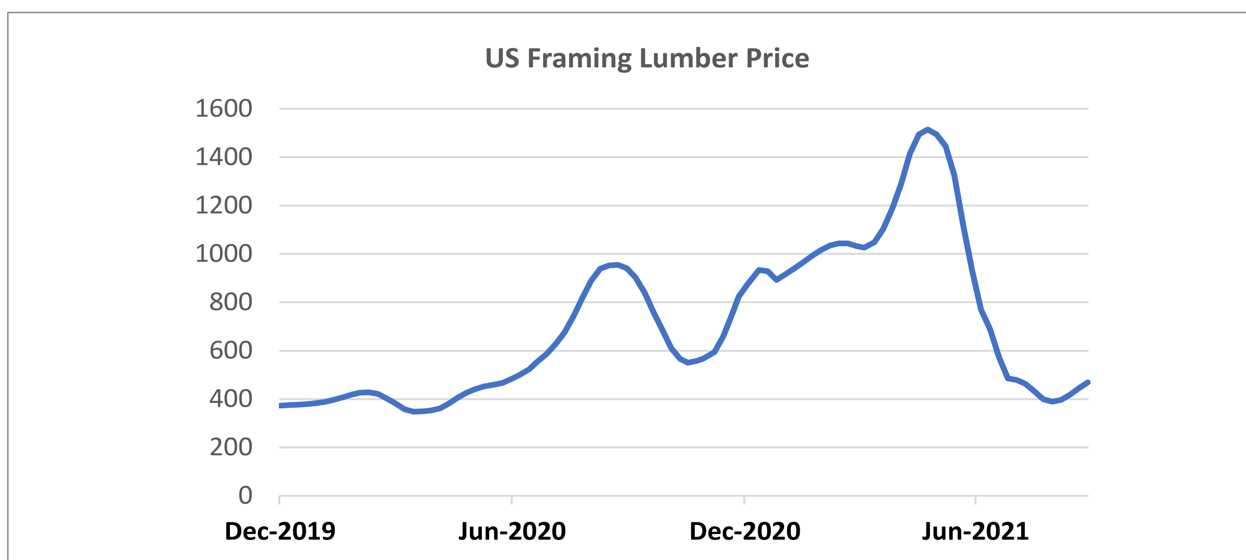
Similarly, a drastic shortage in computer chips has had an impact on the auto supply chain. The production of new cars has been severely impacted – for example Toyota slashed global production by 40% in September. This has had a follow-on impact on demand for used cars (as there are no new ones) – pushing prices higher.

These price increases are causing employees to demand higher wages – which is further helped by a shortage of labour. This shortage is illustrated well by sign-on bonuses in the US fast food industry – where even McDonalds is offering $500 starting incentives.

Some are saying that this will lead to a structural pickup in inflation. When the economic surge caused by reopening dissipates, we could be left with elevated inflation and a stagnant economy – or stagflation. This would cause a real problem for central banks, which could then be faced with the need to hike interest rates and head off inflation, despite a weak economy.

## Inflation could prove temporary

Others argue that this environment of high inflation is unlikely to persist. Supply chain bottlenecks and labour shortages will be worked through in time. We have already seen this with lumber prices which spiked last year and were up over 300% at one point, but they have now returned near pre-pandemic levels.



Some of the more recent economic data also shows that the surge in growth could be short-lived. Employment reports showed that US hiring slowed in August, enhanced unemployment benefits are coming to an end, and the post-reopening spending surge may be starting to dissipate. This would leave us with the disinflationary forces we have lived with over the last decade – including high debt levels and demographics (an aging population) that are creating a headwind to growth. If this scenario plays out, then the outcome could be a continued accommodative stance by central banks and interest rates that stay lower for longer. This would be much like the benign environment we have been in for most of the last decade.

## Corporate fundamentals matter more than the economic path

I have painted a world of two extremes and a near-term fork in the road. But in markets there are never just two possibilities – where one leads to good outcomes and one to turmoil. There is a myriad of paths that the economy and market could head down. Since the Global Financial Crisis we have been warned of numerous existential risks for markets: the European debt crisis, the China trade war, Fed tapering, the Trump administration, the Biden administration – and the list could go on.

These sorts of events often cause short term volatility as they transpire, but five years later they seldom matter. What has mattered is picking the right companies to invest in and holding tight through thick and thin. Not getting deterred and selling due to macroeconomic ambiguity. This is why, for personal and professional investors alike, it is important to have a clear investment strategy that you stick with day in and day out.

In the rest of this quarterly update our portfolio managers talk about their individual strategies, the companies they own and why we believe they are positioned well for the future, even though there will inevitably be some market hiccups along the way.

Ashley Gardyne | **Chief Investment Officer**

# NEW ZEALAND EQUITIES

Sam Dickie, Senior Portfolio Manager

**Mainfreight** was the standout performer in the third quarter. On 1 September, the company released a strong trading update. This was the eighth detailed update in the past 18 months, compared to three trading updates per year normally. This update showed a strong acceleration in performance, with the company's weekly average profit before tax increasing from $6.2 million (in weeks 1–17) to $7.3 million (in weeks 18–22).

The company is helping its Air & Ocean freight customers navigate extreme disruption to supply chains which presents the opportunity to add greater value with commensurate rewards. We trimmed our position slightly during the month as the share price has been very strong on the back of recent market index changes.

Wine producer **Delegat** was a drag on the fund's performance in the quarter. The company reported a slightly lower than expected net operating profit for the financial year ended June 2021. As well as providing subdued profit guidance for the new financial year.

The lower reported profits were due to the impact of dysfunctional global supply chains, with customers unable to fully secure shipping slots and Delegat unable to book some sales towards the end of the financial year. The subdued guidance partly reflects a below-average harvest for the New Zealand wine industry, which increased the cost of grapes purchased from grower partners. The company is also factoring in higher shipping costs and assuming last year's volume shortfall is not recovered.

We do not think that these factors will impact the longer-term prospects of the business. The company has occasionally had low harvests before, like in 2015, with the impact predominantly limited to the following financial year. The underlying consumer demand for its Oyster Bay label remains strong and the company is taking the opportunity for selective price rises and to reallocate product to its highest value distribution channels.

**Xero** was the biggest drag on quarterly performance. All of this drag came in the last three days of the quarter as interest rates moved sharply higher globally. This caused a global rotation out of growth stocks and into value stocks. Xero was caught up in the rotation but the company's fundamentals had not changed. This is the third time this has happened in the last year or so and has typically been a buying opportunity.

## A strong balance sheet can support growth

We prefer companies with strong balance sheets over those that carry excessive debt. Good businesses don't need to take on too much debt to deliver attractive returns. A great example of this is Vista.

Vista's cash reserves allowed it to emerge from covid a stronger company and its shares performed strongly during the September quarter as moviegoers continue to return to cinemas in its key markets

of the US and Europe. Box office figures in August and September have steadily improved towards pre-pandemic levels, and the film release schedule is strong - starting with the latest James Bond movie in October. This should further support the recovery for Vista's customers.

But it's worth rewinding to remember what happened and reflect on the opportunity that was available. At one stage last year almost every movie theatre in the world was closed. This has not happened since the first movie theatre in the world opened over a century ago, although the Spanish flu did close some cinemas.

From March 2020, many cinemas paused paying their fees to Vista as they were closed and in a battle for survival. This put the company's financial position and share price under stress. But we knew that most cinemas normally generate positive cash flows even at a reduced level of admissions, and movie theatres are specialised real estate that cannot easily be refitted for another use. This means that landlords or lenders are not keen to put cinema operators into receivership, as the underlying assets do not have much value. So we thought the prospect of large scale closures of cinemas was unlikely.

Going to the movies is a relatively affordable form of out-of-home entertainment. Vista is the global leader in its field and its product is essential to cinemas' day-to-day operations, so we were convinced Vista would survive and thrive when cinemas inevitably re-opened.

Vista raised capital early in the pandemic. This was critical. It solved the company's financial-position headache and allowed it to navigate the pandemic with clear eyes. We were able to participate at $1.05, which represented a large discount to our assessment of the company's intrinsic value. The share price finished September 158% higher than this at $2.71.

The company doubled down on focusing on its customers. It launched software upgrades that could deal with socially distanced seating as cinemas re-opened, and promoted its mobile ticketing products to late adopters. It forged ahead with Vista Cloud, its software-as-a-service product that can reduce customers' hardware and IT support costs. Vista Cloud increases the size of Vista's recurring revenue and earnings pie. It could only do this because of its strong balance sheet.

Vista has been taking market share from competitors who have not invested in their products or customers, even though Vista's products are more expensive. Vista currently has over 50% market share of the global cinema software market outside of China. And we don't see any good reason why market share can't continue to increase significantly from here.

Vista has undoubtedly been through a torrid time – as have its shareholders! But it is emerging a stronger company than it was pre COVID.

# AUSTRALIAN EQUITIES

Robbie Urquhart, Senior Portfolio Manager

Three themes helped drive returns in the quarter. All three focus on companies that are committed to doing well in the long term. These companies are not taking shortcuts that might benefit them in the short term, but put them in a worse competitive position in the longer term. This pleases us. Some companies like Domino's and WiseTech are profiting now from decisions made years ago. Other companies like CSL are having a tougher time because of covid -19. But they're still investing in innovation. They will likely reap the rewards from this in the future.

## Theme 1: Businesses are increasingly relying on software and internet services to stay ahead of the competition

**WiseTech** was the standout in our portfolio in this regard. Its share price rose 68% (in A$) over the period on the back of its outstanding financial results. WiseTech's pre-tax profits rose a hefty 60% over the last year. WiseTech is the global leader in providing software to logistics companies such as DHL or Mainfreight.

Demand for WiseTech's software has risen strongly because it enables logistics companies to automate their clients' processes – and substantially increase the efficiency of their clients' businesses. WiseTech's core revenue growth increased +25% this year. And the big positive surprise for investors has been how much faster WiseTech's profits grew relative to revenue.

WiseTech has spent a lot of money developing its software over the years. It is now at a point where customers can use its software more – and pay WiseTech more – without the company having to hire people to support the extra demand. This is what we refer to as a 'scale benefit'. And scale benefit has led to the large increase in profits in the year. We expect this trend to continue.

We also saw this theme of rising demand for software or internet services in the results of other portfolio companies.

**Fineos** (+11%) is seeing rising demand for its software from life, accident, and health insurers across the globe. Fineos' software automates and digitises insurance claims procedures.

Online car advertising company **Carsales** (+29%) announced that it would allow dealers to sell cars online. Carsales currently advertises vehicles for sale on behalf of dealers. Potential buyers usually complete the purchase, and pick up the car, at the dealership. Carsales is now enabling dealers to sell cars on the Carsales website. Customers will soon be able to look for a car, secure finance for it, pay for it, and have it delivered (with a 7-day money back guarantee). The entire transaction will take place on the website. Carsales effectively acts as a virtual dealership. This enables car dealers to sell more cars without having to hire more staff, or rent more property to physically showcase cars. It increases profitability for dealers.

Buying cars online is still in its infancy. But this trend is growing in importance internationally. This innovation increases Carsales' runway for growth.

## Theme 2: People love take-aways during lockdown!

Customers have bought a lot of pizza from **Domino's** (+34%) in the last year. Domino's is reinvesting its profits from these pizza sales into rolling out new stores. It has increased its long-term store target, will double the number of stores it has in each country market, and will open stores faster. These measures will boost Domino's overall growth rate.

## Theme 3: Innovation is the foundation for future profit growth

Our investment philosophy is centred on investing in high quality, growing businesses. The amount that a business spends on research and development, or R&D, is one indicator of whether a company is putting itself in a position to grow. R&D is particularly important in the information technology and healthcare arenas. Better software helps companies adapt more efficiently to the digital world. Clients are always looking for better vaccines to improve their lives.

WiseTech, for example, routinely spends 30% of each year's revenue on R&D. This has undoubtedly contributed to its success over the years.

**PWR Holdings**' (+25%) financial results also highlighted how it is benefiting from investing in innovation. PWR makes cooling products for Formula One and super luxury cars. Its emerging technology division has been at the forefront of developing cooling products for companies that make electric cars and hydrogen-powered trucks.

*PWR is developing solutions for electric helicopters – who wouldn't want to fly in one!*

PWR is also designing solutions for companies that are developing the first electric helicopters. The emerging technology division doubled its revenue in the last year. And it is likely to double again in the next few years.

## Portfolio companies have kept up their R&D spend through the pandemic

R&D is akin to planting and watering an orchard of fruit tree seedlings. Not all trees will survive. But, if well looked after, the orchard is likely to bear fruit in the future.

It is pleasing to us that portfolio companies that have been negatively impacted by the pandemic have kept investing in R&D. They have not skimped despite COVID-19 uncertainty.

Plasma products company **CSL** (+3%), for example, spent 10% of revenues – A$1bn – this last year on R&D. It spent this money despite the fact that COVID lockdowns have reduced the amount of blood people have been willing or able to donate. And Nanosonics (+8%) spent over 15% of its revenue on R&D despite pandemic related hospital restrictions impacting demand for its ultrasound disinfectant products.

This R&D investment and long-term focus improves these companies' chances of staying ahead of the competition. This increases our confidence in their ability to grow profits and deliver 'fruit' to their shareholders in the future.

## Portfolio changes – increased weighting in software and banks

Given the themes discussed above, we have increased our portfolio weighting in software companies WiseTech, Fineos, and Audinate, as well as data centre operator Next DC.

We also increased our weighting in ANZ, NAB and Westpac . The banks have begun buying back their shares and increasing dividends as the economic environment is significantly better than feared a year ago. These buybacks support their share prices.

We also increased our weighting in outdoor advertising company oOH!Media. It sells a lot of advertising on billboards in NSW and Victoria. Our confidence in its earnings outlook has increased as these states are soon set to emerge from pandemic lockdowns in October.

To partially fund these changes, we reduced our weighting in Sonic Healthcare and Woolworths.

# SELECT INTERNATIONAL EQUITIES

Ashley Gardyne, Senior Portfolio Manager

## Global markets pause after a strong first half

*Global markets were broadly flat in the third quarter, due to volatility in emerging markets, concern around the delta variant and a slight slowing in economic momentum. Markets have also started to focus on the potential for the US Federal Reserve to start tapering its quantitative easing – which has supported markets over the last 18 months.*

After a very strong first half to the year when global markets (MSCI World Index) gained 12.2%, performance in the third quarter was far more muted. The MSCI World Index was down 0.4%, emerging markets fell 8.8%, European markets were flat, and the US market only edged out a 0.2% gain. The weakness in emerging market equities was largely due to a regulatory crackdown in China, which dragged the Chinese market 18.4% lower for the quarter.

The slight pickup in market volatility in the quarter was driven in part by questions about the economic outlook. While the global economy has rebounded strongly, government stimulus is starting to roll off, the delta variant has impacted consumer sentiment, and when combined with elevated market valuations this has all given investors pause for thought.

All eyes will be on the US Federal Reserve in the coming months. In recent weeks the Fed has indicated that its quantitative easing programme will start to be wound down later this year, paving way for eventually interest rate hikes at some point in 2022. While the Fed has announced its plans to remove the punch bowl, its monetary policy settings are still very accommodative, and the market has so far taken this greater clarity on tapering in its stride.

## Company performance

**Icon (+29%)** delivered another excellent quarterly result, with revenue and bookings both growing above expectations.  Icon is a contract research organisation (CRO), which helps pharmaceutical companies design and run clinical drug trials. It continues to benefit from growing spend on drug research and the increased outsourcing of clinical research to trusted service providers like Icon. Outsourcing clinical trials allows biotech and pharmaceutical companies to get drugs to market faster and allows them to focus on higher value areas like research and new drug development. Earlier this year, Icon announced a merger with competitor PRA Health Sciences to create the world's third largest CRO. While the market was initially sceptical of the merger, positive early commentary from management about the integration, combined with solid quarterly results has contributed to Icon's strong recent performance.

**Gartner (+27%)** provides IT research and consulting services to the corporate sector. Its share price has spiked after recent results showing continued strength across all key product lines. Gartner's core research products continue to see strong demand from customers looking to improve their IT functions. The pandemic has given corporates an important reminder of the need to digitise their operations, and ever-present security threats are also forcing businesses to modernise. Strong revenue growth and cost control now mean that the company expects long-term profit margins to be materially higher than they were pre-

pandemic. With Gartner's in-person IT conferences expected to resume later this year, this should provide a further boost to the business.

**Floor and Décor (+19%)** also performed strongly during the quarter. Traditionally this specialty retailer has focused on serving the hard-flooring needs of its retail customers from its Bunnings sized warehouses. In June the company announced it was moving into the US$13 billion commercial sector through the acquisition of Spartan. Floor & Décor will be able to leverage its supply chain and direct purchasing to grow Spartan's business serving large architecture and design clients on projects such as hotels and hospitals. Even ignoring this commercial opportunity, Floor and Décor is benefiting from a strong US housing market and we continue to believe the company has a long runway for rolling out new stores across the US.

## China's regulatory crackdown

Our two Chinese stocks **Alibaba (-35%)** and **Tencent (-21%)** were both caught up in the China tech sector sell-off. Having benefited from years of light-touch regulation, the Chinese tech industry is now experiencing a period of increasing regulatory focus.

This heightened regulatory intervention began last year when regulators forced Ant Group to scrap its planned initial public offering (IPO) - after Jack Ma (Alibaba's founder) publicly criticized the management of financial sector State Owned Enterprises. The crackdown has since extended to other companies, including ride-hailing firm Didi (which has since fallen over 40% below its IPO price after a cybersecurity probe).

Looking at the specifics of the regulations being targeted at Alibaba and Tencent helps get a sense for how far the government may want to take this. New antitrust regulations effectively update China's antitrust laws for the internet-era. As an example, they are banning anti-competitive practices such as large tech companies abusing their monopoly positions by prohibiting merchants selling on competitors' marketplaces. This would not be acceptable in developed markets, but China had turned a blind eye until recently.

The government has recently limited under-18s from playing online video games for more than an hour a day. While this will impact Tencent's gaming business, under-18s only account for approximately 6% of their gaming revenue. Regulators want to reduce the impact of addictive games on students, but the financial impact for the private sector will be limited.

Regulations have also been created to strengthen data security rules (for example limitations around moving data between countries/jurisdictions or for foreign companies operating in China). This should have little impact on the more domestic focussed Alibaba and Tencent. These regulations also give consumers more control over how their data is used. This is not dissimilar to the GDPR regulations implemented in Europe in 2018. Despite concerns at the time, not only did GDPR not hurt Google and Facebook, but it helped them as smaller advertisers struggled to adapt their business models.

We accept there are probably more regulations to come, but what we have seen to date suggests these regulations are relatively measured - as opposed to a draconian appropriation by the government.

While these developments will have an impact on Alibaba and Tencent, we believe the market is overreacting as it has done in the past. We suspect the ultimate impact on these businesses will be nowhere near the declines seen in their share prices. Investors in China have been here before. The year after Alibaba's IPO, its stock plummeted 49% due to a range of concerns including regulatory action regarding counterfeit products being sold on its marketplaces. The stock has gone on to gain 150% since then. In 2018 Tencent's share price fell over 45% following a temporary government suspension of video game approvals. Its share price went on to increase over 190% to its recent peak (and is still up 75% despite the recent selloff).

Despite the recent regulatory crackdown, we still believe both Tencent and Alibaba are great businesses and have years of growth ahead in sectors with secular tail winds - like ecommerce, online advertising, digital payments and cloud computing.

# NEW ZEALAND CASH AND FIXED INTEREST

David McLeish, Senior Portfolio Manager

## The great interest rate debate

The Reserve Bank of New Zealand has kick-started what it expects to be a series of Official Cash Rate (OCR) hikes. Unsurprisingly, the spectre of higher borrowing costs has caused quite some consternation. But concerns of a large and persistent move higher in interest rates in New Zealand are vastly overstated.

The economics lesson when I first encountered the concept of the law of diminishing marginal utility comes flooding back when I ponder my stance on the great interest rate debate.

Looking on enviously, my high school economics classmates and I watched as one student consumed square after square of delicious chocolate. After each mouthful, the teacher would stop and ask the willing participant to rate the enjoyment that came from the most recently devoured piece. Their descriptions only compounded our envy.

But it wasn't long before our disappointment at not being picked for the experiment gave way to relief, as our classmate's smile turned to a frown. A few squares later and it had become a wince. Then before we knew it, they were making a beeline for the nearby bathroom.

## A sugar high of monumental proportions

New Zealand households have gorged on borrowed money for years. But unlike in my class experiment, borrowed money has provided the economy with a long-lasting sugar high. That's because the economic boost from borrowing is widely estimated to be multiples of the amount borrowed. This is due to the newly created money being spent and re-spent over and over again as it circulates around the economy.

This was made possible by consistently falling interest rates. Because without dependably lower borrowing rates, households would've had to divert more of their income to servicing debt and less on spending.

As borrowing costs do a U-turn, this will almost certainly slow spending, at least once pandemic-induced distortions subside. Without another sector of the economy picking up the slack, rising borrowing costs will reduce economic growth – and with it the need to raise interest rates.

## Bingeing has left us out of shape

This gluttony has caused our collective financial waistlines to bulge. At around 180% household debt to disposable income, New Zealand households are in worse shape to weather interest rate rises than most other households in the world.

The small rise in mortgage rates we have had so far is nothing more than the equivalent of a frown forming on my ex-classmate's face. That's because households are drawing down on the emergency funds they built up, mostly during 2020. But when these are depleted, spending will likely drop to reflect

the greater cost of borrowing on households. The lofty estimates of interest rate rises that are causing all this angst will probably begin to be walked back down around this time.

If this does evolve into a 'running to the bathroom' moment, it will be because the Reserve Bank hasn't read the tea leaves right and has pushed interest rates too high or shifted its primary focus to something other than growth – namely inflation.

## Everything is temporary, not least economist opinions

Many of us will remember the last time the Reserve Bank set out on a similar path to raise the Official Cash Rate. That was 2014 and the Bank managed to raise the OCR just 1% before having to change course. Today, they are projecting that the cash rate will rise by double that over the next couple of years. Their message is that this will return interest rates to some degree of normality.

I'm not sure I buy that. Household debt has risen 20% compared to disposable income since 2014. The environment has changed. The economy is likely far more sensitive to interest rate changes now than ever before. Without some miraculous increase in real incomes, it feels the economy simply can't afford an interest rate rise of that magnitude.

We also can't forget that central bank opinions change easily. That's because they are based on a constantly changing world. We should therefore expect their views to change regularly and often at short notice.

Again, in March 2014, the then Governor Wheeler said that 'New Zealand's economic expansion has considerable momentum' and increasing the OCR was 'needed to keep future average inflation near the 2 percent target mid-point'. But just over a year later, in June 2015, the Bank entirely reversed course, saying instead that 'a reduction in the OCR is appropriate given low inflationary pressures and the expected weakening in demand.'

The only message I get from that is: don't get too worked up about what central banks say.

## A busy quarter for our portfolio

The New Zealand debt capital market sprung to life in September, with deals by corporates, banks, asset originators, and even a historic 30-year Government bond launched and priced.

We participated in seven transactions in all, keeping our five-strong fixed income investment team very busy throughout the month.

Several of these transactions were unique. ANZ Bank brought the first of a new version of subordinated bond (following updated Reserve Bank qualification guidance), TR Group and Oceania returned to the market for the first time since their inaugural deals, UDC Finance issued their first automotive loan securitisation since being acquired by Shinsei Bank, and Kiwibank negotiated a senior unsecured 5-year bond with a small number of institutions, including ourselves.

We were pleased to increase our investment in TR Group in September, as the company came to market with a new wholesale bond. As a reminder, TR Group is New Zealand's leading truck and trailer leasing business with a dominant market position underpinned by superior customer service - enabling its customers to access the right truck for the job. It is fair to say the business is firing on all cylinders! The cash raised will help fund the ongoing growth of its business. As keen supporters of the company, we invested in the new bond, which saw strong demand.

We have also made several investments in the asset-backed securities (ABS). These are assets which are backed by loans ranging from residential mortgages (RMBS), auto loans and personal loans/credit card receivables. The US and European market for these investments is over $13 trillion alone. However, the NZ market is still in its nascency. We believe this presents a compelling investment opportunity.

Through our research process, we have engaged directly with several high-quality originators of loans, who we believe have a strong and impressive underwriting track record.

The first of these is Resimac – one of the largest non-bank mortgage lenders in NZ and Australia. Of all the lenders, we have the longest standing relationship with them. During the quarter we took the opportunity to participate in their latest NZ dollar "Prime" mortgage transaction. In our opinion, these notes exhibit strong creditor protections and offer valuable yield in this low-rate environment.

The next non-bank lender we engaged with was Avanti Finance. They are a smaller but growing specialist lender in NZ. The group has been originating residential mortgages, consumer, and auto loans for over 30 years now. Having participated in several of their prior transactions, we know Avanti to be a strong underwriter offering exposure to a high-quality pool of residential mortgages. We again participated in their recent RMBS transaction.

The third and final loan originator we were involved with this quarter was UDC – the largest non-bank lender in NZ with over 80 years of history behind them. The group has resilient underwriting standards backed by a management team with significant experience through various market cycles. UDC brought its inaugural auto ABS transaction to the market this month offering short-term senior-ranking notes to investors whilst retaining a significant equity stake in the deal. Given the strong alignment of interests between originator and investor and historical quality of the issuer, we were pleased to be involved in the deal.

# PROPERTY AND INFRASTRUCTURE

Sam Dickie, Senior Portfolio Manager

## Portfolio Action

US railroads Union Pacific and Norfolk Southern underperformed as weekly volume growth decelerated, particularly in the automotive and intermodal (container shipping) categories. The slowdown is due to greater impacts from supply chain congestion. There has also been more vocal commentary from the Chair of the Surface Transport Board, encouraging the railroads to focus on service to shippers and grow volumes to take volume share off the highways, rather than focusing on cost reductions to drive profitability.

We think that the volume deceleration is largely due to congestion issues which will be resolved with time. The pricing environment is becoming favourable, with increasing truck rates starting to filter through to railroad customers as contracts roll over. We also think that the regulatory noise is overblown. The regulator is relatively balanced and is unlikely to do much differently to what it has historically, consistent with the parameters of its mandate.

Global airport stocks had a strong quarter, reflecting an increasingly positive outlook for traffic recovery to pre-pandemic levels. The United States and United Kingdom removed entry restrictions for fully vaccinated travellers and relaxed pre-departure testing requirements. Both measures are crucial to restarting transatlantic air traffic, the world's most valuable route for airlines, and act as a catalyst to further long-haul travel that will benefit all our airport holdings.

## Infratil extends its exceptional optionality by investing in Asian renewables

We are naturally drawn to companies with optionality. Companies that can choose which high-returning projects they deploy capital into. Companies that can seamlessly alter their strategy as the world changes. Companies that have a strong balance sheet and cash flows that allow them to pursue new growth options.

Infratil owns a portfolio of companies, so it has many options to maximise returns to shareholders. It is constantly looking at potential company acquisitions to broaden its portfolio and expand the capability of its existing assets.

Infratil is deft at using optionality. The company dedicates more capital to the best ideas while selling out of assets where the investment thesis has played out (the turnaround of Z Energy) or where others perceive greater value (the sale of Tilt Renewables for a big price).

Canberra Data Centres (CDC) is a great example of Infratil deploying more capital into a winner. CDC's existing datacentres generate a lot of cash – earnings last year were AU$147m. CDC has reinvested those earnings into its business, with plans to grow the size of its facilities eight-fold since Infratil became involved. Reinvesting has had a handsome payoff: the value of Infratil's CDC stake is up almost 500% since investing in 2016.

Building out optionality takes time. Infratil invested in Longroad Energy in 2016, committing 2% of its portfolio to the American renewable energy developer. Infratil was happy to let Longroad Energy sell most of the projects it developed. This helped Infratil manage risk by reducing the need for funding and re-investment.

Longroad Energy has now developed a proven track record, with 2,000 MW of developed projects, and has paid more in dividends than Infratil's initial investment! The previously early-stage bet is now an important part of the portfolio, and Infratil recently announced a strategy shift to retain more projects and make Longroad Energy a bigger business.

Infratil recently unveiled its fourth renewable energy platform, Gurin Energy. Gurin Energy has a similar model to Longroad Energy, but with a focus on the fast-growing Asian market. By starting small, but with the ability to go big – Gurin's pipeline is 600 MW, larger than Trustpower's current pipeline – Infratil is using the playbook which has worked successfully so many times before.

AusSuper bid $7.43 a share for Infratil in December last year, an offer which gave no credit for the inherent optionality in the current portfolio, nor the future value to be created. The board was right not to engage.

Some of that value has materialised since – Infratil's share price is comfortably higher than the offer price – but we think there is more to come. Since last December, Infratil has announced a successful CEO transition to an internal candidate, launched a new renewables platform, started to build a leading position in the Australasian diagnostic imaging market, and realised outstanding value for Tilt Renewables.

All of these initiatives can move the needle on their own. Taken together, they illustrate the powerful platform value – and optionality – within Infratil's business.

## New portfolio addition Equinix is the global datacentre leader

We added Equinix to the portfolio during the quarter. Equinix is the world-leading provider of datacentres. Its facilities house sophisticated computer process, storage and networking equipment for the world's largest organisations.

Customers choose Equinix because they can share data with their partners and service providers in a fast, secure and cost-effective manner. In an age of data analytics, high quality streaming video, and increasing cyber crime, fast and secure data sharing has never been more important.

Equinix's optionality stems from its strong balance sheet and nose for a deal. Equinix has used its financial strength to acquire businesses and become a market leader, going from market leader in one country before 2010 to market leader in 19 countries by 2021. Over the past 5 years Equinix has invested $6 billion buying companies and generated $5 billion in additional value from these deals. Equinix has the financial strength – and therefore the option – to do the same again over the coming 5years.

Equinix also creates value by giving its customers optionality. Equinix can set up a physical datacentre footprint for a customer in a new market without the customer having to put boots on the ground – one American customer set up in Europe from their couch! Customers are buying into Equinix's product offering because it helps them expand 'physical infrastructure at software speeds'.

With high switching costs, and a customer-retention rate three times its competitors', Equinix will reap the benefit of that optionality for a long time yet.

fisher funds

# MARKET MOVEMENTS

## As at 30 September 2021

| Stock Markets* | Closing Values | Changes over: 1 Mth % | 3 Mths % | 6 Mths % | 12 Mths % |
|---|---|---|---|---|---|
| S&P Developed LargeMidCap - (Local Curr) | 1156 | -3.6 | 0.6 | 8.2 | 29.5 |
| S&P Developed LargeMidCap ($NZ) | N/A | -3.6 | -0.1 | 7.6 | 21.6 |
| S&P Global LargeMidCap ($NZ) | N/A | -2.1 | 0.4 | 8.1 | 22.5 |
| USA - S & P 500 | 8995 | -4.7 | 0.6 | 9.2 | 30.0 |
| USA - Nasdaq | 17206 | -5.3 | -0.2 | 9.4 | 30.3 |
| Japan - Topix | 3234 | 4.4 | 5.3 | 5.0 | 27.5 |
| UK - FTSE100 | 6982 | -0.2 | 2.0 | 7.7 | 25.4 |
| Germany - DAX | 15261 | -3.6 | -1.7 | 1.7 | 19.6 |
| France - CAC40 | 18531 | -2.2 | 0.4 | 9.5 | 39.0 |
| HK - Hang Seng | 75321 | -4.7 | -13.9 | -11.5 | 7.5 |
| Australia - S & P 300 | 83838 | -1.9 | 1.8 | 10.4 | 30.9 |
| NZ-S&P/NZX 50 Gross Index (inc imp credits) | 16336 | 0.6 | 5.2 | 6.1 | 13.7 |
| NZ-S&P/NZX 50 Gross Index (excl imp credits) | 13276 | 0.4 | 4.9 | 5.7 | 13.0 |
| Market Volatility - VIX | 23.1 | 40.4 | 46.2 | 19.3 | -12.2 |

| New Zealand Property | | % | % | % | % |
|---|---|---|---|---|---|
| S&P/NZX All Real Estate (inc imp credits) | 2017.5 | -3.3 | 3.3 | 5.7 | 10.2 |
| S&P/NZX All Real Estate (exc imp credits) | 1912.4 | -3.4 | 3.2 | 5.5 | 9.6 |

| Ten Year Bonds | % | Yield Changes | | | |
|---|---|---|---|---|---|
| USA | 1.52 | 0.22 | 0.07 | -0.22 | 0.83 |
| Japan | 0.07 | 0.05 | 0.01 | -0.02 | 0.05 |
| United Kingdom | 0.95 | 0.36 | 0.23 | 0.12 | 0.73 |
| Australia | 1.49 | 0.33 | -0.04 | -0.30 | 0.70 |
| New Zealand | 2.00 | 0.28 | 0.24 | 0.19 | 1.50 |

| 90-Day Interest Rates | % | Yield Changes | | | |
|---|---|---|---|---|---|
| USA | 0.04 | 0.00 | -0.01 | 0.01 | -0.06 |
| Japan | 0.06 | 0.00 | 0.00 | -0.01 | -0.02 |
| United Kingdom | 0.08 | 0.01 | 0.00 | -0.01 | 0.02 |
| Australia | 0.02 | 0.01 | -0.01 | -0.02 | -0.06 |
| New Zealand | 0.65 | 0.19 | 0.30 | 0.30 | 0.34 |

| Bond Indices | Closing Values | Changes over: 1 Mth % | 3 Mths % | 6 Mths % | 12 Mths % |
|---|---|---|---|---|---|
| S&P/NZX Bank Bills 90-Day | 735.94 | 0.02 | 0.09 | 0.18 | 0.32 |
| S&P/NZX NZ Government Bond Index | 1848 | -1.10 | -1.23 | -1.02 | -7.13 |
| Barclays Capital Global Aggregate Index (Hedged NZD) | N/A | -0.96 | 0.09 | 1.10 | -0.59 |

| Hedge Funds & Commodities | | % | % | % | % |
|---|---|---|---|---|---|
| HFRX Global Hedge Fund Index (USD) | 1430 | -0.4 | -0.1 | 2.3 | 8.9 |
| DJ-UBS Commodity Index Total Return | 215 | 5.0 | 6.6 | 20.8 | 42.3 |
| Gold (US$/ounce) | 1755.30 | -3.3 | -0.9 | 2.4 | -7.0 |
| Oil (US$/barrel) | 78.52 | 6.9 | 2.1 | 23.6 | 94.8 |

| Currencies | | % | % | % | % |
|---|---|---|---|---|---|
| NZD / USD | 0.6899 | -2.0 | -1.3 | -1.5 | 4.4 |
| NZD / EUR | 0.5952 | -0.2 | 1.0 | -0.1 | 5.6 |
| NZD / GBP | 0.5116 | 0.0 | 1.1 | 0.8 | 0.1 |
| NZD / AUD | 0.9550 | -0.8 | 2.6 | 3.9 | 3.6 |
| NZD / YEN | 76.97 | -0.5 | -0.8 | -0.5 | 10.3 |
| Trade Weighted Index | 73.73 | -1.2 | 0.0 | -0.2 | 2.4 |

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

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**Fisher Funds Management Limited**
Level 1, Crown Centre, 67-73 Hurstmere Road, Takapuna, Auckland 0622, Private Bag 93502, Takapuna, Auckland 0740
Freephone 0508 FISHER (0508 347 437) | Phone 09 445 3377 | Facsimile 09 489 7139 premium@fisherfunds.co.nz | fisherfunds.co.nz