SYNERGY
INVESTMENTS

Investment Report for
Quarter Ending 30th June 2016

QUARTERLY INVESTMENT COMMENTARY

Strategy and persistance trumps fear.

In the previous quarterly report we discussed the difficulties that investors face trying to process the vast amounts of information available in the markets, and attempting to use it to trade successfully. At the time we outlined how the Royal Bank of Scotland (as one high profile example) observed the world and drew conclusions which, as at today, now look completely wrong.

In the April to June quarter, we again witnessed an event which caught so many people unprepared that, for a time, the markets panicked. In this case we are talking about the late June referendum in the UK which saw Britain vote to initiate an exit of the European Union (more colloquially referred to in the media as 'Brexit').

Within minutes of the market opening the next day, the UK's FTSE 100 index was down -8.67% and other major indices in Europe and around the world followed suit. Once the initial shock wore off, markets started to gradually recover these losses and the FTSE 100 ended the day down -3.15%. This was in line with the local currency performances of Australasian, US and emerging shares markets, although the French and German markets (both potentially more exposed to a Brexit) ended the day down -8.04% and -6.82% respectively.

However, as in the first quarter, it was the investors who endured this spike in volatility and stayed the course with their investments who came out ahead. Investors who panicked and sold the day after Brexit were ultimately the ones who lost out. But, for the sellers, this wasn't a strategic decision - far from it. It was an emotional reaction to seek clarity in a world suddenly filled with uncertainty. Whilst this is behaviourally understandable, it is usually a very poor replacement for an investment strategy.

The market reaction to Brexit was nothing out of the ordinary, although, if anything, the recovery rally probably began even faster than we might have expected. Ironically, once it was understood that the only new information (apart from the outcome of the vote itself) was that ongoing uncertainty would now be the order of the day for quite some time to come, the markets simply decided to worry less about it and move on.

As human beings we may never get entirely comfortable with periods of extreme market volatility and uncertainty. As a result, we need to continually remind ourselves that we have to accept some degree of pricing volatility whenever we are investing to achieve returns above the risk free rate.

We often also need to remind ourselves that, at some point in the past, when we were not feeling so spooked, we made a thoughtful decision about investing in a certain way over a certain period of time. When we made this decision we knew that investing in shares involved an acceptance of risk and greater price volatility than most other assets, but the returns they have traditionally delivered above cash and bonds would be the reward for our persistence.

Inevitably, fears fade and markets recover; often much faster than seems likely at that moment when fear is the overriding emotion. That's why sticking to your long term strategic investment plan, even when the outlook suddenly seems more challenging, remains the most reliable way of ensuring that you stay on track to achieving your long term goals and objectives.

Investors in Synergy bore the fruits of this approach as markets began a recovery in the last few days of June which, at time of writing, has extended on quite strongly into the first half of July.

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MARKET REVIEW

Second quarter 2016. A summary of the major asset class returns for the quarter are as follows:

New Zealand Shares

+2.15%

Although the majority of shares in the NZX 50 were down in June, in large part due to the Brexit fallout at the end of the month, the market overall for the quarter posted another sound result. Orion Health Group was the leading performer in the quarter, posting a return of +41.2%, while Z Energy, Xero and Diligent also produced strong double digit gains. With oil appreciating by more than 25% from April to June, Air New Zealand suffered the largest price decline of -26.7%.

Source: S&P/NZX 50 Index

Australian Shares

-2.10%

Although the Australian market was up in local currency terms (the ASX 200 was +3.94% in Australian dollars), a stronger New Zealand dollar meant that returns to unhedged investors here were negative. Small capitalisation companies outperformed large capitalisation companies during the quarter, helped by strength in the materials sector which rallied on news of reduced Chinese production and inventories.

Source: S&P/ASX 200 Index (Total Return)

New Zealand Property

+2.40%

The performance of the domestic listed property sector closely mirrored that of the wider New Zealand equity market. There was a relatively wide dispersion of returns across the sector, with Vital Healthcare Property Trust delivering a sector leading +10.36% while Property For Industry returned -2.68%. Of the larger index constituents, Kiwi Property Group produced a strong +5.99% for the quarter.

Source: S&P/NZX All Real Estate Index

International Property

+1.60%

With further yield compression in global bond markets and at least a temporary increase in equity risk aversion following the Brexit result, global listed property delivered a strong performance. The S&P Developed REIT Index was up +4.95% in US dollar terms, a result which even the much stronger New Zealand dollar couldn't completely overturn. The majority of this return was achieved in June as the sector was largely flat in the lead up to the referendum. The Australian listed property sector was strong again, with the S&P/ASX 300 A-REIT Total Return Index gaining 9.23% in Australian dollar terms.

Source: S&P Developed REIT Index

International Shares

+1.80%
(hedged to NZD)

-2.20%
(unhedged)

Most markets were mildly positive in advance of the Brexit referendum, before initially collapsing after the shock 'leave' vote was confirmed. Markets were continuing to recover as the quarter ended, as investors began to understand the Brexit process would take some time and therefore increased their expectations about ongoing stimulatory monetary policy settings. The performance of emerging markets was broadly similar although, somewhat unusually, the initial 'risk-off' reaction to the Brexit vote hit a number of developed markets much more severely.
A much stronger New Zealand dollar over the quarter saw reported returns from hedged equities outperforming the comparable returns from unhedged investments.

Source: MSCI World ex-Australia Index (Net Div)

New Zealand Fixed Interest

+1.47%

The Reserve Bank of New Zealand's April and June monetary policy statements affirmed local interest rates remaining on hold, but noted house prices and dairy incomes both pose some financial stability risks. With markets continuing to price in further modest interest rate cuts, the New Zealand Corporate A Bond Index delivered another solid result for the quarter.

Source: S&P/NZX A Grade Corporate Bond Index

International Fixed Interest

+1.18%

Once again the Brexit vote had a significant bearing on the performance of this asset class during the quarter as most long term international interest rates spiked downwards in response to the outcome of the referendum. This late quarter rally propelled international bond markets to another solid quarter. The return in June alone represented the best single month return for a number of leading international indices since January 2015.

Source: Citigroup World Government Bond Index I – 5 Years (hedged to NZD)

All returns are expressed in NZD. Australian shares and international property are invested into on an unhedged basis, and therefore returns from these sectors are susceptible to movement in the value of the NZD.

WARREN BUFFETT'S $1,000,000 BET ON INDEX FUNDS OVER HEDGE FUNDS

Words are cheap. Warren Buffett knows all about cheap. He lives in perhaps the most modest primary residence owned by any billionaire, and he doesn't drive a luxury car. This is despite having a personal net worth of about $66 billion and being widely regarded as the world's greatest investor.

For someone who doesn't invest in them, Warren Buffett has a lot to say about hedge funds. What are hedge funds? One definition is "a hedge fund is an alternative investment vehicle available only to sophisticated investors, such as institutions and individuals with significant assets."[1]

That makes hedge funds sound exclusive and special. Unlike most managed funds, hedge funds can bet for or against shares. They can vary their asset allocations significantly, they can invest in derivatives and they can borrow money to invest (called leverage).

In other words, hedge fund managers have incredible scope to implement whatever investment ideas they might think up. With such latitude you might expect hedge funds to outperform shares. You'd be wrong.[2]

The reason isn't that hedge fund managers aren't smart, it's that they aren't smart enough to overcome their large fees. A typical hedge fund charges a fee of 2% p.a., plus 20% of annual profits. As recently as 2012, IFA.com reported that this translates into an average hedge fund fee of about 3.43%.[3] That's a huge fee hurdle for any manager to overcome, and overall, hedge funds don't clear it.

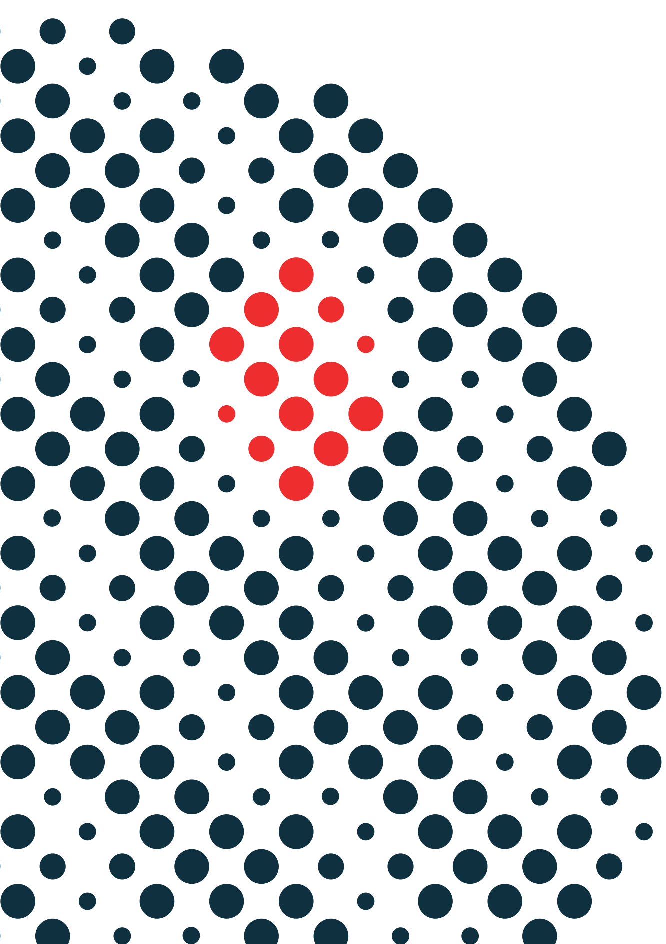
At a recent Berkshire Hathaway shareholder meeting, Buffett suggested that the "supposedly sophisticated people" investing in hedge funds are being fleeced. He went on to say that, "there's been far, far, far more money made by people in Wall Street through salesmanship abilities than through investment abilities."

But again, words are cheap, so, in 2007, Buffett went a step further and put his money where his mouth was. He entered a highly publicised bet with a hedge fund manager named Jeffrey Tarrant, of Protégé Investments. The bet was that a Vanguard S&P 500 Index Fund would beat any hedge fund selected by Mr Tarrant over a 10 year period. The loser would pay $1,000,000 to the winner's charity of choice.

Eight years on, let's review how things stand. Bear in mind that this eight year period included the global financial crisis. As the table opposite shows, Buffett's S&P 500 index fund has outperformed the hedge funds in six out of eight years. As at April 2016 Buffett was up 65.7%, and the hedge funds picked by Tarrant were up just 21.9%.

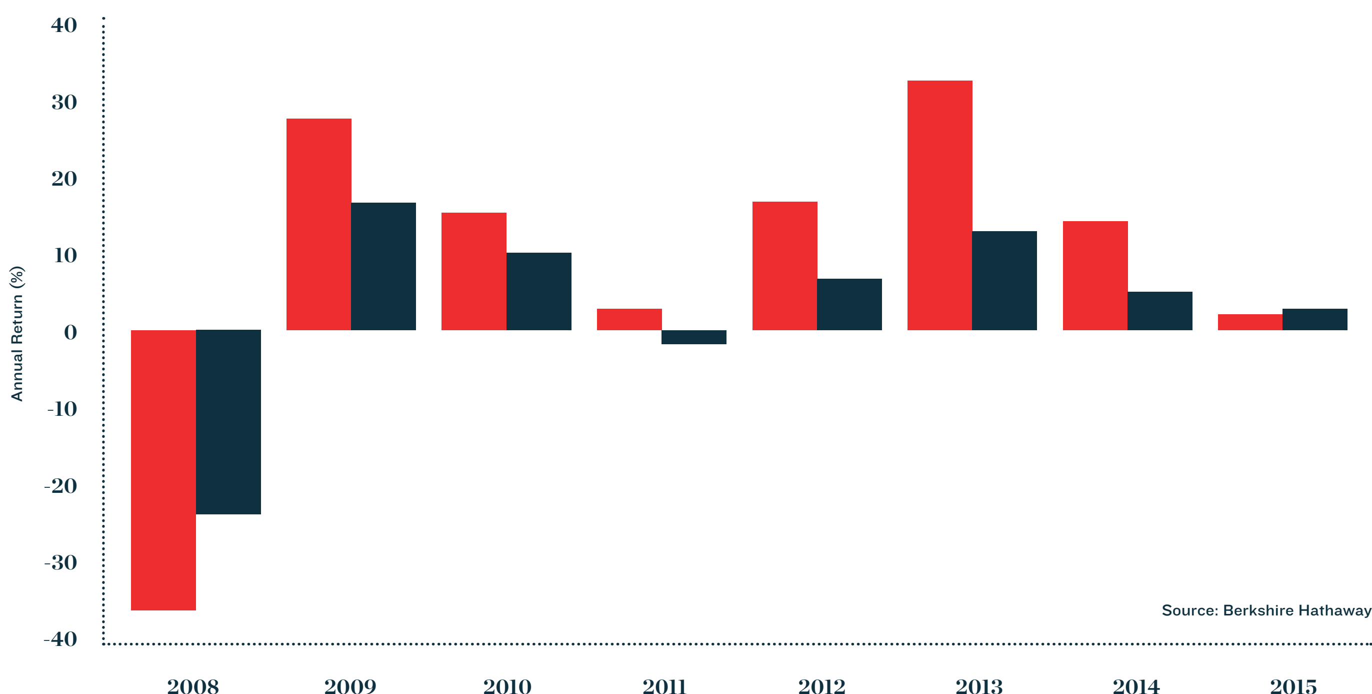
Buffett spoke on this issue at his annual shareholders' meeting, in which he told the audience, comprising tens of thousands of investors, that these poor returns in comparison to the index "may sound like a terrible result for hedge funds, but it's not a terrible result for the hedge fund managers." Why? Because of the incredible amount of money they made (in fees) by trying.

Whilst we take active long term overweight positions in inexpensive companies, profitable companies, small companies and others, we do so inexpensively.



Buffett is beating hedge funds in his 10-year wager on an index fund.

S&P 500 Index Fund   Hedge Fund



As an alternative, Buffett provided, "probably the most important investment lesson in the world."

He said Wall Street salesmanship has masked poor returns for years. Investment consultants have steered pension funds and others towards high-fee managers who, as a group, underperform the returns you could get in an index fund whilst "sitting on your rear end". The high-fee managers recommended by the consultants "eat up capital like crazy", he said.

At Synergy, we employ a low fee investment strategy. Whilst we take active long term overweight positions in inexpensive companies, profitable companies, small companies and others, we do so inexpensively. We do this because we have carefully researched the effects of fees on investment returns. We don't believe that paying for the (often hollow) promises of expensive investment managers represents a prudent long term outlay.

As a result, Synergy investors get to keep more of their investment returns along the way. Over time, and due to the persistent compounding of these additional returns, Synergy has a strong probability of outperforming the majority (perhaps the vast majority) of alternative investment solutions.

[1] http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/what-is-a-hedge-fund.html

[2] An article in the Financial Analyst Journal "The ABCs of Hedge Funds: Alphas, Beta, and Costs" show the huge influence of survivorship bias. Among the 6,169 hedge funds they analysed between 1995 - 2009, 63% went out of business and just 37% survived. It's clear there is a huge gulf between winners and losers. When accounting for the returns earned by the funds that didn't survive, the overall return of hedge funds from 1995 - 2009 fell from approximately 10.21% to 7.70%. This shows that survivorship bias is very important. Interestingly, Bernie Madoff's fund reported returns that were counted and reported until his fraud was uncovered. This also shows the lack of reliability in the reported returns of hedge funds.

[3] https://www.ifa.com/articles/hedge_funds_deeper_look_into_their_returns/

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