SYNERGY
INVESTMENTS

Investment Report for
Quarter Ending 30th September 2016

MARKETS DELIVER STRONG RETURNS

Synergy investors enjoyed strong returns for the three months ending September.

In fact, the September quarter marked the end of Synergy's first full year since inception, and it is pleasing to note that all Synergy portfolios achieved first year returns in excess of our long term expected returns.

Over the long term, of course, markets go up more than they go down, so earning a positive investment return in any period can hardly be considered a surprise. But where did the good returns come from in the recent quarter? In the first three months of the year New Zealand shares performed best and from April to June it was New Zealand property, so did we get more strong performance from local assets, or was it the turn of another asset class to shine?

This is where Synergy's strategic asset allocation approach reaps considerable rewards. Synergy portfolios stay diversified, and stay exposed to the full range of major asset classes, because we know that successfully predicting the winning asset class each quarter is an impossible task.

Leading into the September quarter there appeared to be plenty of reasons for caution. The late June Brexit vote in the UK had initially sent a sharp tremor through markets. Political uncertainty in the USA and concerns about the rate at which interest rates might rise there continued to gain attention. And all the while, sovereign debt in many developed countries sat near record levels while global growth rates remained persistently weak.

If you focused only on these known problems, as some investors did, then you might have thought that cash or high quality bonds represented the smartest investment. As it transpired, the best performing asset class this quarter was emerging market equities (see the key market movements table on the following page for a comparison of the different asset class returns). The strong performance of emerging markets would be surprising to many, not least because it is widely regarded as the riskiest single asset class due to the higher volatility of pricing movements that those assets can experience.

So how could the riskiest asset class perform the best in such an obviously uncertain period?

The answer is that the problems highlighted above were all 'known' problems at the start of the quarter. There was nothing new that happened in the last three months that raised investor fears to even higher levels. In fact, it was arguably the reverse. The initial fears of a Brexit contagion effect lessened dramatically; the political polls in the USA increasingly suggested the unthinkable outcome of a Donald Trump presidency was diminishing; and even the speed at which US interest rates might rise was tempered slightly.

In other words, in a relative sense, investor fears probably declined in the quarter and risky assets like emerging market equities were significant beneficiaries, along with Australasian and international equities. But of course, that's only helpful if you have exposure to those assets!

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We also know that investment performance tends to come in spurts, as it did for the first four to six weeks of the September quarter. This means the decision to move your entire portfolio into cash for even a short period of time can prove extremely damaging to your investment returns if that coincides with a period when risky assets perform strongly.

Thankfully that is one common investment fault that investors in Synergy do not have to be concerned about.

KEY MARKET MOVEMENTS

New Zealand Shares

+6.72%

The local market continued its strong recent run in the third quarter of 2016. With local interest rates reducing in August, several of the higher dividend paying companies in the NZX experienced particularly strong demand. Leading performers were Heartland Bank +33.9%, Kathmandu +32.7% and Steel & Tube +30.0%. At the other end of the spectrum, Tower announced an increased provision for the Canterbury earthquakes which was expected to impact after tax profit by $16.2m. Tower's shares ended the quarter down -32.5%.

Source: S&P/NZX 50 Index (gross)

Emerging Market Shares

+7.03%

This was the leading asset class over the three months to September as the pendulum swung firmly back in favour of risky assets. Signs of greater economic stabilisation in China and additional stimulus from global central banks outweighed previous concerns about the projected pace of future US interest rate hikes. Although Egypt was the best performing single country in the emerging markets this quarter, it was the double digit returns from leading constituents China and Brazil which propelled the strong overall performance of the region.

Source: MSCI Emerging Markets Index (gross div.)

International Property

-1.96%

The ongoing messaging coming out of the Federal Reserve in support of a further interest rate hike was enough to dampen investor enthusiasm for global listed property assets. The S&P Developed REIT Index was flat in US dollar terms, however, a general appreciation in the value of the New Zealand dollar during the quarter dragged the return to unhedged investors into the negatives.
The Australian listed property sector was also in the red for the quarter, with the S&P/ASX 300 A-REIT Total Return Index shedding 1.88%% in Australian dollar terms.

Source: S&P Developed REIT Index (total return)

Australian Shares

+5.80%

Like most international markets, the Australian share market enjoyed a sizable post-Brexit recovery in July. Although the Reserve Bank of Australia cut its Official Cash Rate in August, which signalled a temporary lull in proceedings, the market closed strongly in September. The ASX 200 produced an attractive +5.8% return (in New Zealand dollars) driven by strong performances from metals and mining companies. Small capitalisation companies delivered a considerable return premium over the quarter with the S&P/ASX Small Ordinaries Index returning +9.2%.

Source: S&P/ASX 200 Index (total return)

New Zealand Property

+2.06%

The moderating domestic interest rate environment supported the performance of the domestic listed property sector, which registered its tenth positive return in the last 11 quarters. Precinct Properties (+5.9%) and Property for Industry (+5.8%) were the clear leading performers in the sector this quarter.

Source: S&P/NZX All Real Estate Index (gross)

New Zealand Fixed Interest

+1.61%

The Reserve Bank of New Zealand reduced the Official Cash Rate by 0.25% in August which was right in line with market expectations.
In justifying the cut, Governor Wheeler cited concerns about weaker global growth and New Zealand's relatively high interest rates contributing to a high exchange rate. With interest rates declining across the domestic curve, 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

+0.55%

It was a much less eventful quarter in international bond markets. US ten year bond yields inched 12 basis points higher over the quarter as the Federal Reserve continued to hint at a potential additional rate hike before the end of 2016. However, comparable global yield curves exhibited mixed behaviour, with German ten year yields effectively flat for the quarter and UK yields falling by 12 basis points. Overall, it was a relatively benign quarter for this asset class, which is reflected by the return of the reference index.

Source: Citigroup World Government Bond Index 1-5 Years (hedged to NZD)

International Shares

+5.23%
(hedged to NZD)

+2.75%
(unhedged)

Developed market shares performed well in the third quarter. This was largely due to the significant bounce-back in sentiment that occurred once the initial fears about the impact of the UK's vote to exit the European Union had receded. US second quarter earnings announcements were higher than expected and this helped support international indices, and even British and European markets moved higher over the quarter. A stronger New Zealand dollar saw reported returns from hedged equities outperforming the comparable returns from unhedged investments.

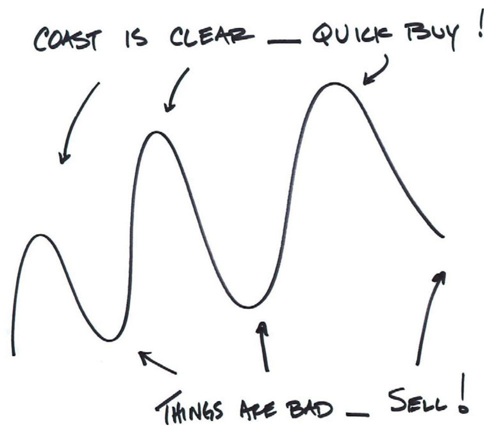
Source: MSCI World ex-Australia Index (net div.)

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

INVESTING WHEN OTHERS ARE FEARFUL

Legendary investor, Warren Buffett, has made billions of dollars investing in shares. Surprisingly, he doesn't attribute his success to his outstanding business acumen. Instead, he believes it has more to do with having mastered a fundamental behavioural premise – to be greedy when others are fearful.

When share prices look like the chart below[1], almost everyone intuitively understands the best time to invest is at the bottom of the curve. In other words, buy low (and aim to sell high).



Unfortunately, because human beings are susceptible to strong behavioural impulses, many end up doing the opposite.

With the situation in the world so uncertain these days, many investors are reluctant to invest. Some conclude that, since the world is struggling with slow economic growth (measured by GDP), it must mean the outlook for share markets is also poor.

After all, it is widely assumed that share market returns are based on economic growth. If growth looks to be sluggish, doesn't that mean that the share market performance will also be sluggish?

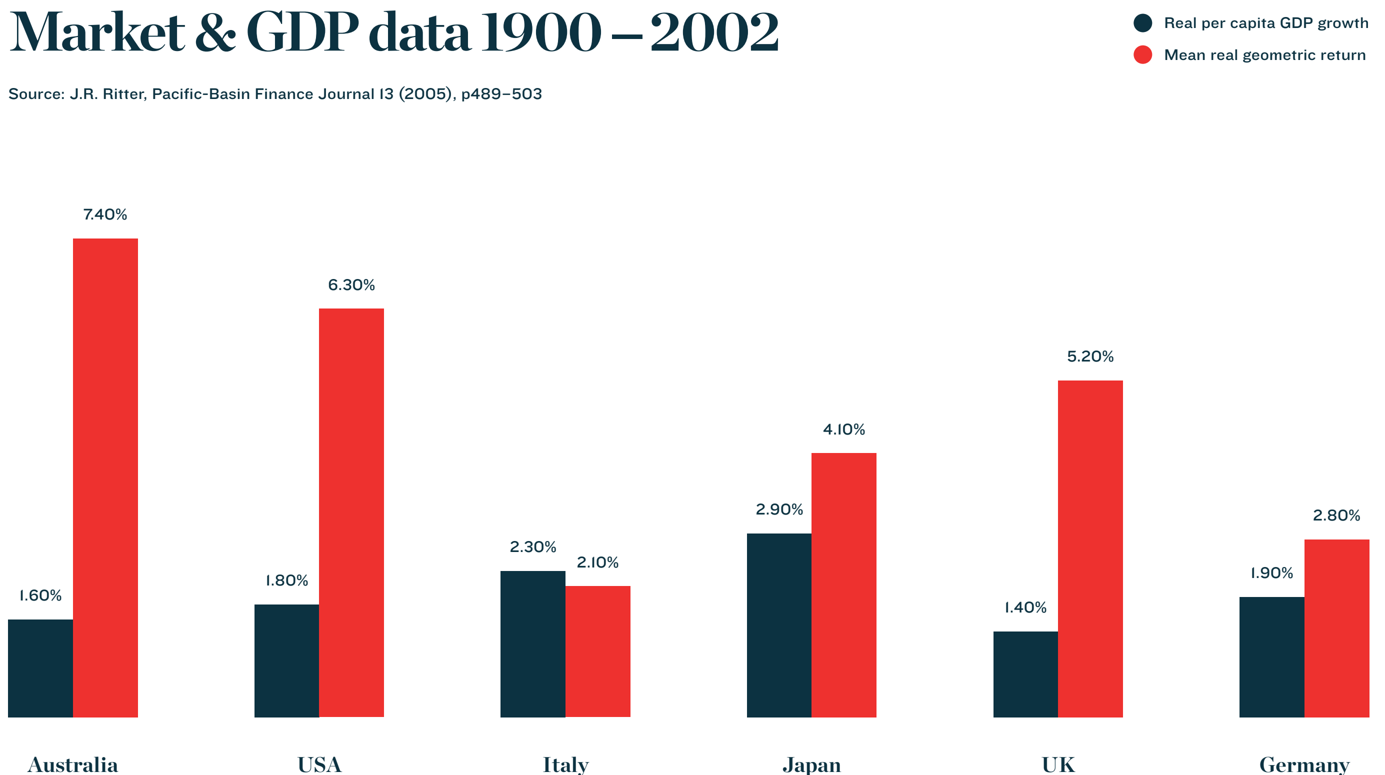
The answer may surprise you.

There is compelling academic evidence that suggests the assumed link between economic growth and share market returns may be flawed, or at least overstated.

Research conducted by an American professor, Jay Ritter of the University of Florida, on the relationship between economic growth and real share market returns from 1900 to 2002, showed that economic growth did not at all explain share market returns over the 102 year period[2]. In the chart below you can see that the height of the blue bars (economic growth) and the height of the red bars (share market performance) are unrelated across several different countries.

Market & GDP data 1900 – 2002

Source: J.R. Ritter, Pacific-Basin Finance Journal 13 (2005), p489–503



“Investors should remember that excitement and expenses are their enemies. And if they insist on trying to time their participation in equities, they should try to be fearful when others are greedy and greedy when others are fearful.”

For example, Australia had 1.6% p.a. real per capita economic growth – the second worst of the six countries listed above – yet it had the best share market performance.

Japan had the best per capita growth at 2.90% p.a., but only the fourth best share market performance. The UK has the worst growth but enjoyed superior share market performance to the Japanese.

In other words, the economic growth rate fails to explain the large differences in relative share market performance.

It’s also noteworthy that this result encompassed a 102 year period. That period included a global financial crisis (the Great Depression), a series of world wars, oil shocks and currency crises, a tech bubble and a terrorist attack, so it’s a very robust data set.

Why does economic growth do such a poor job of explaining share market performance? Ritter’s paper offers multiple suggestions:

1

When an economy grows, it’s often the workers who share the benefits, not just the owners of shares.

2

New businesses owned by private investors, and not owned in public share markets, are often more successful at achieving faster growth rates.

3

Economies with poor growth rates often have low share prices because existing market participants are cautious. But this enables new investors to pick up bargains, leading to higher potential investment returns.

Buffett captured the last point best in his Berkshire Hathaway 2004 Chairman’s letter:

“Investors should remember that excitement and expenses are their enemies. And if they insist on trying to time their participation in equities, they should try to be fearful when others are greedy and greedy when others are fearful.”

Fear is the natural human response when there is a catalogue of negative news flows about economic growth. However, what investors generally overlook is that fear is already embedded in the price, meaning prices are low relative to old values.

Buffet is one outstanding example of someone who responds to these sorts of scenarios like it’s Boxing Day and everything is on sale. It’s just a shame that, for most of the rest of us, successfully implementing Buffett’s simple philosophy is hard.

Synergy’s approach is to diversify so that you are not overexposed to any one set of market expectations for companies, industries or countries. To that end, Synergy invests in over 40 countries and about 8,000 underlying securities. Just as importantly, Synergy follows clear investment rules which prevents trading on fear and enforces prudent discipline.

History tells us again and again – most recently in 2003 and 2009 – that discipline and patience are rewarded. Down markets are an inevitable reality of global business, but markets have always recovered and, with discipline, smart investors (like Buffett) reap the benefits.

[1] from Carl Richards of Behavior Gap

[2] The paper can be found at http://bear.warrington.ufl.edu/Ritter/PBFJ2005.pdf.

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