SYNERGY
INVESTMENTS

Investment Report for Quarter Ending 31st December 2016

SYNERGY PORTFOLIOS – DESIGNED FOR SUCCESS

While unexpected political events dominated the headlines in 2016, Synergy investors can look back on 12 months of attractive investment returns.

In June, UK voters stunned market watchers when they voted to leave the European Union. Then, in November, Donald Trump stunned the world by claiming the US presidency on the back of a wave of anti-establishment feeling. In New Zealand we even saw the surprise resignation of John Key, ending the tenure of one of New Zealand's most consistently popular prime ministers.

Although Key's exit barely caused a ripple, the UK and US surprises were both major news events. In fact, they were so unexpected they created tremendous uncertainty in the minds of investors, which initially had a major impact on markets everywhere.

Through each period of market instability Synergy portfolios displayed their resilience, and this is largely attributable to their design. Some of the key portfolio attributes, which not only helped protect capital but also helped to deliver strong returns to Synergy investors, are:

- Wide diversification – meaning 'never putting all your eggs in one basket', so that even if one or more of your assets struggles, your overall strategy can still succeed.
- Low cost – allowing more of your investment dollars to be left working for you.
- A focus on high quality assets – which often tend to perform better when investors become increasingly concerned by unexpected events.
- Evidence-based allocations – which means having persistent exposure to specific parts of the market which have been academically proven to deliver higher long term expected returns.

It was this final point which really set Synergy apart in 2016. Many of these strategic 'tilts' towards sources of higher expected return paid off handsomely over the year, particularly in relation to undervalued companies and smaller companies both in Australia and internationally.

The common weakness in strategies that seek out high returns is they often expose themselves to unnecessary (and unprotected) risk when markets do something unexpected.

Viewed in simple terms, investing successfully over a long period of time involves doing two things consistently well:

1

Capturing the returns the markets make available in the good times.

2

Having a portfolio structure that is strong enough to withstand the inevitable periods when market conditions are tough.

In 2016, Synergy portfolios demonstrated both of these qualities in spades.

The common weakness in strategies that seek out high returns is they often expose themselves to unnecessary (and unprotected) risk when markets do something unexpected. Following the UK vote in June, the wrong investments were GBP denominated assets, and following the Trump victory, it was New Zealand shares and property assets. Unfortunately, investors who had a concentrated exposure to these assets at the wrong time ended up with a very disappointing return for the additional risks they were taking.

Long term investors need to accept that risk is unavoidable and sometimes it will hurt returns. But Synergy portfolios, by focusing on the key design attributes highlighted above, put themselves in the best possible position to weather all conditions.

And as 2016 showed, this approach can still generate attractive returns even when the investment environment is at its most challenging.

KEY MARKET MOVEMENTS

-6.40%

New Zealand Shares

The local market endured a weak final quarter in 2016. With overseas interest rate markets reacting swiftly to Donald Trump's victory in the US presidential election, some of the previous strong foreign demand for New Zealand high yield stocks cooled quickly. Selected companies still performed well, including Pacific Edge +28.3%, New Zealand Oil & Gas +22.4% and Air New Zealand +18.0%. But, overall, losers outnumbered winners with Orion Health -42.7%, Trustpower -35.7% and Auckland International Airport -15.0% helping drag the index lower.

Source: S&P/NZX 50 Index, gross with imputation credits

+3.95%

Australian Shares

The Australian share market performed significantly better than the New Zealand market over the quarter, driven by the energy sector (higher oil prices) and banking shares (higher interest rates and Basel IV relief). This led to large capitalisation companies faring the best on a relative basis with the S&P/ASX 100 delivering a useful +4.57%, while the S&P/ASX Small Ordinaries shed -3.57% (both returns in New Zealand dollars).

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

+5.27%

(hedged to NZD)

+6.79%

(unhedged)

International Shares

Developed market shares performed well over the quarter, generally benefitting from an increased investor appetite for risk assets. Economic data, particularly for the US and China, continued to beat expectations, and the additional economic stimulus anticipated under the Trump administration proved to be positive for US shares in particular. Commodity prices also strengthened, with the oil price lifting further after OPEC announced production cuts. A slightly weaker New Zealand dollar saw reported returns from unhedged equities outperforming the comparable returns from hedged investments.

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

+0.53%

Emerging Markets Shares

Returns from emerging markets shares were only mildly positive for the quarter (in New Zealand dollars). While the fundamentals in emerging markets are strong with gross domestic product growth accelerating, their prospects became a little more clouded given the stated economic and trade policies of the incoming Trump administration in the US. Egypt was again the best performing single country in the emerging markets this quarter, however, it was the double digit returns from many of the European constituents, including Russia, which helped offset weaker returns from China and India.

Source: MSCI Emerging Markets Index

-6.23%

New Zealand Property

The rapid shift in overseas interest rate expectations provided a strong headwind for New Zealand property assets. With relatively high yielding New Zealand property having been a popular destination for foreign yield-seeking investors in recent years, the turnaround in US interest rate expectations saw a sizable rotation away from New Zealand property this quarter. This resulted in the domestic real estate index suffering its worst quarter since the March 2009 quarter at the end of the GFC.

Source: S&P/NZX All Real Estate Index, gross with imputation credits

-0.24%

International Property

International property fared somewhat better than domestic property during the quarter, when the main investor reaction appeared to favour some movement from bonds (and previously high yield New Zealand assets) into selected international risk assets. The S&P Developed REIT Index was negative in US dollar terms, however, a general weakening in the value of the New Zealand dollar during the quarter helped offset the bulk of the underlying asset class weakness. The Australian listed property sector was also down for the quarter, with the S&P/ASX 300 A-REIT Total Return Index shedding 0.73% in Australian dollar terms.

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

-1.69%

New Zealand Fixed Interest

The Reserve Bank of New Zealand reduced the Official Cash Rate by a further 0.25% in November. However, global and domestic bond yields continued to rise through the quarter, fuelled in part by the US Federal Reserve hiking rates in the US and additional anticipated stimulus from the Trump presidency. Although the bond sell-off over the quarter returned longer dated bonds closer to fair value, the immediate pricing impact saw the New Zealand Corporate A Bond Index deliver its worst quarterly result on record.

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

-0.13%

International Fixed Interest

The US Federal Reserve met expectations by hiking interest rates by another 0.25%, and the US Federal Open Market Committee members also raised the projected path of forward rate movements (at least partly due to the anticipated stimulus from the Trump presidency). This resulted in a sharp spike in longer dated bond yields, which saw the US ten year bond yield unexpectedly rise 0.85% over the quarter and impacted yield curves around the globe. This pulled most bond indices into the negatives, with longer duration and/or credit indices generally faring worse than the relatively shorter duration Citigroup World Government Bond Index 1 – 5 Years (in NZD).

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

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.

IMPROVE YOUR RETURNS BY NOT RETIRING

The whole concept of retirement has changed a lot in the last 135 years.

In 1881, Otto von Bismarck, the conservative president of Prussia, presented a radical idea to the Reichstag – that the government should provide financial support to older members of society. In other words, a government sponsored retirement. The idea was radical because, back then, people simply did not retire. If you were alive you worked, probably on a farm, or if you were wealthier you might have managed a farm or larger estate.

But von Bismarck was under pressure from socialist opponents to do better by the people, so he argued that "those who are disabled from work by age and invalidity have a well-grounded claim to care from the state." It would take another eight years to bring this to fruition, but by the end of the decade the German government would create a retirement system which provided for citizens over the age of 70, if they lived that long. The qualifying age subsequently reduced to 65 in 1916.

At the time, most potential pensioners would, of course, be dead by 65. So, what was arguably smart politics in 1881 looks like rather flawed policy in 2017. If you reach 65 in good health in New Zealand today, on average you can expect to live another 19 years (male) to 21 years (female).

Statistically speaking, these could be considered some of the unseen risks of changing from full time work to full time leisure at age 65. Or, more simply put, some of the risks of not having thought through an effective retirement plan.
Rather than going cold turkey at 65, for many the answer lies in planning creatively for other options later in life. This could involve scaling work back to some degree (but not immediately to zero!) or even changing careers around 55 or 60, but still working another 15 or 20 years in some capacity.

If you can find a way to extend your working life by a decade or more, even with part time work, you give your retirement savings that much longer to grow. It's not uncommon for people to 'retire' from jobs they hated a decade (or more) earlier than they thought financially possible. This can work wonders for your stress levels and quality of life, as long as the income from your substitute job is enough to cover regular expenses. Often, these 'retirees' can't keep saving for retirement, but, more importantly, they don't need to dip into their retirement savings either. Don't underestimate the effect of another decade of compound interest on your savings pool at that point in your life. It's a very big deal.
The real icing on the cake is this – if you realise that you aren't going to retire, then maybe you don't have to keep working at a job that's slowly driving you insane. For many people, retirement is the light at the end of a deep, dark tunnel called a career. How about flipping that paradigm on its head so that the end goal isn't to stop

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So Bismark's original idea of promising to provide financial support in the highly unlikely event that you lived long enough to need it has, over a century later, become an increasingly heavy millstone around the necks of western governments the world over. This is particularly so for those governments (like New Zealand's) who have been slow to adjust their retirement systems in the face of an inexorable demographic trend towards greater longevity.

With people living so much longer these days, the whole notion of retirement has also changed. For many today it looks something like this – work for 40-50 years, then have a party, get a gold watch and get ready for an exciting 20 years or so of golf.

Unless you're really into golf, it might not come as a surprise that some studies have shown that retirement increases the chances of suffering from clinical depression (by around 40%), and of having at least one diagnosed physical illness (by around 60%).

doing the wrong kind of work, but to start doing the right kind of work? With that mindset, just imagine how much more enjoyable those later working years will be.

Or maybe that long-awaited retirement party and the gold watch will keep you satisfied for the next 20 years. And hey, there's always golf, right?

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