SYNERGY
INVESTMENTS

Investment Report for Quarter Ending 31st December 2017

POSITIVE GROWTH, POSITIVE SENTIMENT, POSITIVE RETURNS

A year ago, we reported on the challenging market conditions faced by investors in 2016.

Today, a look back at 2017 reveals an investment environment (particularly for higher risk assets), that was much more favourable.

It is a testament to its evidence-based design and prudent management that Synergy's portfolios performed well under *both* these very different sets of conditions.

Synergy portfolios, as they proved in 2016 and again in 2017, do a tremendous job of cost effectively capturing the returns that markets make available to diversified investors.

The dominant contributors to portfolio performance in 2017 were the widespread strong returns from global share markets.

Synergy allocates to share investments in New Zealand, Australia and internationally, both to developed and emerging market regions. The calendar year returns across all these asset classes ranged from approximately 18.5% (Australia) to 35.0% (emerging markets).

Why were these share markets so uniformly good?

The answer has its origins in the aftermath of the 2008 global financial crisis. Back then, with the global financial sector under pressure and many countries entering recession, interest rates around the world were slashed to historically low levels. This was intended as a stimulatory measure. The idea was that lower interest rates would help reduce debt servicing costs faced by individuals and businesses. It was expected that this would stimulate spending and investment, which would in turn lead to greater economic growth.

It didn't exactly turn out that way; at least, not initially. Over much of the following decade, economic growth rates around the world remained well below historical averages, with only a few exceptions —New Zealand notably being one. And, with sluggish growth and no inflation problems to deal with, interest rates remained stubbornly low as well.

To put this in perspective, ten years ago average six month term deposit rates in New Zealand were around 8.0% and floating mortgage rates were at 10.5%. Today, the equivalent rates are closer to 3.3% and 5.8%. While the much lower interest rates have encouraged greater investment into growth assets like property and high quality businesses, they haven't been anywhere near as enjoyable for investors looking to continually roll over term deposits at the bank.

In 2017, the cumulative effects of the post-GFC stimulatory policies finally appeared to start having an effect on the global economy. The economic growth rates in many advanced economies began to pick up in a synchronised fashion, and this led to improving business and consumer confidence across the US, Eurozone and Japan. It was the same in New Zealand as well, until the surprise result of September's general election caused local sentiment indices to slump towards the end of the year.

In any event, the improving global growth environment and the generally improving sentiment attached to it coalesced into a significantly positive year for most major share markets. And, until such time as the growth outlook or inflation/interest rates or sentiment changes in a meaningful way, these broad conditions remain in place and continue to look supportive for at least the early part of 2018.

As always, we make no predictions about what markets will deliver in 2018. Of course, we hope they will do well again, but we know that, traditionally, volatile investments cannot go up in an unchecked fashion forever.

Synergy portfolios, as they proved in 2016 and again in 2017, do a tremendous job of cost effectively capturing the returns that markets make available to diversified investors. If the markets in any one year are good, bad or somewhere in between, then the returns from Synergy portfolios will naturally reflect this. However, given that markets on average generate positive and more predictable returns over long term horizons, for anyone with an appropriate long term strategic investment plan in place, the Synergy approach should work out just fine.

KEY MARKET MOVEMENTS

New Zealand Shares

+6.07%

The quarter began with a surprise result in the general election which, at least initially, had a negative impact on business confidence. However, buoyed by continued accommodative global growth conditions, the markets shrugged this off and produced three more positive months, rounding out a remarkable year in which all 12 individual months were positive. Since its inception in 1991, the NZX 50 Index has never previously achieved this feat. Leading performers during the quarter included the two big healthcare companies—Fisher & Paykel Healthcare (+13.3%), and Ryman Health (+15.26%) —while Fletcher Building (-4.9%) and Air New Zealand (-5.3%) were among the small group of companies to deliver a negative performance for the quarter.

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

New Zealand Fixed Interest

+1.41%

The Reserve Bank of New Zealand maintained the Official Cash Rate at 1.75% in November, and in December Adrian Orr was appointed Reserve Bank Governor, effective 27 March 2018. Yields across the board ended the quarter at the lower end of the relatively narrow band in which they traded all year, as the market pushed out expectations for the commencement of future rate rises. Consequently, longer dated bonds rewarded investors for their additional term risk. In addition, the spread between yields of securities with differing credit ratings widened during the quarter, resulting in lower rated bonds returning less than higher rated bonds.

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

New Zealand Property

+6.77%

Although there was some variation amongst the individual constituents, overall, this asset class made strong gains in the quarter and slightly outperformed the New Zealand equity market. The three biggest trusts all performed very well (Kiwi +7.3%, Goodman +9.4% and Precinct +7.9%), as did Stride (+9.3%). Conversely, Vital (+0.4%) was much more subdued after enjoying a strong run over the prior 18 months.

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

Australian Shares

+9.12%

The Australian share market posted a strong gain for the quarter, up +7.6% in Australian dollar terms. Small capitalisation companies fared better than larger firms, with the S&P/ASX Small Ordinaries advancing +13.7% versus +7.1% from the S&P/ASX 100 (both returns in Australian dollars). Returns to unhedged New Zealand investors were further enhanced by a relatively strong Australian dollar. Leading sectors included energy and materials companies, as commodity prices continued to advance (particularly oil and industrial metals such as copper and iron ore). Utilities and financials were the lagging sectors, but were both still positive overall.

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

International Shares

+5.72% (hedged to NZD)

+7.50% (unhedged)

Developed markets equities also delivered excellent results in the quarter, to complete a robust year. The US was strong, aided by the house and senate agreement on the tax reform bill, which will lead to tax cuts for corporations. Japan outperformed as Prime Minister Abe's incumbent LDP won the general election, confirming the continuation of accommodative monetary and fiscal policies there. Europe was mildly positive, with political events such as Catalonia's push for independence and uncertainty from the failed German coalition negotiations weighing on the region.

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

Emerging Markets Shares

+9.57%

Emerging markets had another very strong quarter, with improving global growth paired with nation-specific positive events spurring gains. Leading the way was Greece, which reached new agreements with creditors, helping finalise the use of bailout funding. Greece was followed closely by South Africa, where the election of a more orthodox leader of their governing political party signalled more stability in the region. Asian indices were also strong (India and China in particular), while Latin America was more subdued.

Source: MSCI Emerging Markets Index (gross div.)

International Fixed Interest

+0.23%

Within the quarter, international fixed interest markets exhibited some variability between regions. The US Federal Reserve increased interest rates by 0.25% (to 1.50%) in December. This was anticipated, but the positive commentary accompanying the announcement led US yields to rise, in particular on shorter dated bonds. Conversely, yields in the UK, Europe and Australia all declined over the quarter. Even though most central banks are looking to taper back their respective monetary stimuli, the market is now pricing that this will take longer than anticipated. In aggregate, the global index delivered a small gain and corporate bonds slightly outperformed government bonds.

Source: Citigroup World Gov't Bond Index 1–5 Years (hedged to NZD)

International Property

+5.14%

The international property sector also performed well, although returns were lower than those delivered by the broad equity markets. The S&P Developed REIT Index returned +3.16% in US dollar terms. The Australian listed property sector made a sizable gain, with the S&P/ASX 300 A-REIT Total Return Index advancing +7.79% in Australian dollar terms. A relatively strong US dollar further enhanced reported returns to New Zealand investors holding unhedged investments in this asset class.

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

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.

BEWARE THE GAMBLER'S FALLACY

At the end of 2016, when you looked at the annual returns for the NZX 50 Index for the previous five years (summarised in the table below), what might you have thought about the odds of the NZX 50 earning a positive return in 2017?

TABLE 1: S&P/NZX 50 INDEX (GROSS)

2012	2013	2014	2015	2016
24.18%	16.49%	17.55%	13.58%	8.81%

Source: NZX and Returns 2.0. Past performance does not guarantee future results. Indexes are unmanaged baskets of securities which investors cannot directly invest in. They do not reflect the payment of advisory fees or other expenses associated with specific investments or the management of an actual portfolio.

Some might have predicted that the odds were against a positive return in 2017, simply because they thought the bull market had lasted too long. Some might even have adjusted their portfolios or moved out of the market altogether because of this thinking. But if they understood the gambler's fallacy, they might have thought again.

The gambler's fallacy is the tendency to over predict reversals in situations such as coin tosses, games of chance and market returns. In a 2007 research paper[1], Hersh Shefrin, professor of behavioural finance at Santa Clara University, explained the gambler's fallacy using a coin tossing example. Professor Shefrin pointed out that many people incorrectly presume, after tossing five heads in a row, the probability of a tail on the sixth toss is greater than the actual probability. This is because they know that, in any long stretch of coin tossing, roughly half should be tails, and they haven't seen a tail for a while.

Going back to our initial question about the performance of the NZX 50 in 2017, did you know that the NZX 50 has a 70% chance of being positive in any year, irrespective of previous year's returns?[2] Odds of 70% are really good, but investors can still fall prey to the gambler's fallacy and fear that too many good years in a row indicates a greater chance that a down year is imminent.

Knowing that the returns above represent five great years in a row, how would you have guessed 2017 would turn out? Would you have assigned something less than a 70% probability of another positive year?

We now know that, in 2017, the NZX 50 (Gross) Index returned 22.04%.

So, as we head into 2018, investors again face the question of whether a recent run of good years increases the chances of a bad one.

We are reminded of a quote from famous investor Peter Lynch, who once said,

"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."

Odds of 70% are pretty appealing. To use an analogy, we could say that an investor in the NZX 50 Index is similar to a casino, patiently playing their above average odds deal after deal, knowing that, if they play long enough, they've got a high chance of winning, even if the occasional punter hits the jackpot.

Synergy investors own far more than just the S&P/NZX 50, and are usually planning on investing for much longer than one year. So, even if there's a blip in any market—and the odds tell us this should happen about 30% of the time in New Zealand—it shouldn't be a major problem because it's already factored into Synergy's long term portfolio return expectations.

Far more detrimental to a long term investment strategy would be succumbing to the gamblers fallacy and sitting on the sideline. Missing a string of good markets like we've had recently—that can do permanent damage to a portfolio.

Acknowledgement—this article was based on an original article published US based investment firm Loring Ward (https://loringward.com/blog/investors-beware-the-gamblers-fallacy/) that was repurposed for New Zealand investors.

[1] Shefrin, Hersh, Behavioral Finance: Biases, Mean-Variance Returns, and Risk Premiums, CFA Institute Conference Proceedings Quarterly, June 2007.

[2] Since 1992 the S&P/NZX 50 Gross has had positive returns 72% of the time, or 18 out of 25 years.

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