SYNERGY
INVESTMENTS

Investment Report for
Quarter Ending 31st March 2018

SHORT TERM PAIN, LONG TERM GAIN

Following its launch in October 2015, Synergy has enjoyed an excellent first two and a half years. Overall, investment markets have been very favourable and Synergy's low cost, widely diversified, strategic asset allocation approach has generally performed above our long term expectations. However, as we should always remember, markets never go anywhere in a straight line. They go up and down at different times, but over longer and longer time periods they always go up.

Although two and a half years is not a long time in an investment context, it is still worth considering the chart below which graphically highlights the compound returns of the initial nine Synergy model portfolios[1] since their inception. Even over this relatively short period, we can start to see some trends.

What this chart visually demonstrates is that, even though the markets have delivered plenty of dips—or down periods—along the way (including in the recent January to March 2018 quarter), the picture that is beginning to emerge is not unexpected—that is, over longer time periods the higher risk portfolios should be expected to deliver higher returns as compensation for taking higher risks.

Over short time periods, such as in January/February 2016, and again in the recent quarter, the highest risk portfolios can perform the worst. That is why it is usually inadvisable to take high investment risk if you only have a short term investment horizon, because there is always a chance your short term horizon might coincide with one of those dips. That would be painful.

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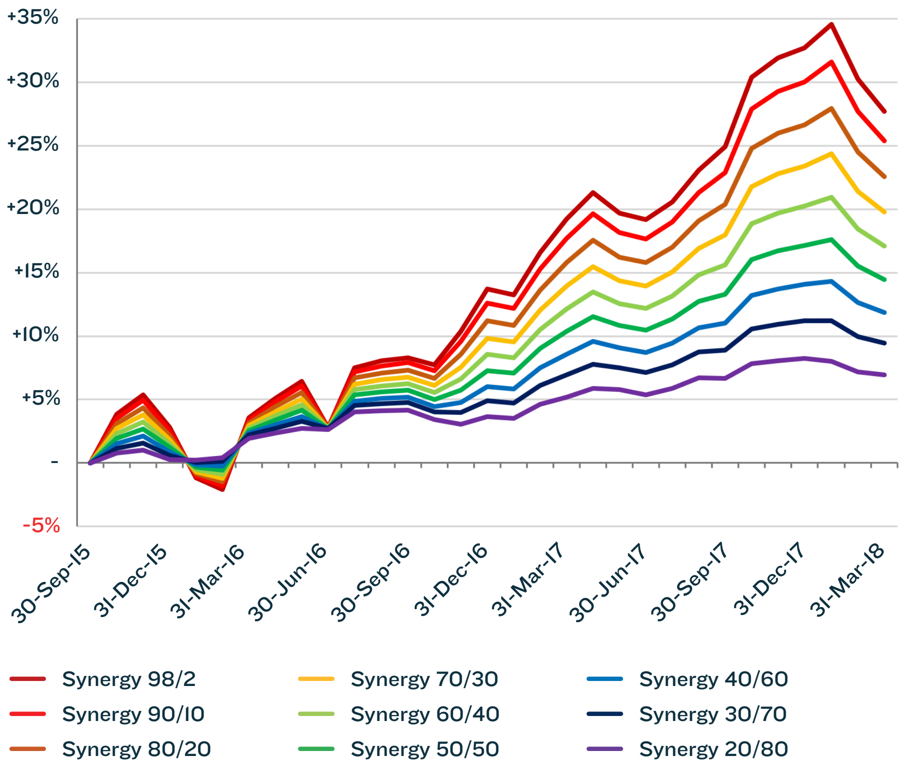

Note: for each model portfolio the above returns have been calculated after ALL costs (ie, after all fees and tax). For ease of presentation, these returns also assume the maximum possible fees, and tax paid at the highest marginal rate. Therefore, although individual investment results will differ, for some they may be even better than the above, particularly for investors on lower marginal tax rates. Note that past performance is no guarantee of future performance.

But that doesn't mean that risk taking itself is bad. In undertaking an investment strategy that seeks to earn higher expected returns, we are knowingly taking higher risks. Over time, we take these risks because we expect to be compensated in a way that enables us to achieve our investment goals. However, in positioning ourselves to reap these long term gains, we have to be mindful that, sometimes, over shorter time periods, the risk will not play out as we would like.

If we remove all risk then we also remove the opportunity for portfolios to earn more than the risk-free rate of return. So, getting rid of portfolio volatility and avoiding the occasional negative quarter can have more far reaching (negative) consequences on your investment plan than putting up with some greater variability of returns along the way.

Importantly, the fact that markets will occasionally go down is known with absolute certainty, and it is factored in to our long term expected return calculations. In other words, experiencing a negative quarter every once in while is highly unlikely to suddenly mean you are no longer on track to meeting your long term investment goals and objectives.

Given that markets (and portfolios) go up far more often than not, the best strategy bar none is to stick with your plan. Stay diversified, stay disinterested in unrelated media noise, and stay the course.

[1] Four additional SRI portfolios were launched in April 2017 and their performance from April 2017 onwards has been similar to the comparable risk portfolios in the above chart.

KEY MARKET MOVEMENTS

New Zealand Shares

-0.58%

The year began with another positive month, however, the 13 month winning streak for the NZX 50 was snapped in February as the increase in global volatility was also felt in New Zealand. By mid-February the index was down -4% year to date, and, if not for an outstanding performance by a2 Milk, the overall loss for the index may have settled near this figure. Instead a2 advanced +54% for the quarter, with earnings exceeding expectations and the firm announcing a new deal with Fonterra. The milk juggernaut is now the largest listed company in New Zealand. Conversely, Fletcher Building announced further unexpected provisioning for losses and fell -21%. Sky TV (-15%) and Heartland (-13%) were among the worst performers in the quarter.

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

New Zealand Fixed Interest

+0.74%

The Reserve Bank of New Zealand maintained the Official Cash Rate at 1.75% in February and March, and Adrian Orr officially took the helm as Reserve Bank Governor on 27 March 2018. Long term government bond yields in New Zealand initially tested recent highs, before returning to their end 2017 levels by the end of the quarter. Overall this resulted in index returns broadly in line with expectations. The spread between yields of securities with differing credit ratings widened during the quarter. In general, this resulted in lower rated bonds returning less than higher rated bonds.

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

Australian Shares

-7.20%

The Australian share market posted a loss for the quarter, with the ASX 200 down -3.86% in Australian dollar terms. Small capitalisation companies fared slightly better than larger firms, with the S&P/ASX Small Ordinaries declining -2.79% versus -3.90% for the S&P/ASX 100 (both returns in Australian dollars). Returns to unhedged New Zealand investors were further reduced by the New Zealand dollar strengthening by over 3% relative to the Australian dollar over the quarter. The worst hit sectors included telecommunications, utilities, energy and financials. Conversely, healthcare, information technology and consumer staples all ended the quarter up (in Australian dollars).

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

International Property

-7.45%

With the prospect of rising interest rates weighing heavily on the sector, global property assets were impacted the most and delivered a much lower return than broad equity markets. The S&P Developed REIT Index lost -5.62% in US dollar terms and the S&P/ASX 300 A-REIT Total Return Index declined -6.19% in Australian dollar terms. A relatively weak US dollar further reduced reported returns to New Zealand investors holding unhedged investments in this asset class.

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

International Shares

-2.06% (hedged to NZD)

-3.07% (unhedged)

Spurred on by strong economic data and robust earnings, indices across the developed markets broached new highs throughout January. The remainder of the quarter saw a sharp increase in volatility as markets digested, amongst other things, higher inflation expectations in the USA. This is generally viewed as a negative by investors as it typically means interest rate rises, increased future borrowing costs and potentially reduced corporate earnings. While the US Federal Reserve raised rates by 0.25% in March they did not alter their existing projections for future rate hikes, which helped moderate the market reaction. USA/China trade sanctions late in the month contributed to the heightened volatility, helping push US market quarterly returns into the red. Europe, the UK and Japan were also negative, on concerns about the outlook for global trade.

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

Emerging Markets Shares

-0.50%

Emerging markets broadly outperformed developed markets with many nations delivering a positive quarter. Political stability helped drive Brazilian equities up, and the re-election of Vladimir Putin coincided with a reduction in interest rates to help the Russian market advance. Both of these energy exporting nations also benefited from rising oil prices. Chinese equities gained overall, with macroeconomic data remaining stable. Of the other main emerging markets countries, Taiwan was up, Korea was flat and India declined.

Source: MSCI Emerging Markets Index (gross div.)

International Fixed Interest

+0.30%

In March the US Federal Reserve increased interest rates by 0.25% (the target range is now 1.50 - 1.75%). This was again highly anticipated, and they continue to project three to four further rate hikes this year. An increase in inflation expectations contributed to an increase in US yields across the board. Elsewhere, yields also broadly moved up, which negatively impacted fixed interest returns. However, overseas yield changes were generally smaller than in the USA. In fact, the yield of US ten year government bonds is now above those in New Zealand for the first time since 1994. Corporate bonds were generally negative contributors during the quarter, as were longer dated securities, but the shorter term global government bond index delivered a small gain.

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

New Zealand Property

-3.72%

Perhaps influenced by renewed expectations of rising global interest rates, this asset class declined by -3.72%, a larger fall than the broad equity market. The six largest trusts were all down, between -2% and -6%. Two of the largest trusts were in the middle of the pack (Kiwi -4.63% and Precinct -4.75%) while Goodman (-2.19%) was relatively more resilient. Argosy posted the largest loss within the sector, down -6.12%.

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

All returns are expressed in NZD. We assume Australian 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.

INTERPRETING FINANCIAL BABBLE

A professional fund manager once mentioned that half the research on his desk was a complete waste of time. All he needed to do was figure out which half was rubbish and he would immediately double his productivity!

Although it sounds like a joke, he was really making two points. Firstly, most research is backward looking rather than predictive, and most of this has little prospect of leading to better results. Secondly, a lot of 'financial information' is nothing more than hype and sensationalism masquerading as news—press releases that spin the facts, earnings announcements that fail basic mathematical scrutiny, and management explanations or projections that test the boundaries of probability and credulity.

Unfortunately, this isn't just a problem for fund managers. If they are having a hard time sorting through the noise of the financial news, imagine how confusing it must be for regular investors. Compounding the problem is that people don't really read the news anymore. Nowadays people barely get past a quick glance at the headlines.

For those of you tempted by this 'headline surfing' approach, here is a crash course in how to interpret what you are really reading...

HEADLINE:
"Shares rose/fell today because of ________."

HOW TO READ IT:
Millions of shares changed hands today because investors all have different goals, strategies, risk profiles, holding periods and ideas.

HEADLINE:
"[Popular economist/fund manager] expects market volatility to increase"

HOW TO READ IT:
Saying that you expect volatility to increase at some point is like saying you expect it to rain at some point. Remember that volatility works both ways—to the upside and the downside—so this is really just another way of saying that the markets will fluctuate. Which, of course, they will.

HEADLINE:
"Markets suffered losses today: a sign of worse to come?"

HOW TO READ IT:
No one ever really knows why shares rise or fall on a single day. The market is up on just over 50% of all trading days and down just under 50% of the time, so you can never put too much weight on the performance of any single day.

HEADLINE:
"When will the Reserve Bank raise interest rates?"

HOW TO READ IT:
Has understanding Reserve Bank policy ever really helped you make better investment decisions? Even if you knew exactly what they were going to do in the future, you can still have no certainty about how other investors will react.

HEADLINE:
"Investors face increased uncertainty"

HOW TO READ IT:
The future is <u>always</u> unknown, and therefore, uncertain. The past only feels more certain because we know what actually happened.

HEADLINE:
"Investors panic as shares enter a bear market"

HOW TO READ IT:
Don't panic. Expected returns and dividend yields go up during bear markets. That's a good thing for long term investors.

HEADLINE:
"Is [fashionable share of the day] a bargain buy?"

HOW TO READ IT:
Chances are, by the time you see a fad stock being mentioned in the headlines, you've already missed your opportunity to buy it at a bargain.

HEADLINE:
"A perfect storm caused markets to fall"

HOW TO READ IT:
Markets move for all kinds of reasons, but media outlets seem hell bent on delivering financial articles encased in hyperbole. As if we needed an independent example, how many 'one-in-100 year' storms have we had this decade?

HEADLINE:
"[Permanently-bearish commentator] predicts a market crash worse than 1987"

HOW TO READ IT:
Certain analysts constantly predict the end of times for markets. You should expect to read predictions like these every few months, as these 'experts' make for great media headlines and they typically keep guessing until they finally get it 'right'.

HEADLINE:
"Interpreting financial babble"

HOW TO READ IT:
A helpful user's guide about how not to get misled by common media double-speak!

Disclaimer

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