SYNERGY
INVESTMENTS

Investment Report for
Quarter Ending 30th September 2018

As an investor in Synergy, you will have received communication recently letting you know that the Synergy Investment Programme is now 100% owned by Consilium, with Consilium taking over the DIMS and administration from FANZ on 1 October.

Consilium has enjoyed a great partnership with FANZ and SBS over the three years since Synergy's launch, and we are now looking forward to maintaining the same high standards as we take over all aspects of Synergy's administration.

Investors should notice very little change, with the investment philosophy and processes underpinning Synergy remaining the same.

So, on that note, we invite you to enjoy this quarter's newsletter and look forward to catching up with you again in January.

INVESTMENT REVIEW

The end of September marked Synergy's three year anniversary!

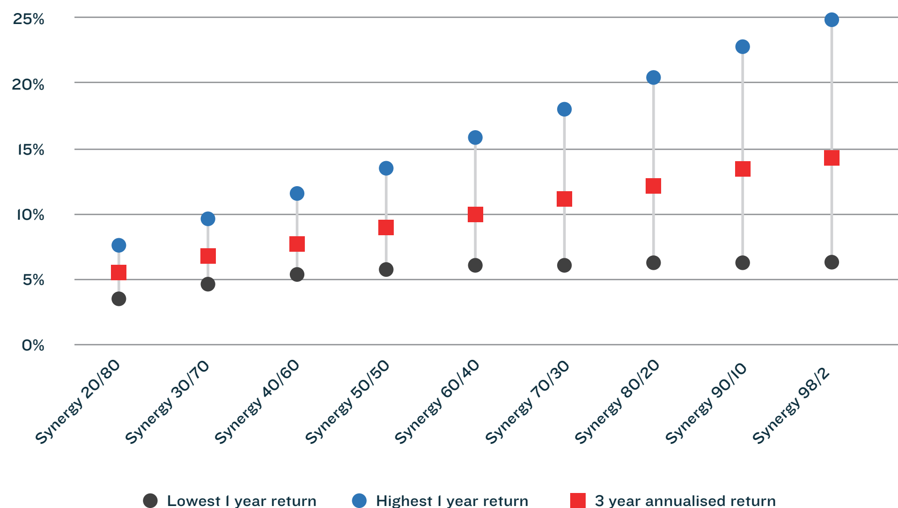
Under such illustrious circumstances it was probably only fitting that Synergy portfolios continued their resurgence during the third quarter of 2018 with another three months of solid gains.

As is so often the case, these good returns were delivered in an international environment that looked anything but stable. Included in the melting pot of issues that surfaced during the quarter were heightened US trade tensions (with both China and Canada), emerging market strains in Turkey and Argentina, political instability in Australia generating their fifth prime minister in five years, and a US Supreme Court nomination process that further widened the political divide in America.

In light of this, it was perhaps ironic that global developed market equities delivered the best asset class returns for the quarter. That they were able to do so continues to make a lie of the idea that there is any reliable link between negative news events and investment outcomes. In fact, as we have noted in the past, if we were to let negative news flows dictate Synergy's investment strategy, it would have meant sitting on the sidelines for most of the last three years and missing out on some outstanding returns.

Whilst Synergy has expanded to include some additional model portfolio options over the last three years (that is, four portfolios with greater social responsibility tilts and four portfolios constructed principally of PIE fund structures) there have been nine model portfolios that have been consistently available since launch. These models range from low risk (a 20/80 portfolio which allocates 20% to growth assets and 80% to income assets) all the way up to high risk (a 98/2 portfolio).

Since it's Synergy's three year anniversary, it is extremely pleasing to see how these portfolios have been performing since inception:



The above graph shows a range of different model portfolio returns (after fund management fees only) covering this initial three year period.

The blue circles show the return from the best continuous 12 month period in each portfolio. In the case of the 98/2 portfolio, that was a gain of almost 25% occurring between November 2016 and October 2017.

The grey circles show the return from the worst continuous 12 month period. For all portfolios, with the exception of the 20/80 and 30/70 models, this worst outcome has so far still been greater than 5%.

The red squares, perhaps the most useful of all, show the annualised average return over the entire three year period. In the case of the 60/40 portfolio, that has been an annualised return of almost exactly 10% p.a.

For the higher risk portfolios, these returns are higher than we should expect to achieve over the long term, but for investors in Synergy since its inception, we hope you have enjoyed the experience so far.

What this graph doesn't show (because it hasn't happened yet) is how the Synergy portfolios will perform throughout a prolonged difficult period in the markets. In a scenario where share markets go down for an extended period of time, the position of the grey circles will almost inevitably drop. For example, if growth assets were to deliver negative returns in any future period, it would be almost unavoidable for a 98/2 portfolio (with 98% of its assets exposed to growth assets) not to deliver negative returns as well.

But this isn't a forecast. We don't know what the next three, five or ten years will deliver in terms of investment returns. We don't have a crystal ball that can look into the future that accurately. No one has. That's why delivering investment strategies based on fund manager hunches (i.e. guesswork) is so difficult – it's almost impossible for the investor to reliably know what they are likely to receive. That's not just our view, that represents the aggregate findings of the majority of academic studies into this important subject.

So Synergy sticks to what we do know. That is, if we focus on keeping costs as low as we can, staying widely diversified, restricting ourselves to only high quality and highly liquid assets and strategically tilting portfolios towards sources of higher long term expected returns, we can deliver more reliable outcomes for investors.

And on the evidence of Synergy's first three years, it's off to a very good start!

KEY MARKET MOVEMENTS

+4.94%

New Zealand Shares

The NZX 50 delivered another strong performance in the September quarter, returning 4.94%. The majority of companies within the index saw their share prices advance. This was led by medical distribution company Ebos and health services provider Orion Health, with both firms gaining +27% in the quarter. Several of New Zealand's larger listed companies, including Fletcher Building and former market darling a2 Milk, disappointed by posting small negative returns. The laggard for the quarter was Sky Network Television, which fell -12.5% as competition from new age streaming services providers like Netflix and Lightbox continues to disrupt their subscriber base.

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

+1.29%

New Zealand Fixed Interest

Reserve Bank Governor Adrian Orr extended the 'no change' streak to 13, by keeping the Official Cash Rate on hold at 1.75% in both the August and September updates. In September, the prospect of interest rate rises was pushed out until 2020, and, in line with the new Policy Targets Agreement, Orr even outlined a scenario where interest rates could fall if future GDP growth rates disappointed. This softening in outlook, coupled with ongoing muted inflation pressures, helped contribute to New Zealand's long term government bond yields drifting lower over the quarter. This proved beneficial for bond returns.

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

+2.49%

International Property

A backdrop of slowly rising global interest rates saw international property stocks generally struggle to match the returns of broader equity markets. With risk assets and, in particular, US equities back in favour, the greater defensive attributes of property took a back seat for the quarter. The S&P Developed REIT Index gained +0.31% in US dollar terms and the S&P/ASX 300 A-REIT Total Return Index gained +1.98% in Australian dollar terms. A relatively weak New Zealand dollar further enhanced reported returns to New Zealand investors holding unhedged investments in this asset class.

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

+5.62% (hedged to NZD)

+7.42% (unhedged)

International Shares

The tone in global markets has remained relatively cautious, with trade tensions in particular creating a backdrop of uncertainty. However, global macroeconomic data, particularly in the USA, continued to paint a picture of solid actual economic activity running at or near expectations. The US Federal Reserve raised rates by another 0.25% in September, but this was so widely anticipated that, aside from a generally strengthening USD over the quarter, there was otherwise no discernible market effect. In fact, the S&P500 Index in the USA was one of the standout developed market equity performers in the third quarter, posting a gain of +7.71%, while the Japanese and French share markets also enjoyed good results. On the other hand, the German and UK markets were both slightly down. In the UK's case the lingering uncertainty around Brexit negotiations continues to act as a handbrake on UK equities. European banking stocks were generally weaker amid concerns over their exposures to emerging markets as well as worries over the Italian budget.

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

+5.86%

New Zealand Property

The New Zealand property asset class outperformed the broader equity market by delivering a robust +5.86% return for the quarter. The prospect of lower interest rates for longer in New Zealand played its part in helping maintain positive sentiment towards the sector. The seven largest listed property trusts delivered returns ranging from +3.35% to +8.16%, with Goodman, Precinct and Stride all delivering between +7.70% and +8.16%.

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

+1.21%

Emerging Markets Shares

In USD terms the underlying emerging markets region posted a small negative return for the quarter (down -0.95%), but a weaker New Zealand dollar led to small reported gains to unhedged investors. US dollar strength and trade tensions continued to weigh heavily on the region and the Chinese share market in particular underperformed, as the US implemented tariffs on a total of $250 billion of Chinese goods. Thailand, on the other hand recorded a strong gain and was the best performing country within the emerging markets region, with energy stocks leading their local index to a double digit gain. The Mexican market was also a beneficiary, following their general elections and an agreement with the US and Canada on NAFTA negotiations.

Source: MSCI Emerging Markets Index (gross div.)

+1.33%

Australian Shares

After posting a stellar return in the second quarter of 2018, the Australian share market delivered a far more modest return in the third quarter, with the ASX 200 gaining +1.53% in Australian dollar terms. Gains were fairly evenly distributed across the market, with the largest 100 companies delivering an average return of +1.55% and the small ordinaries (companies ranked 101 to 300 by size) delivering +1.10%. The best performing sector by far was communication services with a +25.29% return. This was propelled in no small part by a +23.11% recovery in the price of Telstra. Reported returns to unhedged New Zealand investors were slightly reduced by the Australian dollar weakening by approximately 0.2% relative to the New Zealand dollar over the quarter.

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

+0.18%

International Fixed Interest

Major government bond yields rose over the quarter due to positive economic data, particularly from the US. This outweighed a bout of safe haven demand in August caused by concerns relating to emerging market instability, trade tensions and political issues in Europe. The Federal Reserve implemented its third rate hike for the year, removing references to "accommodative" policy and striking an optimistic tone. The Bank of England raised rates by 0.25% to 0.75%, citing the weather as the cause of a weak first quarter. US 10 year yields rose from 2.86% to 3.06%, with Bund and UK gilt 10 year yields rising from 0.30% to 0.47% and 1.28% to 1.57% respectively. The rising yields provided a slight headwind to returns this quarter, with high quality sovereign bond indices generally returning low/flat returns.

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

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.

MAKING UNBIASED DECISIONS

Researchers have documented a number of biases in the way in which we filter and use information when making investment decisions. In some cases, we use mental shortcuts to help simplify decision making in complex situations. Sometimes these shortcuts can be helpful, but more often they can lead us towards making a poor decision.

Anchoring

Decisions can be 'anchored' by the way information is presented. In the financial world, market index levels are a commonly used as anchors. In particular, a round number such as an index value of 6,000 on the NZX 50 Index (the New Zealand top 50 share market index), might attract disproportionate interest, despite it really being just another number.

Availability bias

Studies also suggest that recently observed or experienced events will tend to exert a strong influence on decisions. Psychologists refer to this as the 'availability bias'. For example, you are likely to overestimate the chance of being in a car crash if you have witnessed one on a recent journey. The recent memory made the prospect more vivid (or available) and therefore, more likely in your mind. To give a financial example, investors are more likely to be fearful of a share market crash when one has occurred in their recent memory.

Representativeness bias

The concept of 'representativeness bias' describes a situation where decisions are made based on superficial characteristics (i.e. what something looks like) rather than on a detailed evaluation of the reality. Another way of putting it would be saying that decisions are made based on stereotypes.

A common financial example is for investors to assume that shares in a high profile, well managed company must automatically be a good investment. While this may sound reasonable, it usually ignores the fact that the current share price of the firm will already reflect its known qualities. If the current share price is already higher as a result of this, then the future returns available to new shareholders that purchase at today's price might actually be much lower. Another example would be assuming that the past performance of an investment provides an indication about its likely future performance. As just about every financial professional will tell you, past performance provides no guarantee at all about future performance.

Investors also suffer from representativeness bias when they evaluate different fund managers they may be considering investing with. Investors are often excited by a manager with a short term track record of beating the market by a lot. Conversely, they often show less interest in managers with much longer track records that have exceeded market averages by only a small margin. Statistically speaking, the manager with the long term track record has the far stronger case to claim the results are due to skill as, in spite of what the newer fund manager says, their short term record may be entirely due to good luck.

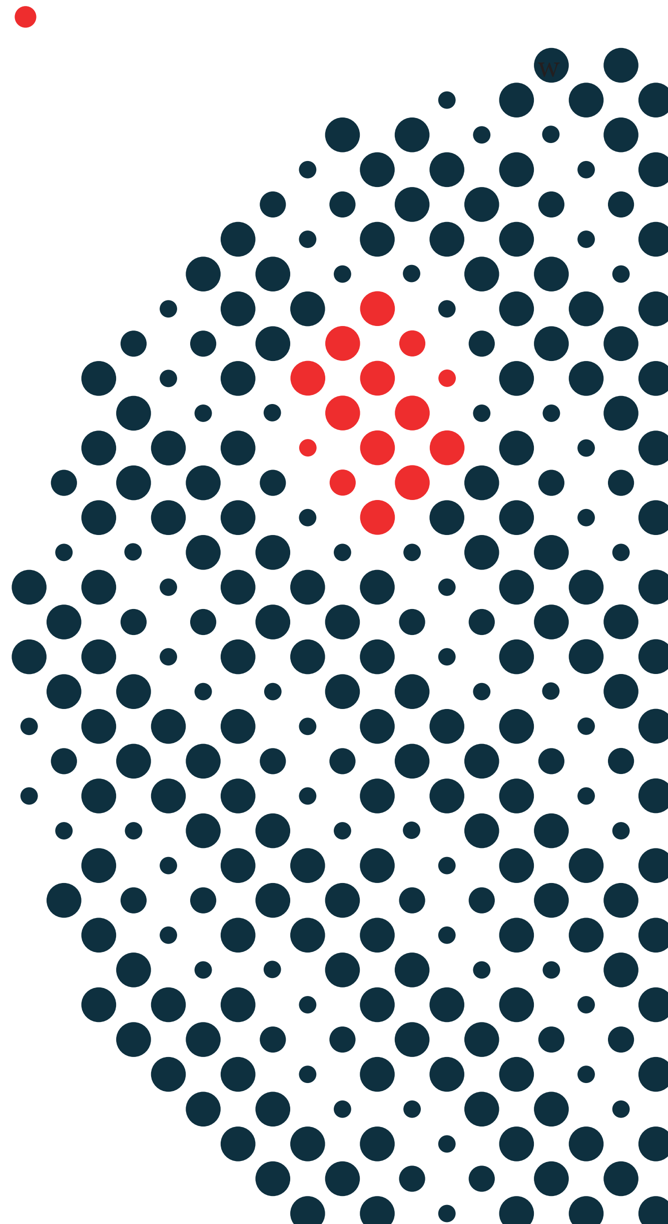
Sadly, thanks to representativeness bias, we will tend to look at the manager with the short term track record and convince ourselves that this superior performance will continue.

Conservatism bias

This is the idea that a decision maker will cling to an initial decision in spite of new contradictory information (or they will make only a partial adjustment to this new information). Taking the example above, investors who buy shares in a high profile company may be reluctant to adjust their view of the company's prospects in the future, even after the company's profitability deteriorates.

When it comes to decision making, investors can be their own worst enemy. The bad behaviours or biases that many of us exhibit are so widespread, that the field of behavioural science has evolved to try to understand and explain it!

Our suggestion is to start small. Just try to be more aware of your own behavioural biases when making important financial decisions in the future. Of course, greater awareness may still not enable you to avoid succumbing to these biases - we are only human after all – but that's where a good financial adviser steps in to guide you.



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Consilium NZ Limited
PO Box 1106
Christchurch 8140
Wellington

0800 4 SYNERGY
synergyinvestments.co.nz
info@synergyinvestments.co.nz