SYNERGY INVESTMENTS

Investment Report for Quarter Ending 31st March 2016

QUARTERLY INVESTMENT COMMENTARY

Timing the market is a loser's game.

Over the years, numerous investment professionals have commonly said "time in the market is more important than timing the market". It's not known who originated the phrase, but it's been used equally by both active and strategic investment managers alike, albeit for totally different reasons.

Active (and generally high cost) managers have had a tendency to say this to dissuade investors from withdrawing from their funds after a period of poor performance. In this context it has often been a self-serving proclamation, because the fund manager only gets paid if the client stays invested. However, strategic investors like Synergy have a different perspective. Synergy only uses low cost investments to begin with, so staying invested is not recommended for the benefit of the fund managers, but for the benefit of the underlying investor.

The reason it benefits investors is that it is incredibly difficult to consistently make money by attempting to time movements into or out of volatile markets.

Not only would you have incurred transaction costs to liquidate all your investments, you would have only just finished turning the last of your holdings into cash before the market began to bounce. The bounce was so strong during March that portfolios supposedly facing a "cataclysmic" performance turned in useful gains for the quarter.

However, if you were in cash instead of following your strategic long term investment plan, you would have missed out on the recovery. That's bad enough, but it poses another problem for market timers to address – the decision about when to get back in to the markets.

Therein lies the challenge for active investors. Not only do you have to correctly foresee an upcoming market decline (which is exceptionally difficult), but you have to make great market timing decisions twice – when to get out and then when to get back in.

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The first quarter of 2016 highlights this perfectly.

In early January markets appeared to be spooked by fears of a severe slowdown in China, sharp declines in the price of oil (it had just hit USD30 per barrel, down from USD47 only three months earlier) and share market volatility was rapidly spiking upwards.

What should investors do in such an uncertain environment? The Royal Bank of Scotland answered this question on 12 January by publishing a recommendation to "sell everything" as, in their opinion, investors faced a "cataclysmic year".

This is coming from the Royal Bank of Scotland, so surely it makes sense that we should simply accept their advice, abandon our long term strategic investment plan and try to get out of the markets before they crash, right? Wrong.

Both movements will incur transaction fees and if you get either one of them wrong - even just a little bit wrong - you may never be able to make up the returns that you missed by being on the sidelines.

For most, that's a loser's game and the benefit of investing in Synergy is it's a game you just don't need to play.

MARKET REVIEW

First quarter 2016. A summary of the major asset class returns for the quarter are as follows:

+6.77%

New Zealand Shares

After struggling in January and February the NZX 50 rebounded in March to post another strong quarterly performance. On 10 March the Reserve Bank unexpectedly cut the Official Cash Rate (OCR) to 2.25% and this further increased the attractiveness of New Zealand companies offering consistent dividend yields. Large capitalisation shares such as Spark (+15.9%), Fletcher Building (+9.9%) and Sky City Entertainment (+15.5%) led the market up.

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

+1.23%

Australian Shares

Although the broad Australian market was down for the quarter, a weaker New Zealand dollar meant that unhedged investors here still enjoyed a small gain overall. In contrast to the New Zealand market, smaller Australian companies outperformed large capitalisation companies which were weighed down by weakness in the banking sector.

Source: S&P/ASX 200 Index (Total Return)

-1.75%
(hedged to NZD)

-1.46%
(unhedged)

International Shares

Global developed share markets generally struggled through the quarter. The Federal Reserve's removal of two previously forecast US rate hikes this year reminded investors that economic conditions there remain fragile. Europe also continues to face its challenges although significant European Central Bank intervention and a weakening currency are providing some support. The emerging markets managed to brush aside these concerns and easily outperformed developed markets during the quarter on the back of significant investor inflows. A slightly weaker local currency saw hedged New Zealand dollar returns falling a little short of the comparable returns from unhedged investments.

Source: MSCI World ex-Australia Index (Net Div)

+5.60%

International Property

With further yield compression in global bond markets and a less aggressive outlook for future US rate hikes, global listed property delivered a strong performance for the quarter. The Australian listed property sector led the charge, with the S&P/ASX 300 A-REIT Total Return Index gaining 6.38% in Australian dollar terms.

Source: S&P Developed REIT Index (Net Div)

+2.69%

New Zealand Fixed Interest

The surprise cut in the OCR highlighted the Reserve Bank's determination to meet their medium term domestic inflation target. After benefiting from risk aversion trades throughout January and February the fall in swap rates in March (following the cut in the OCR) assisted the Corporate A bond index to its best quarterly performance in five years.

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

+1.73%

International Fixed Interest

Early in the quarter, US and global growth concerns and a plummeting oil price sparked a strong Treasury rally, which drove high quality bond yields lower in the US and globally. By the end of the quarter, improving market data and supportive central bank actions saw significant gains in lower rated and emerging market debt, while higher rated bonds were largely unchanged.

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

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

DIVERSIFICATION RULES!

Over the last several years we have collected articles highlighting local sharebrokers' best picks for the year ahead.

In late December each year the National Business Review features an article in which the brokers compete with one another by nominating their three or four top investment picks for the year. What makes this a really enlightening exercise is that, at the end of the next year, you can review the results and see exactly how they each performed.

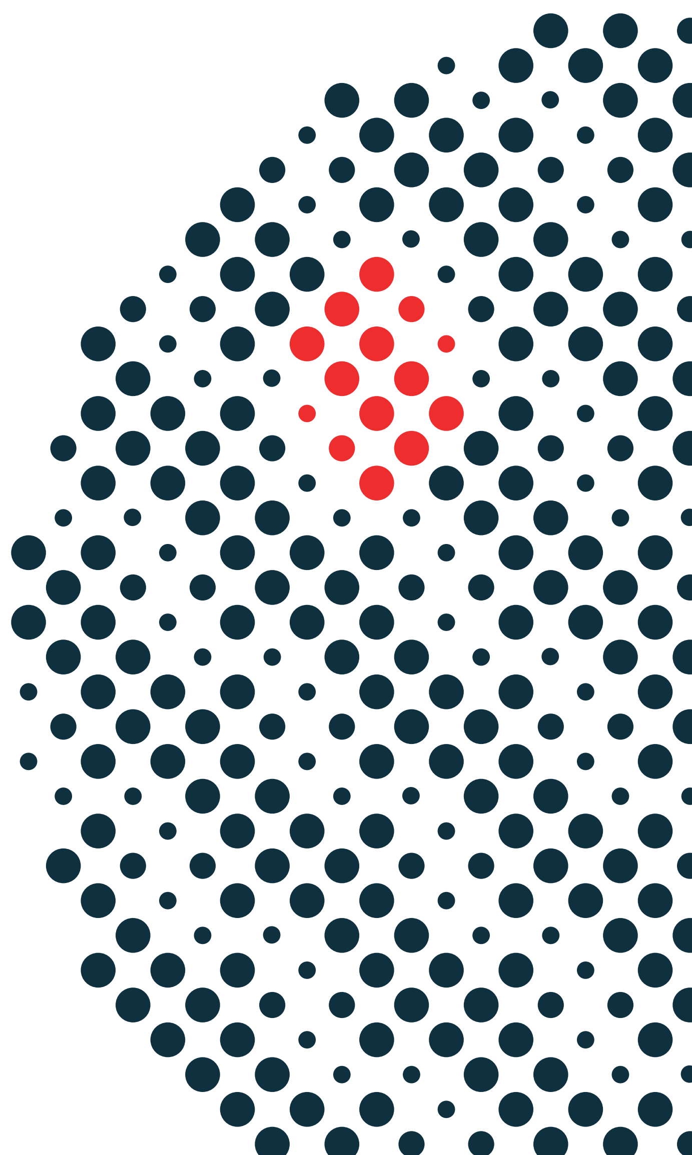
In general, the brokers will tend to select firms from within New Zealand's top 50 listed companies. In a year's time we can therefore expect that whatever the average return of those 50 companies turned out to be, about 25 companies will have performed above that average and about 25 below it.

Straight away you might think that someone whose one and only job was to find undervalued securities, would be in a good position to select three out of the 25 or so better performing firms in the top 50. You might also like to imagine they should be able to do this reasonably consistently. Perhaps if they had to pick 10 or 15 companies you could expect a few to fall into the bottom 25, but by only having to select three or four companies, you would want to believe they had a much higher chance of picking three of the best.

So how have the top broker picks fared in recent times?

BROKER	*2015*	*2014*	*2013*
Forsyth Barr	-5.49%	25.33%	3.21%
Hamilton Hindin Green	19.13%	35.18%	-23.84%
Craigs	6.94%	13.69%	35.56%
NZX Portfolio Index (top 50 companies)	14.41%	19.80%	17.30%

Source: The individual broker picks were taken each year from articles reported in the National Business Review ("Hot stocks for 2013" printed in Dec 2012; "Hot stocks for 2014" printed in Dec 2013 and "Hot Stocks and ones to watch in 2015" printed in Dec 2014). The above average returns have been calculated from total returns data supplied by Morningstar Direct. Note: the calendar year returns highlighted above may differ from returns published in the National Business Review, because the NBR typically published their results before the end of each calendar year.



There are several lessons to be learnt from these results.

1

Over half of the best pick selections subsequently lost to the NZX Portfolio Index in the following year. Forsyth Barr beat the index in 2014 but lost in both 2013 and 2015. Craigs beat the index in 2013 but lost in both 2014 and 2015. Hamilton Hinden Green (HHG) beat the index in 2014 and 2015 but lost heavily in 2013.

Lesson: There is no pattern or consistency with these results. There is no evidence of reliable skill. By selecting a highly concentrated portfolio of just a few companies (even if they are your 'best picks'), you should expect to lose as often as you win before counting fees.

2

Look at how volatile the returns of the brokers' best picks are. While the portfolio index produced relatively smooth returns of 14.4%, 19.8% and 17.3%, the brokers' best picks produced much higher highs and much lower lows. In 2013 Craigs' best picks returned an average of 35.56%, whilst HHG averaged -23.84%. Those two results in the exact same year are almost 60% apart.

Lesson: Concentrated portfolios are very likely to lead to a much greater dispersion of potential returns. Investing in shares at the best of times can feel a like a roller coaster, but when the peaks and troughs are bigger the overall investment experience can be that much more difficult to stomach, especially when returns fall well short of expectations.

3

Concentrating the number of holdings creates the best chance of beating an index. For example, in 2013 Craigs 'crushed' the index with a 35.56% average return, while the index delivered 17.30%. If your focus is to try to beat the index, then concentrating the portfolio probably makes sense. However, there is a very real risk that you can significantly underperform as well. In 2015 Craigs' best picks earned just 6.94% compared to the index return of 14.41%, so concentrating your holdings also creates the best chance of 'getting crushed' by the index.

Lesson: If aspiring to beat the index is important to you and you don't mind an equal and opposite chance of losing, then concentrate your holdings. If having more certainty about achieving your investment goals is important, then diversify.

Our crystal ball is always cloudy. However, we're happy to report that everyone else's crystal ball is cloudy too.

To be fair to the brokers referred to above, they have supplied their best picks each year simply as part of a public contest. They are not advocating that only holding a handful of shares is a smart investment strategy and they certainly weren't giving advice. Nevertheless these 'best pick' competitions do give them an opportunity to demonstrate their stock-picking prowess. You can be assured they are putting their best ideas forward, because it's great free advertising for the firms if they do well.

Even though the brokers aim to identify the companies they believe will outperform in the coming year, the data suggests that highly concentrated holdings will often struggle to consistently measure up to the index. More than anything, the data demonstrates the results are random and highly volatile. These are not attributes that are particularly well suited to creating certainty around the achievement of long term investment goals.

The Synergy programme provides access to portfolios that include well in excess of 8,000 different shares from over 40 countries, and achieves this diversification at very low cost. We do this because we acknowledge that we don't know which security or country will do best next year.

Our crystal ball is always cloudy. However, we're happy to report that everyone else's crystal ball is cloudy too. By diversifying, we do ensure one thing. We ensure that our returns will be more consistent than the average concentrated portfolio and are therefore much better suited to a strategy designed to achieve your financial goals and objectives.

Disclaimer

Information contained in this newsletter does not constitute personalised financial advice because it does not take into account your individual circumstances or objectives.
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