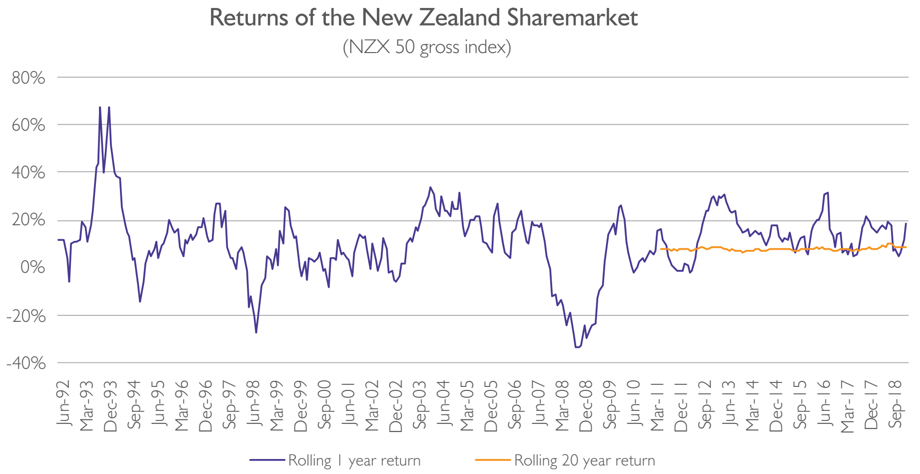
INVESTMENT
REPORT
FOR QUARTER
ENDING
31ST MARCH 2019

Synergy
Investments

Economic Commentary

Fight or flight, choose wisely

Investors who resisted the urge to meddle with their strategy at the end of 2018, should give themselves a well-deserved pat on the back. After enduring a challenging three months to end the year, Synergy portfolios bounced back strongly from January to March, comfortably recording their best calendar quarter of returns since the investment programme launched in October 2015.



Note: As the index data only starts in July 1991, the first rolling 20 year return starts in June 2011, as per the orange line.

As we indicated three months ago, it was a classic test of human behaviour. As investors we don't like it when markets are weak. Emotionally, we feel the pain of a loss about twice as acutely as we enjoy the pleasure of a gain. So, when prices are falling, the natural human reaction for many people is flight (making an ill-judged change), rather than fight (sticking with the strategy).

And if you were considering taking flight, unfortunately you didn't need to look far to find so-called expert confirmation. Near the end of the previous quarter the global research team at JP Morgan – the largest bank in the United States – published their assessment of the 2019 market outlook. Overall, they didn't make a strong case for fighting.

Amongst other things, they suggested the globally significant American share market could perform well if USA and China could agree on a trade deal but were otherwise pessimistic if that didn't eventuate. They also stated the emerging markets regions will likely experience a "weak start to the year". And with respect to the direction of global interest rates, they forecast the important 10 year US Treasury yield would rise to 2.95% by the second quarter of 2019.

How accurate were they?

Not very. In spite of no resolution (to date) on a USA/China trade deal, we saw share markets in both the USA and emerging markets surge upwards in the first quarter. On the other hand, the US 10 year Treasury yield went in the complete opposite direction. It didn't head up towards 2.95% as projected by JP Morgan but headed lower reaching 2.47% by the end of the quarter.

What does this tell us?

Unfortunately, it's just another example of the futility of forecasting. If JP Morgan, with their almost unbridled access to data and analytical talent, can't accurately predict even the near future, then perhaps forecasting is a fool's errand. Yes, a great number of investment firms keep wanting to shower us with their predictions, but this is much more a marketing exercise than anything else. They are often just trying to convey how smart they are to an unsuspecting public in the hope that enough people will invest with them. But all too often the results suggest the forecasts are little more than guesswork. And since it costs money to make a trade and costs even more to be invested in the wrong thing at the wrong time, we don't think guesswork is a suitable foundation for any long-term investment strategy.

How does Synergy remove the guesswork?

We focus on what we know about returns and markets and we don't waste time pretending to know about things that are unknowable – like the future.

Capitalism has generally done a very good job of allocating productive resources efficiently, improving competition and choice for consumers, and generating corporate profits which are recycled into wages, dividends and generally higher share prices. Although returns at an individual company level can be volatile, and the timing of short-term market returns unpredictable, we can legitimately have more confidence about expected market returns over longer time periods.

Synergy's approach is to carefully consider these expected long term returns when building investment portfolios. In our view, these returns are definitely worth fighting for.

To demonstrate this, consider the returns of the New Zealand share market (represented by the NZX 50 gross index) since mid-1992.

In the graph above, we highlight the average annual returns of this market over two different measurement periods.

The purple line shows the rolling one-year return of the New Zealand share market. In an investment context, one year is regarded as a short time period. What the purple line shows very clearly is that over short time periods the average annual return of the share market can be extremely volatile, ranging from **-33.3%** (year ending Nov 08) to **+67.8%** (year ending Oct 93).

The orange line shows the rolling twenty year returns for the same market. In contrast to the purple line, the most striking feature of the orange line is how remarkably stable it is, ranging from **+6.5%** (20 years ending Jan 14) to **+10.1%** (20 years ending Sept 18).

The relative stability of the orange line is what makes long term strategic planning so powerful and good investor behaviour so important.

In a world where we can't predict the future – and we can't – we know that short term results can be highly unpredictable, and investors will be occasionally tempted to change tack at entirely the wrong time. But, despite this short term unpredictability, we are still able to make surprisingly accurate estimates of long term returns.

As long as capitalism continues to function and investors choose not to take flight when the inevitable short term market volatility next appears, their long term plans – and their future selves – will be the significant beneficiaries.

Key Market Movements

NEW ZEALAND SHARES

+12.09%

After a testing finish to 2018, the new year started strongly across most equity markets worldwide. The domestic market participated in this rally and had recovered from the Christmas low by early March. The NZX top 50 went on to set several new all time highs, and by the end of the quarter it was 12.09% higher than the 2018 close. Large companies led the recovery, with the two largest stocks on the index – a2 Milk and Meridian Energy – gaining in excess of 25%, and many more in the top 25 posting double digit returns. Air New Zealand's share price hit some turbulence following a warning its annual earnings may fall by as much as 37%, while Spark similarly announced reduced profits which led to a loss for the quarter. Vista Group was the strongest stock in the NZX top 50, with the film industry software solutions firm reporting impressive growth and profitability stats across its businesses. *Source: S&P/NZX 50 Index, gross with imputation credits*

NEW ZEALAND FIXED INTEREST

+2.03%

The Reserve Bank of New Zealand (RBNZ) held the Official Cash Rate (OCR) at 1.75% at both their 13 February and 27 March updates. However, the surprising aspect of the March announcement was the clear signal that "the more likely direction of our next OCR move is down". This helped push New Zealand government stock yields to record lows by the end of the quarter. Local bond investors benefitted from the associated reduction in corporate bond yields, with the New Zealand A Grade Corporate Bond Index returning a very healthy 2.30% for the quarter. With the market now pricing in an OCR of just 1.30% in February 2020, down from 1.75% at present, it seems apparent that the very low yields currently on offer in the New Zealand bond market can be expected to persist for some time to come. And, if current market pricing is accurate, the prospect of even lower yields into 2020 is an increasing possibility. *Source: S&P/NZX A Grade Corporate Bond Index*

NEW ZEALAND PROPERTY

+8.69%

The New Zealand listed property asset class enjoyed the rising tide of the equity market resurgence by delivering a gain of 8.69% for the quarter. Although this was lower than the gain in the wider equity market, it was perhaps only a reflection that the property sector was more resilient than the equity sector during the tough final quarter last year. The prospect of an enduring low interest rate environment in New Zealand continues to underpin strong investor support for listed property assets. *Source: S&P/NZX All Real Estate Index, gross with imputation credits*

AUSTRALIAN SHARES

+10.18%

The Australian share market also enjoyed the swing back in favour of higher risk assets during the quarter as the ASX 200 gained 10.89% in Australian dollar terms. Whilst the gains were relatively evenly dispersed across the Australian market, it was within the small company space that the greatest average gains were posted, with the ASX Small Ordinaries Index gaining 12.59% in Australian dollar terms. Small companies outperforming large companies is typically also consistent with investors displaying a generally increased appetite for investment risk. The leading Australian equity sectors in the first quarter were information technology, materials and communications services, which posted sector returns of between 17.0% to 20.7%. Healthcare, financials and consumer staples firms, on average, delivered 'only' mid-single digit gains. Reported returns to unhedged New Zealand investors were slightly reduced by the Australian dollar weakening by approximately 0.6% relative to the New Zealand dollar over the quarter. *Source: S&P/ASX 200 Index (total return)*

INTERNATIONAL SHARES

+12.53% (hedged to NZD)

+10.89% (unhedged)

International equity markets rebounded strongly during the first quarter of 2019 as concerns over the China/USA trade dispute showed some signs of moderating and major central banks signalled more accommodative monetary policy intentions. These factors, along with an end to the Government shutdown in the US, helped drive US equity market returns. The UK and Eurozone markets also responded positively to the prospect of looser monetary policy settings and both managed to perform well in spite of ongoing Brexit-related uncertainties. Japanese shares also gained, but the advance was somewhat muted compared with other developed markets. Overall, quarterly gains were impressive across most developed nations including USA +13.9%, UK +9.4%, Europe +11.7% and Japan +7.8%, making it the best quarter for this asset class since the first quarter of 2012. *Source: MSCI World ex-Australia Index (net div.)*

EMERGING MARKETS SHARES

+8.37%

Emerging market equities registered a strong return in the first quarter. This was led by a sizable rally in the Chinese share market. The Federal Reserve's announcement of a pause in interest rate hikes, the USA's decision to suspend tariff hikes on US$200 billion of Chinese goods and ongoing government support for the Chinese domestic economy were all very supportive. A recovery in the price of crude oil from around US$55 per barrel to around US$70 per barrel was also favourable for net oil exporting countries such as Russia and Colombia. Bucking this trend, though, was Qatar, which was the weakest index market during the quarter as Qatari equities fell back after a particularly strong rally in 2018. *Source: MSCI Emerging Markets Index (gross div.)*

INTERNATIONAL FIXED INTEREST

+0.96%

The first quarter of 2019 saw a notable change in tone from the US Federal Reserve. In January they confirmed they would adjust planned interest rate hikes to compensate for deteriorating economic momentum. By March, they had officially lowered projections for USA growth and inflation and similarly reduced their expectations for future interest rate hikes. Their revised expectation is for no further rate hikes in 2019 and only one in 2020. The adjusted growth outlook caused the US Treasury yield curve to invert – a signal historically associated with a pre-recessionary environment. However, in the current environment the economic counter-argument is that central bankers have successfully reduced market risks and helped ease financial conditions which should be supportive of the current growth cycle. With other global central banks also joining the accommodative-monetary-policy-party, we generally saw long government bond yields fall, which was a favourable environment for bond returns. The FTSE World Government Bond Index 1-5 Years (hedged to NZD) gained 0.96% in the quarter and the longer duration Bloomberg Barclays Global Aggregate Bond Index (hedged to NZD) delivered 2.77%. The return of the Bloomberg index was also assisted by its higher average credit exposures. *Source: FTSE World Government Bond Index 1-5 Years (hedged to NZD)*

INTERNATIONAL PROPERTY

+12.92%

Contrary to the domestic performance, international property securities in general outperformed their respective equity markets. With a significant proportion of the asset class linked to financial conditions in North America, the surprise change in stance from the Federal Reserve provided a sizable tailwind for the sector during the quarter. The S&P Developed REIT Index gained 14.57% in US dollar terms and the Australian S&P/ASX 300 A-REIT Total Return Index gained 14.38% in Australian dollar terms. A slightly stronger New Zealand dollar (relative to the US dollar) reduced reported returns to New Zealand investors holding unhedged investments in this asset class. *Source: S&P Developed REIT Index (total return)*

Unless otherwise specified, 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.

Strategic asset allocation changes from 1 April

Synergy investment portfolios are all designed to be diversified, long term investment solutions that take into account what we believe to be the most robust and reliable academic evidence available.

In essence, the portfolios seek to:

- take a non-forecasting investment approach
- gain a widely diversified exposure to global investment securities
- keep management and transactions costs low
- be highly liquid and transparent
- be strategically tilted towards selected sources of higher, long term expected return.

Although the science behind the portfolios doesn't change very quickly, the investment environment around us can.

Over time, different new investment options can become available (some also disappear), new analytical methods are unearthed and implemented, fee structures can adjust, and regulation and tax systems may change as well. Even though we design Synergy portfolios to be held for the long term, we still need to periodically review the construction of our models to make sure that we are always making the best portfolios we can.

For example, if lower fee funds become available, we want to have the opportunity to consider selecting them for our models; if funds with better diversification or better social screens become available, we may want the opportunity to utilise these as well.

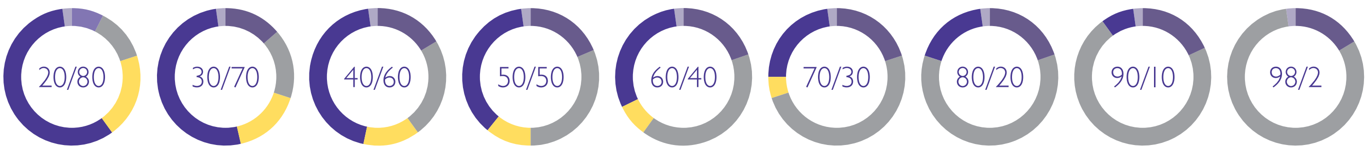
For these reasons, we undertake a comprehensive review of Synergy's recommended strategic asset allocations at least every three years; the most recent of which was completed in December 2018 with a view to implementation on 1 April 2019.

With the strategic reviews, we are not interested in recommending change for change's sake. Our aim is to limit any changes only to those areas where we believe we can make a meaningful difference to the performance of a portfolio, either to control risk and/or improve expected returns.

With the Synergy investment programme now encompassing the nine original model portfolios launched in October 2015, joined by four socially responsible portfolios (April 2017) and four portfolios limited to investment in portfolio investment entities (April 2018), it is impractical to provide a forensic description here of all of the various portfolio changes recommended in the strategic review.

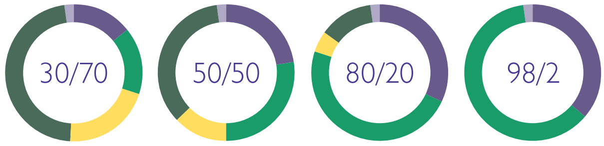
However, the major portfolio changes on 1 April for each Synergy portfolio suite, can be summarised as follows:

ORIGINAL NINE SYNERGY PORTFOLIOS



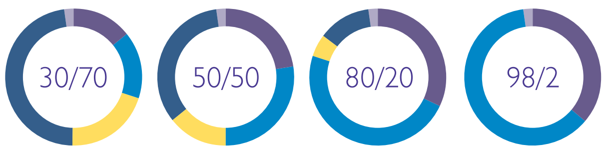
CHANGE	RATIONALE
New allocation (in all portfolios) to the Vanguard International Share Index Fund	The inclusion of this low cost managed fund from Vanguard - the largest provider of mutual funds and second largest provider of exchange traded funds in the world - helps us control total portfolio costs.
New allocation (in 20/80 to 40/60 portfolios only) to the Dimensional Two Year Diversified Fixed Interest Trust (NZD)	The inclusion of this fund helps us reduce the overall investment risk of the three lower risk portfolios.
Removal (from all portfolios) to the prior allocation to the Dimensional Global Real Estate Trust	Based on our updated modelling assumptions and tolerances we can improve the expected performance of portfolios by reallocating these small weights into different asset classes.
Increased allocations to Dimensional Global Small Company Trust and reduced allocations to Dimensional Global Value Trust	Based on our updated analysis of expected fund risk and return characteristics we can improve the expected performance of portfolios by adjusting the amount of exposure to these two funds.
Increased allocations to Dimensional Global Bond Trust and reduced allocations to Dimensional Five Year Diversified Fixed Interest Trust	Based on our updated analysis of expected fund risk and return characteristics we can improve the expected performance of portfolios by adjusting the amount of exposure to the Global Bond Trust.
Allowing the 50% hedging ratio on international (non-Australasian) growth assets to vary according to investor risk profile	Based on our updated modelling assumptions and tolerances, our recommended hedge ratio now varies from 40% in a 20/80 portfolio up to 60% in a 98/2 portfolio. The lower hedge ratio in more conservative portfolios helps control portfolio risk, while the higher hedge ratio in more aggressive portfolios leads to a small increase in risk in the pursuit of higher expected returns.

FOUR SYNERGY SRI PORTFOLIOS



CHANGE	RATIONALE
New allocation (in all portfolios) to the NZ Core Equity Trust, replacing the existing Harbour Advanced Beta Fund	These funds have almost identical expected risk and return characteristics. The NZ Core Equity Trust is favoured for the SRI models because it excludes Skycity Entertainment Group from its portfolio.
New allocation (in all portfolios) to the Dimensional Australian Sustainability Trust, replacing existing allocations to the iShares Indexed Australian Equity Fund, Dimensional Australian Small Company Trust and Dimensional Australian Value Trust	The inclusion of this fund helps improve the SRI screening within the Australian equity market.
New allocation (in all portfolios) to the Vanguard Ethically Conscious International Shares Index Fund, replacing the Vanguard International Share Index Fund and reducing the allocations to the Dimensional Global Sustainability Trust (NZD)	The inclusion of this fund helps us deliver portfolios with improved SRI screening within the global developed equity market.
Remove (from all portfolios) the prior allocation to the Dimensional Global Real Estate Trust	Based on our updated modelling assumptions and tolerances we can improve the expected performance of portfolios, and overall level of SRI screening, by reallocating these small weights into different asset classes.
New allocation (in 30/70 and 50/50 portfolios only) to the Vanguard Ethically Conscious Global Aggregate Bond Index Fund (NZD)	The inclusion of this fund helps us deliver portfolios with an improved level of SRI screening within the global fixed interest market.
Remove (from 30/70, 50/50 and 80/20 portfolios only) the prior allocation to the Dimensional Five Year Diversified Fixed Interest Trust and increase allocations to the Harbour Corporate Bond Fund and Dimensional Global Bond Sustainability Trust (NZD)	The reallocation of assets enables us to deliver portfolios with an improved emphasis on responsible investment practices and SRI screening within the New Zealand and global fixed interest market.
Allowing the 50% hedging ratio on international (non-Australasian) growth assets to vary according to investor risk profile	Based on our updated modelling assumptions and tolerances, our recommended hedge ratio now varies from 42% in a 30/70 portfolio up to 60% in a 98/2 portfolio. The lower hedge ratio in more conservative portfolios helps control portfolio risk, while the higher hedge ratio in more aggressive portfolios leads to a small increase in risk in the pursuit of higher expected returns.

FOUR SYNERGY PIE PORTFOLIOS



CHANGE	RATIONALE
Increased allocation (in all portfolios) to the Harbour NZ Equity Advanced Beta Fund and a corresponding reduction in allocations to the AMP All Country Global Shares Index Fund	Based on our updated modelling assumptions and tolerances, we can improve the expected performance of portfolios by readjusting the amount of exposure we seek to New Zealand and international developed market equities.
Increased allocation (in 30/70, 50/50 and 80/20 portfolios only) to the Harbour Corporate Bond Fund and a corresponding reduction in allocations to the AMP Capital Hedged Global Fixed Interest Index Fund	Based on our updated modelling assumptions and tolerances, we can improve the expected performance of portfolios by readjusting the amount of exposure we seek to New Zealand and international developed market bonds.

Whilst the above tables highlight the major asset allocation changes being implemented, there may also be smaller changes to existing fund weights which are simply a by-product of the updated model portfolio design, but which are otherwise not material with respect to the underlying investment strategy.

In general, these asset allocation changes enable us to broaden the investment options available to existing Synergy clients and to improve the risk and return trade-offs of the different model portfolios.

In lower risk portfolios, this generally means we have been able to deliver the same or higher levels of expected return for a lower level of risk. In higher risk portfolios we have been able to increase expected return, albeit with an increase in the level of expected volatility.

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