Synergy Investments
Newsletter

INVESTMENT REPORT
FOR QUARTER ENDING 31 MARCH 2021

Synergy INVESTMENTS

www.synergyinvestments.co.nz

Market Commentary

In the context of a long term investment plan, a single year is not a very long time. That said, it's difficult to write this particular report without reflecting, at least a little, on what an extraordinary year we have all just experienced.

Twelve months ago, we were about three weeks into our national Covid-19 lockdown, and this corresponding quarterly report was being drafted in a temporary home office.

At the time, the only thing we knew for certain was that, globally, we had been thrust into unfriendly territory. It was certainly a worrying time from a health perspective, with a pandemic raging, and this initially created a gigantic upheaval in investment markets. At the time, the immediate outlook was highly unsettled, and no one had any idea what would happen the next day, let alone the next month or year.

Apart from the age-old (but extremely appropriate) advice of not panicking, one of the points we stressed in that 2020 report was that share markets would be a "leading indicator" of the eventual recovery. What that meant was that share markets would start to improve well before we would see any clear evidence of improvement in the world around us. And so it proved.

In a global context, we are still a long way from being "back to normal". Yes, vaccination programmes are being implemented, economic growth rates are recovering and the recent announcement of a travel bubble with Australia are all reasons for improving optimism.

But, if we scratch a little deeper, we see that unemployment rates remain elevated, global supply lines are stretched, international travel is still challenging for many, and a significant third wave of the coronavirus is currently sweeping Europe and many emerging nations.

Some of these issues may take months or years to be settled, but forward-looking share markets are not sitting waiting. Quite the contrary. Share markets have generally been going from strength to strength. The quarter ending 31 March was no exception, as most share markets (excluding New Zealand) again performed well.

In fact, most share market returns over the 12 months ending March 2021 have also been well above average. This is partly because this recent 12 month period now excludes the negative returns experienced in February and March 2020 when markets fell sharply in the wake of the first wave of Covid-19.

In contrast to the ongoing resurgence in global share markets, fixed interest markets generally struggled during the quarter as government bond yields rose quite sharply.

Rising bond yields are often an indicator of rising growth and inflation expectations and, during the quarter, these lifted on the back of the continued global rollout of Covid-19 vaccinations, and expectations of ongoing economic stimulus.

The evidence available to us over the last 100 years of capital markets is that consistently and accurately forecasting the future is impossible.

In 2020 alone we experienced an unprecedented market decline in February and March, followed by an equally extraordinary rebound over the remainder of the year. To correctly forecast that outcome would have required not only the prediction of a global pandemic, but even more guesswork about how the share and bond markets (not to mention governments, businesses and individuals) might react to it!

Thankfully, one of Synergy's great strengths is that it doesn't rely on guesswork. Synergy portfolios are designed to provide different investors with a consistent means of efficiently gaining a level of risk exposure that is appropriate to their investment needs.

Overall, Synergy investors who held at least some consistent exposure to growth assets (i.e. shares) in their portfolios enjoyed a very good return for the 12 months ending March 2021. For those who simply stayed committed to their long term investment plans, this provided good compensation for having endured the unforeseen challenges of Covid-19 in the first few months of 2020.

Although we can't expect another 12 months of strong double-digit share market returns, Synergy portfolios are, as always, very well placed to deliver the returns that the markets will ultimately make available.

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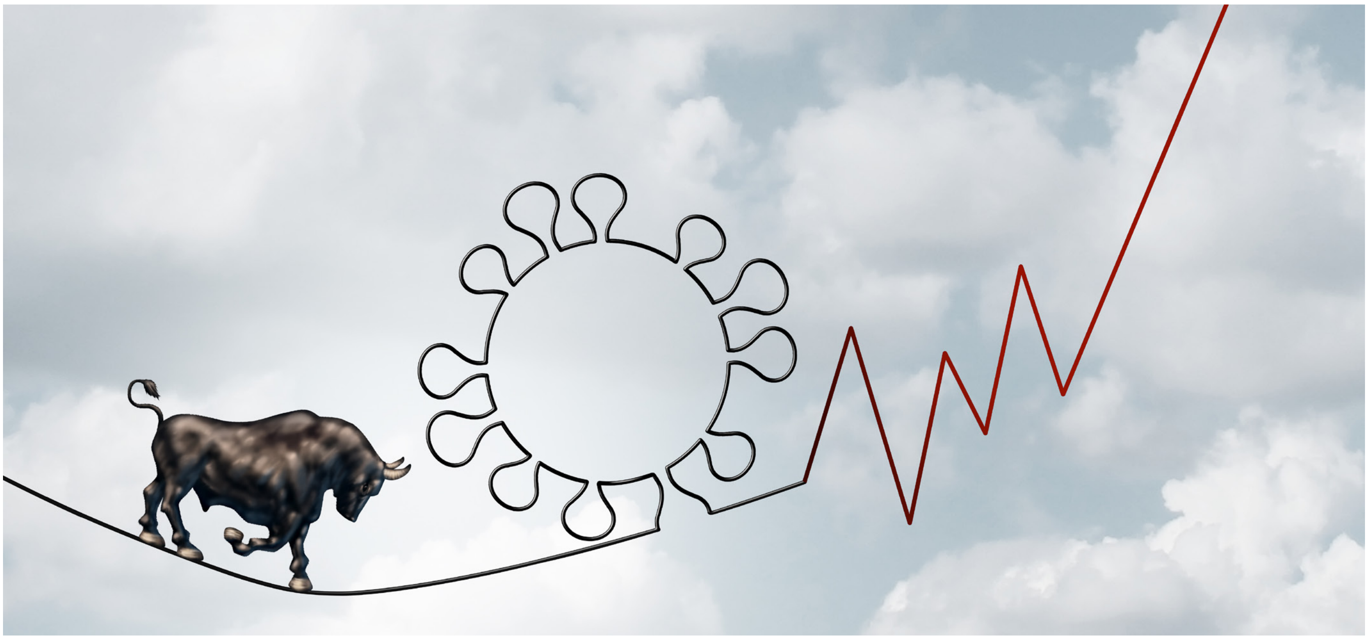

Key Market Movements

The first quarter of 2021 saw broadly positive returns for riskier assets supported by the rollout of the Covid-19 vaccines, paired with ongoing supportive fiscal and monetary policy.

The start of the quarter was volatile, with the siege of the US Capitol Building threatening to overshadow or disrupt President Biden's inauguration on January 21. However, the 46th US president eventually took office without incident. Biden's early executive orders included rejoining the Paris Climate Agreement, directing the government to rejoin the World Health Organization, and the American Rescue Plan Act of 2021. The latter was a $1.9 trillion stimulus package to support the US's recovery from the pandemic and recession, including direct payments to most Americans, funds for vaccine distribution, and other business and healthcare support.

One of the most interesting stories of the quarter was the price action of several small US companies, most notably GameStop, a brick-and-mortar retailer of video games. An internet forum targeted GameStop's share price, pushing it up by as much as 30 times in early January. Their aim was to hurt hedge funds that were known to be betting against this firm. The initial price rise had its intended consequence as hedge funds were forced to exit their positions crystalising significant losses. However, as quickly as the price had shot up, momentum quickly turned, and the share price plummeted back towards its earlier range. The net impact on markets was negligible as GameStop, and the companies involved represented very minor weights, but it served as a reminder of the risks in holding concentrated positions. It also highlighted an understated impact that web forums can have on markets and shone a spotlight on the regulator's shortcomings in monitoring these areas.

The first quarter also saw the anniversary of the fastest market correction ever seen - during February and March 2020. The subsequent 12 month returns for many asset classes reflect the sharp subsequent recovery from those lows, providing a forceful reminder of the merits of a disciplined long term investment approach.

INTERNATIONAL SHARES

+6.2% (hedged to NZD)

+8.1% (unhedged)

With global vaccination programmes underway, an improving economic outlook along with continued government support has meant improving prospects of companies' future revenue and profitability. This has been very positive for most share markets. In the US, the flagship S&P 500 Index (total returns in USD), advanced +6.2% for the quarter for a remarkable +56.4% return over the past 12 months.

In Europe, share market performance was also very strong. The MSCI Europe ex UK Index (in local currency) gained +8.4% through the quarter and, during March, this index surpassed its highest pre-crisis level. The MSCI Europe ex UK Index gained +40.0% over the last 12 months.

British equities were also strong, although they did not increase at the same rate as their neighbours. In GBP terms, the FTSE 100 advanced +3.9% for the quarter and +18.4% for the last 12 months. Japanese equities were among the best in developed markets for the quarter, as a relatively weak Japanese Yen enhanced the revenue of exporters. The MSCI Japan Index jumped +8.9% for the quarter for a +43.5% return over the last 12 months.

Small capitalisation companies generally outperformed larger companies in the quarter and also posted higher returns over the last 12 months. Economically sensitive industries such as energy, industrials, and financials were the best performing as the prospect of strong economic growth drove their prices higher. Defensive industries such as utilities (e.g. power companies) and consumer staples (e.g. food producers) are typically less volatile and advanced at a slower rate.

Healthcare and information technology – sectors that had thrived through the pandemic – lagged through the quarter, although information technology remains near the top over the last 12 months.

The New Zealand dollar was generally weak versus foreign currencies and this meant that unhedged foreign assets outperformed. In New Zealand dollar terms, the MSCI World ex Australia Index delivered a quarterly return of +6.2% on a hedged basis and +8.1% unhedged. The rolling 12 month return for the New Zealand dollar hedged index was +49.7%, while the unhedged index gained 'just' +31.4%.

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

EMERGING MARKETS SHARES

+5.4%

Emerging market equities generated gains as well, albeit less than developed markets. The vaccine roll out in these nations has been slower than in developed nations, and high infection rates again meant social restrictions in some countries. Oil heavy economies such as Russia and Saudi Arabia were among the best performing nations as renewed global demand for oil pushed prices up. Taiwan was also strong, led by large semiconductor producers who produced good results.

Korea and India produced small gains while regional heavyweight, China, struggled in the face of ongoing US-China tensions, even under the new US administration.

In unhedged New Zealand dollar terms, the MSCI Emerging Markets Index produced a quarterly return of +5.4%, for a +35.8% return over the last 12 months.

Source: MSCI Emerging Markets Index (gross div.)

NEW ZEALAND SHARES

-3.9%

Although the Royal New Zealand Yacht Squadron proved to be world beaters, domestic equities took on a little water in the first quarter of 2021. It was a handful of disappointing results from the larger firms and the announcement of a 1 percent drop in our GDP during the last quarter of 2020 (worse than expectations) that knocked us right off our foils. In aggregate, the broad S&P/NXZ 50 Index declined -3.9%.

Dairy companies Synlait Milk and a2 Milk were among the poorest performers as multiple earnings downgrades soured investor demand. Synlait's largest client is a2 Milk, and a2 has seen demand for their infant powder dry up through the latter half of last year, negatively impacting both firms' reported profit expectations.

Meridian and Contact Energy also had volatile quarters, and each ended down more than -20%. Both had enjoyed a strong end to 2020 as high demand for these clean energy companies from international investors had pushed their prices up. However, during the first quarter, Standard and Poors signalled the expansion of their global clean energy index from 30 holdings up to 100, slashing Meridian and Contact's weightings. Investors tracking this index reduced their holdings in both companies which pushed each firm's price well down.

At the other end of the spectrum, Fletcher Building enjoyed another strong quarter, as did The Warehouse Group, which reported a record profit late in the quarter.

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

AUSTRALIAN SHARES

+5.8%

Australian share market returns were strong over the quarter. The S&P/ASX 100 (the largest 100 companies in the Australian market) returned +4.5% in Australian dollar terms, while the S&P/ASX Small Ordinaries Index (the companies ranked 101 to 300 in the Australian share market) delivered +2.1%. Over the last 12 months, small capitalisation companies have been very strong, with the S&P/ASX Small Ordinaries Index up +52.1% versus +36.8% for the top 100 companies.

The strongest performing sector in Australia was financials, where Westpac led the rally on the back of strong profit reporting through the quarter. The market sees an improving outlook for the banking sector with a strong economy and a thriving housing market, in particular, helping profit projections.

Heavyweight miners BHP Group and Rio Tinto posted small gains, however many of the mid cap gold miners posted losses as the price of gold fell during the quarter, harming these firms' prospects.

Returns to unhedged New Zealand investors were slightly enhanced by a small appreciation in the Australian dollar over the quarter.

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

INTERNATIONAL FIXED INTEREST

-0.4%

As mentioned earlier, longer term yields broadly rose as the market priced in prospects of an improving economic growth outlook. As was the catalyst in equity markets, the vaccine rollout and continued government support drove expectations, and the market began to price in interest rate increases earlier than was the consensus at the start of the year.

The US 10 year yield – the yardstick for global yields – increased to 1.74%, effectively returning it to pre-Covid levels. These yields are now at the lower end of the broad range observed in the decade following the GFC. Many developed market government yields saw similar moves, with the 0.83% increase in the US being matched in Australia with the UK not far behind. Yields in the European union also rose, although by smaller magnitudes. The Japanese 10 year yield was relatively unchanged.

When bond yields are relatively stable, bond investors receive the bulk of their return from the bond yield and from something called the 'roll down' return, which is a valuation benefit that generally accrues to investors as the bonds they hold move closer to maturity. At the start of the period, both of these sources of return were minimal as yields were low and curves were relatively flat. In the first quarter, the prices of bonds fell as bond yields increased sharply, and the impact of the lower bond prices was far larger than the positive combined yield or roll down benefits.

Longer duration bonds were hit the hardest, while corporate bonds performed slightly better than government bonds. The FTSE World Government Bond Index 1-5 Years (hedged to NZD) declined -0.4%, while the broader Bloomberg Barclays Global Aggregate Bond Index (hedged to NZD) returned -2.5% for the quarter. These declines are among the worst seen in this asset class since the turn of the century. However, the impact of Covid-19 on both equity and bond markets has generated some short term results (both good and bad) which have been far from normal. When we look at the annualised performance of bonds over longer time periods, we quickly find returns that are a lot closer to long term expected averages, such as the Bloomberg Barclays Global Aggregate Bond Index (hedged to NZD), which has returned +4.0% pa over the 3 years to end March 2021.

It should also be noted that although the increase in yields contributed to a negative quarter for bonds, it also serves to increase the expected return of these same assets going forward.

The final silver lining within this period of higher volatility in bond markets is the diversification benefits we have seen in portfolios. This negative performance on fixed income assets occurred alongside another very strong performance from the riskier equities. The flipside of this was exhibited during the initial Covid-19 crisis early last year, where high-quality fixed income assets benefitted (at that time) from a drop in yields when equities were delivering large losses. This is precisely the sort of diversification benefit we expect from pairing these different asset classes together in portfolios; when one does poorly, the other will often perform well and help carry the portfolio.

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

NEW ZEALAND FIXED INTEREST

-2.1%

Yields in New Zealand followed the global trend and spiked with the NZ 10 year yield closing the quarter at 1.84%, 0.82% above its starting point. The impact was negative on performance, although generally less so here than overseas, as our market has a relatively shorter average time until maturity, and the yield changes were less amplified.

Government bonds generally outperformed credit securities, and shorter maturity bonds that have less price sensitivity to rising interest rates outperformed longer maturity bonds, but generally, all parts of this asset class posted losses.

The S&P/NZX A-Grade Corporate Bond Index declined -2.1% over the quarter, and the rolling 12 month return has been +1.9%. Longer term performance remains robust, with both the 3 and 5 year annualised average coming in at +4.0%, while the 10 year return is +5.0% per annum.

The longer duration but higher quality S&P/NZX NZ Government Bond Index declined -3.4% for the quarter and has retreated -1.6% over the preceding 12 months.

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

Table 1: Asset class returns to 31 March 2021

ASSET CLASS	INDEX NAME	3 MONTHS	1 YEAR	3 YEARS	5 YEARS	10 YEARS
New Zealand shares	S&P/NZX 50 Index (gross with imputation credits)	-3.9%	+28.9%	+15.7%	+14.3%	+15.2%
Australian shares	S&P/ASX 200 Index (total return)	+5.8%	+45.0%	+10.5%	+9.8%	+5.6%
International shares	MSCI World ex Australia Index (net div., hedged to NZD)	+6.2%	+49.7%	+12.4%	+13.6%	+12.0%
International shares	MSCI World ex Australia Index (net div.)	+8.1%	+31.4%	+14.2%	+13.2%	+11.0%
Emerging markets shares	MSCI Emerging Markets Index (gross div.)	+5.4%	+35.8%	+8.1%	+12.2%	+4.9%
New Zealand fixed interest	S&P/NZX A-Grade Corporate Bond Index	-2.1%	+1.9%	+4.0%	+4.0%	+5.0%
International fixed interest	FTSE World Government Bond Index 1-5 Years (hedged to NZD)	-0.4%	+0.6%	+2.6%	+2.3%	+3.5%
New Zealand cash	New Zealand One-Month Bank Bill Yields Index	+0.1%	+0.3%	+1.1%	+1.5%	+2.2%

Unless otherwise specified, all returns are expressed in NZD. We assume Australian shares and emerging markets shares are invested on an unhedged basis, and therefore returns from these asset classes are susceptible to movement in the value of the NZD. Index returns are before all costs and tax. Returns are annualised for time periods greater than one year.

Developments in the Synergy portfolios

Since last quarter, Consilium has been working on a number of Synergy portfolios, as we look to deliver better overall investment outcomes to Synergy investors.

In this article, we explore how these recent changes to portfolios deliver lower fund manager fees for investors, better expected risk/return profiles and growing emphasis on the environmental and social characteristics of our SRI portfolios.

Reduction in fund management fees

Consilium has been able to achieve a reduction in some management fees for all Consilium Synergy portfolios.

1. In April 2021 the Harbour NZ Equity Advanced Beta Fund had a mandate change and was renamed the Harbour NZ Shares Index Fund. This change resulted in a management fee reduction for investors, from 0.25% p.a. to 0.10% p.a. This change only affects Consilium Classic and PIE portfolios.
2. Synergy SRI portfolios have had an allocation change from the NZ Core Equity Trust to the Harbour Sustainable NZ Shares Fund. The new fund also comes a fund management fee reduction for investors, from 0.35% to 0.10% p.a.

Improvements in SRI characteristics within SRI portfolios

Australasian equities

The new Harbour Sustainable NZ Shares Fund has a wider focus on SRI characteristics. In addition to the gambling exclusion that the incumbent fund has, this new fund excludes investment in companies involved in the manufacturing or sales of alcohol, tobacco, recreational cannabis, adult entertainment, weapons (firearms, munitions, or nuclear armaments), and companies with a record of animal welfare violations.

In light of New Zealanders' generally strong support for the consideration of environmental impacts (for example carbon emissions) and of human rights violations (including child labour), any companies with a poor record in these areas will also be excluded.

International equities

A change in allocation from the iShares Emerging Markets IMI Equity Index Fund to the iShares MSCI EM SRI UCITS ETF, includes exclusions on all weapons (including civilian firearms), alcohol, gambling, tobacco, nuclear power, adult entertainment, genetically modified organisms, thermal coal, oil sands and unconventional oil and gas extraction, and exclusions on companies that have been flagged for controversies including human rights violations.

Slightly higher expected returns and risk

Following the implementation of all changes, the expected returns of Synergy Consilium portfolios will generally be a little higher, with broadly similar levels of portfolio volatility (i.e. the potential ups and downs in returns).

Disclaimer

Information contained in this newsletter does not constitute personalised financial advice because it does not take into account your individual circumstances or objectives. You should carefully consider whether the Synergy investment portfolios are appropriate for you, read the applicable offer documentation, and seek appropriate professional advice before making any investment decision.

The information in this newsletter is of a general nature only. Investors should be aware that the future performance of the Synergy investment portfolios may differ from historic performance. Details are correct as at the date of preparation and are subject to change. The investment objectives and strategies of the Synergy investment portfolios may change in the future.

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