PHWM Autumn Update

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Following a tremendous run over the last five or six years, model portfolio returns slipped into the negatives for the first quarter of 2018.

So, does this mean that markets are now going down? Well, there's not a simple yes or no answer to that question, and your investment timeframe will play an important part in the answer.

If your timeframe is only the last three months, then 'yes' probably feels like the right answer. But if your timeframe is longer than the last three months, there is a strong argument to say that the markets are still going up. As we know, 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.

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We have 27 full calendar years of model portfolio returns on file. The data reflects actual portfolio returns over the last 15 years or so, and the results from earlier years reflect the outcomes that would have been possible, had the same strategies been in place during those years. Over this complete period, the range of returns (after fund management fees only) from our lowest risk to highest risk portfolios has been 7.87% to 10.02% p.a. For all risk types, the 27 year market has unquestionably been going up.

But it hasn't done so without some setbacks along the way, and occasionally, some big ones. Of the 108 calendar quarters (ie, quarters ending March, June, September or December), even our lowest risk portfolios have experienced quarters where the portfolios have declined.

Over the long term, we expect a 20/80 portfolio will go down about one quarter in every ten, and for portfolios with higher and higher proportions of risky assets, we expect negative returns more often (i.e. for a 50/50 portfolio we expect a negative quarter about one in five).

The point is that, in plotting an investment strategy that seeks to earn higher expected returns, we are knowingly taking higher risks. And a risk is an outcome that is not guaranteed. 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 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.

Over the first quarter of 2018, most asset classes struggled to maintain their previous price momentum. However, after such a strong finish to 2017 when a number of global share markets gained 5% - 10% over the final three months of the year alone, it is not unreasonable that the markets would pause to draw breath at some stage.

New Zealand was not immune from the slowdown in investor sentiment. The S&P/NZX 50 Gross Index (including imputation credits) eased -0.58% over the quarter. Although this is unlikely to be considered a catastrophe by investors in local equities, who have seen this index rise 16.93% over the last 12 months and 14.89% p.a. over the last five years.

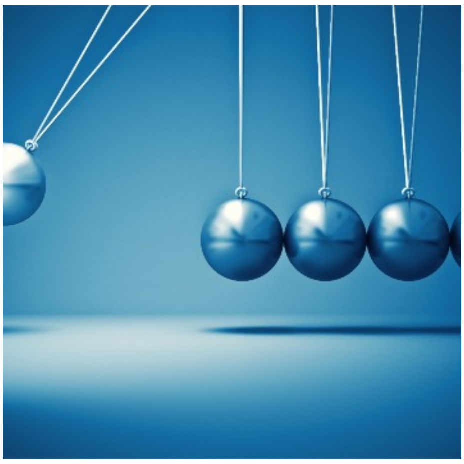
Local property assets were also weaker, with the S&P/NZX All Real Estate Gross Index shedding -3.72% for the quarter, effectively giving back the gains made in December 2017. The New Zealand real estate market continues to cool, with the QV House Price Index indicating a 6.6% growth in property prices in the 12 months to December 2017, compared with 12.5% in 2016. Whilst prices are still rising, the volume of sales declined sharply in 2017. This is likely due to tight lending criteria, prevailing high prices and ongoing uncertainty post the 2017 general election.

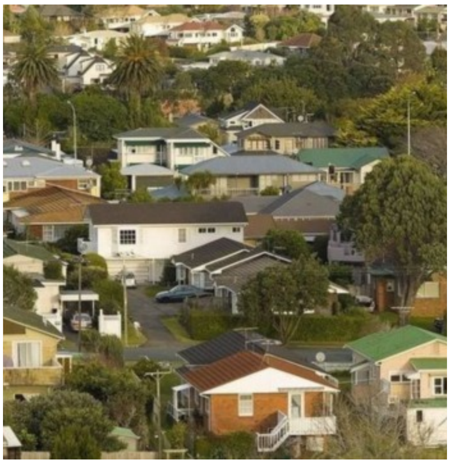
Completing the domestic picture for the quarter were small positive returns from local bond markets, with the S&P/NZX A-Grade Corporate Bond Index and the S&P/NZX NZ Government Bond Index up 0.74% and 0.49% respectively. The Reserve Bank of New Zealand revised down their near term forecasts for growth and inflation, and continue to expect the official cash rate (OCR) to remain on hold for quite some time. With the slight softening in growth and inflation expectations, New Zealand yields were little changed throughout the quarter.

The Australian share market also tracked lower, with the main S&P/ASX 200 Total Return Index dropping -3.86% in local currency terms. New Zealanders investing into this market on an unhedged basis endured a further currency impact of -3.47%, as the New Zealand dollar strengthened against the Australian dollar over the quarter.

Overseas, share market returns were generally weak. An optimistic employment report in the USA was identified as one of the catalysts for profit-taking in February. It seems the prospect of reducing unemployment, rising wages and increasing inflationary pressures in the world's largest economy helped markets do a u-turn after a strong January. By quarter end these concerns were displaced by fears of a possible trade war between China and the USA, with each country making escalating announcements on trade tariffs targeting each other's exports.

There is unease that a tariff 'arms race' between the two biggest global economies could lead to collateral damage in other markets. However, apart from an initial tariff hike in the USA on solar panels, washing machines, steel and aluminium, the rhetoric surrounding this issue is running far ahead of any actual new tariff implementation. It remains to be seen whether Donald Trump (seen as the instigator) really wants to move beyond the current brinkmanship and engage the Chinese head on. It is certainly difficult to envisage the USA emerging stronger from such a course of action, so hopefully wiser political heads will prevail.





A review of the Morgan Stanley Capital International index returns in local currencies reveals that leading developed nations all delivered negative results over the quarter. In spite of being blamed for triggering the sentiment shift, it was ironically the USA that showed the greatest resilience with a fall of just -0.63%. Perhaps concerns about rising interest rates weren't so strong that investors were prepared to completely disregard the very strong corporate profits in the USA and the projected profitability benefits of the government's US$1.5 trillion tax stimulus package.

Elsewhere, Germany (-5.80%), France (-1.98%) and Japan (-4.67%) all experienced larger losses. The UK (-7.29%) was the worst performing developed market over the quarter. UK companies were negatively impacted by a weak growth outlook, a stronger pound, and growing expectations that the Bank of England may raise interest rates sooner and faster than previously anticipated.

While still mixed, average returns across the emerging market regions were better than in developed markets. In local currency terms Brazil was a standout, gaining 12.69% amidst revelations that corrupt ex-President Luiz Inacio Lula da Silva would be barred from contesting October's presidential elections. Of the other notables in this asset class, China gained 2.12%, Korea was -0.81% lower, India lost -4.92% and Russia gained 9.31% as the price of Brent Crude oil rose for the third quarter in a row.

Global listed property largely mirrored the performance of international equities. The prospects of a rising interest rate environment are a headwind for the sector, and overall for the quarter, the S&P Developed REIT Index (total return) was down -5.62% in US dollar terms.

Global bonds delivered a largely flat result. Yields in the USA moved higher on the back of another 0.25% interest rate hike in March and increasing expectations of greater growth, inflation and interest rates rises to come. UK and German interest rates also rose, but off very low bases. Corporate bonds underperformed government bonds as investors reduced their appetite for holding corporate credit risk during the quarter. By quarter end, the FTSE World Government Bond Index 1-5 Years (hedged to NZD) gained 0.29% while the Bloomberg Barclays Global Aggregate Bond Index (hedged to NZD) returned 0.02%.

Although investors experienced a negative quarter, the fact that markets will occasionally go down is known with certainty. Accordingly, 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.

What lies ahead for markets is, as always, impossible to predict. Unfortunately, that won't prevent people from guessing. So you need to be very wary of anyone, including most in the media, prone to dressing up their guesses as facts.

Economic indicators tell us that the global economy remains buoyant and, regardless of other distractions, we are currently in the unusual situation of having all major economies growing in unison. This could be great news for the markets, particularly if the concerns of a USA/China trade war begin to fade.

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.

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Key market movements for the quarter

-0.58%

New Zealand shares

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*

+0.74%

New Zealand fixed interest

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*

-3.72%

New Zealand property

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*

-7.20%

Australian shares

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)*

-2.06% (hedged to NZD)

-3.07% (unhedged)

International shares

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.)*

-0.50%

Emerging markets shares

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.)*

+0.30%

International fixed interest

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: Citigroup World Government Bond Index 1-5 Years (hedged to NZD)*

-7.45%

International property

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)*

Returns expressed in NZD. It is assumed that Australian and emerging markets 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.

The smart way to be charitable

For a long time, many of our clients have been involved with philanthropy. They support a variety of organisations, communities and causes. However, planning for philanthropy can be challenging.

Here are some of the issues:

1. Fear - they want to be generous but don't want to run out of money themselves, so they give money away in their will. This means they miss the pleasure of seeing the money help their cause while they are alive, and they miss the opportunity of a government tax credit on their donation.
2. Uncertainty - they know they have more money than they need. They don't just want to enrich their heirs, but they don't know which cause or organisation to give the money to yet.
3. Publicity - they want to give money away, but they don't like the chance that they might be hassled for contributions on an ongoing basis.
4. Impact - they want to give money to support a cause, but they aren't sure of the most effective and efficient way to go about it.
5. Expense - they want to create a legacy of giving but aren't interested in the time and expense of setting up their own charitable trust.

Overseas there are solutions to these issues, called 'donor advised funds'. These funds are themselves charities. They hold the money in trust, allowing you to invest it how you choose (within limits), giving you an immediate tax credit and allowing the money to grow tax free while you take the time you need to decide who to give to.

The best way to describe donor advised funds is as an investment account for your charitable giving. When you are ready to give some (or all) of the money to a cause, you let the donor advised fund know. They undertake the necessary due diligence and process the donation. It's easy.

Donor advised funds can also consult with you about how to make the big impact with your giving that you want. And, best of all, they can make the donation anonymously if you prefer to do it this way.

All these reasons contributed to $23 billion being donated worldwide into donor advised funds in 2016[1].

They are a wonderful solution and, up until recently, haven't really been available in New Zealand.

We are proud to announce that we are now able to offer a donor advised fund to our clients, called The Gift Trust.

If you're looking to donate in a structured way, there are definite advantages to using a donor advised fund like The Gift Trust. This includes the option to grow your dollars tax free in a portfolio, allowing you to ultimately give even more. You can separate the desire to give from the secondary question of knowing exactly where to give, and how best to do it. You can give anonymously. And, for people looking to donate on a larger scale, using a donor advised fund offers far less hassle and cost than creating your own charitable trust.

The Gift Trust offers expert philanthropic support to help you shape your giving intentions, and focuses on helping donors do more than just send a cheque to their favourite charity once a year[2].

If you've thought about giving but have encountered some of the issues we've discussed in this article, let us know if you'd like to find out more.

[1] https://www.nptrust.org/daf-report/recent-growth.html

[2] Depending on the level of support required, The Gift Trust may charge an extra fee for this service.