

PHWM Summer Update

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Markets became increasingly volatile during the final part of the year.

This was uncomfortable for many investors who, after enjoying a sustained period of relatively benign and generally strong returns, may have forgotten what more elevated equity market volatility felt like. For many, and particularly newer investors, this was emotionally challenging. And when investors are worried, they tend to look at every headline and try to interpret every presidential tweet in terms of the impact they think it might have on the market and their portfolio. In general, that's a fraught approach to investing and doesn't make for a restful night's sleep.

Doing the wrong thing at the wrong time can often be far more damaging to a long term investment plan than a temporary market correction.

It's not always clear why investor sentiment changes. Long term investors had generally done extremely well since the Global Financial Crisis. However, they had also been getting increasingly fatigued by the prevailing uncertainties in the world. Included in this list are the simmering trade tensions between USA and China, diminishing prospects for a clean Brexit deal, concerns about US interest rate rises, a plethora of political issues in the Eurozone (including riots in France and Italian defiance of European Union fiscal policy), and concerns about a gradual slowing in the world economy. Fuelled by incessant media speculation, investors had probably also been anticipating that the end of the long period of gains may have been overdue.

As share markets became more volatile during the final three months of the year, price drops were no longer viewed as buying opportunities but were rather viewed as confirmation that investors' prior concerns were justified. Unfortunately, with investors putting their wallets away for much of the final quarter, equity markets retreated from their highs in early October and most ended the year in the red. This resulted in a very poor three months for most investors as the negative returns from equity markets dragged portfolio returns into the red as well.

For a more detailed breakdown of the recent quarter's returns, we refer you to the key market movements table that follows this article.

With the disappointing headline returns for the quarter, we need to dig a little deeper to find the good news.

Firstly, the globally important US economy is not even close to a recession. This helps underpin the global marketplace and, more generally, investor sentiment.

Secondly, although US interest rates have been steadily rising over the last three years, the benchmark Federal Funds rate of 2.25% is still low and indications are that the case for further rate rises may be faltering. This means the likely continuation of an interest rate environment that will still be generally very accommodative for business borrowing and investment.

Thirdly, as is the case with any market correction, company valuations have been realigned downwards, meaning the expected return for investors buying shares today has gone up markedly.

For example, the previously high-flying technology stocks that helped propel the markets upwards now look like potential bargain buys compared with the prices investors were happy to pay only a few months ago. Apple, until recently the world's largest company, currently has a price to earnings ratio of around 12.5. What this ratio means is that investors are prepared to pay about \$12.50 for every dollar of Apple's estimated future annual earnings. At the end of September 2018 this same ratio was just over 20. That means the cost to buy a share of Apple's future revenues has fallen by more than a third in just three months.

Similarly, Facebook floated in 2012 with a price to earnings ratio of 45. At the end of December 2018 this had fallen to around 19. Regardless of what the future may hold for either company, investors have rarely been able to acquire an interest in these firms' profits quite so cost-effectively. A similar situation exists outside of the technology sector with firms across a wide range of industries now selling at lower relative prices.

The other point we need to make about the recent correction is that it's not an unusual event. It is always extremely disappointing when markets go down, but as we've said many times in these reports, markets rarely go anywhere in a straight line. It is also the case that we cannot strive to achieve consistently higher returns than bank interest rates without assuming a higher risk that sometimes those returns will be lower than we would like; even negative.

In fact, in the last 20 years alone there have been at least eight separate occasions where markets in aggregate have delivered a broadly comparable (or worse) three month return than that experienced by

investors in the last quarter of 2018. The three month periods ending August 1998, September 2001, July 2002, February 2003, January 2008, November 2008, June 2010 and September 2011 all fit into that category.

The point is, what happened in the last quarter of 2018 is not new. It has happened before and it will happen again. Having that knowledge is part of what makes a successful long term strategic investor. It's having an understanding and acceptance (at least a grudging one), that sometimes returns will be negative. We need to have this understanding, because otherwise our emotional response to difficult markets may prompt us to want to do the wrong thing at the wrong time. Quite often that can be far more damaging to a long term investment plan than a temporary market correction.

We need reminding of this because the last comparably poor three month period ended in September 2011 - over seven years ago - and that experience has since been heavily overwritten by our enjoyment of much more prosperous times. We also need reminding because, as human beings, we are all prone to what is known as recency bias. We tend to overemphasise the most recent data and extrapolate that into the future (usually incorrectly) while at the same time undervaluing long term trends.

When it comes to trends, the longest reliable data set we have is 93 years worth of calendar year data from the US share market. Luckily, given the high global relevance of the US share market, this is an extremely useful reference.

When we look at 93 years of returns for the main US equity market index (the S&P 500), we can calculate the **historical probability of the US share market rising in any calendar year**. The results make for some interesting reading (see Figure 1).



The first bar highlights that out of all 93 calendar years 68 were positive, meaning a historical probability of just over 73% that any individual year was positive.

The second bar shows the probability of any year following a negative year, being positive. Excluding 2018 (for which we don't know the result of the year following it), we observe 24 negative years and found that, of the years following each of those negative years, 16 were positive. This means that two thirds of the time (67%) a positive year followed a negative year. In fact, four of the five best calendar years in this sample followed a negative year.

Even when the S&P 500 index was down a lot (the last bar) the probability that the following year was positive was still 67%. Thankfully, big falls in the S&P 500 have only occurred on just six occasions in 93 calendar years, but four of those were followed by positive years.

What this graph tells us is that regardless of what has just happened in the market, the historical probability of the S&P 500 index being positive in the next calendar year has been 67% or better. On the back of a poor 2018, that's a comforting statistic.

The second leg of this analysis is to consider what the average returns were under each of those same scenarios. Again, the findings are revealing (see Figure 2). Over all 93 years, the average return of the S&P 500 index in any year was a little under 12%. What's striking is the average return didn't change all that much whether the market was up or down (by a little or a lot) in the previous year. Although, by a very small margin, the highest average return of 12.4% was achieved in the 24 years following a negative year.

The take out from all of this is to always remember that share markets can (and do) go up and down. That's okay. In fact, it's necessary. If there were no higher risk investment options available to us there would be no prospect of ever achieving a higher return. Our challenge then would be figuring out how we could possibly retire (or sustain our lifestyle in retirement) if our only option was to earn a 3-4% term deposit rate. After allowing for taxes and inflation, that's just not a viable long term solution for most people, particularly those who can't easily increase savings rates or work for longer.

In order to achieve higher long term expected returns and hopefully give yourself more retirement options, the alternative is to be exposed to a measured amount of higher investment risk consistent with your time horizon and your risk tolerance levels.

With this approach, it's also important to measure your performance over a suitable longer term time horizon as well. Our expected returns and projection modelling already take into account the likelihood

Figure 1. Probability of US share market rising

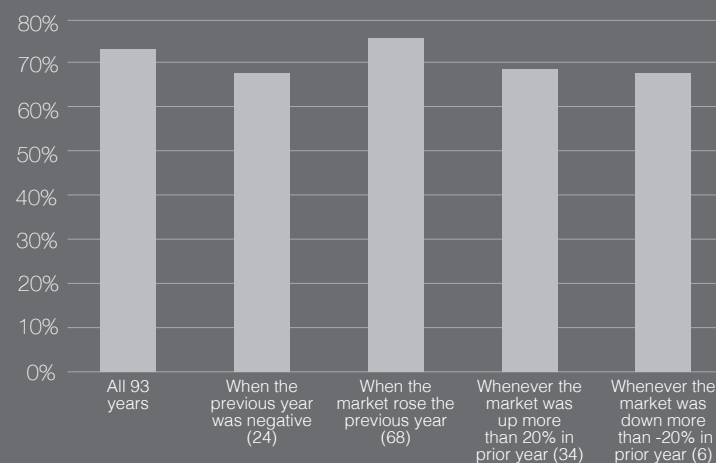
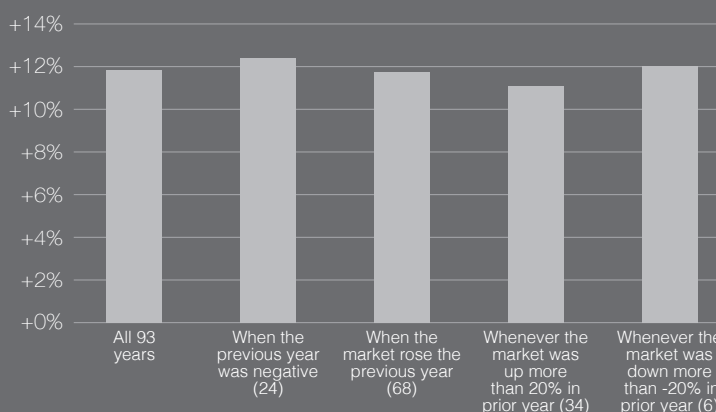


Figure 2. Average US share market return



that markets will have periods of negative returns.

So, when corrections do happen in the midst of a long term investment strategy, you should try to avoid viewing the corrections in isolation.

The local currency returns of the New Zealand and USA share markets over the last three months and ten years respectively, highlight why this is the case:

Share market	Sep - Dec 2018 (last 3 months)	2009 - 2018 (last 10 years)
New Zealand (NZX 50 Index, gross with imputation credits)	-5.60%	+13.93% p.a.
United States (S&P 500 Index)	-13.52%	+13.12% p.a.

A long term investor who focused only on the last three months might make a rash decision to change tack.

However, over a horizon more consistent with the underlying strategy, returns have generally been well above expectations – even allowing for the recent correction.

Returns, then, are often not the issue; the issue is emotionally handling the short term volatility. Combatting this might be easier said than done at times (we are only human after all), but a good place to start is by always reminding yourself that risk is a two way street. Most often it works in your favour, and over longer and longer time horizons the odds of a favourable outcome get better and better, even though there will always be periods of poor returns along the way.

But sound investment strategy doesn't change just because market conditions do. Sound investment strategy includes a clear understanding and acceptance that changing market conditions are unavoidably part of the bargain in order to achieve your long term goals.

Key market movements for the quarter



-5.60%

New Zealand shares

In a period of high volatility and, in most cases, significant share market declines around the world, the New Zealand market fell -5.60% for the quarter. On a relative basis this made it one of the better performing global share markets for the quarter and, in spite of the weak finish, completed a return of +6.04% for the year. The New Zealand share market contains a higher than average exposure to defensive sectors such as utilities (power producers) and REITs (property companies), which helped provide some insulation to the domestic market in this environment. Most companies in the index saw their share prices decline, particularly the large companies. Fletcher Building was one of the most affected over the quarter, completing a very difficult year for the company, while healthcare companies also struggled. Conversely, utilities were robust with firms such as Mercury, TrustPower and Meridian delivering gains. TradeMe was the standout, gaining 22% on the back of a \$2.5 billion takeover offer from a private equity firm. *Source: S&P/NZX 50 Index, gross with imputation credits*



+1.21%

New Zealand fixed interest

The Reserve Bank of New Zealand (RBNZ) held the Official Cash Rate (OCR) at 1.75% at the 8 November update and reinforced expectations of no rate changes until 2020. RBNZ Governor Adrian Orr also stated there are both upside and downside risks to their growth and inflation projections and that the timing and direction of any future OCR change remains data dependent. This outlook, along with an increase in demand for more defensive securities, contributed to yields moving lower over the quarter, which proved beneficial for bond returns. The index delivered a +4.43% return for the year. *Source: S&P/NZX A Grade Corporate Bond Index*



+2.34%

New Zealand property

The New Zealand property asset class was very resilient for the quarter, delivering a gain of +2.34% which rounded out a +10.88% year. The prospect of lower interest rates for longer in New Zealand played its part in helping maintain positive sentiment towards the sector. Six of the seven largest listed property trusts delivered positive returns, led by Argosy, which returned in excess of +10% for the quarter. *Source: S&P/NZX All Real Estate Index, gross with imputation credits*



-11.70%

Australian shares

The Australian share market was hit harder by the increase in global market volatility. The ASX 200 lost -8.24% in Australian dollar terms, with large companies faring better than small companies (the ASX 100 Index was down -7.73% versus the MSCI Australia Small Cap Index down -12.38%). Defensive sectors such as utilities and real estate were among the most resilient, as were large materials firms such as BHP and Rio Tinto, which were both near flat. Conversely, consumer discretionary and telecommunications sectors were some of the worst affected, while energy was also poor as oil prices declined. Reported returns to unhedged New Zealand investors were further reduced by the Australian dollar weakening by approximately -3.7% relative to the New Zealand dollar over the quarter. The ASX 200 returned -7.39% for the year in NZD (and -2.84% in AUD). *Source: S&P/ASX 200 Index (total return)*



-13.49%

(hedged to NZD)

-14.57%

(unhedged)

International shares

Several factors contributed to heightened market volatility in the last quarter of 2018. Fears over slowing economic growth and reduced earnings expectations were fuelled by ongoing concerns about the impact of the US-China trade tariffs, the impact of continued increases in interest rates, and the uncertainty still surrounding the UK's pending exit from the EU. Britain continues to struggle to find a satisfactory pathway out of the EU, with Prime Minister Theresa May failing to gain support for her proposed EU Withdrawal Agreement. This increased concerns about the stability of the UK government, further compounding the global risks facing investors in the UK. Overall, quarterly losses were significantly negative across most developed nations including USA -13.5%, UK -10.3%, Europe -11.2%, and Japan -17.1%, making it the worst quarter for this asset class since the Eurozone debt crisis of 2011. For the year, the index declined -3.52% in New Zealand dollar terms on a currency hedged basis and -7.19% on an unhedged basis. *Source: MSCI World ex-Australia Index (net div.)*



-8.55%

Emerging markets shares

Emerging market equities were also down in the fourth quarter, although less so than in developed markets. This closed out a difficult -9.45% year for unhedged New Zealand investors. Chinese shares were among the worst hit, as trade uncertainty combined with disappointing earnings to drag them lower. Korean and Taiwanese shares also disappointed, with several large technology firms suffering falls amid concerns about the potential for reduced demand for these discretionary products. Nations with a dependence on oil exports (eg, Russia and Colombia) also struggled, although Brazil was a positive outlier posting a +10.8% gain on the back of a stabilising election outcome. *Source: MSCI Emerging Markets Index (gross div.)*



+1.43%

International fixed interest

The US Federal Reserve raised rates by another 0.25% in December but also signalled that the track of regular rate rises may be coming to an end. This, and a classic flight-to-safety trade - which saw increased demand for bonds at the expense of shares during the quarter - drove government bond yields lower, which was beneficial for bond returns. This helped the index finish +2.17% higher for the year. The European Central Bank confirmed they were ending their quantitative easing (ie, bond purchasing) programme, although reduced their economic outlook forecasts, suggesting that rates will remain low for some time. The preference for lower risk assets in the quarter (bonds over shares) was also seen within the bond market, as lower risk government bonds generally outperformed corporate bonds. *Source: FTSE World Government Bond Index 1-5 Years (hedged to NZD)*



-6.63%

International property

International property was not immune to the market volatility, although the more defensive nature of the asset class meant its returns were less negative than the broader equity market. The S&P Developed REIT Index lost -5.45% in US dollar terms and the Australian S&P/ASX 300 A-REIT Total Return Index lost -1.71% in Australian dollar terms. A stronger New Zealand dollar (relative to the 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)*

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.

The importance of being independent

Susan B Anthony, who led the fight for women's suffrage in the United States, once said, "Independence is happiness".

She was talking about the ability to choose - to choose your representatives in government, to set your own course as a free person.

The same is true today. The ability to independently choose without unnecessary constraint often leads to better and happier outcomes. Unfortunately, in the financial advisory industry, the ability to be independent and freely choose is often impeded.

As you may know, Australia's banking, mortgage and insurance industry recently underwent a royal commission inquiry. Here in New Zealand we've followed this inquiry with great interest.

There have been a number of findings related to investment advice.

Vertical integration

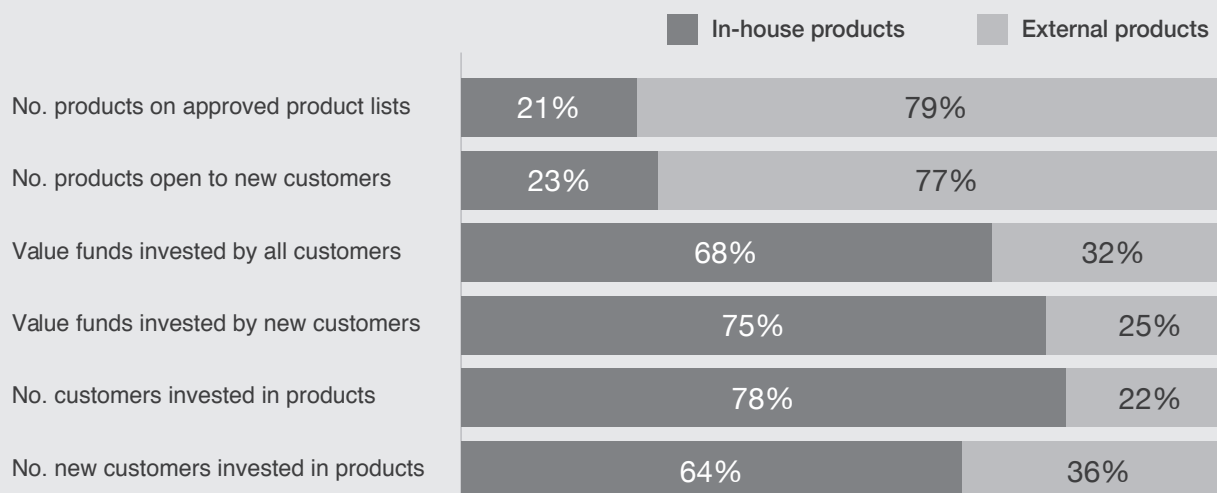
Vertical integration is the combination, in one firm, of two or more stages of production; stages which are typically operated by separate firms. For example, if an adviser recommends a product owned by their employer, or recommends buying or selling a product where their employer gets paid to process the trade, they are vertically integrated.¹

The commission has found this behaviour to be rife in Australia, predominantly in major banks and institutions, and they've suggested it's led to conflicted advice. For example, the Australian Securities and Investments Commission (ASIC) looked at ten vertically integrated advice offerings. They found that, while only 21% of the products on their respective approved products lists were manufactured in-house, these 21% of products received a whopping 75% of the money from new investors. You wouldn't imagine this happens by chance. It's more likely it happens because there is either pressure or inducement to put new money into investments manufactured in-house.

Fees for no service

Some organisations agree to purchase adviser businesses when the adviser retires. The clients are generally assigned to advisers within the new organisation, but some clients are 'orphaned'. There were instances where an organisation had charged a client an advice fee where no service was being provided², or even after they'd died³! To cap it off some organisations lied to regulators about the practice, because it was profitable⁴.

Proportion of customers and funds invested in in-house or external products



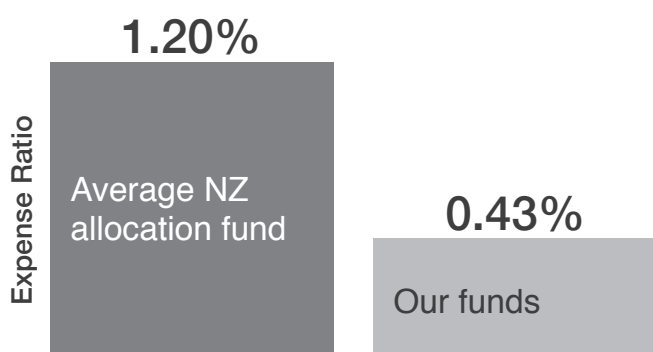
The commission has found other issues related to insurance and mortgage lending as well.

What does this mean for you?

We're proud to tell you that we are an independent firm, but what does that mean exactly?

It means that we are free to use practically any investment available to retail investors in New Zealand. It means that we do not receive revenue from any investment we recommend, and therefore, we only recommend those investments our research shows to be in our clients' best interests.

It is for this reason the investments we recommend are very low cost, in comparison to averages in New Zealand. The chart below shows the average cost of an allocation fund in New Zealand (data accessed from research firm Morningstar), compared to a 50% growth/50% income portfolio we recommend.



Source: Average NZ allocation fund is the equal weighted average of the management fee quoted on Morningstar for 176 open-ended, allocation category, non-KiwiSaver funds available for investment in New Zealand as at 28/2/2018. Our fund based on 50% growth and 50% income and has 0% TER direct property and cash.

Perhaps now, more than ever, it's clear why independence is so important.

When working with new clients, our independence is sometimes seen as a disadvantage. This is because we don't have the brand name and reputation of a large bank or institution. Who are we compared to them?

However, if we wanted to work for an institution such as a bank, we could. We don't, though, because we want to be in a position where we can advocate for our clients' best interests without any outside pressure. We want to be in a smaller business where we personally know our clients and, frankly, we know when one of them has passed away - there is no such thing as an orphaned client here! Being large isn't necessarily an advantage in the advice business, because the advice business is, and will always be, a relationship business.

There are rumours⁵ that banks in New Zealand may get out of the wealth management business altogether. Obviously, it's been a rough year for many over in Australia. However, we want you to know that we are committed to this business, and committed to it for the long term. We are actively growing our business and have an independent, relationship driven business model which will thrive in the years to come.

We believe that greater adviser independence helps us provide perhaps the most important thing we can for our clients - their own financial independence.

So, we welcome the scrutiny the industry has been under and sincerely hope it leads to the customers of those institutions being treated like clients, receiving better and more personal advice for more reasonable costs.



1. <http://download.asic.gov.au/media/4632718/rep-562-published-24-january-2018.pdf>
2. <https://www.theguardian.com/australia-news/2018/apr/17/banking-royal-commission-amp-executive-says-company-put-profits-before-the-law>
3. <https://www.theguardian.com/australia-news/2018/apr/19/commonwealth-bank-charged-fees-to-dead-clients-royal-commission-hears>
4. <https://www.abc.net.au/news/2018-04-16/banking-royal-commission-financial-planners/9662166>
5. <https://www.goodreturns.co.nz/article/976514026/kiwi-banks-may-follow-australians-out-of-wealth-business.html>

Randomness of returns

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Avg
New Zealand shares	13.3%	-8.0%	13.9%	-1.2%	25.6%	25.1%	10.0%	20.3%	-0.3%	-32.8%	18.9%	2.4%	-1.0%	24.2%	16.5%	17.5%	13.6%	10.1%	23.6%	6.0%	8.9%
Australian shares	28.6%	6.2%	8.0%	-20.1%	22.2%	21.0%	21.5%	29.6%	18.2%	-35.6%	42.1%	7.8%	-10.5%	15.0%	3.9%	1.8%	4.4%	9.0%	18.5%	-7.4%	7.6%
Global large shares	26.9%	2.1%	-11.6%	-36.2%	6.0%	4.3%	15.7%	16.6%	-0.3%	-21.9%	4.5%	4.0%	-5.5%	9.4%	27.0%	10.6%	13.5%	5.3%	20.1%	-3.3%	3.1%
Global value shares	18.6%	17.7%	-9.6%	-36.3%	10.0%	7.7%	15.8%	21.5%	-5.5%	-21.5%	1.8%	1.5%	-5.5%	9.1%	27.0%	9.3%	9.0%	10.0%	14.9%	-5.5%	3.3%
Global small shares	28.9%	15.4%	7.2%	-33.1%	25.7%	13.0%	22.3%	13.8%	-7.9%	-23.5%	15.9%	17.4%	-9.0%	11.0%	32.7%	7.4%	14.1%	10.4%	20.4%	-8.8%	7.2%
Emerging markets shares	69.0%	-18.7%	3.5%	-25.3%	24.1%	14.1%	41.7%	28.3%	27.5%	-38.5%	43.5%	10.7%	-18.4%	11.6%	-2.3%	3.1%	-2.6%	9.9%	35.0%	-9.5%	7.3%
New Zealand property	-6.4%	7.3%	12.1%	10.4%	13.4%	20.0%	19.7%	24.9%	-4.3%	-20.8%	11.8%	3.4%	11.2%	20.5%	3.9%	24.2%	14.5%	3.8%	13.9%	10.9%	9.2%
Global property	-0.1%	44.1%	12.6%	-11.9%	11.5%	25.2%	17.9%	38.3%	-20.8%	-28.7%	9.5%	15.1%	0.1%	17.7%	3.1%	28.7%	14.2%	4.1%	5.0%	-0.1%	7.8%
New Zealand fixed interest	6.5%	6.8%	6.4%	6.5%	4.3%	5.9%	6.3%	5.9%	2.7%	15.4%	5.7%	8.7%	9.3%	6.3%	1.9%	7.4%	5.8%	4.1%	5.8%	4.4%	6.3%
Hedged global bonds	0.4%	10.3%	8.2%	12.1%	6.3%	9.5%	9.1%	5.5%	8.9%	15.2%	3.5%	6.3%	8.3%	7.2%	2.2%	11.1%	4.5%	5.8%	4.0%	1.8%	6.9%
New Zealand cash	4.8%	6.6%	5.9%	5.7%	5.6%	6.3%	7.3%	7.7%	8.6%	8.3%	3.1%	3.0%	2.7%	2.7%	2.7%	3.4%	3.3%	2.3%	1.9%	1.9%	4.6%
Portfolio 50/50	12.8%	6.4%	5.7%	-5.1%	11.8%	11.7%	12.2%	16.0%	3.5%	-8.2%	17.0%	9.1%	0.1%	12.4%	9.1%	9.0%	6.2%	9.0%	12.3%	-2.0%	7.2%

Highest



Lowest

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
	69.0%	44.1%	13.9%	12.1%	25.7%	25.2%	41.7%	38.3%	27.5%	15.4%	43.5%	17.4%	11.2%	24.2%	32.7%	28.7%	14.5%	10.4%	35.0%	10.9%
	28.9%	17.7%	12.6%	10.4%	25.6%	25.1%	22.3%	29.6%	18.2%	15.2%	42.1%	15.1%	9.3%	20.5%	27.0%	24.2%	14.2%	10.1%	23.6%	6.0%
	28.6%	15.4%	12.1%	6.5%	24.1%	21.0%	21.5%	28.3%	8.9%	8.3%	18.9%	10.7%	8.3%	17.7%	27.0%	17.5%	14.1%	10.0%	20.4%	4.4%
	26.9%	10.3%	8.2%	5.7%	22.2%	20.0%	19.7%	24.9%	8.6%	-8.2%	17.0%	9.1%	2.7%	15.0%	16.5%	11.1%	13.6%	9.9%	20.1%	1.9%
	18.6%	7.3%	8.0%	-1.2%	13.4%	14.1%	17.9%	21.5%	3.5%	-20.8%	15.9%	8.7%	0.1%	12.4%	9.1%	10.6%	13.5%	9.0%	18.5%	1.8%
	13.3%	6.8%	7.2%	-5.1%	11.8%	13.0%	15.8%	20.3%	2.7%	-21.5%	11.8%	7.8%	0.1%	11.6%	3.9%	9.3%	9.0%	9.0%	14.9%	-0.1%
	12.8%	6.6%	6.4%	-11.9%	11.5%	11.7%	15.7%	16.6%	-0.3%	-21.9%	9.5%	6.3%	-1.0%	11.0%	3.9%	9.0%	6.2%	5.8%	13.9%	-2.0%
	6.5%	6.4%	5.9%	-20.1%	10.0%	9.5%	12.2%	16.0%	-0.3%	-23.5%	5.7%	4.0%	-5.5%	9.4%	3.1%	7.4%	5.8%	5.3%	12.3%	-3.3%
	4.8%	6.2%	5.7%	-25.3%	6.3%	7.7%	10.0%	13.8%	-4.3%	-28.7%	4.5%	3.4%	-5.5%	9.1%	2.7%	7.4%	4.5%	4.1%	5.8%	-5.5%
	0.4%	2.1%	3.5%	-33.1%	6.0%	6.3%	9.1%	7.7%	-5.5%	-32.8%	3.5%	3.0%	-9.0%	7.2%	2.2%	3.4%	4.4%	4.1%	5.0%	-7.4%
	-0.1%	-8.0%	-9.6%	-36.2%	5.6%	5.9%	7.3%	5.9%	-7.9%	-35.6%	3.1%	2.4%	-10.5%	6.3%	1.9%	3.1%	3.3%	3.8%	4.0%	-8.8%
	-6.4%	-18.7%	-11.6%	-36.3%	4.3%	4.3%	6.3%	5.5%	-20.8%	-38.5%	1.8%	1.5%	-18.4%	2.7%	-2.3%	1.8%	-2.6%	2.3%	1.9%	-9.5%