RUTHERFORD REDE

insights

AUTUMN 2022

IN THIS ISSUE

ECONOMIC & MARKET COMMENTARY

MARCH QUARTER 2022

Markets fell as Russia invaded Ukraine

Russia's invasion of Ukraine had a large impact on markets over the quarter.

Just as the global economy was saying goodbye to the COVID-19 pandemic, the world faces a second 'shock' from Russia's invasion of Ukraine. Unprecedented sanctions have been placed on the Russian economy by Western governments and Russian stocks have been dropped from global index providers and most managed funds. Oil and especially European gas prices have surged in response to the conflict, along with commodity prices more generally.

More than a glimmer of hope has been provided by Ukraine's strong resistance and the roll back of Russian armed forces from Kyiv at the time of writing. Partly in response, market performances were stronger in the month of March than over the quarter as a whole. While these are uncertain times, Russia and Ukraine are not large contributors to the global economy and history suggests that recovery from small scale conflicts is rapid. That said, the war has clearly raised global inflation and inflationary risks at a time when central banks were already 'behind the curve' in terms of getting on top of surging inflation rates.

Figure 1: Property and Infrastructure offered the highest returns over the year

Source: Morningstar Direct, MyFiduciary

Most asset classes suffered, but there were a few bright spots.

Market performances over the quarter were very much driven by the contrasting impacts of the conflict. Most equity markets fell, as did bonds, as higher inflation and interest rate risks were priced in. Within equities, resource stocks rallied strongly, benefitting the Australian equity market with its large mining and energy sector. Asset classes expected to be more resilient to inflation risks, such as infrastructure, property and gold, were also relatively resilient. Please see figure 1 for performances.

Market roundup

Most equity markets fell, with the notable exception of Australia, given its large exposure to resources and energy.

Developed market equities fell around 6.5% over the March quarter in NZD terms while NZD-hedged equities fell around 5%. While a poor result, it is on the back of very strong returns in 2021, with the annual return to March 2022 being around 11%. Within global equities, higher risk small-caps had a much weaker annual return (-0.5%) while value stocks have out-performed as the shine has come off growthoriented stocks towards companies with lower valuations, and hence less reliance on future growth conditions.

Emerging Market (EM) equities bore the brunt of the sell-off as war broke out in Ukraine, falling around 8.5% in the quarter and 11% over the year to March 2022. It is important to note that the contribution of Russian stocks to this fall was quite small given Russian equities were a very small part of emerging markets. In response to the invasion and sanctions placed on Russia, EM index providers removed Russia from their indexes and fund managers have followed suit.

NZ and Australian equity market performances were very mixed. Australian stocks increased around 4% over the quarter, driven by a huge rally in its resources sector (up over 20%). New Zealand equities fell around 3% as the RBNZ increased interest rates and as risk appetites waned.

Fixed income returns were generally poor as markets priced-in higher interest rate levels.

As mentioned above, international infrastructure and property stocks had a relatively strong quarter as they are generally resilient to a higher inflation environment. International property stocks fell around 3% in the quarter but returned 16% over the year. Global infrastructure stocks – as we feature below – returned around 2.5% in the quarter and 18% over the year. As shown in figure 1 these are stand-out performances over the year.

But short term bonds funds out-performed as did listed infrastructure.

On the flip-side, bonds are less resilient to rising inflation and interest rates. As a consequence, New Zealand and offshore investment grade (IG) bonds with benchmark terms (or duration) both fell around 4% in the quarter and have similarly sized negative returns over the year. In contrast, bonds with short terms and "cash enhanced" exposures, which we have tilted your portfolios towards given our concern over inflation risks, fared much better and eked out small positive returns.

Infrastructure and the role it has in your portfolio

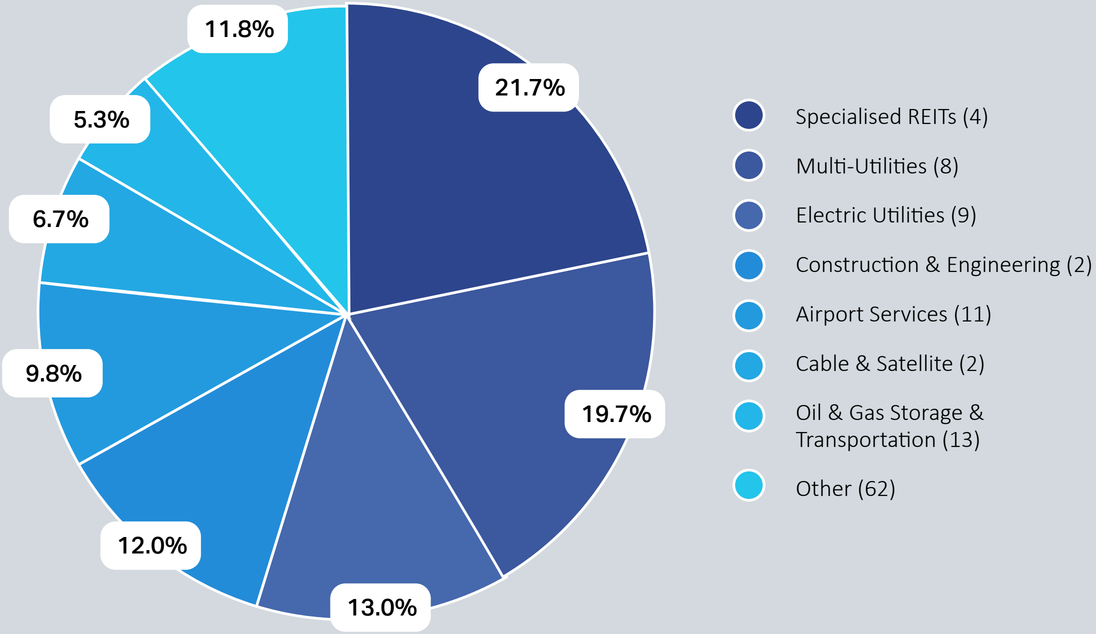
We allocate to infrastructure because we believe it offers several benefits for portfolios.

The portfolios we offer have around a 5% weight to global listed infrastructure. Infrastructure assets provide essential services for societies to function and consist of physical assets that are costly and difficult to replace. Examples include electricity transmission, water utilities, air and seaports and various cellular networks and data centres.

The inclusion of infrastructure is motivated by several factors. First, many infrastructure companies have monopolistic functions in the market, which enables them to have true pricing power. As a result, this asset class is often seen as one of the best ways to protect against rising inflation. Second, the long-dated nature of the assets and essential services they tend to offer provides stable and repeatable earnings, which are resilient through a market cycle. That is, the asset class tends to be a 'defensive' growth asset which normally outperforms in a market sell-off – as occurred over the March quarter. Third, infrastructure stocks (like listed property stocks) tend to have higher dividend yields than equities overall. Given these features, infrastructure is likely to offer a portfolio diversification benefit.

Figure 2: Global infrastructure Sectors

Source: Dow Jones Brookfield



Our allocation is to a fund that tracks at low cost, a respected global infrastructure index.

Access to listed infrastructure is typically global as most markets (excepting perhaps the US) are simply too small to offer reasonable diversification across different infrastructure companies and sectors. Our global infrastructure exposure is obtained through the Kernel Global Infrastructure Fund, which is run by NZ fund manager Kernel Wealth. This fund was selected from the menu of options in the market because it is highly aligned with our investment philosophy of favouring low cost, broadly diversified exposures. In line with this, the fund manager tracks a global infrastructure index that has been developed by a global expert in infrastructure, Brookfield Global Asset Management. The sectoral make-up of this fund is provided in figure 2.

HOW THE MARKETS FARED

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.

QTRLY RETURN	PAST YEAR	
-6.8%	-2.9%	**New Zealand Shares:** New Zealand shares fell almost 7% in the quarter as the Russian invasion of Ukraine, higher inflation and interest rate rises all weighed on returns. This meant a negative return for the year, although our market's 5 year performance remains very strong with an annual average return of around 12% over the period. Source of Figures: S&P/NZX 50 Total Return Index with Imputation Credits
-3.5%	-6.0%	**New Zealand Fixed Interest:** New Zealand investment grade corporate bonds fell around 3.5% in the quarter and returned around -6% for the year ended March 2022. The poor result reflected NZ markets pricing in materially higher interest rates and inflation, which causes bonds to suffer a short-term capital loss. Source of Figures: S&P/NZX Investment Grade Corporate Bond Index
+4.0%	+14.1%	**Australian Shares:** Australian shares bucked the trend, returning around 4.0% in the quarter. This brought the annual result to around 14%. This mainly reflected resource stocks performing very strongly on the back of surging energy and commodity prices. Within Australian equities, small cap stocks fell, while value stocks out-performed. Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries
-6.6% (-5.0% hedged)	+10.9% (10.5% hedged)	**International Shares:** International shares fell by around 5% over the quarter in NZD hedged terms. Annual results were still strong at around 11%, with unhedged returns slightly out-performing given the decline in the kiwi vs. the US dollar over the year. Within global equities, higher risk small caps had a much weaker annual return (-0.5%) while value stocks out-performed returning around 11.5% over the year. Source of Figures: MSCI World Index; Morningstar Developed Markets NZD hedged, MSCI World Value MSCI World Small Cap in NZD terms.
-8.4%	-10.8%	**Emerging Markets:** Emerging Market bore the brunt of the sell off as war broke out in Ukraine, falling around 8.5% in the quarter and 11% over the year to March 2022. Note that Russian stocks have now been removed from Emerging Market indexes, and their contribution to the fall was modest given Russia comprised only around 3% of the index. Source of Figures: MSCI Emerging Markets Index
-4.8%	-3.5%	**International Fixed Interest:** Global investment grade bonds fell -4.8% in the quarter and around -3.5% over the year. As with the NZ result, this soft annual performance reflected bonds being re-priced lower as longer-term interest rates rose on the back of surging inflation and expectations that central banks need to raise rates materially. Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)
-3.4%	+16.1%	**International Property and Infrastructure:** International property stocks fell around 3.5% in the quarter, while global infrastructure rallied around 2.3%. Both of these asset classes returned over 16% in the year and have benefited from rising inflation, as they are expected to be relatively resilient to a higher inflation environment. Source of Figures: FTSE EPRA NAREIT NZD Hedged, FTSE Dvlp Core Infrastructure TR USD

Q&A WITH CHRIS DOUGLAS

Chris is the Principal of MyFiduciary and Fi360. He leads the tools and fund manager monitoring services.

What lead you to being involved in investment?

My grandfather was a bank manager at the Commercial Bank of Australia (now Westpac) and he was always keeping a close eye on interest rates and investments, which sparked my interest. I had a few small sharemarket investments while at school, but quickly realised picking stocks was not easy and not for me. Then a university lecturer in finance spiked my interest in managed funds and diversified portfolios, which led me to a chance meeting with a finance adviser, and a job straight out of university.

Tell me about your experience

I have been very lucky to work for a variety of institutions across financial advice, funds management and investment consulting in New Zealand and offshore. I graduated with a Bachelor of Commerce in 1999 and started working for a financial advice firm at the tail-end of the technology bubble, which was wonderful to experience at a young age, but has also had an indelible impact on how I think about investing. After a few years, I left for the classic kiwi "OE" and moved to London where I worked for several large multi-national fund managers in a variety of analyst roles. In 2006 I joined global research firm Morningstar in their Sydney office where I spent 12-years in leadership roles within the fund research and data business, including two years in Chicago from 2014-16. It was a great experience; I was able to meet with some of the best fund managers from around the word and work within a large and insightful research team. I learnt a tremendous amount about asset allocation, portfolio strategy and fund manager style and due diligence. My desire to work more closely with NZ clients and within a NZ business led me to MyFiduciary in 2018. I joined as a principal and become a director in 2021. I enjoy working with a broad range of clients across financial advice, charitable trusts and Iwi organisations.

Q&A WITH CHRIS DOUGLAS

What do you think are the three most important things to get right with respect to investment

i. Understand your risk profile and the relationship between risk and return over the long-term. Investors tend to get caught in the weeds looking at companies and funds, but the most important decision is to first decide your risk profile.

ii. Diversify across different asset classes and investment styles. No-one has a crystal ball and a good portfolio has resilience and a number of different return drivers.

iii. Take a long-term view and ignore the noise. Very few people can profit from trying to make short-term returns. And don't pay too much! (ok, that is probably four points.) High fees will erode your investment returns, so take a look at what you are paying.

What do you do to stay current with investment knowledge

In this industry you are always learning. I am lucky to be part of an experienced investment team at MyFiduciary, where we share knowledge and insights and keep up-to-date with market developments. We also partner with a broad number of industry groups and academics for a variety of research initiatives, which has recently involved taking a deep dive into sustainable investing, a growing and important investment movement. Finally, we regularly meet with fund managers and investors to hear their insights around asset allocation and portfolio positioning.

What other areas of business are you involved with. E.g Trustee governance

At this stage I don't have any external governance roles or other business involvement, my life is busy enough with a young family and work! However, I am lucky enough to be involved with several charities through MyFiduciary where I get exposure to boards and trustees and we regularly hold workshops around investment governance, which is very rewarding.

Rutherford Rede Limited
91 College Hill, Ponsonby, Auckland, New Zealand
PO Box 147246

+64 9 361 3670

rutherfordrede.co.nz