RUTHERFORD REDE

insights

WINTER 2022
IN THIS ISSUE

ECONOMIC & MARKET COMMENTARY

JUNE QUARTER 2022

Overview

War, pandemic, and inflation. Markets have grappled with all three headwinds this year, falling further across most asset classes in the June quarter. US and NZ equity markets are down around 20% from their peak, putting them into “bear market” territory. Bonds also suffered large declines.

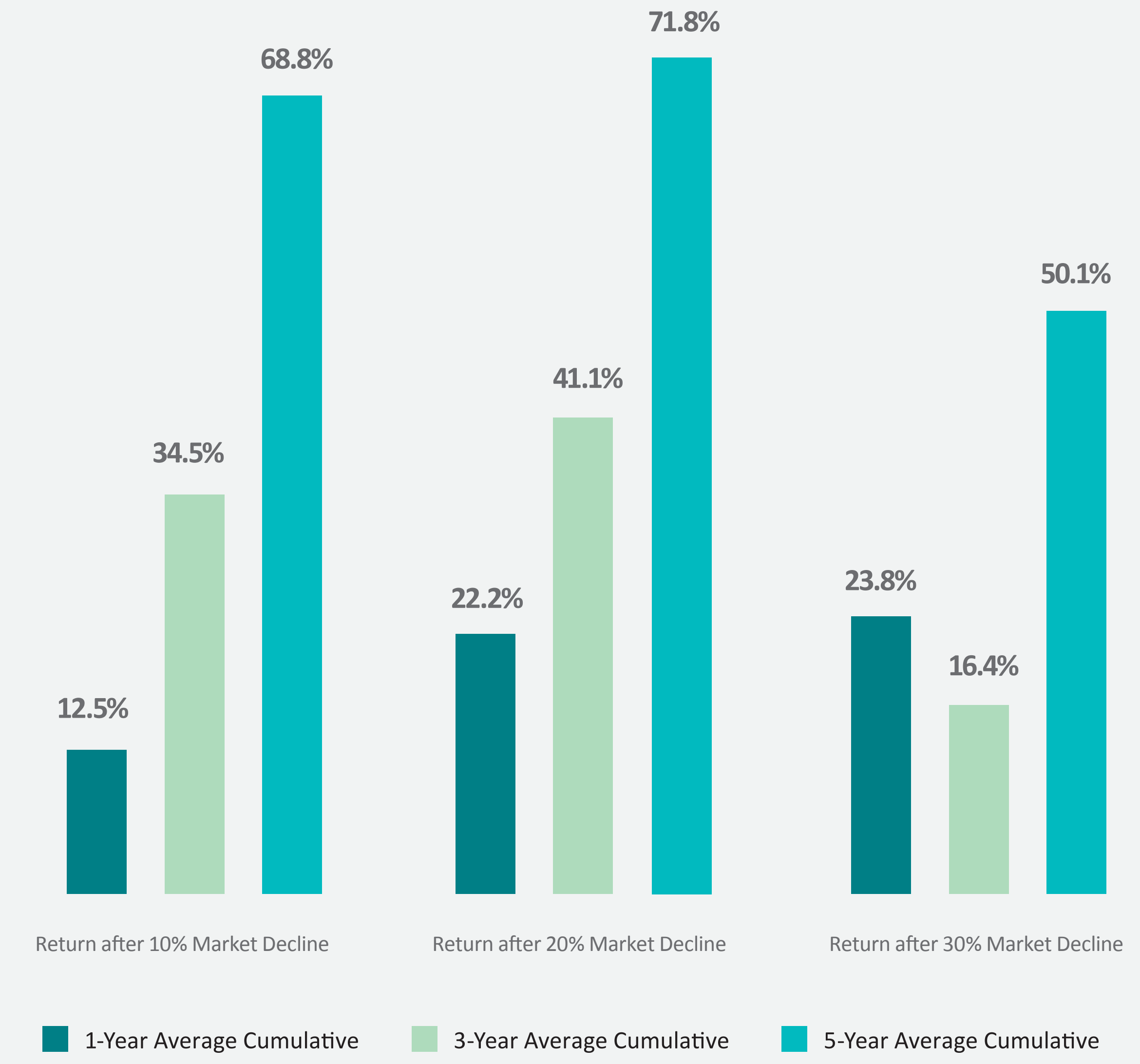
Equity markets fell into bear territory over the June quarter.

Nobody knows how much further markets could fall. Nevertheless, we can say with certainty that the large bond and equity price declines offer investors much better value today, therefore higher likely returns over the medium to longer term. As can be seen in Figure 1 over the past century US equity markets have delivered an average five-year cumulative return of over 70% (12% per annum) following a market decline of 20%. Investment grade bond fund yields are now around 4%, a large jump from the 1% or so yield offered a year ago.

Historically, investors have enjoyed outsized returns following a bear market.

Figure 1: Over the past 100 years large gains have followed large falls

Source: History Shows That Stock Gains Can Add Up after Big Declines | Dimensional Fund Advisors



The economic picture

The key economic determinant for markets forming a bottom and setting the stage for rallying will be whether inflation starts to moderate, and with it the quantum of interest rate increases central banks need to deliver. Global and NZ growth is no doubt slowing from the blistering pace that was achieved following the bounce from initial pandemic lockdowns, and with it, in theory, we should see inflation pressures and actual inflation decline.

The economic picture is very complicated, with upside and downside risks.

But on top of the economic cycle, the pandemic and war in Ukraine present considerable uncertainty with both upside and downside risks. We can expect prices for manufactured goods to fall if global supply chains don't face further significant covid and flu-related interruptions. Despite the ongoing war, oil (and many commodity) prices at the time of writing are down over 10% from their peaks, as markets factor in slowing global growth. Any sign of war letting up in Ukraine would cause energy prices to plummet, and with it headline CPI inflation. Unfortunately, we would expect the opposite to occur if the war were to spread beyond Ukraine's borders.

While markets are pricing in a recession it is not inevitable.

Is economic recession inevitable? It's a very complex economic picture and economic forecasting is not something that is known for its accuracy. Equity markets have fallen to the extent that they are now 'pricing in' an economic recession (i.e. at least 2 consecutive quarters of negative economic growth and a steep rise in unemployment rates.) Historically, however, markets have also not been very good at predicting recessions. They have forecast roughly twice as many recessions as have actually occurred! In contrast, the most recent June forecasts from the OECD still predict global GDP growth of 3%, and 2% growth for New Zealand. This is a large decline from the growth we have had recently, but still far from recession. Time will tell.

Market roundup

Market performances are reported in Figure 2. Developed market equities fell around 6.5% over the June quarter in NZD terms while NZD hedged equities fell around 15%. The difference in performance reflected the large decline in the NZD over the quarter, something we typically see in a 'risk off' environment. We have significant allocations to unhedged equities that in part reflects the shock-absorbing role the NZD can play in times of stress.

Global, NZ and Australian equity markets fell over the quarter, with value and emerging market stocks falling less.

Within global equities, higher risk small caps fell around 7.5%, while value stocks again out-performed (falling around 1% and are up 4% over the year) as the rotation

towards companies with lower valuations, and hence less reliance on future growth conditions, continued. Please see below for a feature on the 'value' factor and how we select exposure to a value-based fund.

Emerging Markets outperformed most other equity markets in the quarter, falling by 'only' around 1%. This reflects that they bore the brunt of the sell off as war broke out in Ukraine in the March quarter. On an annual basis returns were poor at around -16% in NZD terms. NZ and Australian equity markets both declined around 10% in the quarter as the RBNZ and RBA lifted interest rates. Over the year to June, however, the resource-sensitive Australian equity market has fared better, with it down around 4% compared to around 13.5% in New Zealand.

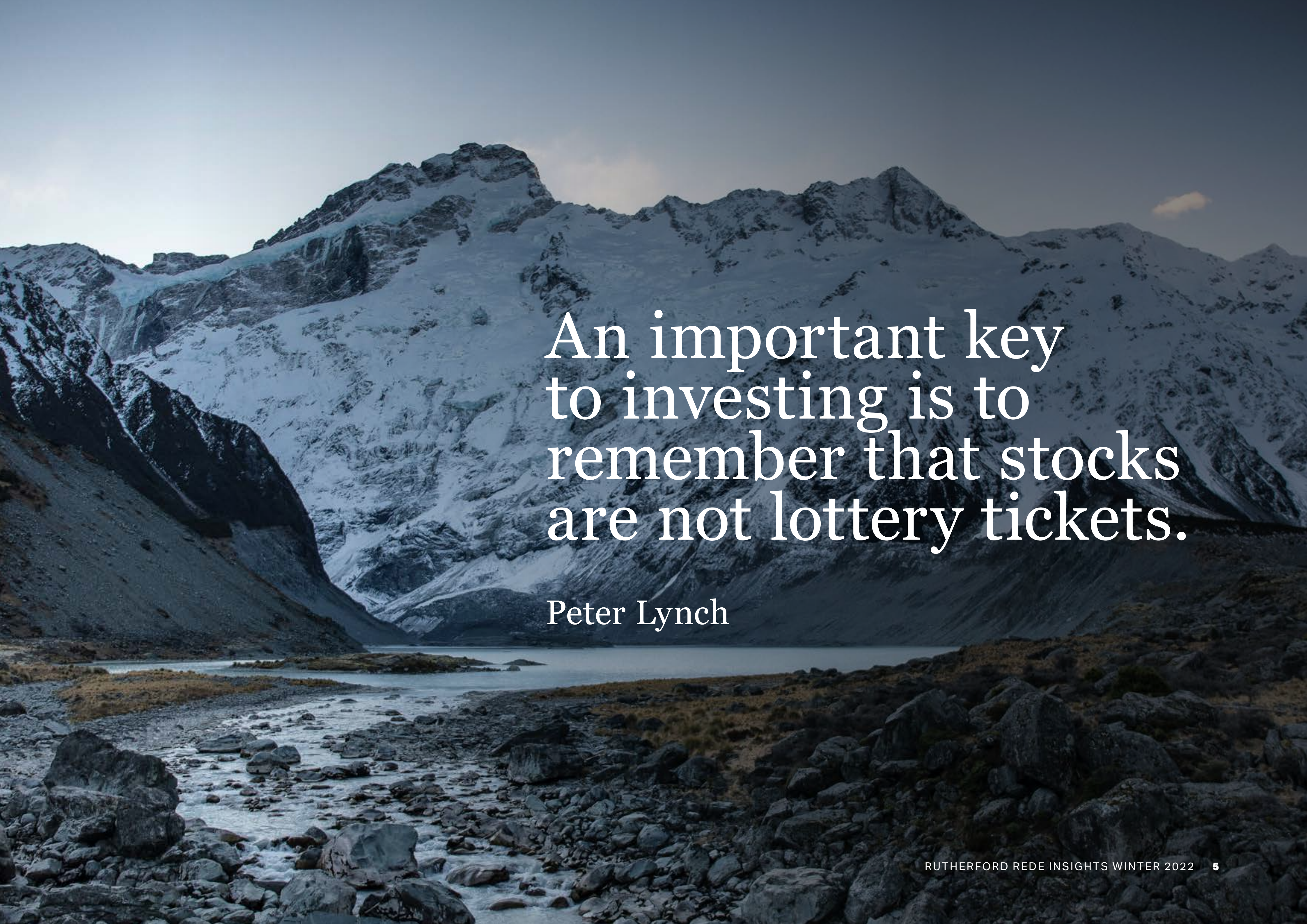
Fixed income returns were also poor as market interest rate curves steepened. NZ bonds fell around 3% and global investment grade bonds fell around 4.5%. Over the year to June, bond declines are close to 10%.

Listed infrastructure was a bright spot.

As featured in our last update international infrastructure is expected to be more resilient to inflation risks, and this has been the case over the past year. It increased around 2% in the quarter and 17% over the year to June in NZD terms. Global listed property returned around -3% in NZD terms over the year, also a relatively strong result in the context of the large declines in global equities and bonds.

Figure 2: Infrastructure offered the highest returns over the year

Source: Morningstar Direct, MyFiduciary



An important key to investing is to remember that stocks are not lottery tickets.

Peter Lynch

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 -10.2%
PAST YEAR -13.5%

New Zealand Shares: New Zealand shares fell around 10% in 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 strong with an annual average return of around 8% over the period.
Source of figures: S&P/NZX 50 Total Return Index with Imputation Credits

QTRLY RETURN -3.0%
PAST YEAR -9.8%

New Zealand Fixed Interest: New Zealand investment grade corporate bonds fell around 3% in the quarter and returned around -10% for the year ended June 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. The silver lining is that NZ bond yields are now much higher at over 4% per annum.
Source of figures: S&P/NZX Investment Grade Corporate Bond Index

QTRLY RETURN -10.1%
PAST YEAR -4.0%

Australian Shares: Australian shares were less resilient this quarter, with the market down around 10% as in New Zealand. Within Australian equities, higher risk small cap stocks fell further, while value stocks out-performed and have been flat over the year to June.
Source of figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries

QTRLY RETURN -6.2% (-14.9% hedged)
PAST YEAR -3.7% (-12.4% hedged)

International Shares: International shares fell by around 6% in the quarter in NZD terms and almost 15% in NZD hedged terms. The performance difference reflects the NZD declining materially over the quarter, as it usually does in a "risk off" environment. Within global equities, higher risk small caps fell further, while value stocks out-performed, returning around -1.1% over the quarter and 5% over the year in NZD terms.
Source of figures: MSCI World Index; Morningstar Developed Markets NZD hedged, MSCI World Value

QTRLY RETURN -0.9%
PAST YEAR -16.0%

Emerging Markets: Emerging markets outperformed most other equity markets in the quarter, falling by "only" around 1%. This reflects them bearing the brunt of the sell off as war broke out in Ukraine in the previous March quarter. On an annual basis returns were poor at around -16% in NZD terms. Source of figures: MSCI Emerging Markets Index

QTRLY RETURN -4.5%
PAST YEAR -8.8%

International Fixed Interest: Global investment grade bonds fell -4.5% in the quarter and around -8.8% 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 continue increasing interest rates. Source of figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)

QTRLY RETURN -7.7%
PAST YEAR -2.7%

International Property and Infrastructure: International property stocks fell around 7% in the quarter in NZD terms while global infrastructure increased around 2.1%. On an annual basis infrastructure increased around 17%, while global property returned around -2.7%. in NZD terms. These asset classes have been relatively resilient to higher inflation, as should be expected given their income streams typically rise with inflation.
Source of figures: FTSE EPRA NAREIT, FTSE Dvlp Core Infrastructure TR USD

Q&A WITH AARON DREW

Insights now includes a section introducing the people Rutherford Rede engages with to build and maintain your investment strategy. Aaron is one of the principals of My Fiduciary; an organisation specialising in asset management and investment governance consisting of a team of experts with a wide range of prior experience across economics, modelling, portfolio construction, fund management, and research. Aaron and his team have been working with Rutherford Rede since 2015. They sit on our Investment Committee and develop the papers that are presented to the Committee each quarter.

Tell us a about your background and qualifications

I was born in Wellington and raised in West Auckland. I graduated from Auckland University in 1995 with a Masters degree in economics, and undergraduate degrees in statistics and finance. I started my career as an economist at the RBNZ and ended up running their forecasting and modelling teams before leaving to work offshore at the OECD in Paris in the early 2000s. My next big career shift was to work for the New Zealand Superannuation Fund in 2007, where I helped develop a number of their investment strategies and was part of the Fund's Investment Committee. In 2015 I left the Superfund to provide investment consultancy and education services, which continues today as a Principal at MyFiduciary.

What is your investment philosophy?

Given my economics and finance research background, and experience of markets through many cycles now, I would describe my investment philosophy as evidence-based and fairly contrarian. I get most nervous when markets are running very hot as they were up to the end of last year and am most excited about return prospects when we see a large sell-off. I do believe climate change risks are still not being factored in by markets in many cases, and for this and ethical reasons, I think that it's very important that Environmental, Social & Governance (ESG) risks are managed in any investment decision.

What do you think are the biggest challenges that asset managers will face over the next few years?

I think the biggest challenge which asset managers and investors are now grappling with is the return of interest rates to more sane levels. We are seeing businesses and investors alike who set their strategies on the basis that interest rates would stay at post-GFC lows 'forever' becoming unstuck, and this process probably still has some way to go when we look at asset classes like NZ residential property.

Do you ever take a punt in your personal investment strategy? If so, how often does it work out?

My personal strategy is pretty boring. I tend to invest in low cost broadly diversified funds that take into account ESG but do take less or more equity risk in line with a contrarian approach. I recently upped my exposure to global equities; we'll see how that pans out!

Do you think New Zealand has any challenges that are different to those faced by developed economies in general?

We have the tyranny of distance and small scale. That means we need to have business and macroeconomic policy settings that are at the head of the pack if we are to at least maintain our standard of living vis-à-vis most other developed economies.

Can you tell us a little bit about your family and what you do in your spare time?

Sure, my wife and I have 3 school-aged children aged 9 to 17, and a 2-year-old dog that is often more trouble than the three combined. Aside from ferrying around the kids to their various activities, my current obsession is tinkering with my hi-fi system. We also love to travel and are looking forward to a few weeks in Canada at the end of this year now that our borders are open again.

THE VALUE FACTOR

Insights looks to provide ongoing explanation to Rutherford Rede's investment strategy. With each edition we will bring you a feature on one aspect of our strategy, highlighting its role in achieving investment returns and which provider we use to deliver the outcomes we are trying to achieve from that particular aspect. This time we bring you the Value Factor.

First though a brief revision of our strategy. We look to build portfolios that are very broadly diversified across markets and asset types; diversification helps manage risks and smooths returns. Your portfolios will perform very consistently with the market with the use of factors to enhance market return of the medium and long-term. We gain exposure to asset types that have been proven to deliver the return expected and deserved for investing in the chosen assets. We do not try to time markets or select individual under-priced assets as academic research shows this to be a folly. The track record of providers who consistently 'pick winners' is well under 50% and for us we need greater certainty when managing your money for you. We need to be confident that the returns expected from our investments over the long-term can be relied on so that future spending budgets can be sustained. Put simply, we want the greatest probability that investment returns match with your goals. Speculation, therefore, is not an option for us.

We invest in a very broad representation of market assets like shares, listed property, listed infrastructure and bonds. With respect to shares we add exposure to types of shares that academic research confirms as providing higher returns over the long-term; these types of shares are known as factors and include the value factor, the size factor and the profitability factor. This time we bring you the Value factor.

Value investing is an approach that essentially looks to add-value by investing into cheap assets. The idea sounds simple, but in practice there is a fair bit to it. Below we outline our approach to capturing the so called 'value factor' and cover a global value fund run by the manager Dimensional Fund Advisers (DFA).

What is the value factor and how does it contribute to investment returns?

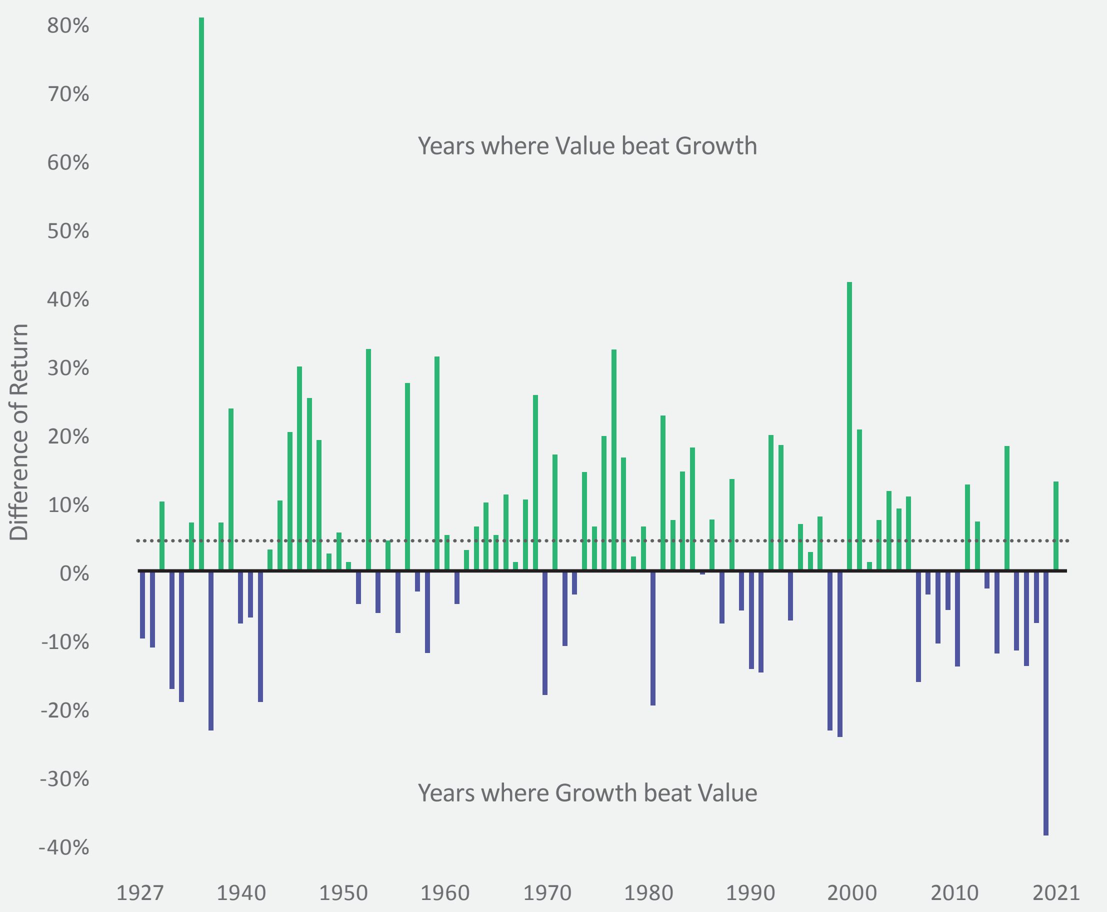
Value investing relies on a belief that stocks that are 'cheap' will outperform those that are 'expensive'. Common summary ratio metrics that are used to help determine what stocks are cheap or expensive are the price to earnings, price to book, and price to cashflow ratios. In equity markets, investing in the market value factor means putting more weight on stocks that are priced at lower levels than the market overall, and less weight on stocks that are priced at higher levels.

Why are we confident the value factor will deliver a premium?

Intuitively it is reasonable to think that cheap stocks should outperform expensive ones. Academic studies back this up - over the long-term and across many equity markets 'value' delivers a premium. The chart below from DFA shows that from 1927 to 2021 'value' outperformed 'growth' (stocks with high ratios) by around 4% p.a. on average. But the chart also suggests this outperformance is erratic. It is far from consistent year on year, and while value has been strong in 2022, over the past decade the value factor has under-performed.

Value Add

Yearly observations of premiums: value minus growth in US markets, 1927-2021



Who are DFA and do they satisfy of our due diligence requirements?

DFA was established in the US in 1981. Research conducted by Nobel prize winner Eugene Fama and colleague Kenneth French on the 'value' factor was the inspiration for the establishment of DFA, and both are directors of the firm.

The funds that DFA run all apply a rigorous research-based approach to investing. Today, DFA manages approximately NZD 1 trillion and has 1,400 employees in 14 global offices. We employ several DFA funds in our portfolios and have had no issues in terms of their ability to satisfy our due diligence requirements.

Why do we choose Dimensional Global Value Trust to gain exposure to the value factor?

Dimensional Global Value Trust is long-established fund designed to capture the value factor in global equity markets. We believe that their rigorous factor approach is more likely to deliver the performance of the value factor than a value manager who selects a relatively small number of stocks only. The fund 's management fee is relatively low at under 0.5% per annum and the manager tends to perform well relative to the peer group of value funds that we monitor.

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