RUTHERFORD REDE

insights

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IN THIS ISSUE

ECONOMIC & MARKET COMMENTARY

DECEMBER QUARTER 2022

Overview

Interest rate increases and the pandemic and war "shocks" hit returns hard over 2022.

So long and good riddance to 2022! War, inflation, rising interest rates, and supply-side hangovers from the pandemic drove poor performance by most asset classes over the year. This was most notably the case for bonds, which normally act as a 'safe haven' when equity markets fall. In contrast, Aussie shares, value stocks and asset classes that offer inflation resilience such as infrastructure and short-term credit fared much better. The portfolios we design include these exposures and as such performed relatively well in the context of the large market declines.

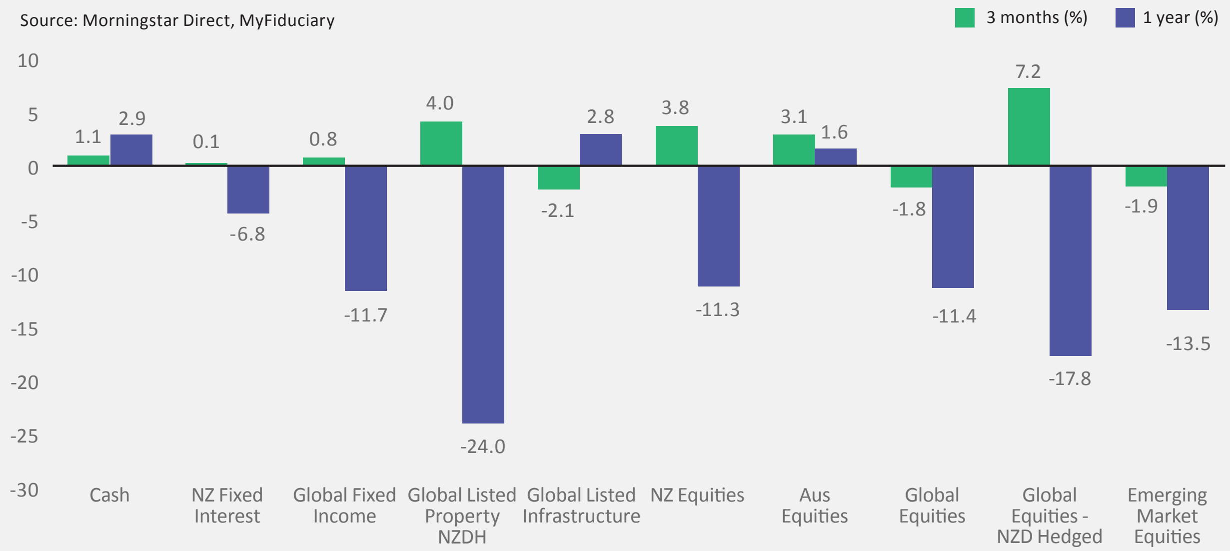
Purely speculative investments fared the worst, while inflation-resilient assets and 'alternatives' fared well.

Markets had to adjust to interest rates returning to more normal levels, and large cap growth-stocks (such as Meta and Tesla), which had led the market on the upside, suffered much larger declines than the overall market. Purely speculative investments, such as digital currencies and NFT tokens, were harder hit still, with some suffering complete capital loss. These type of adjustments – unfortunately – occur every cycle as 'speculative excesses' are worked through (or, less euphemistically, as the naïve are parted from their money). Our principles of portfolio design ensure we avoid such investment. Closer to home, we also saw residential property prices begin to fall – again ending the myth that they can only rise!

The adjustment was not accompanied by a financial crisis as in 2008.

Despite the seismic shift in interest rates and accompanying asset price declines, one welcome aspect **we didn't see** over 2022 was the type of stresses associated with the global financial crisis of 2008. Overall, the adjustment to higher rates globally has been fairly orderly, and, as discussed below, the silver lining is that we should now expect higher longer-term returns from most asset classes given higher cash rates and income yields on offer. In our view, risks are now more evenly balanced. Although economic growth is expected to be quite weak in 2023, with many economies likely to experience recessionary conditions, this reduces the risk of core inflation grinding higher still. Energy prices are now clearly off their peak, in part due to the good luck of a very warm European winter, which will reduce headline inflation rates

Figure 1: Annus Horribilis



Market roundup

Currency movements again had a large impact on December quarter returns. NZD hedged international equities offered the best return, while unhedged equities fared poorly.

Market performances are reported in Figure 1. International shares on an NZD hedged basis rallied around 7% in Q4, but fell by around 2% in NZD terms. The difference reflected that, yet again, currency volatility was a key feature of the quarter, with the NZD rallying as the shine came off the previously very strong USD.

For calendar-year 2022, International equities declined around 11% in NZD terms, which was in-line with the return from NZ equities. In contrast, Australian equities, with their resource focus, performed relatively well.

Within global equities, value stocks also outperformed, returning around 2.6% over the quarter and 1.2% over the year in NZD terms.

Value stocks had a relatively strong year, as did Global Infrastructure.

However, higher risk small caps and Emerging Markets fared worse, returning around -12% and -13.5% in 2022 respectively.

Global bonds underperformed global equities over 2022 – one for the record books.

NZ and International investment grade bonds eked out small positive returns in the quarter bolstered by their now meaningful running yields. But quite strikingly, over 2022 as a whole, International Bonds fared marginally worse than International Equities. This is very unusual in financial history. The silver lining is that their cash yields, at +5%, are back to around 'normal' pre-GFC levels. This means that we can expect bonds to play their traditional diversification role should inflation and growth outturns be weaker than is currently being priced by the market.

International property stocks increased 4% in the quarter in NZD hedged terms, but performance over 2022 was very weak on both a hedged and unhedged basis as the office segment, in particular, priced in much lower tenancy demand. In contrast, global infrastructure performed well once again, returning a handy 3% for calendar 2022 on an unhedged basis.

The outlook ahead

We expect higher longer-term returns given higher cash rates and the market declines over 2022.

No-one can consistently forecast short-term market movements, though, as per our last update, we believe that inflation is the key economic determinant for markets to be able to form a bottom, and to rally from current levels. In our view, current and forecast interest rate levels should be sufficient to reduce inflationary pressures, though the surge in Covid in China may reignite short-term supply-side challenges. Of course, we also need to take into account the war in Ukraine, which presents considerable uncertainty and both upside and downside risks.

One aspect we are more confident about, given both long term financial history and basic investment logic, is that over the medium to longer-term markets offer a premium, or excess return, to cash, to compensate for their higher level of investment risk. It follows, that with Central Banks now having finally performed their jobs and raised rates to more normal levels, we should expect higher longer-term returns. To take a simple example, NZ investment grade bonds now offer running yields over 5% per annum (a 1% or so premium to the OCR), compared to under 2% a couple of years ago).

Figure 2: The longer-term risk return trade-off has improved

Source: MyFiduciary

Figure 2 above presents our updated long-term forecasts for a range of asset classes taking into account higher cash rates and the sell-off in markets over 2022. These are compared to the same forecasts made in 2021. We see that there is an increase in the level of returns expected for the risk borne across all the asset classes we consider (compare the blue line to the green line). Furthermore, we see that most assets classes lie close to the blue line, indicating that they are now around 'fair value'. This is a marked change from 2021 where we saw more variability with low-risk assets classes (ie bonds) being particularly expensive, as indicated by the green dots lying well below the green line in the bottom left.

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 + 3.8%
PAST YEAR − 11.3%

New Zealand Shares: New Zealand shares increased around 4% in the quarter despite the ongoing challenging market environment. Over the year to September returns were -11.3%, but remain very solid over the past 5-years and decade with annual returns of around 7.5% and 12% respectively.

Source of figures: S&P/NZX 50 Total Return Index with Imputation Credits

QTRLY RETURN + 0.2%
PAST YEAR − 5.1%

New Zealand Fixed Interest: New Zealand investment grade corporate bonds increased in the quarter and returned around -5.1% in 2022. The negative annual result reflected materially higher interest rates and inflation, which caused bonds to suffer a short-term capital loss. The silver lining is that NZ bond yields are now much higher at over 5% per annum.

Source of figures: S&P/NZX Investment Grade Corporate Bond Index

QTRLY RETURN + 3.2%
PAST YEAR − 0.2%

Australian Shares: Australian shares remained a bright spot, returning around 3% in the quarter, and a fairly flat performance over the year in NZD terms. Value stocks outperformed, returning 4.2% over 2022, while small caps significantly under-performed with a 17.6% return over 2022.

Source of figures: S&P/ASX 200, S&P Australia BMI Value, S&P/ASX Small Ordinaries

QTRLY RETURN − 1.8% (+7.2% hedged)
PAST YEAR − 11.4% (-17.8% hedged)

International Shares: International shares fell by around 2% in the quarter in NZD terms, although this was due to a large rally in the NZD (fall in the USD) over the period. In NZD hedged terms the return was around +7.2%, in line with the rally in offshore markets. Within global equities, value stocks returned around 2.6% over the quarter and 1.2% over the year in NZD terms. Small caps fared worse, returning around -12% in 2022.

Source of figures: MSCI World Index; Morningstar Developed Markets NZD hedged, MSCI World Value MSCI World Small Cap in NZD terms.

QTRLY RETURN − 1.9%
PAST YEAR − 13.5%

Emerging Markets: Emerging Markets under-performed in the quarter, falling by around 2% in NZD terms. On an annual basis returns were around -13.5% in NZD terms, mildly behind returns of developed markets on an unhedged basis.

Source of figures: MSCI Emerging Markets Index

QTRLY RETURN + 0.8%
PAST YEAR − 11.7%

International Fixed Interest: Global investment grade bonds slightly increased in the quarter, but ended the year down 11.7% – a worse result than those of NZ and global equities (unhedged basis). This reflected Central Banks finally moving away from ultra-loose monetary policy on the back of surging inflation. With interest rates now back to more 'normal' levels, interest rate risk is now much more evenly balanced, and bonds now again offer the prospect of solid returns given their high-running yields.

Source of figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)

QTRLY RETURN + 4.0%
PAST YEAR − 24.0%

International Property and Infrastructure: International property stocks increased around 4% in the quarter in NZD hedged terms while global infrastructure increased around 7% on a NZD hedged basis. Over 2022 infrastructure returned -3% and global property returned around -24% on a NZD hedged basis. On an unhedged basis annual returns were better at around -19% for property and +3% for infrastructure.

Source of figures: FTSE EPRA NAREIT, FTSE Dvlp Core Infra 50/50; NZD & NZD-hedged basis

Q&A WITH NOAH SCHILTKNECHT

Insights introduces people that we work closely with so that you can understand the wider team that provides our services. This edition introduces Noah Schiltknecht, an investment professional who has been a member of our Investment Committee since 2019.

Noah, where did you grow up and how did you come to live in New Zealand?

I grew up in Zurich, Switzerland and studied economics at the University of Bern. After University, I started a job at Swiss Re, a reinsurance company in Zurich. After our marriage in 2003, my wife and I thought that it was time to explore the world a bit more. I took a break from work, and we went on a trip around the world. This brought us to New Zealand for the first time. We immediately fell in love with the country, the people and the lifestyle. On the plane from Fiji to New Zealand, we sat next to a farmer who invited us to come and visit him at home and have lunch. The welcoming and open-minded nature of New Zealanders impressed us straight away.

After our trip, I went back to work at Swiss Re, and we decided to postpone our dream of living in New Zealand and have kids first. When our family outgrew our tiny apartment in 2008, it was finally time to give it a go. I quit my job and we put the family on a plane. It happened to be in the middle of the global financial crisis, so the timing was not ideal. But the rest is history, as they say.

What do you like most about providing asset consulting?

I enjoy having a positive impact on our community. Be it through a retail advisory firm, a not-for-profit or a superannuation fund; good asset consulting will help to better the situation for someone in the community – without disadvantaging others. That is a powerful motivator that helps to give my work purpose. Naturally, I am also a bit of a geek that enjoys numbers and statistics, and I do enjoy researching investment managers, where rational, economic decision-making and psychological biases sometimes clash. But first and foremost, the enjoyment comes from the purpose.

Where did you learn how to be an asset consultant?

I have two decades of experience with investments in different roles and markets. In addition, I have always tried to learn more outside of work, whether through personal experience in investing or through reading books and studying. So, the understanding of investments has grown naturally over time. However, the formative years

for learning the craft of asset consulting were definitely my first few years at Russell Investments in New Zealand. That is when I fully appreciated how an institutional investment programme should be built and governed. I also learned to avoid one of the main traps people fall into when investing: selecting managers based on past performance. Working with institutional clients also taught me how important trust and personal relationships are to asset consulting. It is not just about theory and knowledge; you need to earn clients' trust to be able to give them good advice.

Do you follow your own advice when it comes to personal investing?

I do, for the most part. My portfolio looks relatively institutional, and I believe I am able to avoid irrational, short-term decision-making such as following hypes and panics in my own investments. However, I have to admit that I still have a small number of individual stocks. That is not something I would recommend to my clients; I know I am unlikely to outperform the market! Accordingly, I restrict myself from taking any significant risks with single-stock investments.

What do you like most about living in New Zealand?

I love the lifestyle and the community: down-to-earth people and friendly interactions in a beautiful, relatively unpopulated – and warm - country. I do not think there is any other place in the world where you can get that, and I am grateful that my family and I are healthy and in a position to enjoy it.

Tell me about your family and what you like to do when you are not at work.

I have a lovely wife and three amazing kids, a 17-year old boy and two girls, 14 and 9. I love seeing them grow up, spending time with them, and doing things we all enjoy as a family. This often involves some physical activity: surfing, wakeboarding or hitting the slopes in winter, for example. We also enjoy travelling and exploring New Zealand and other countries. Every now and then, I also read a book and watch a movie or listen to music to relax. And I do like to watch sports as well. When we moved to New Zealand, my wife was hopeful that taking the ability to follow ice hockey and football away from me would free up some wasted time. But I adapted quickly and now enjoy watching rugby and cricket as well.

LISTED REAL ESTATE
AND THE ROLE IT HAS IN YOUR PORTFOLIO.

The portfolios we offer have around a 5% weight to global listed real estate investment trusts (REITs). REITs invest into income-generating property assets. Examples include residential apartments, cell towers, data centres, hotels, medical facilities, offices, retail and warehouses.

The inclusion of infrastructure is motivated by several factors. First, the yield of the underlying properties resets reasonably frequently and is often indexed to inflation. As a result, this asset class is generally considered to be one of the better ways to protect against rising inflation. Second, the long-dated nature of property assets provides a relatively stable income stream, although capital values can be volatile. The asset class has characteristics of both growth and income assets, and accordingly we regard REIT exposures as 50% growth. Third, although impacted by economic conditions, REITs perform differently to equities and bonds and as such is likely to offer a portfolio diversification benefit.

Access to listed property can be either local or global, although we prefer the latter because certainly New Zealand, and even Australia, are both too small to offer sufficient diversification. Our global REIT exposure is obtained through the Dimensional Global Real Estate NZDH Fund, which is run by the US based quantitative manager Dimensional Fund Advisors. This fund was selected because it is highly aligned with our investment philosophy of favouring low cost, broadly diversified exposures. All Dimensional funds have tilts to value, size (smaller is better) and profitability. The fund, which is hedged to NZD, tracks a 'reference index' comprising the S&P Developed ex Australia REIT index and the S&P/ASX 300 A-REIT Index, both hedged to NZD. Australian holdings represent around 15% of the fund which is several times larger than its weight in global indices. The sectoral make up of this fund is provided in the table to the right.

REIT Industries

Specialised REITs	28.03%
Industrial REITs	16.17%
Retail REITs	16.16%
Residential REITs	12.66%
Diversified REITs	9.62%
Office REITs	8.17%
Health Care REITs	6.59%
Hotel & Resort REITs	2.53%
Other Real Estate	0.03%
Other Non-Real Estate	0.01%

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