RUTHERFORD REDE

insights

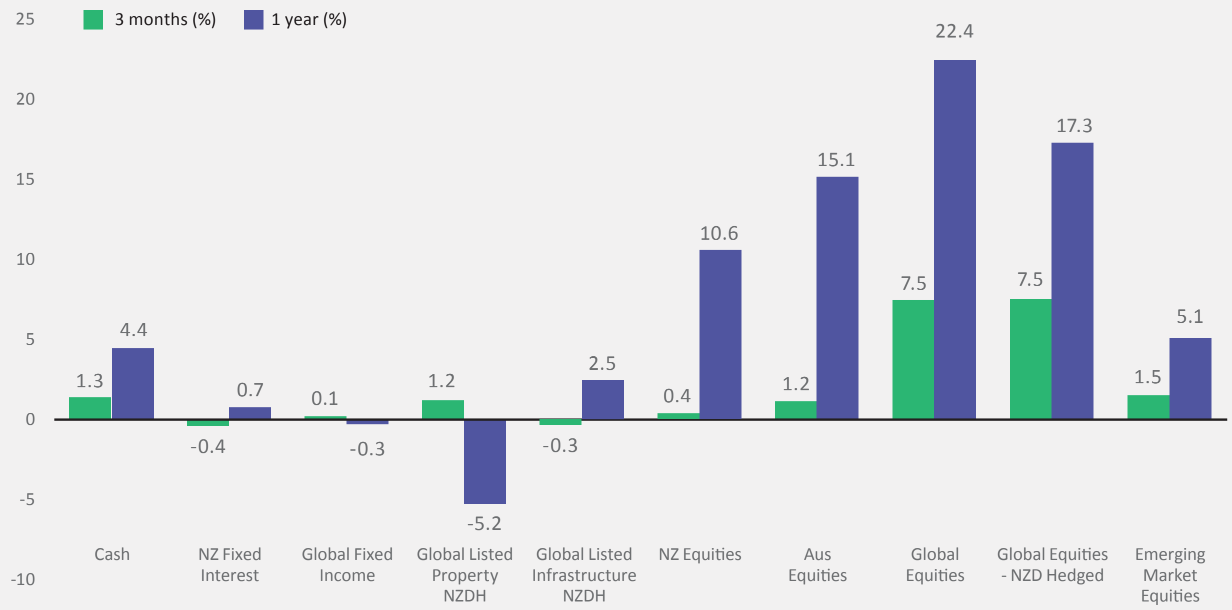
WINTER 2023
IN THIS ISSUE

ECONOMIC & MARKET COMMENTARY

JUNE QUARTER 2023

Figure 1: Global equities performed well, elsewhere was more subdued

Source: Morningstar Direct, MyFiduciary to 30 June 2023



Overview

Markets climbed higher over the June quarter, led by the tech sector.

Global equity markets bounced higher again in the June quarter, the second quarter in succession. This was in part due to continued evidence of CPI inflation moderating, but mainly because larger cap tech stocks rallied on the prospect that they will see another surge in profitability as machine learning and related 'AI' algorithms are integrated into their core products and services.

Market roundup

Global equities had the strongest returns, elsewhere performances were subdued.

Market performances are reported in Figure 1. International shares rallied strongly by around 7.5% in the June quarter, but elsewhere performances were more subdued. Australian and EM equities and global listed property increased a little over 1%, NZ equities rose around 0.5%, while bonds were flat to slightly declining, as was global infrastructure.

Global equities are now back around the peaks reached in 2021, but NZ equities and bonds still have ground to make up.

Over the year to June, performance was very strong for most equity markets, with global equities in NZD terms leading the pack being up 22.4%. This gain more than offsets the decline over 2022. However, in part this reflects that the NZ dollar also plummeted over 2022, and has not bounced back nearly as much. On a local currency basis global equities are still slightly below the peak levels they had at the end of 2021.

In contrast to global equites, NZ equities are still around 11% lower than their 2021 peak levels. Bonds have a similar amount of ground to recover given the large marked-to-market declines they suffered in 2022. The good news in this regard is that with running yields now around 6% for investment grade funds, and with inflation trending lower, we can reasonably expect this ground to be made up over the next year or two assuming that the macroeconomic picture evolves broadly in line with what is expected.

Reading the tea leaves

Central banks appears to have gotten on top of inflation, but it is too early to declare victory just yet.

There is now little doubt that inflation rates and economic activity is declining both in New Zealand and globally. This is welcome news for central bankers trying to return CPI inflation back to their target levels, but cold comfort for almost everyone else. The key question remains have they done enough?

Bond markets seem to think so. Interest rate yield curves are inverted, meaning that short term interest rates are higher than

expectations of future short term rates. This is shown in Figure 2 for New Zealand, which is expected to be amongst the first countries to start cutting. Interest rates in one years' time are expected to be around 0.5% lower, and in 5 years' time over 1% lower. But bond markets, like macro economists, are not great at forecasting. The chart also shows that the level of the curve has jumped up from its levels of just one month ago. This reflects that while inflation is coming down, 'core' inflation rates are still too high for central banks to declare victory, meaning interest rates may stay higher for longer. Time will tell.

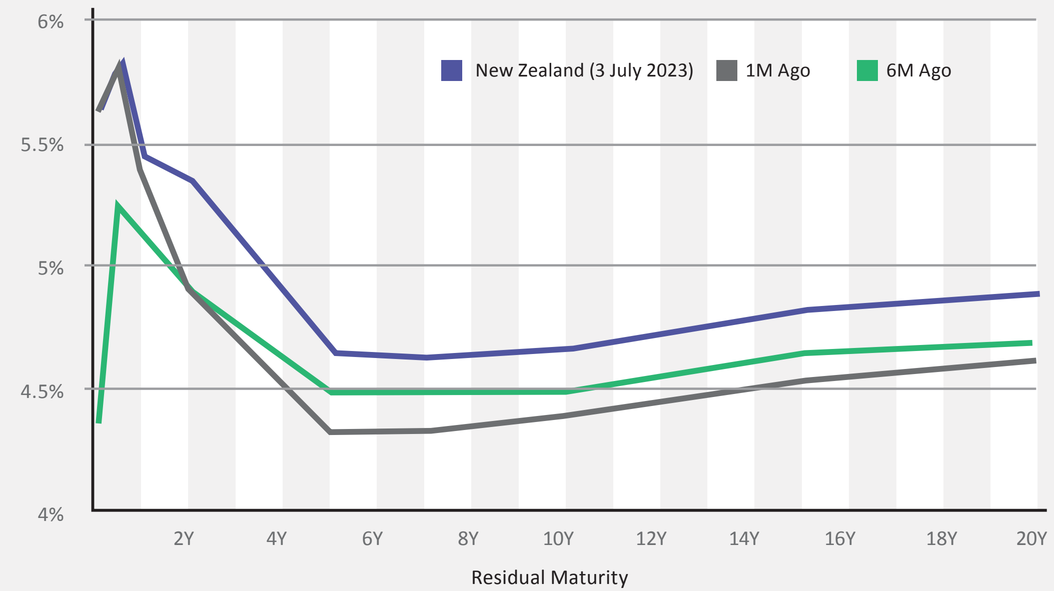
Global geo-political risks around the Russian-Ukraine War, the tussle between the US and China, and now the divide between the so called BRICS and the West remain on the radar. As does the increasing severity of extreme weather events as climate change gathers pace.

AI software advances are poised to unleash a surge in productivity.

But to end on a positive (probably) note, the AI tools rolling out across a range of applications do present a large upside potential to economic growth and productivity levels, and in that sense the surge in select tech stocks may not be all pie in the sky. Goldman Sachs[1] estimates that AI could lift global GDP by 7% and productivity by 15% over the next decade – a simply enormous gain of more than double average annual global GDP growth. While we should treat these estimates with a healthy grain of salt, it is also worth remembering that ultimately productivity is most of what propels livings standards and equity markets higher – as uncomfortable as they are at the time interest rate cycles and most other 'shocks' just cause blips along the way.

Figure 2: Bond markets think the RBNZ has more than done enough

New Zealand Yield Curve: New Zealand Government Bonds
Source: Highcharts.com



1 https://www.goldmansachs.com/intelligence/pages/generative-ai-could-raise-global-gdp-by-7-percent.html

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
+ 0.4%
PAST YEAR
+ 10.6%

New Zealand Shares: New Zealand shares increased marginally over the quarter. Over the year to June returns were around 10.5%, reflecting the rally off the low point reached in June last year.

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

QTRLY RETURN
+ 0.4%
PAST YEAR
+ 2.0%

New Zealand Fixed Interest: New Zealand investment grade corporate bonds increased 0.4% in the quarter and 2.0% for the year ended June 2023. The positive annual result is a marked turn-around from prior negative results and reflects that interest rate increases made by the RBNZ are now likely "priced in".

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

QTRLY RETURN
+ 1.0%
PAST YEAR
+ 14.8%

Australian Shares: Australian shares increased around 1.0% in the quarter and 14.8% over the year to June in NZD terms. Australian value stocks have had a similar performance over the year, but small cap stocks have underperformed, returning around 8.5% over the year.

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

QTRLY RETURN
+ 7.5%
(+7.5% hedged)
PAST YEAR
+ 22.4%
(17.3% hedged)

International Shares: International shares rallied strongly again over the quarter, by around 7.5% in NZD terms and in NZD hedged terms. This brought the annual results to around 22.5% in NZD terms, implying global equities are now back to the level they had in March 2022. Much of the recent rally has focussed on larger cap tech stocks. As a consequence, value and small caps under-performed. Small caps returned 3.9% in the quarter and 16.7% over the year, while value stocks returned 3% in the quarter and 10.7% over the year to June.

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

QTRLY RETURN
+ 1.5%
PAST YEAR
+ 5.1%

Emerging Markets: Emerging Markets also increased over the quarter by around 1.5% in NZD terms. On an annual basis returns were around 5.1% in NZD terms, which was behind returns of developed, NZ and Australian markets.

Source of figures: MSCI Emerging Markets Index

QTRLY RETURN
+ 0.1%
PAST YEAR
- 0.3%

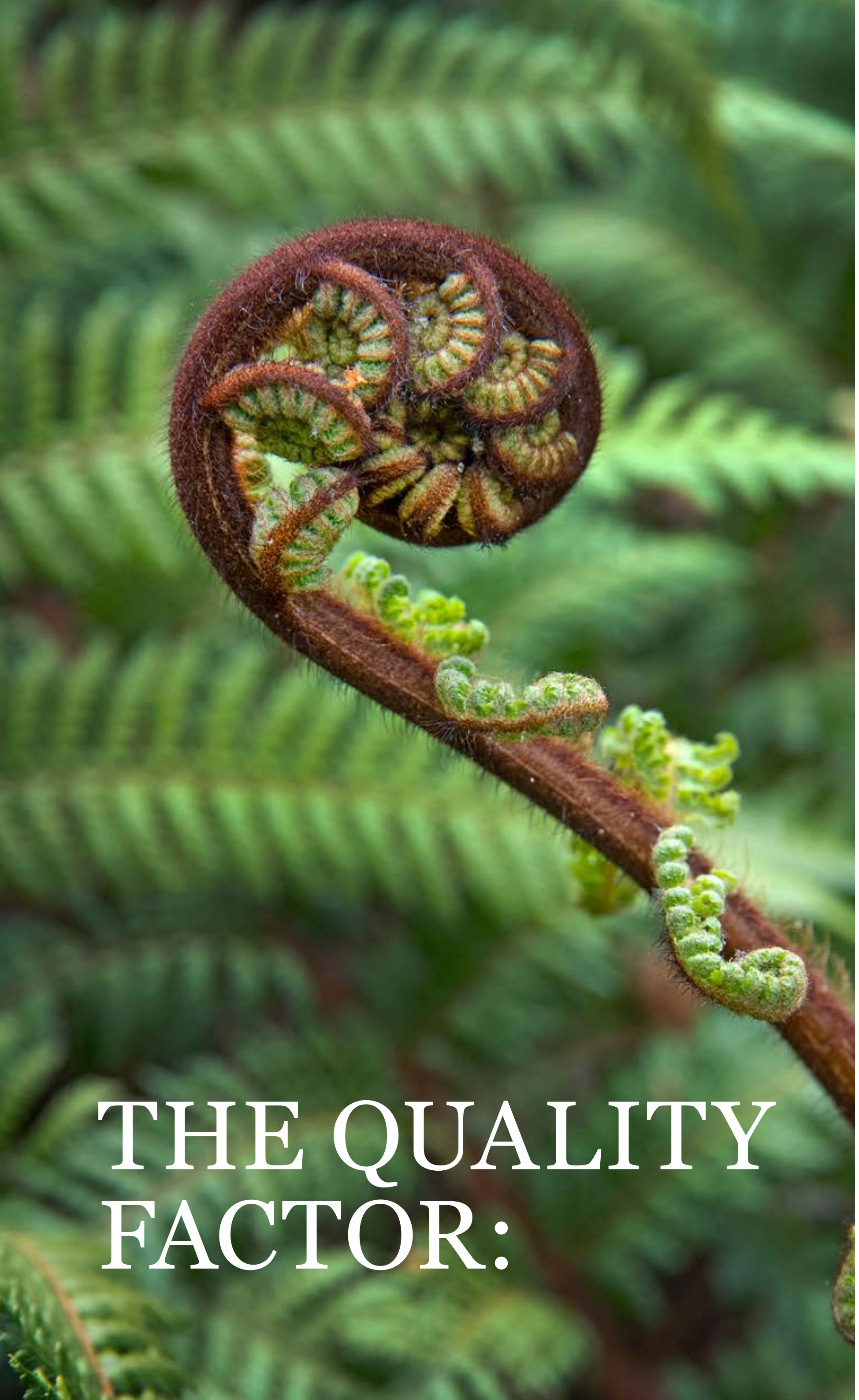
International Fixed Interest: Global investment grade bonds returned around 0.1% in the quarter, and ended the year to June slightly down by around 0.3%. With interest rates now back to more "normal" levels, interest rate risk is now much more evenly balanced, and bonds offer the prospect of solid returns given their high running yields of around 6%.

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

QTRLY RETURN
+ 1.2%
PAST YEAR
- 5.2%

International Property and Infrastructure: International property stocks increased by around 1.2% in the quarter in NZD hedged terms, while global infrastructure fell around -0.3%. Over the year infrastructure returned around 2.5%, and global property returned around -5.2% on an NZD hedged basis.

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



THE QUALITY FACTOR:

Along with exposure to small and value factors, in some funds we also have an exposure to the "quality" factor. Below we outline what this factor is, why we choose to select for it, and our approach to capturing this factor.

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

A listed company is judged to be high quality if some combination of its profitability, after tax cash-flows, balance sheet strength, earnings and dividend history, and governance are better than market averages. While there are a lot of ways of measuring these attributes, in essence a quality company is more likely to be profitable over an economic cycle, and less prone to suffer stress in a recession, than the 'average' company. As such sometimes the quality factor is also referred to as a profitability factor.

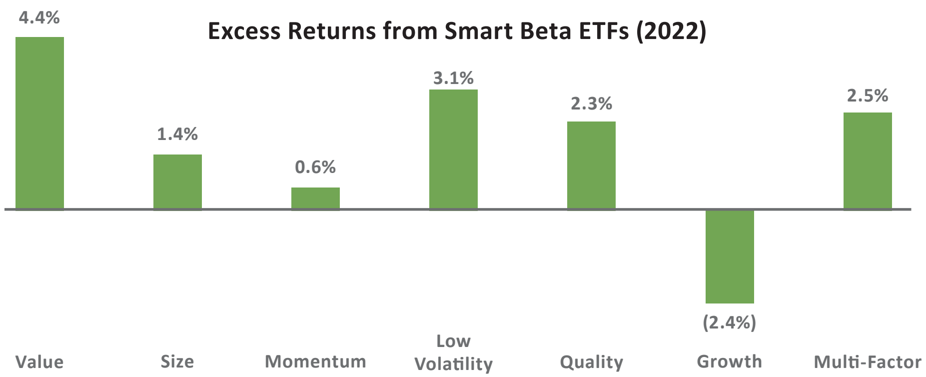
Investing in the quality factor relies on a belief that stocks that are more consistently profitable and resilient to adverse economic conditions are likely to outperform stocks that have less consistent profitability over time. This out-performance is more likely to be realised in stressed market conditions, which may help meaningfully reduce the size of losses an investor faces when equity markets decline.

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

Intuitively it is reasonable to think that higher quality stocks should out-perform lower quality stocks in times of stress. But given this, we might think this advantage is "priced in" and as such there is no long-term premium or extra return from investing in the quality factor. Academic studies, however, suggest this is not the case. Quality companies are estimated to out-perform lower quality companies by around 1-3% per annum on average across global equity markets. In 2022, a study of quality ETFs found that they out-performed the market on-average by 2.3%, in line with the longer term academic estimates. This is seen in the graphic below, which also shows that value stocks also handily outperformed over calendar 2022.

How do we gain exposure to the quality factor?

While we have no funds dedicated to capturing the quality factor in isolation in our portfolios several equity funds include quality as factor, alongside other factors that the manager targets. In particular, Dimensional includes the quality factor in its global core and small cap funds. This inclusion is consistent with a multi-factor approach, which reduces the risk of any single factor not delivering in any given year. Over calendar 2022 when global equities fell around 11.5% in NZD terms this was put to the test. Dimensional Global Core and Global Small both outperformed global equities (MSCI World basis) by 3.7%, handily cushioning the large fall in markets.



Q&A WITH PATRICK FOGARTY

Insights introduces people that we work closely with so that you can understand the wider team that provides our services.

Where did you grow up and where have you lived in the world?

I grew up in Christchurch, the youngest of four brothers. My father, Paul, was a Surgeon and my mother, Joanna, worked in television. I went to school at Christ's College, then took the well-trodden path to Otago University, before moving up to Wellington to complete my degree at Victoria.

After a very brief failed attempt at becoming an actor, I moved to London with the humble ambition to become a rockstar. Also a failure. London became home for over a decade, with dreams of rock stardom slowly abating/morphing into the realities of finance.

What brought you back to New Zealand and how long have you been here?

I returned to New Zealand in 2018. One of the main reasons I left London was to be closer to my father, Paul, who suffers from dementia. It was becoming progressively difficult to be away, and it was important to me that I was able to see him more often than once a year.

I was also keen to make a move out of the corporate world into private client advice, where I could use my knowledge of investing and finance to help people 'in the real world'.

Lastly, I missed the lifestyle that New Zealand offers. I love being in the outdoors and missed spending time in my 'happy place' the Marlborough Sounds. You can't go spearfishing in London!

Tell me a little bit about your family?

I met my wife, Sophie, not long before deciding to move to New Zealand. Luckily, she was open to the idea and made the move with me. Sophie owns a business called Unity Studios, a pre/post-natal physiotherapy clinic that she set up with her business partner, Caitlin Fris. I am immensely proud of what she has been able to achieve in such a short space of time, especially in a foreign country.

We have a little toddler called Hazel, who has been tearing up our house for the last two and a half years, and a new arrival, Olive, who is almost two months old. Hazel is a very loving big sister and is slowly getting used to being 'gentle' with her much less robust sister. Long may that trend continue!

Soph and I both have family in the UK which can be hard, especially for Soph who has both parents and her extended family in and around, London.

Why did you decide to engage in a career in financial planning?

I decided to pursue a career in advice as it affords the ability to have a direct relationship with the people you are helping day to day. We get to work with such interesting people, with such unique stories, stories, and it is an immense privilege to be held in a position of confidence and trust by so many individuals and families.

Investing and financial planning are the tools we use, but what we achieve for the clients we work for is so much more important than that. Giving people peace of mind and confidence when they have experienced tragedy, providing a blueprint to achieve financial independence, helping people provide for their children and grandchildren, these are things financial planning enables, and the reason I love my job.

What do you think matters most in having a good financial plan?

I think it is the discipline that working inside a financial planning framework brings. Identifying your objectives, quantifying them, setting up a strategy to achieve them, and monitoring your investments to make sure you are on track requires a lot of time and energy.

Working with a dedicated professional ensures that you don't neglect this important area of your life, and while a lot of people have the financial acumen to engage in this work, very few have the time or inclination to give it the attention it needs and deserves.

How has your experience working for fund managers strengthened your ability to deliver sound financial advice?

Prior to Rutherford Rede I worked for Dimensional Fund Advisers, one of the largest asset management companies in the world. The unique thing about Dimensional was the proximity it held to the academic world, and as a result, its financial pedigree. Dimensional has deep connections with Chicago Business School and has worked closely with a number of Nobel Laureates, including Eugene Fama, a bit of a personal hero to me. Dimensional pioneered what is called the 'evidenced based' approach to investing, and the ideas and concepts I was exposed to over the decade I worked for them had a massive impact on me.

A big part of my job at Dimensional was helping to communicate these often-complex academic investment principles in a way that anyone could understand them. I loved this part of the job and continue to utilise these skills when interacting with my clients.

Helping people understand money and investing is hugely important in my opinion, and badly neglected in our society. Understanding even just the basic principles of successful investing can have a massive impact on the financial decisions people make throughout their lives.

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