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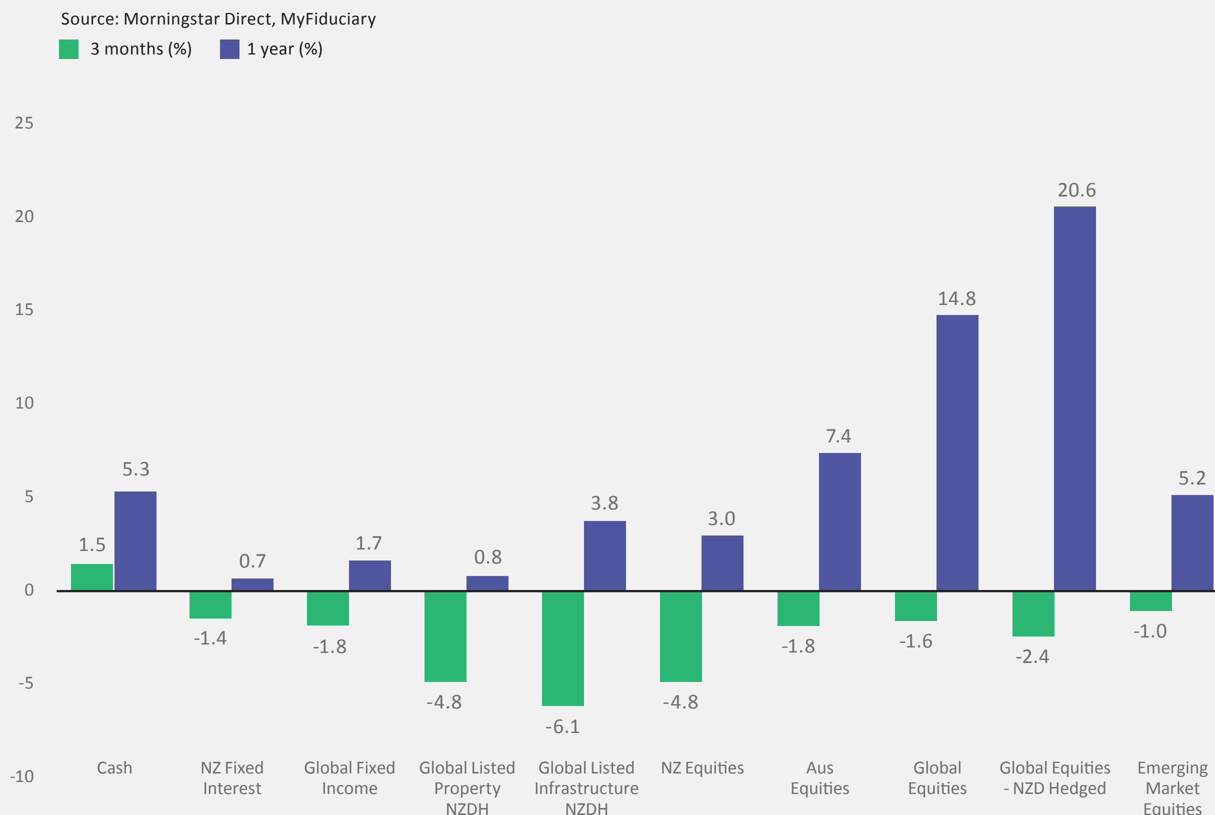
Q&A with Herna Maddock

ECONOMIC & MARKET COMMENTARY

SEPTEMBER QUARTER 2023



Overview

Most asset classes suffered negative returns in the September quarter.

The strong first half of calendar 2023 gave way to a pull back in the September quarter. Most conventional asset classes suffered negative returns, including global and NZ equities, global and NZ fixed income, and listed property and infrastructure. In contrast, cash and short-term bonds fared relatively well.

Economies performed better than expected, meaning interest rates may be higher for longer.

The main factor behind the sell-off is concern that interest rates need to be higher for longer. While inflation has been trending lower, it is still higher than central bank targets. Economic growth and employment levels have also been stronger than anticipated in many countries, including New Zealand, Australia and the United States. The silver lining in this regard is that these outcomes have lessened the chances of a large slump in economic activity, which is ultimately much worse for asset prices than a pull-back caused by activity being stronger than expected. In addition, higher interest rates mean that the portfolios now have much higher income yields than they had a year or two ago. This source of return is much more certain (less risky) over the short term than the return from capital gains.

Market roundup

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

Market performances are reported in Figure 1. International, Australian and Emerging Markets equities fell moderately, as did NZ and global bonds. NZ equities, listed property and infrastructure had larger declines of around 5% or so.

Over the year to September, performances remain very strong for international equities, particularly on an NZD hedged basis, with returns of over 20%. The hedged performance is however flattered by the fact that September 2022 was a low point for our currency, and around 6% of the return is due to the NZ dollar appreciating against the US dollar from that point. Australian equities also performed well. Elsewhere returns were still mildly positive on an annual basis, although behind the return for cash.

As mentioned, there were some bright spots. So-called cash enhanced funds and short-term bonds performed well in the quarter given their high running yields of 6% or more.

DIVERSIFICATION & CORRELATIONS BETWEEN ASSET CLASSES

We seek to ensure portfolios are well diversified at the individual security and asset class level.

While a soft quarter is never comfortable, from an overall portfolio design point of view, we are perhaps most uncomfortable whenever we see everything going strongly up or down at once. Mixed performances over the short term indicate that portfolio diversification is working. In this section we elaborate on diversification and why it matters for returns.

It is intuitive that investing into a fund comprising many stocks is more diversified than a single or small number of stocks. Investing in single stock comes with the risk of permanent capital loss if the company suffers from an event that it never recovers from. In contrast, investing into an equity fund that comprises hundreds of stocks means that the failure of any one company, even a large global multi-national, has a negligible to small impact in the short run, and simply does not matter over a longer term. For this reason, the funds we select for the portfolios typically are very well diversified at the individual company or security level.

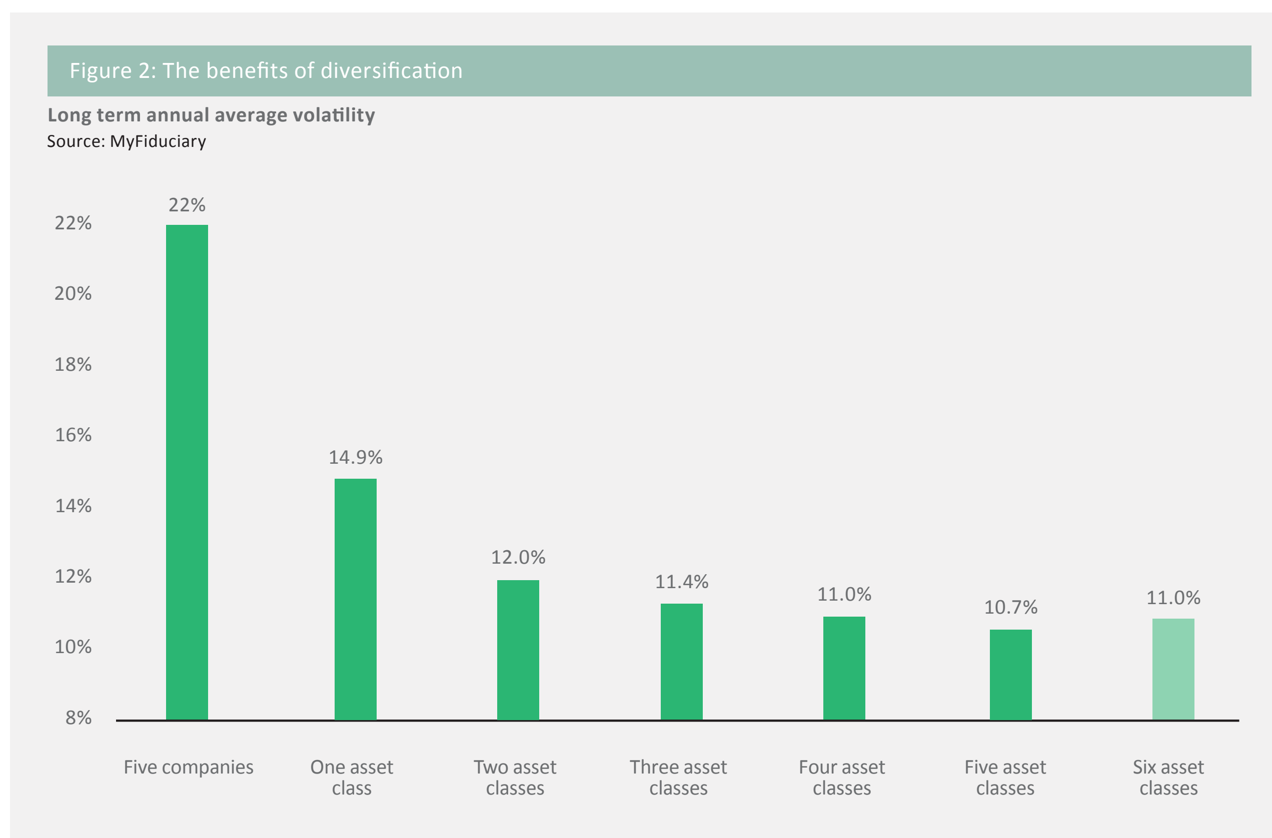
Asset class diversification reduces portfolio risk for a given return.

Perhaps less intuitively, diversification at the asset class level (cash, NZ bonds, global bonds, NZ and global equities etc) also matters, because it reduces portfolio risk, as measured by the volatility in portfolio returns, for a given overall portfolio return. For this reason, diversification has been referred to as the "one free lunch" in finance. An insurance policy reduces risk for the event insured against, but it also requires a premium or payment. No such payment is required to diversify portfolio risk through effective asset class diversification. To provide an illustration, Figure 2 shows a marked decline in annual volatility, for the same overall return, as we move from holding 5 global stocks (randomly selected) to a single asset class (global equities) to a range of different asset classes (different equity markets and fixed income).

Diversification occurs because markets have different drivers of return, they are not perfectly correlated.

Diversification occurs because asset class co-movements or correlations are not perfect. NZ equity returns do not always move in lock-step with global equities. In turn, this reflects that companies on our exchange are much more impacted by domestic economic conditions than any stock on, say, the US S&P500 exchange. In a similar vein, global listed property and infrastructure tend to be less impacted by global growth conditions, but are more sensitive to interest rate changes, than global equities overall. And NZ or global government bonds historically have had a very low, often negative, correlation with equities. Government bonds have typically rallied when equities have fallen as investors "rush to safety" that the relatively certain return quality bonds entails.

While we can expect diversification to occur from having a mix of assets classes in the portfolio, we can't expect it to work perfectly all the time. Over 2022 and in the current quarter, longer term bonds and equities both fell (were positively correlated) given the common "shock" of rates being higher for longer. In addition, there are potential limits to diversification. Adding an asset class to the portfolio that is very volatile and highly correlated with equities could raise, rather than reduce, overall portfolio risk, as illustrated in the final box of Figure 2.



The best source of diversification is time, which is why having a long term horizon is so important.

In designing portfolios, we are mindful of the fact that correlations can vary over time depending on economic conditions and the source of "shocks" to markets. Given this, our focus is on adding classes that should help diversify risk under a range of scenarios. And as always, the most important factor is time – bad outcomes tend to be unwound with time, and assets are more certain of earning a premium over cash the longer the time horizon. For this reason, we can regard time as the ultimate source of diversification.

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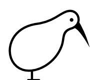
HOW THE MARKETS FARED

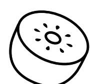
All returns are expressed in NZD. We assume Australian Shares and International Property are invested on an unhedged basis, and therefore returns from these sectors are susceptible to movement in the value of the NZD.



QTRLY RETURN
- 4.8%

PAST YEAR
+ 3.0%

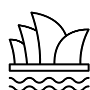
New Zealand Shares: New Zealand shares fell around 5% over the quarter. Over the year to September returns were still positive at around 3%, and the longer term 10-year return remains very strong at over 10% per annum..
Source of figures: S&P/NZX 50 Total Return Index with Imputation Credits



QTRLY RETURN
- 0.4%

PAST YEAR
+ 2.6%

New Zealand Fixed Interest: New Zealand investment grade corporate bonds fell -0.4% in the quarter as longer-term rates rose on the back of NZ GDP coming in stronger than expected. The annual return was around 2.5%, and with current yields on NZ corporate bonds now around 6.5% we can expect higher returns going forward.
Source of figures: S&P/NZX Investment Grade Corporate Bond Index



QTRLY RETURN
- 1.9%

PAST YEAR
+ 7.2%

Australian Shares: Australian shares fell around 2.0% in the quarter, but the annual return remains fairly solid at 7.2%. Australian value stocks faired better, with a flat quarterly performance and an annual return of around 8.5%. In contrast, Australian small caps fell 3% and are up only 1% for the year to September.
Source of figures: S&P/ASX 200, S&P Australia BMI Value, S&P/ASX Small Ordinaries

QTRLY RETURN
- 1.6%
(-2.4% hedged)

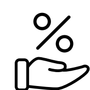
PAST YEAR
+ 14.8%
(20.6% hedged)

International Shares: International shares also fell in the quarter, by around 1.5% in NZD terms and 2.5% in NZD hedged terms. This brought the annual results to around 14.8% in NZD terms, while NZD hedged returns were around 20.5% in the year to September. The large outperformance of hedged returns reflects the 6% rally in the NZ dollar against the US dollar over the last 12 months. Small caps returned -2.5% in the quarter and 7.3% over the year, while value stocks were flat in the quarter and returned 10.2% over the year to September.
Source of figures: MSCI World Index; Morningstar Developed Markets NZD hedged, MSCI World Value

QTRLY RETURN
- 1.0%

PAST YEAR
+ 5.2%

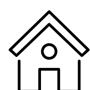
Emerging Markets: Emerging Markets fell by 1% over the quarter and rose around 5.2% over the year to September in NZD terms. This was soft relative to developed markets, although more in line with their performance if we exclude large cap US stocks.
Source of figures: MSCI Emerging Markets Index



QTRLY RETURN
- 1.8%

PAST YEAR
+ 1.7%

International Fixed Interest: Global investment grade bonds fell by around 1.8% in the quarter as the US Federal Reserve signalled interest rates need to be higher for longer. 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 6.5%.
Source of figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)



QTRLY RETURN
- 4.8%

PAST YEAR
+ 0.8%

International Property and Infrastructure: International property stocks fell by around 4.8% in the quarter in NZD hedged terms, while global infrastructure fell around 6% on a NZD hedged basis and 4.2% on a NZD basis. Over the year infrastructure fell around 1.3% (NZD basis), and global property returned around 0.8% on an NZD hedged basis.
Source of figures: FTSE EPRA NAREIT, FTSE Dvlp Core Infra 50/50; NZD & NZD hedged basis

Q&A WITH HERNA MADDOCK

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

What is your role with Rutherford Rede?

My career in finance started in 2008 as an admin clerk for a company selling risk policies. Here I learned how important it is to have the correct balance between risk and investment and how this balance brings calm to the turbulence that life can bring. With this knowledge I moved to specialise in investments. I completed a Bachelor of Commerce with a major in Financial Planning in South Africa and decided it was time for another big change and made the leap over the Indian Ocean.

I joined Rutherford Rede six years ago, which marked the inception of my next transformative journey. I started as a Paraplanner working very closely with our Advisers, servicing our clients while completing the New Zealand Financial Planning Certificate. My role has since morphed into a dual function as General Manager and Financial Adviser. Over this time, I have actively contributed to our firm's growth and client satisfaction.

Where did you grow up? Can you tell us about the lifestyle you had growing up?

Growing up in Springs, a small town in Gauteng, in a household where both parents were teachers and having three sisters, was a lively and intellectually stimulating experience.

Life was a lot like it is here. We walked to school, we hung out at the dairy, we climbed over our fence to play with neighbours, we had both swimming and spa pools.

Our home was a bustling hub of activity, filled with laughter, debates, and a constant exchange of ideas. With three sisters, there was never a dull moment; we formed a tight-knit sisterhood, supporting and challenging each other in various aspects of life and continue to do so. The bond we share as sisters laid the foundation of the people we have become today. Over the last 10 years, we have all moved to New Zealand where we continue to be a very close-knit family and still enjoy our tradition of having a big Sunday lunch together.

What is the training regime for financial advice like in South Africa?

The training regime for financial advisors in South Africa involves several steps. The process typically includes education, examinations, work experience, and ongoing professional development.

- Educational Qualifications usually start with the relevant tertiary qualification, such as a bachelor's degree in finance, economics, accounting, or related fields.
- Regulatory Examinations are overseen by the Financial Services Conduct Authority (FSCA) in South Africa. A Financial Adviser must pass the Regulatory Exam Level 1 (RE1) for key individuals in the business of a financial services provider and Regulatory Exam Level 2 (RE5) for representatives who give advice on financial products.
- After passing the required regulatory exams, individuals typically need to undergo practical training under supervision, often referred to as an internship or learnership.
- Financial advisors are required to engage in ongoing education as well as belonging to their professional body.

What are the differences between the financial services environment in South Africa and New Zealand?

In South Africa, the financial sector is regulated by the Financial Sector Conduct Authority (FSCA) to ensure compliance, consumer protection, and market integrity. It's a diverse sector comprising local and international banks, insurance companies, and asset managers, each playing a vital role in the country's economy. The financial products target a wide customer base, ranging from traditional banking to advanced investments, aiming for financial inclusion.

Conversely, New Zealand's financial sector is overseen by the Financial Markets Authority (FMA) and the Reserve Bank of New Zealand (RBNZ), focusing on market conduct and stability. It's smaller compared to South Africa and influenced by the country's economic structure, involving domestic and foreign banks, insurers, and investment firms.

Tell us about your family?

In the past three years, my life has seen beautiful transformations. I got married, marking the beginning of a new chapter filled with love, companionship, and shared dreams. The decision to share my life with my partner has brought immense joy and stability, strengthening our bond through the ups and downs of everyday life. Our love and support for each other have been the foundation on which we've built a nurturing home.

And just under a year ago, our family grew by one and welcomed a precious baby boy into the world, filling our lives with immeasurable happiness and a sense of awe. Watching our son grow and learn has been a source of constant wonder, reminding us of the beauty in life's simplest moments. Together, as a family, we look forward to the adventures and growth that the future holds, cherishing every moment as it comes.

What is your favourite place in New Zealand?

Kūaotunu, a hidden gem nestled on the Coromandel Peninsula of New Zealand, holds a special place in my heart as this was where my husband proposed. We often visit the campground and love the simplified lifestyle this holiday destination offers. The serenity of this coastal haven, where lush green hills meet the blue embrace of the Pacific Ocean, captivates my soul every time I visit. The sunsets here are nothing short of breathtaking, painting the sky in hues of oranges and pinks, leaving a lasting impression on my senses.

Whether basking in the tranquillity of its beaches or exploring the nearby hiking trails, Kūaotunu offers a sanctuary to unwind and reconnect with the pure essence of the natural world, making it a haven that I long to return to time and again.

Image: Kūaotunu, Coromandel Peninsula

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