Axiome Summer Update

October—December 2021

IN THIS ISSUE

Investment Market Review

Markets were mixed in the December quarter

Our summary of what happened in markets

Page 1

Key Market Movements

A brief look at how the key asset classes moved last quarter.

Page 4

Article

Uncertainty underscores the need for ongoing disciplined portfolio management.

Page 5

Investment Market Review

Market performances were mixed in the December quarter. Bonds again performed poorly, and New Zealand equities could not repeat their September quarter strength. Emerging market equities treaded water, while developed market large company shares performed well. At the other end of the spectrum, property and infrastructure enjoyed exceptionally strong returns.

Performances were mixed over the quarter given different economic conditions and risks

The performance differences reflected cross-currents in macroeconomic conditions and country or sector specific factors. Rising inflation and the prospect of central banks increasing interest rates weighed down fixed income, but lent strong support to "real asset" classes such as listed infrastructure, property and gold.

Developed market equities were propelled by solid corporate earnings and continued strong growth conditions, while emerging market equities were held back by lingering concerns around Chinese risks.

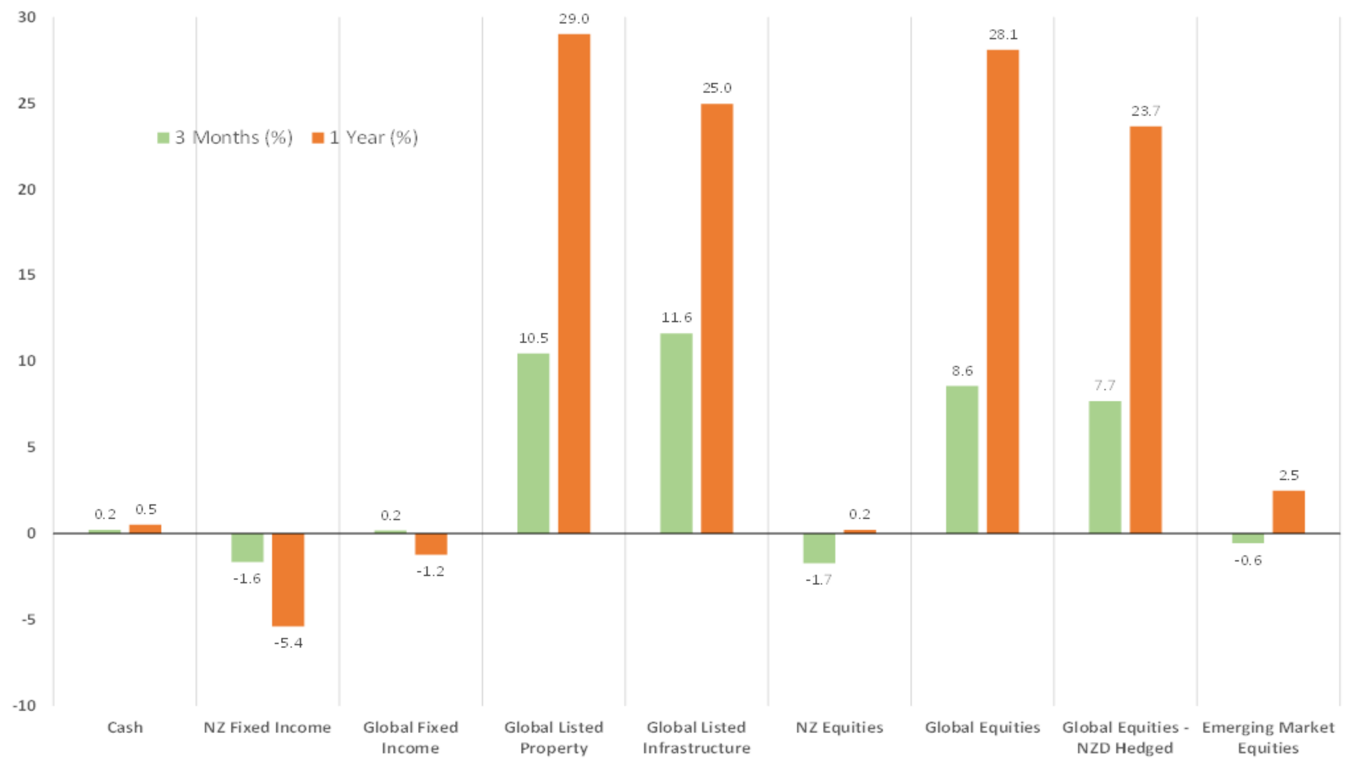
Market Roundup:

Developed market equities climbed further over the December quarter, by around 8.5% in NZD terms. This resulted in an annual return of 28%, while NZD hedged international shares increased around 24% (see Figure 1). Within global equities, higher risk smaller companies had a weaker annual return (18.5%) while 'value' stocks performed in line with the market.

Global equities marched higher...

Emerging markets had a softer quarter, falling by around 0.5%. This reflected ongoing geopolitical tension with China and

Figure 1: Patchy returns over the quarter



Source: Morningstar Direct, MyFiduciary

concerns around the surprisingly heavy-handed approach that the Chinese authorities have taken to rein in "excess profits" in its technology sector and related listed companies such as Alibaba and Tencent.

..while emerging markets fell, but Australian stocks rebounded

That said, Chinese growth has remained relatively firm and concerns around property developer Evergrande's failure severely denting this have dissipated. Australian equities reflected this diminished risk, increasing around 3.5% in the quarter and have returned 17% over the year.

Listed property and infrastructure had a standout performance

As mentioned above, international infrastructure and property stocks had a very strong quarter. International property rose 10.5% in the quarter and around 30% for calendar 2021. International infrastructure returned around 11.5% in the quarter and 25% over the year. Both of these asset classes have in part benefited from rising inflation and inflation risks as they are expected to be relatively resilient to a higher inflation environment.

Fixed income returns were generally poor as markets priced in higher interest rate levels, but short-term bond funds outperformed

On the flip-side, bonds are less resilient to rising inflation and interest rates. As a consequence, New Zealand investment grade (IG) bonds fell 1.4% in the quarter and 4.2% over the year. International IG bonds fared a little better, being flat in the quarter and falling around 1.4% over the year. Finally, NZ cash fared better still, increasing by around 0.5% over the year.

Outlook for the years ahead

We do not have a crystal ball to predict what will happen in the months ahead to markets – nobody does of course. However, to facilitate the periodic planning necessary for individual client portfolios we have recently updated our long-term asset class expected return forecasts. In this review we take into consideration the very strong run in growth asset classes over the past 5 plus years, and the likely implications of the exit we are now seeing from ultra-supportive monetary policy with historically low interest rate levels.

The view of our asset consultants is broadly consistent with the forecast ranges of other industry "experts" including global asset managers, investment organisations and consultants. Key points are that:

1) We expect lower long-term returns from most asset classes than we have seen over the past decade, in line with our previous commentary.

2) We expect to see cash rates continue to lift towards levels that are higher than today but still quite moderate compared to longer term history. This lift should provide some relief to savers relying on the income streams from their portfolios.

3) We expect to see equities and other growth assets offer a premium (higher return) than cash and bonds over the long term. This is in line with long-term financial history which suggests it is both rare and fleeting to see share markets (across most countries) underperforming over long time horizons.

4) We expect bonds to only offer a very modest excess return to cash, and there is a chance that this may be negative over a medium term time horizon. This reflects that while we think cash rates should and will head higher over the next few years or so, markets are yet to fully factor this into bond prices. For this reason, your portfolios have materially reduced their exposure to bond funds with relatively "standard" maturity terms (or duration) to bonds and related instruments with relatively short duration.

5) We expect reasonable returns from listed property, infrastructure and "alternative" assets.

In summary..

As always, we can point to a laundry list of risks that may present challenges to markets at some stage: the ongoing pandemic, supply chain issues, rising inflation and interest rates, geopolitical tensions between the Western nations, China and Russia, huge national debt levels, overpriced housing markets, etc. We can also point to the fact that global growth has remained robust through the stops and starts to activity, and should the current Omicron wave mark an end to the pandemic, growth should bounce higher still.

Through the ups and downs, we are confident that your portfolios are well designed to manage inflation and other risks, and that they will continue to offer a better return than cash over the medium to longer term.

Key Market Movements for the Quarter

Quarter	Past year	
-1.7%	+0.2%	**New Zealand Shares** *New Zealand shares had a soft quarter, falling 1.7%. This meant a fairly flat return for calendar 2021, although our market's 5 year performance remained very strong with an annual average return of around 15% over the period.* *Source of Figures: S&P/NZX 50 Total Return Index with Imputation Credits*
-1.4%	-4.2%	**New Zealand Fixed Interest** *New Zealand investment grade corporate bonds fell around 1.5% in the quarter and returned around -4% for the year ended December 2021. The soft 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*
+3.7%	+16.5%	**Australian Shares** *Australian shares finished the year strongly, returning 3.7% in the quarter. This brought the annual result to around 16.5%. Within Australian equities, small cap stocks performed in line with the market, while value stocks outperformed in 2021, returning around 18.7% in NZD terms.* *Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries*
+8.6% (7.7% hedged)	+28.1% (23.7% hedged)	**International Shares** *International shares had a very strong finish to 2021. They rose 8.6% in the quarter in NZD terms, whilst NZD hedged shares increased around 7.7%. Annual results were similarly strong, with unhedged returns outperforming, given the decline in the Kiwi dollar vs. the US dollar over the year. Within global equities, higher risk small caps had a weaker annual return (18.5%) while value stocks performed in line with the market.* *Source of Figures: MSCI World Index; Morningstar Developed Markets NZD hedged, MSCI World Value, MSCI World Small Cap in NZD terms.*
-0.6%	+2.5%	**Emerging Markets** *Following a poor September quarter, Emerging Market equities had another soft quarter given lingering concerns around Chinese growth and risks. This reduced the annual return to a relatively low figure of 2.5%.* *Source of Figures: MSCI Emerging Markets Index*
+0.2%	-1.2%	**International Fixed Interest** *Global investment grade bonds increased 0.2% in the quarter and fell around -1.2% for calendar 2021. 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 increasing global growth and inflation expectations.* *Source of Figures: Bloomberg Barclays Global Aggregate Index (hedged to NZD)*
+10.5%	+29.0%	**International Property and Infrastructure** *International property stocks increased 10.5% in the quarter and around 30% for the year. International infrastructure also enjoyed a strong end of year bounce, returning around 11.5% over the quarter and 25% over the year. Both of these asset classes have benefited from rising inflation risks 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*

Disciplined, Diversified and Discerning

As 2022 begins, with Covid still dominating headlines and the new variant Omicron perpetuating the state of limbo we all feel ourselves in, it is worth reiterating the comfort to be drawn from a well thought out and disciplined approach to achieving your financial goals. This should be an area of life where there is clarity and consistency. Yes, markets will fluctuate as news rolls through, and market movements may be sharper than is comfortable at times, but it is bearing this risk that allows investors to achieve their returns and is a necessary part of investing. It does not mean that investors need to react to every piece of bad news, even major bad news such as pandemics. Leave the markets to price in the news flow, even in the throes of a pandemic, and take comfort in the knowledge that your financial plan, based on properly assessed goals incorporating all factors relevant to you, will stand you in good stead and help you to achieve your goals. Remaining invested is essential in order to capture all the returns available, as can be seen in Figure 2 below.

It follows therefore that the planning process for retirement or managing wealth is crucial in allowing you to relax, knowing your financial affairs are well managed.

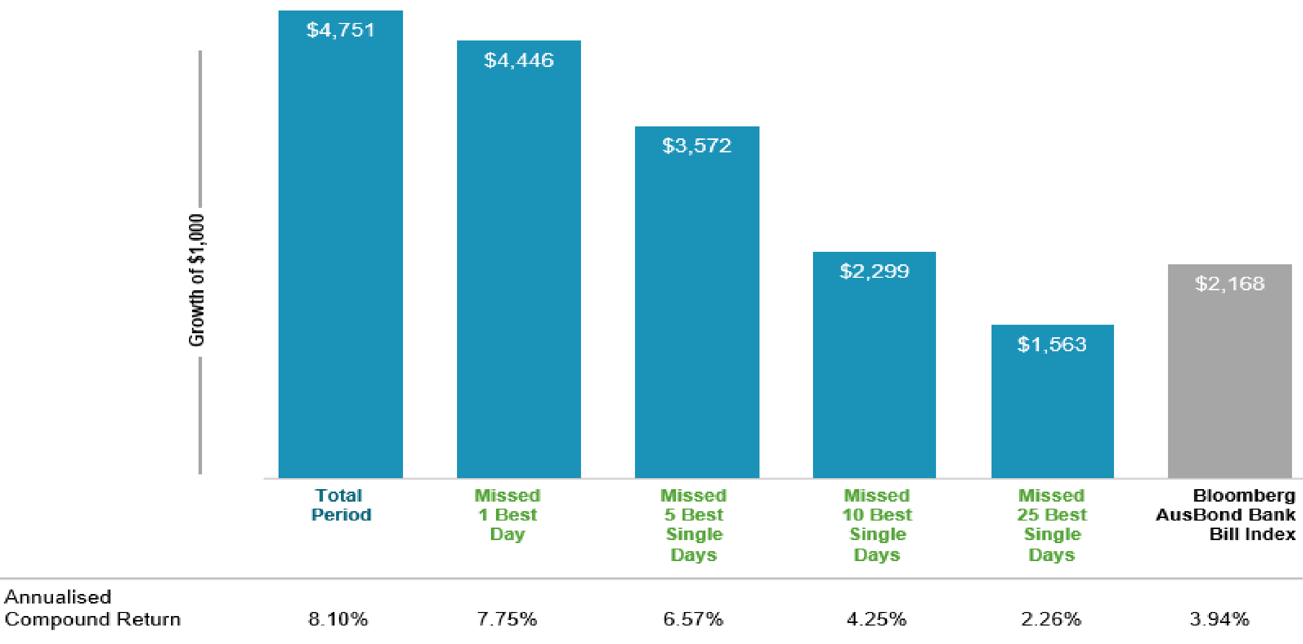
1) Define the goal – is it growth of assets or preservation of capital?

2) Identify the risks. The ability to bear volatility will vary according to the individual and a risk tolerance questionnaire will tease out this information. One thing to note about volatility is that it returns to its long-term average (as measured by the VIX index which monitors the volatility of the US stock market) relatively quickly, often within a few weeks though more typically within a few months.

3) Build solutions that systematically pursue reliable sources of higher expected returns, such as small companies, companies with higher profitability and value stocks – whilst also managing risks and costs. The extra return from employing such strategies is demonstrated in Figure 3.

4) Monitor – this includes being able to look through the roar of constant media noise and blaring panic-inducing headlines.

Figure 2: Market timing folly



Source: Dimensional Fund Advisers

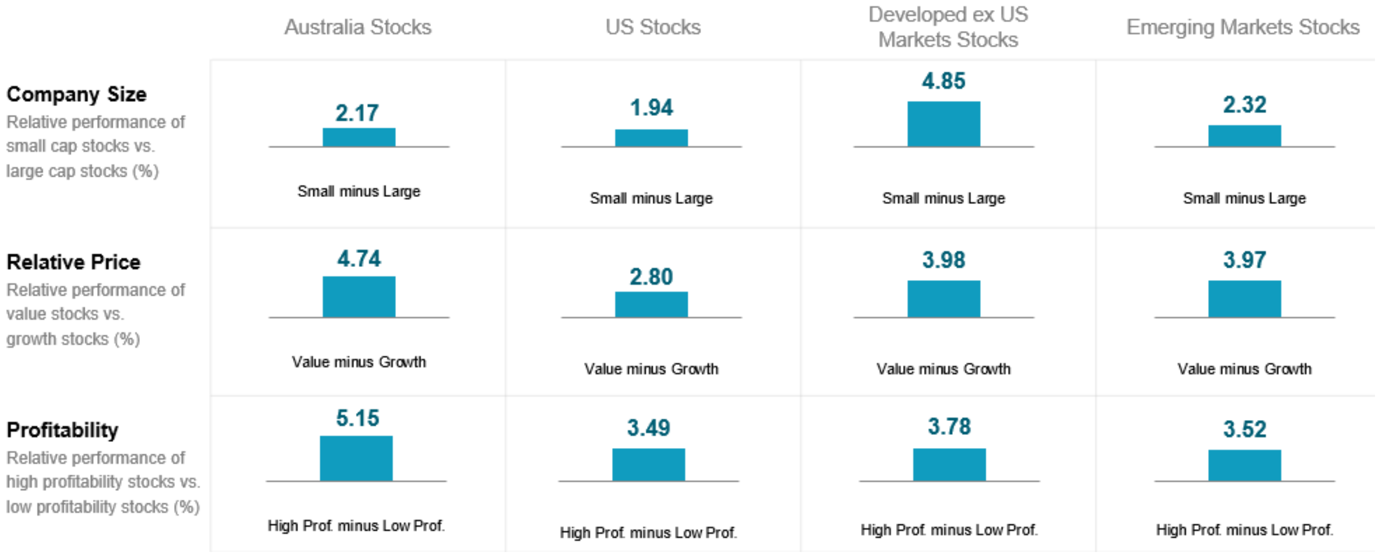
There are important criteria to consider, such as the split between growth (equities) and defensive (fixed income) holdings, diversification through international investment, tax considerations and other factors unique to each individual investor, eg financial goals and personal circumstances. A well-constructed portfolio will address all of these. Plans of course should be reviewed regularly to ensure they continue to align with your circumstances and goals.

What is crucial is not to be swayed by news flow into reactive decision-making. Being discerning about what you should and should not be paying attention to is an important part of investing.

Humans have an innate negativity bias, stemming from survival instincts honed over a multitude of generations. Our news services are a direct result of this negativity bias (bad news sells and is profitable for publishers), and the resulting constant flow of bad news can make us more risk averse than we need to be.

Discerning investors with a solid financial plan in place will be able to see past the latest news flash to a longer timeframe, remaining invested and reaping the returns.

Figure 3: Dimensions of Expected Returns



Source: Dimensional Fund Advisors

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