Axiome Quarterly Update

January—March 2023

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Overview

Markets climbed higher over the March quarter despite monthly volatility and wobbles in the banking sector.

Both equity and bond markets bounced higher in the March quarter, following increasing signs that central banks are getting on top of inflationary pressures. However, the pattern of returns was quite volatile. Equity markets surged in January on the back of reducing interest rate expectations, only to sell off most of this gain in February and into early March as the banking sector particularly came under pressure with the failure of Silicon Valley Bank. Later in March markets rose again as banking contagion risks receded, and macroeconomic data, in general, reported better than expected (see Figure 1 for the US economy).

Market roundup

Global equities had the strongest returns, followed by emerging markets.

Bonds also rose over the quarter, in part because they now offer 5%+ running yields .

Market performances are reported in Figure 2. International shares rallied strongly over the quarter, by around 9% in NZD terms and 7.2% in NZD hedged terms. Within global equities, value stocks took a breather and returned only 2% over the quarter, but they still outperformed over the year, returning 5.6% in NZD terms. Small caps have fared worse, returning around 5.5% in the quarter, but only 0.7% in the year to March 2023.

Emerging markets returned around 5% over the quarter, slightly stronger than the 3.9% and 3.3% returns posted by the NZ and Australian markets respectively. Over the year to March, however, all performed quite similarly, returning around -1%.

NZ and international investment grade (IG) bonds returned around 2.5% in the quarter with some of this gain reflecting a paring back of future rate rise expectations.

Over the year to March NZ IG bonds fell around 1%, while international IG bonds fell around 5%. This difference in performance largely reflects that the RBNZ was generally quicker than offshore central banks to raise rates, and hence the marked-to-market capital losses were incurred earlier in our bond market than most offshore markets.

International property stocks again struggled in the quarter, increasing only 0.6% in the quarter in NZD hedged terms. In contrast, global infrastructure performed well once again, returning a handy 2.6% for the quarter and 3% for the year to March 2023.

Bonds and their role in your portfolio.

Bonds are held in your portfolio because of their income stream and risk diversification potential.

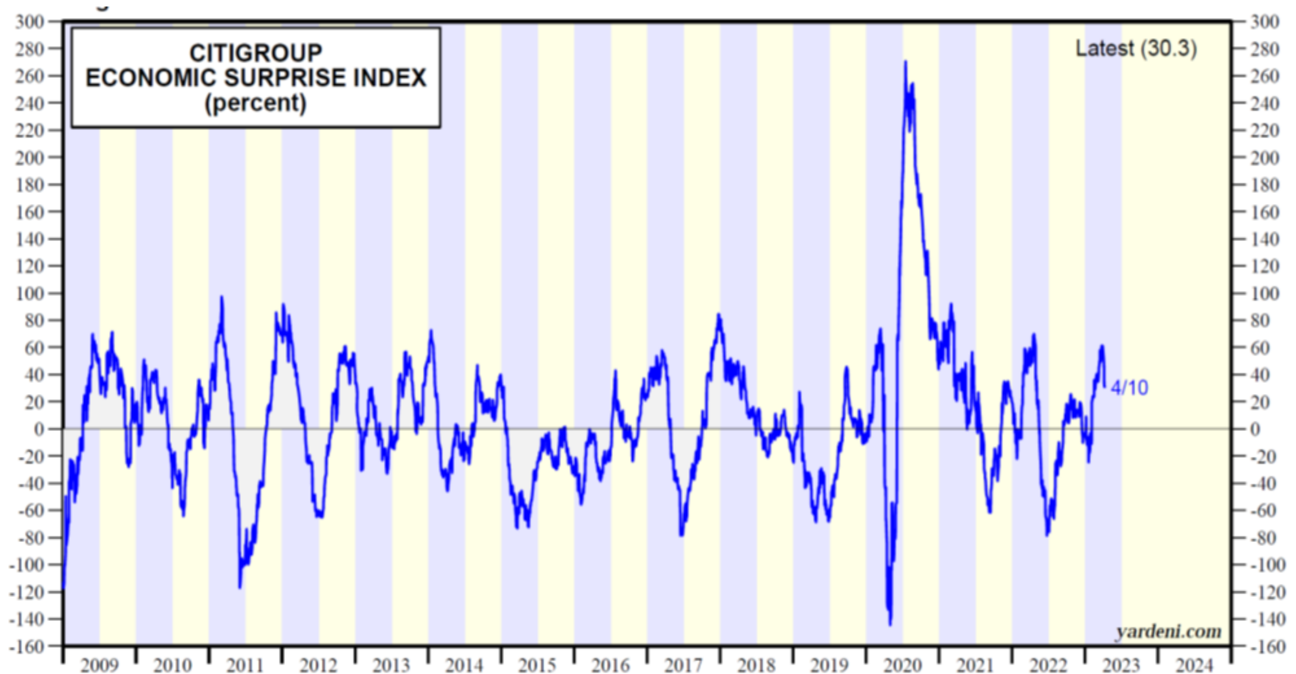
Bonds play an important role in all but the highest risk portfolios. They provide a predictable income stream, and typically rally in times of stress, providing a portfolio diversification benefit. These benefits are more certain today than they were a year or so ago now that both short term interest rates and bond yields have risen to more normal levels. We can expect a return of 5% p.a. or more from most bond funds in your portfolio given their current yields.

When an investor buys a bond, they essentially lend to the issuer of the bond (a government, company or other type of organisation), who promises to pay back the amount borrowed plus interest over a specified period of time. Their predictable income stream is the reason bonds are considered less risky than stocks, where neither the dividend income stream nor the capital return are certain.

Bonds issued by governments – at least those in the most advanced economies - are considered the lowest risk because they are backed by the ability of governments to raise taxes to pay their debt obligations. Bonds issued by corporates are considered riskier as there is some chance that a business will fail. This is why they typically offer higher yields than government bonds. Credit rating agencies essentially assess the risk that an issuer may fail in its obligations to repay lenders. Investment grade (IG) bonds, which comprise most of the bonds in your portfolios, are assessed to have the highest probability of meeting debt obligations.

While increasing rates in 2022 caused significant marked-to-market losses, the upside is now bonds offer higher yields and an enhanced potential to cushion returns when equity markets sell off .

Figure 1: US data has been positive relative to expectations so far this year



Source: Morningstar Direct, MyFiduciary

While IG bonds have the highest credit ratings, and issuers of IG bonds very rarely default on their debt obligations, this does not mean that they are risk-free. Bonds can still suffer negative returns even when there is no default, including because:

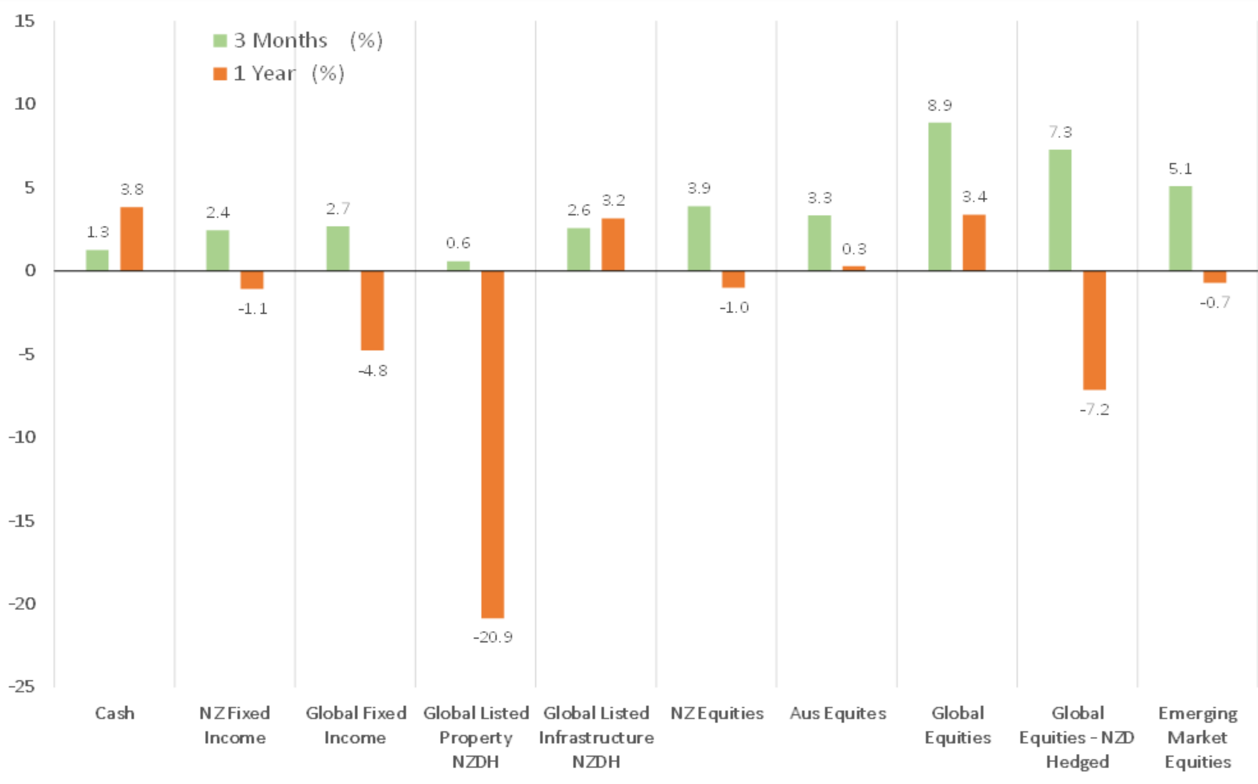
- The assessed creditworthiness of the issuer deteriorates, causing the value of the bond to decrease. An example would be if the NZ government has a credit rating downgrade.
- Interest rates rise by more than is factored into bond prices when they are bought. This is the main reason why bonds suffered a large decline in 2022, and why we allocated to short duration bonds to reduce this risk.
- Some bonds may be difficult to sell during times of market stress. In these circumstances the investor may have to sell them at a lower price.
- Finally, most bonds pay a coupon that is fixed and does not adjust for inflation. As such real returns will fall when inflation rises, as it has over the past year.

Your bond investments are mainly in investment grade bonds funds diversified across government, country, term and country issuances to mitigate individual bond risks.

Your exposure to bonds comes in the form of well-diversified bond funds that have been selected in part to mitigate the risks above, and in part because of the strong conviction we have in the selected fund managers (Dimensional, Harbour, Nikko and Daintree) based on their track records, SRI credentials, business stability, and operational risk controls.

Finally, while bonds are not risk-free, they still may be preferred to term deposits (TDs) for several reasons. Firstly, because they typically offer higher yields than TD rates. Secondly, because an investor can, in most circumstances, sell their holdings at any time without financial penalty, unlike with TDs where "break fees" apply. And thirdly, because a diversified portfolio of bonds may in fact be *lower risk* than putting money "in the bank". The GFC in 2008, and the more recent wobbles in US banks, serve to illustrate that bank deposits are not risk free. Furthermore, NZ does not have a deposit guarantee scheme, and the scheme expected to be enacted later this year will only guarantee up to $100k per investor.

Figure 2: Markets bounced higher in March 2023

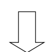


Source: Citigroup, Yardeni Research Inc.

Key Market Movements for the Quarter

Quarter	Past Year

New Zealand Shares



+3.9% -1%

New Zealand shares bounced 4% higher in the quarter. Over the year to March, returns were -1.0%, but remain very solid over the past 5 years and decade with annual returns of around 7.4% and 8.3% respectively.

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

New Zealand Fixed Interest

+2.4% +0.1%

New Zealand investment grade corporate bonds increased 2.4% in the quarter and were flat for the year ended March 2023. This is a marked turnaround from negative results over 2022, 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

Australian Shares

+3.3% -0.8%

Australian shares increased around 3.3% in the quarter, and fell by around 0.8% over the year in NZD terms. Much of the recent gain was concentrated in large cap banking and commodity stocks. In contrast, value and small cap stocks underperformed, returning around 1.5% in the quarter.

Source of Figures: S&P/ASX 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries

International Shares

+8.9% +3.4%

(+7.3% hedged) (-7.2% hedged)

International shares rallied strongly over the quarter, by around 9% in NZD terms and 7.2% in NZD hedged terms. Within global equities, value stocks returned 2.0% over the quarter, but outperformed over the year, returning 5.6% in NZD terms. Small caps fared worse, returning around 5.5% in the quarter, but only 0.7% in the year to March 2023.

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

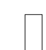
Emerging Markets

+5.1% -0.7%

Emerging Markets also performed well in the quarter, rallying by around 5% in NZD terms. On an annual basis returns were around -0.7% in NZD terms, mildly behind returns of developed markets on an unhedged basis, but in line with the returns on the NZ and Australian markets.

Source of Figures: MSCI Emerging Markets Index

International Fixed Interest



+2.7% -4.8%

Global investment grade bonds returned around 2.7% in the quarter, but still ended the year down around 5%. 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 offer the prospect of solid returns given their high running yields.

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

International Property and Infrastructure

+0.6% -20.9%

International property stocks increased around 0.6% in the quarter in NZD hedged terms while global infrastructure increased around 2.6% on an NZD hedged basis. Over the year infrastructure returned 3.2% and global property returned around -21% on an NZD hedged basis. On an unhedged basis, annual returns were better at around -13% for property and +4% for global infrastructure.

The Security of a Custodian

Bank deposit insurance

The recent failures of several second-tier US banks have no doubt given many of us pause for thought as to the security of our savings in the bank. New Zealand currently does not have a banking deposit insurance scheme which is unusual in the context of international developed nations, where 145 jurisdictions have some form of deposit insurance.

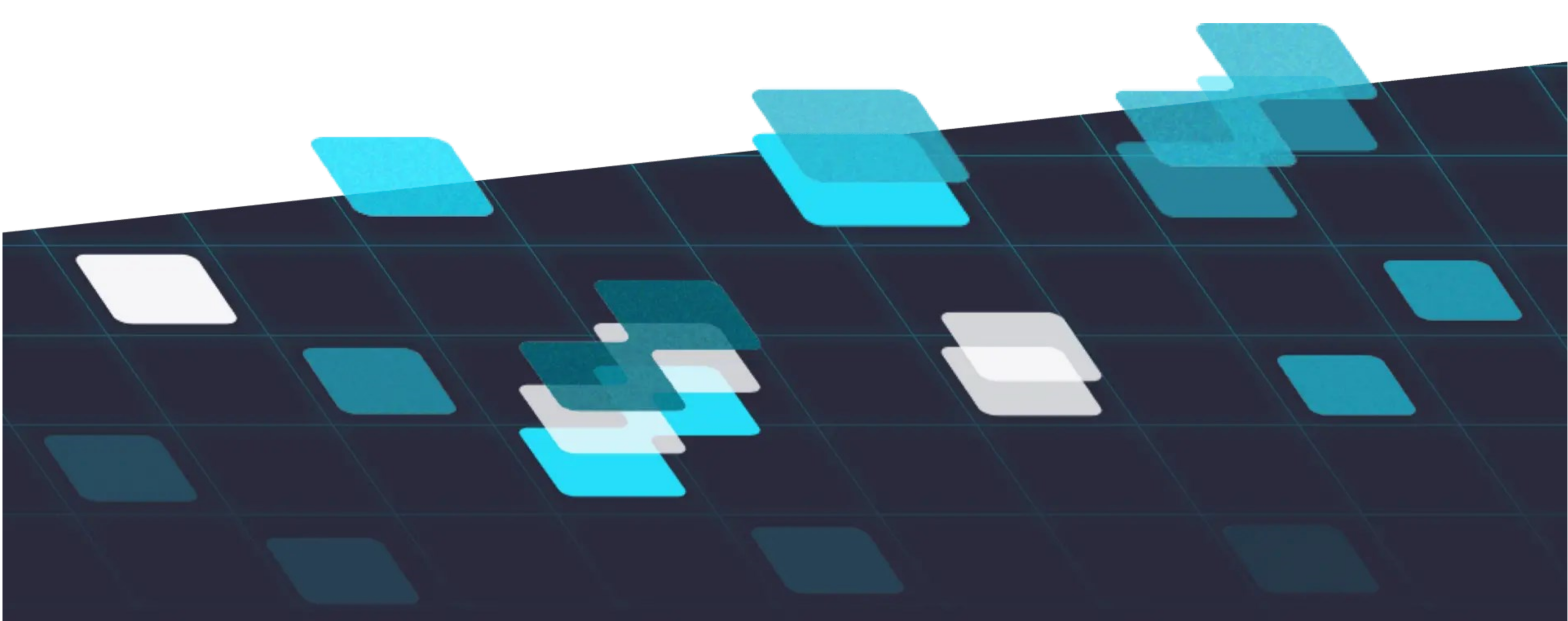
NZ regulators have adopted a "light touch" supervision of banks thus far, with an emphasis on market discipline whereby creditors are incentivized to keep a close eye on their banks. The thinking has been that providing deposit insurance erodes those incentives. However, a regular Financial Sector Assessment Programme conducted by the IMF in 2021, which assesses the stability of financial systems and evaluates the adequacy of regulatory systems and bank resolution schemes, identified the lack of depositor insurance as a weakness in NZ's financial system. Market discipline can still be an effective element of the system if deposit insurance amounts are not set too high, thereby protecting household deposits but still exposing business deposits to risk. New Zealand's scheme will set a limit of $100,000 per deposit per deposit taking institution.

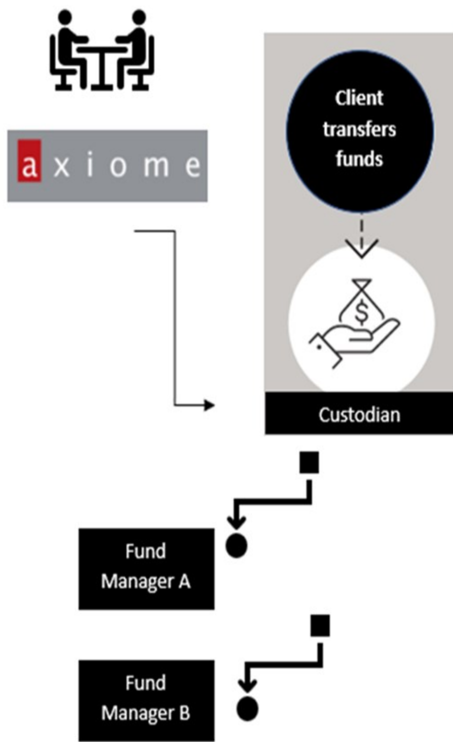
This is on the low side when compared to Australia (NZ$268,000), the US (NZ$400,000) and the UK (NZ$167,000) but is estimated to be sufficient to protect 93% of NZ deposits. The Deposit Takers' Bill will pass into statute later this year and the scheme itself is expected to be up and running by 2024.

What about the security of other financial investments?

So, our bank deposits should be safe, but what about the safety of assets in investment portfolios? These assets are held in custody by specialist institutions or as part of a banking operation. Custodians hold and safeguard financial assets, such as cash, securities, and other investments, on behalf of their clients. What this means is that the underlying securities are held by the custodian and are therefore separated from control by any financial intermediary or fund manager. The custodian is the 'registered owner' of the shares, bonds or funds, and the end client is the 'beneficial owner'. Custodians are subject to strict regulatory oversight and independent audits.

The simplified diagram below shows how client funds pass directly to the NZ or overseas custodian for safe custody. Client funds are not handled by your adviser but transfer directly to the custodian's bank. Instructions are issued to the custodian by Axiome regarding which funds or securities to purchase for the portfolio and those security purchases are traded, processed and registered by the custodian. Neither the fund manager nor the adviser has any control over the assets held in custody.





The core functions of a custodian are to:

- Process dividend payments
- Handle asset pricing and portfolio valuation
- Conduct foreign exchange transactions
- Report on portfolio performance
- Manage short-term cash transactions
- Produce tax reports

Apart from simply holding assets for clients, custodians offer the following benefits:

- Centralised administrative reporting and daily portfolio valuation
- Security of assets – as specialist custodians must not commingle client assets with their own
- Technology investment – assets are protected by the high level of investment in technology to process transactions efficiently and in cybersecurity
- Access to institutional wholesale funds and other investments not otherwise available to retail investors
- Global reach – a custodial platform gives clients an efficient gateway to wider choice of assets

Custodians are tightly regulated within the financial services sector. Various safeguards are employed to protect client assets, including access controls, sophisticated electronic security measures like encryption and firewalls. Importantly assets are held beneficially in each client's name. Finally, custodians are also required to carry insurance to protect against losses should fraud, theft, or other risks materialise.

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