Axiome Quarterly Update

July—September 2023

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Visit us at our office at 6 Victoria Rd, Devonport, Auckland 0624

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Economic and Market Commentary

Overview

Most asset classes suffered negative returns in the September quarter.

The strong first half of calendar 2023 gave way to a pullback 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, as did select alternative asset classes.

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, whilst 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%.

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 to cash.

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

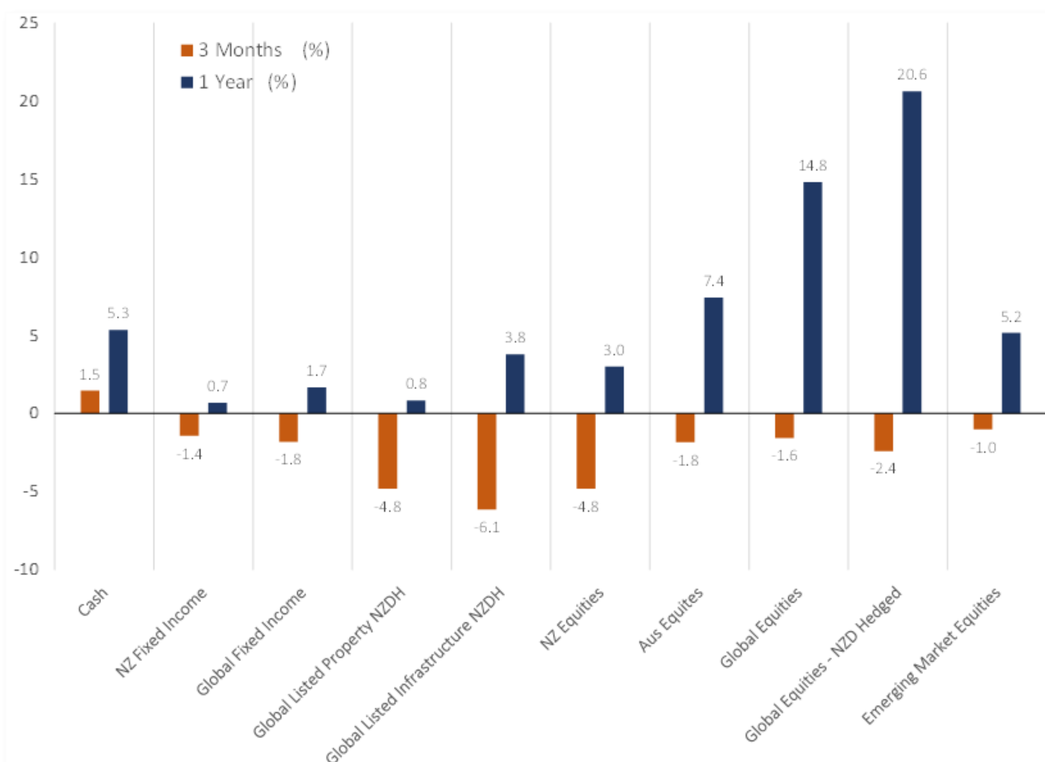
We seek to ensure portfolios are well diversified at the individual security and asset class level.

Diversification and correlations between asset classes

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.

Asset class diversification reduces portfolio risk for a given return.

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 stocks 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.



Source: Morningstar Direct, MyFiduciary

Figure 1:

Most asset classes struggled in the September quarter

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 asset class co-movements or correlations are not perfect. NZ equity returns do not always move in lockstep 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&P 500 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 their relatively certain return entails.

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

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 positive 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.

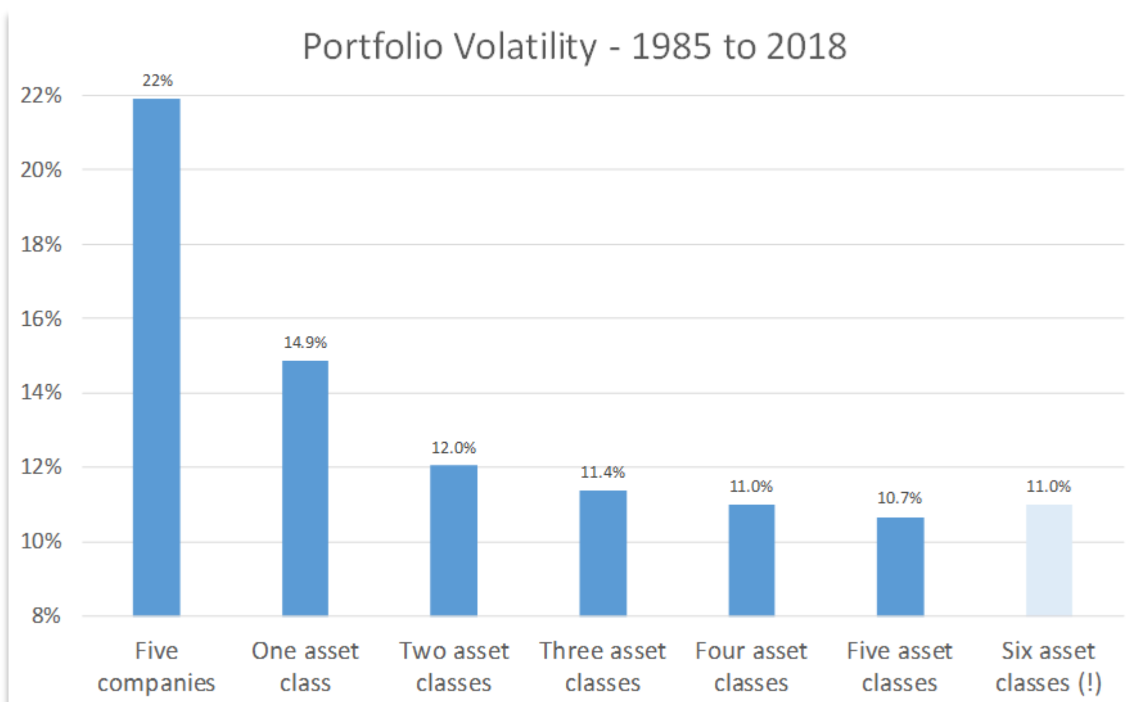
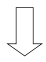
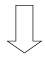
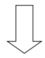
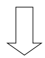
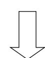
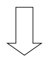
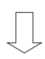


Figure 2:

The benefits of diversification

Source: MyFiduciary

Key Market Movements for the Quarter

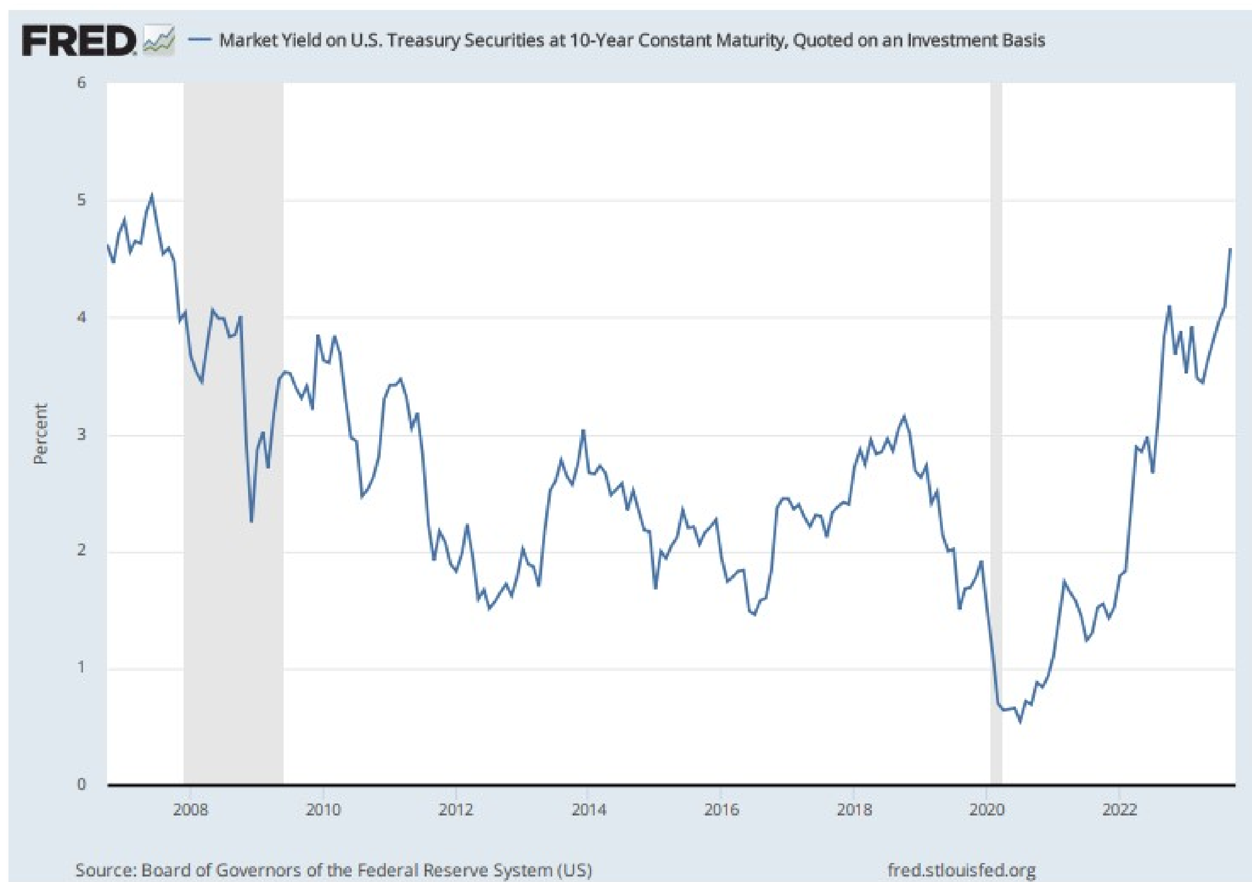
Quarter	Past Year	
 -4.8%	+3.0%	**New Zealand Shares** *New Zealand shares fell around 5% over the quarter. Over the year to September returns were still positive at around 3%, and the longer term 10-year return remains very strong at over 10% per annum.* *Source of Figures: S&P/NZX 50 Total Return Index with Imputation Credits*
 -0.4%	+2.6%	**New Zealand Fixed Interest** *New Zealand investment grade corporate bonds fell -0.5% 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.*
 -1.9%	+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 faied 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 300, S&P Australia BMI Value, S&P/ASX Small Ordinaries*
 -1.6% (-2.4% hedged)	+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 in this timeframe reflects that September 2022 marked a low point in the value of the NZ dollar against the US dollar. 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 MSCI World Small Cap in NZD terms.*
 -1.0%	+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*
 -1.8%	+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)*
 -4.8%	+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 NZD, FTSE Dvlp Core Infra 50/50 TR NZD

US Treasuries

The most important bond in the world is the US 10 Year Treasury Note ("Treasuries"): debt issued by the US federal government and of a ten-year maturity. Treasuries anchor the global financial system, are backed by the full faith and credit of the United States and are issued in the world's dominant currency, the USD. Because of this, they are deemed to be the 'risk-free' investment against which all other long term investments are compared. Large banks and insurance companies are required by their regulators to own them and no asset is easier to trade in a crisis.

Three years ago, 10 yearTreasuries had an annual interest rate (or yield) of only 0.7%. Today they yield approximately 4.5%; a 650% increase! Furthermore, they are now yielding more than they have done since 2007. Treasury yields tend to respond to three factors: inflation, central bank short-term interest rates and purchaser demand. If the first two are low and the last is high, then yields tend to fall and stay low and this was the case in most years from 2008 until 2020. In exactly the opposite circumstances, yields will rise and stay high and this is indeed what has happened from 2021 onwards.

What impact then does a changing Treasury yield have on *prices*? Fixed-interest mathematics can get difficult very quickly but one thing to remember is that yields (or interest rates) go in the opposite direction to prices. A simple way to think of this is that if you can get an interest-only 100% mortgage and can afford exactly $50,000 of interest payments in a year, then you can buy a $1,000,000 house if the interest rate is 5% but only a $500,000 house if the interest rate is 10%. Given that the Treasury yields have gone up so much recently, their corresponding prices have fallen; they have become cheaper.



At Axiome, we do not make predictions about the future state of the market or the prices of any given security. However, we can make the observation that with Treasury yields at a 16-year high and the corresponding prices at a 16-year low, you are more likely, in the long run, to see them (or similar fixed-interest securities) increase in value than not. Even if this does not occur and prices stay lower for longer (i.e. yields stay where they are for longer than expected), you will still be harvesting an annual risk-free yield of around 4.5%. Of course risks remain should inflation unexpectedly rise again or the issuing of Treasuries be so excessive as to depress the demand for them.

Your bond allocation within your portfolio will contain many different types of fixed-interest securities and not necessarily a large exposure to Treasuries. However, the higher yield on Treasuries (which set the baseline of bond yields) is a good indication that bonds should make a valuable contribution to total investment returns for the next few years.

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