NZFUNDS

Investment Report 1H 2019

NZ Funds' lunchtime run, Auckland _

Cover: Stephan Clark, Dale Henderson, Damon Murfitt and Josh Wilson. Stephan works in compliance, Damon and Dale in technology and Josh equities. Thanks to an open plan office and our flexible working structure, it is not unusual to find a cross-section of the firm going for a run or a bike ride together to break up the day. || **Photographer: Mark Smith.**

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NZ Funds enters its fourth decade managing New Zealanders' wealth

Entering our fourth decade, it is interesting to reflect on how our management of New Zealanders' savings, invested alongside our own, has gone over the last three decades. With the caveat that our early track record is more product-orientated, and that the mandate we discuss is growth-orientated, but nevertheless well diversified, we have accumulated the following 26 year investment record. It is also worth noting that our long-term performance is not a paper tiger, but the management of significant sums on behalf of thousands of New Zealand individuals, trusts and institutions.

Our investment performance over the first decade of business, 1988 to 1998, benefited from an excellent starting point. NZ Funds' growth-orientated mandates grew each $1,000 investment in 1992 to $1,975 by 1998, a cumulative gain of 97.5%. From 1998 to 2008 market gains were more muted. The decade started with the tech crisis and ended with the Global Financial Crisis. During this period clients' capital grew less, from $1,975 to $3,286, adding a further gain of 66.4%. The last decade, 2008 to 2018, has been our second strongest on record. We ended the decade 78.2% ahead, taking our long-term track record to $5,856 from $1,000, 26 years earlier. This equates to a 7.0% p.a. long-term compound rate of return.[1]

Our approach to wealth management is designed to diversify clients' portfolios across four investment categories: cash, income, inflation, and growth.[2] Each category has different risk and return characteristics and therefore a different role to play in building, and maintaining, long-term capital. Our clients have been able to grow their wealth over time at a faster rate than by using term deposits, and in a manner not solely dependent on the New Zealand share market.

What of the decade to come? None of us know what the future holds, but we can take great comfort in the quality and stability of the team at NZ Funds. We enter our fourth decade with the strongest panel of individuals, business associates and international investment experts the firm has ever worked with. It may interest you to know that 95% of our employees and all of our partners have their own personal capital invested alongside clients. We believe NZ Funds' diversified approach, which seeks to protect and grow clients' capital over the long-term, is the most reliable way of building wealth over time.

1. These returns are after portfolio fees but before tax. This information represents a composite strategy, which is used to illustrate the long-term performance of the investment approach used by NZ Funds. It does not represent the historic return of any particular portfolio, nor is it an indication of the future returns.
2. In the case of our Superannuation, UK Pension Transfer and KiwiSaver Scheme, clients are diversified across three categories: income, inflation, and growth, although our UK Pension Transfer service does also offer the opportunity to hold transferred capital in Pounds Sterling.

Review of 2018

Returns *after* Portfolio fees assuming highest fee level*, but *before* client's tax, to 31 January 2019

TERM DEPOSIT INDEX	RETURN 2019 YTD	2018[1]	2017[1]	2016[1]	2015[1]	2014[1]	2013[1]	SINCE INCEPTION[2]	INCEPTION DATE
Six month term deposit rates	0.27%	3.33%	3.34%	3.29%	4.17%	3.90%	3.98%	36.91%	31 Oct 2010
NZ FUNDS KIWISAVER SCHEME	**RETURN 2019 YTD**	**2018[1]**	**2017[1]**	**2016[1]**	**2015[1]**	**2014[1]**	**2013[1]**	**SINCE INCEPTION[2]**	**INCEPTION DATE**
Income Strategy	1.04%	0.84%	4.37%	5.94%	1.44%	4.52%	2.76%	37.61%	31 Oct 2010
Inflation Strategy	4.85%	-5.77%	8.29%	1.98%	1.08%	11.57%	5.69%	44.77%	31 Oct 2010
Growth Strategy	4.60%	-8.25%	16.96%	-2.93%	7.13%	11.79%	27.91%	74.76%	31 Oct 2010
NZ FUNDS UK PENSION TRANSFER SERVICE[7]	**RETURN 2019 YTD**	**2018[1]**	**2017[3]**	**2016**	**2015**	**2014**	**2013**	**SINCE INCEPTION[2]**	**INCEPTION DATE**
Income Strategy – Pounds Sterling[8]	1.12%	-0.98%	7.32%	-	-	-	-	7.46%	11 Aug 2017
Income Strategy	1.05%	0.78%	3.75%	-	-	-	-	5.66%	25 Jan 2017
Inflation Strategy	4.88%	-5.76%	6.27%	-	-	-	-	5.04%	25 Jan 2017
Growth Strategy	4.65%	-8.32%	12.35%	-	-	-	-	7.79%	25 Jan 2017
NZ FUNDS SUPERANNUATION SERVICE[7]	**RETURN 2019 YTD**	**2018[1]**	**2017[3]**	**2016**	**2015**	**2014**	**2013**	**SINCE INCEPTION[2]**	**INCEPTION DATE**
Income Strategy	1.05%	0.78%	3.75%	-	-	-	-	5.66%	25 Jan 2017
Inflation Strategy	4.88%	-5.76%	6.27%	-	-	-	-	5.04%	25 Jan 2017
Growth Strategy	4.65%	-8.32%	12.35%	-	-	-	-	7.79%	25 Jan 2017
NZ FUNDS MANAGED PORTFOLIO SERVICE	**RETURN 2019 YTD**	**2018[1]**	**2017[1]**	**2016[1]**	**2015[1]**	**2014[1]**	**2013[1]**	**SINCE INCEPTION[2]**	**INCEPTION DATE**
Core Cash Portfolio	0.15%	1.85%	1.78%	2.20%	3.25%	3.19%	2.55%	37.06%	28 Feb 2008
Core Income Portfolio	0.33%	3.42%	4.15%	4.93%	2.34%	5.44%	3.20%	63.52%	23 Jul 2008
Global Income Portfolio[4]	2.19%	-2.76%	3.71%	5.60%	1.03%	4.02%	2.19%	45.79%	31 Oct 2008
Core Inflation Portfolio[4]	3.52%	-5.36%	9.53%	0.34%	-0.31%	9.83%	4.04%	42.24%	31 Oct 2008
Property Inflation Portfolio	3.92%	0.65%	6.42%	-1.74%	7.34%	14.21%	2.73%	66.35%	31 Oct 2008
Equity Inflation Portfolio[4]	6.54%	-9.01%	6.27%	-0.72%	5.14%	13.30%	7.54%	46.06%	31 Oct 2008
Core Growth Portfolio[6]	4.66%	-12.75%	12.46%	-5.61%	5.03%	7.55%	26.06%	148.70%	01 May 2003
Global Equity Growth Portfolio[6]	6.80%	-9.98%	17.32%	-2.13%	8.08%	14.99%	22.74%	247.51%	06 Mar 1996
Global Multi-Asset Growth Portfolio[5]	4.76%	-13.79%	-6.71%	16.88%	-16.54%	-13.96%	-2.02%	-35.16%	07 Nov 2011
Dividend and Growth Portfolio[6]	3.05%	-6.12%	18.38%	10.44%	13.00%	15.78%	5.69%	731.08%	02 Dec 1992

1. Returns for each year are annualised. 2. Since inception returns are cumulative to 31 January 2019. 3. 2017 returns for NZ Funds Superannuation Service are from inception (not annualised). 4. Performance is measured since the launch of the APS platform (now known as NZ Funds Managed Portfolio Service) on 31 October 2008. 5. The inception date shown is the inception date of the current investment strategy. 6. The 'Since inception' information represents a composite strategy, which is used to illustrate the long-term performance of the investment approach used in managing the Portfolios. It does not represent the historic returns of the Portfolios, nor is it an indication of future returns. 7. Together these make up the NZ Funds Managed Superannuation Service. 8. Current legal name ROPS GBP Income Strategy, to be renamed Income Strategy - Pounds Sterling on 1 April 2019.

Pre-tax returns are stated after Portfolio/Strategy fees and expenses, but before any advisory fees or investor tax. Past performance is not necessarily an indication of future returns.

* As stated in the current PDS for each of the NZ Funds Managed Portfolio Service, NZ Funds KiwiSaver Scheme and NZ Funds Managed Superannuation Service.

We have previously written at some length about the end of the current market cycle. A market cycle simply means a period of strong economic growth which is then followed by a period of low growth, or a contraction in growth. In this way economies, and the financial markets which track them, move higher over time in a 'two steps forward, one step back' fashion.

Six months ago, we discussed how the global economy had enjoyed a period of strong growth which has so far lasted nine years. This is longer than the average period of expansion which has been five years. We therefore cautioned that as the cycle gets longer in the tooth market volatility would increase, and we would do our best to mitigate this while at the same time continuing to ensure clients' portfolios remained invested for long-term growth.

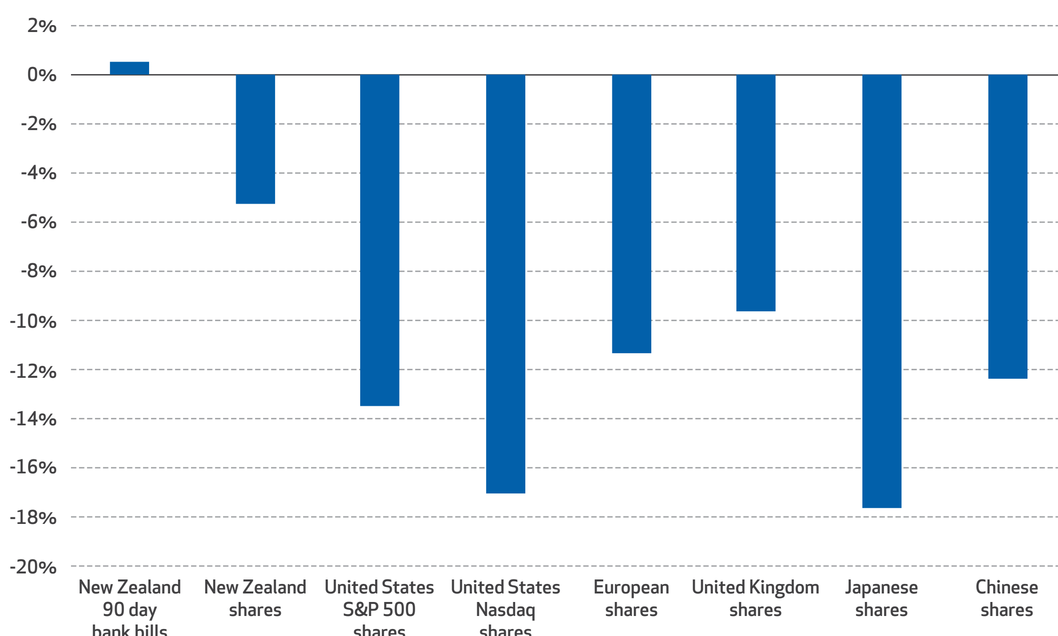
It is the job of central bankers around the world to manage inflation and economic growth. Their primary tool is interest rates. Central bankers use their ability to increase interest rates to slow an economy in the same way a driver uses the brake to slow a car. The higher they set interest rates, the less money is borrowed and spent, and the more money is saved.

We wrote in 2017 that America's central bank (the Federal Reserve, or Fed as it is known internationally) would begin raising rates more seriously in 2017 - 2018 and this would lead to a slowing of not only the American economy but also the global economy. This occurred in 2018. The Fed raised short-term interest rates four times from 1.5% to 2.5%. This has the effect of slowing both American and global economic growth.

Working with our global managers, we formed the view that while the global economy would slow, growth would remain positive. We thought this would create financial market volatility, but nevertheless shares and other growth assets would continue to appreciate and remain a better source of medium to long-term returns than term deposits. In short, we hypothesised that we are in the two to four-year period known as late cycle, rather than at the end of the cycle. We continue to think this is the case.

After a choppy start to the year, the global share market rose to new highs during 2018, only to drop sharply by year end. As at 31 December 2018, the main United States share market indices, the S&P500 and NASDAQ were 14% and 17% lower than the high point reached during the year. Other share markets also fell from their highs; Great Britain, Japan and China, falling by 15%, 18% and 27% respectively.

Fourth quarter returns[3]



3. Source: Bloomberg. New Zealand (S&P NZX 50 Portfolio Index), Europe (Euro Stoxx 50 Index), United Kingdom (FTSE100 Index), Japan (Topix Index), China (CSI300 Index).

Clients' portfolios fell more than we would have liked during the December quarter, caused not by clients' international investments but by a difficult reporting season for a number of the New Zealand and Australian listed companies. In particular, Fletcher Building, Rio Tinto, and Nufarm. Declines in these names were partially offset by gains in the market value of Meridian, our second largest holding, and TradeMe, which received a takeover offer. We sold Nufarm and purchased more shares in Fletcher Building and Rio Tinto at lower prices as we expect both companies to recover in value given time.

The year ended with client portfolios being depressed by more than we thought was reasonable, given the continued strength of the New Zealand and international economies. We, and the managers we employ on clients' behalf, used the downturn to purchase a number of investments at attractive discounts to where we feel the long-term price should be. We anticipated that when markets rebounded clients would enjoy strong gains. And this is what occurred in January 2019.

Outlook for 2019

The best way to understand the strong recovery in asset prices in January is by analysing the reasons for the investment market slump in 2018. Asset prices were depressed by three fears. First, the fear that central bankers would raise interest rates too fast and trigger a recession in the United States. Second, that the trade dispute between the United States and China would turn into a trade war, and third that China might also experience a recession.

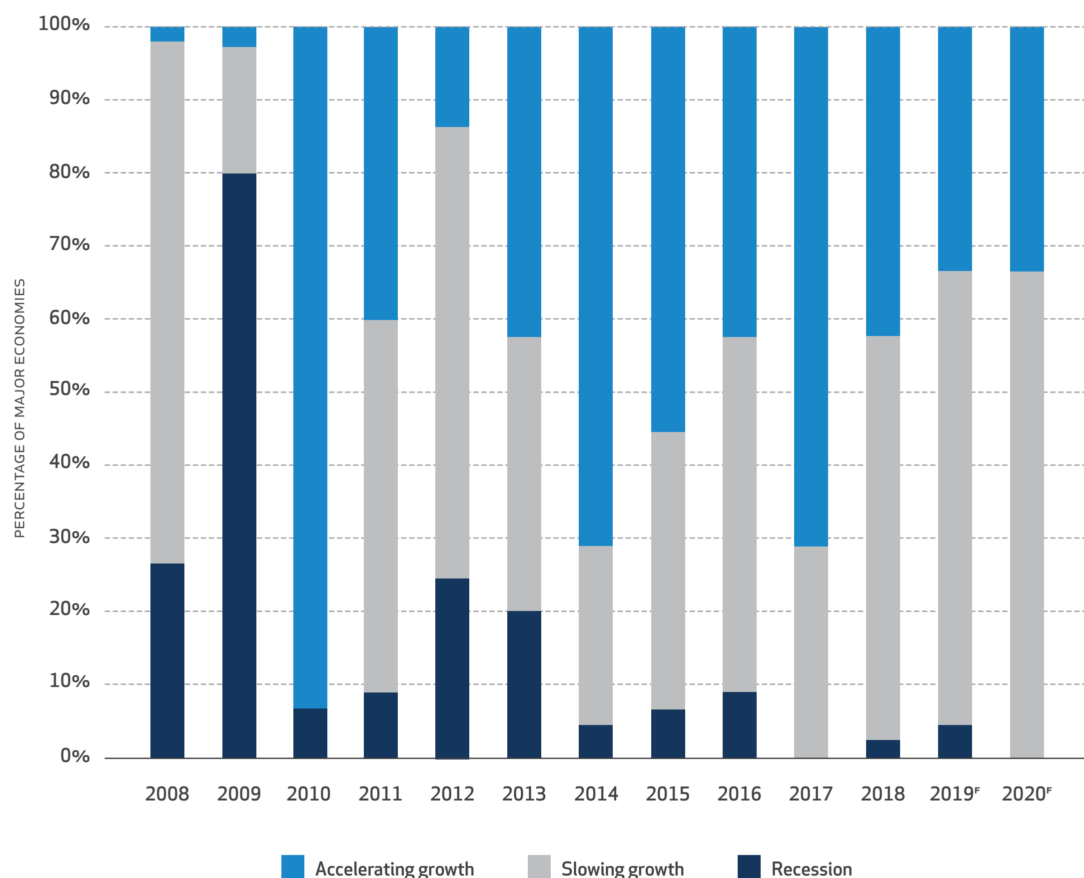
While these were all valid concerns, global financial markets quickly priced in a worst-case scenario. For buyers of assets at these depressed prices, this meant that anything less daunting than a trifecta of negative news would likely see asset prices rise again. Year-to-date this is what has occurred.

Asset classes

International shares

Notwithstanding the strong start to the year, we expect the return from international shares to moderate this year. Our forecasts are for high single digit returns after dividends and fees. We expect companies will continue to grow profits, albeit at a slower pace, as the effects of Trump's tax cuts wane and the global economy slows. Our global investment partners forecast a similar situation in Europe, Japan and China. On the positive side, global share market valuations are now more in line with long-term averages which reduces the risk of a share market collapse.

Global economic growth[4]

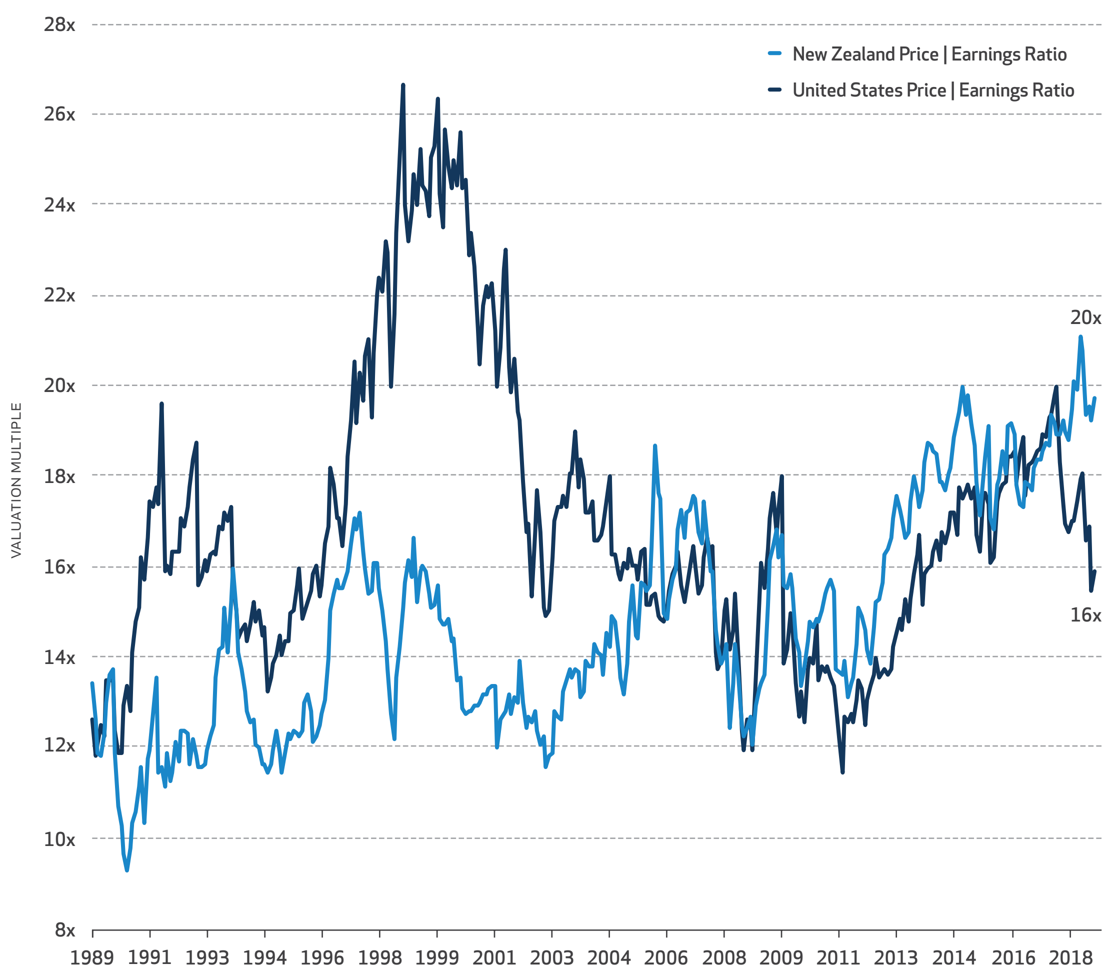


4. Source: OECD, November 2018 forecasts. F – forecasts.

New Zealand shares

In 2018, New Zealand listed companies rose in value by more than their Australian and American counterparts for the second year running. We see limited downside in the local market, as the largest component of the New Zealand index is the defensive property and infrastructure sector which is underpinned by strong and sustainable dividend yields. However, with valuation measures now 25% above international shares and an absence of strong global growers (with the exception of A2 Milk and Fisher & Paykel HealthCare) we expect New Zealand to perform in line with its global peers. Australia, on the other hand, is likely to remain under pressure. Australian listed companies, which are predominantly made up of banks and mining companies, face head winds from slowing Chinese growth, falling property prices and the prospect of low interest rates for some time to come, which reduces the banking sector's profitability.

Share market valuations[5]

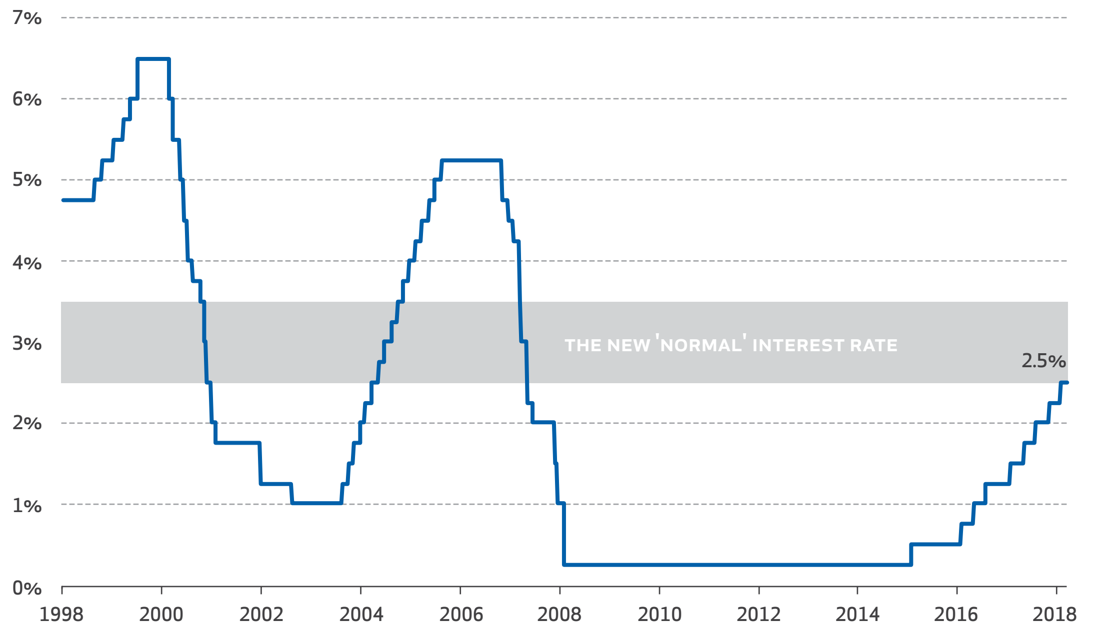


Corporate bonds

After a sharp rise in long-term interest rates last year, which depressed the price of corporate bonds, we expect interest rates to be range bound this year, with United States 10-year Government bonds capped at 3%. Similarly, despite a widening of credit spreads last year in investment grade bond markets, we do not expect any further deterioration for now. An exception to this is the United States high yield sector. Here prices initially declined but have rebounded strongly. In this area, as we have written before, we do not believe the return justifies the risk. Taking these factors into account, we think that this year corporate bonds returns will be driven by their running yield which is currently around 4.0% for local bonds and 3.7% for global bonds.

5. Source: Bloomberg, Forsyth Barr. NZSE40 (1989 - 2001) S&P NZX50 (2001 - 2019) and S&P500 price earnings ratios.

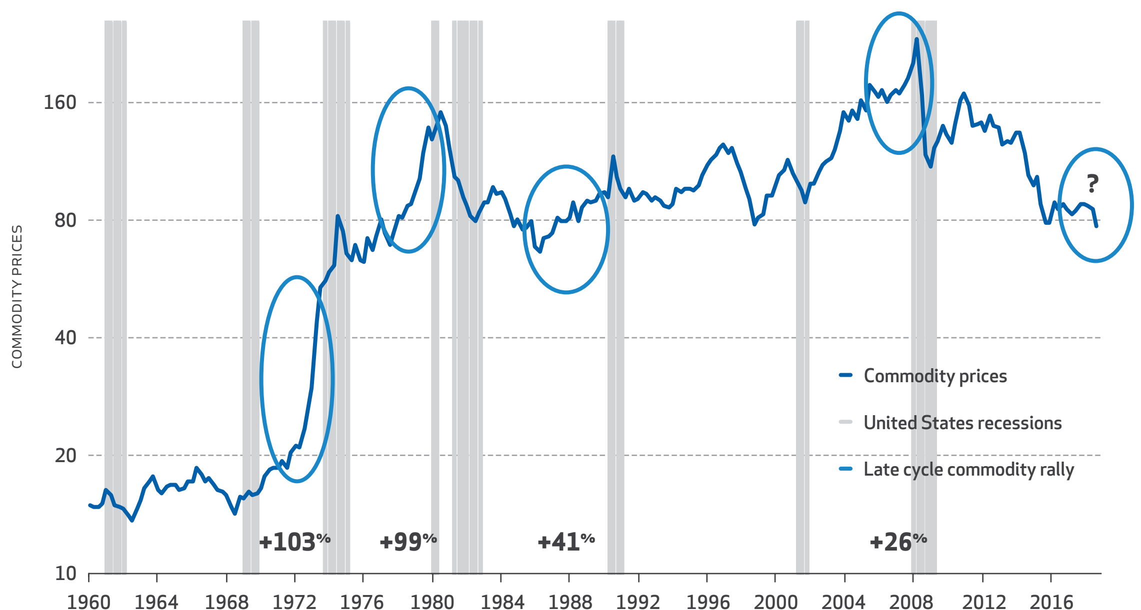
United States interest rates[6]



Commodity prices

In hindsight, there are many things about this cycle that were predictable, such as the rise in house prices, investment markets and employment rates, as the global economy rebounded from its lows in 2009. However, we forecast that inflation expectations and interest rates would also rebound. Instead, they remained at near all-time lows. As a consequence, both oil and metal prices continue to trade below their long-term replacement prices, while the shape of commodity futures curves provide little incentive for investors to allocate capital. We continue to focus on low cost, high quality producers in the metals and mining sector who have substantially de-levered and offer long-term investors an attractive dividend yield. However, given the different nature of this cycle we no longer anticipate a late cycle 'blowout' in commodity prices fuelled by a combination of rising inflationary expectations and strong demand from late cycle capital expenditure.

Commodity price rallies[7]

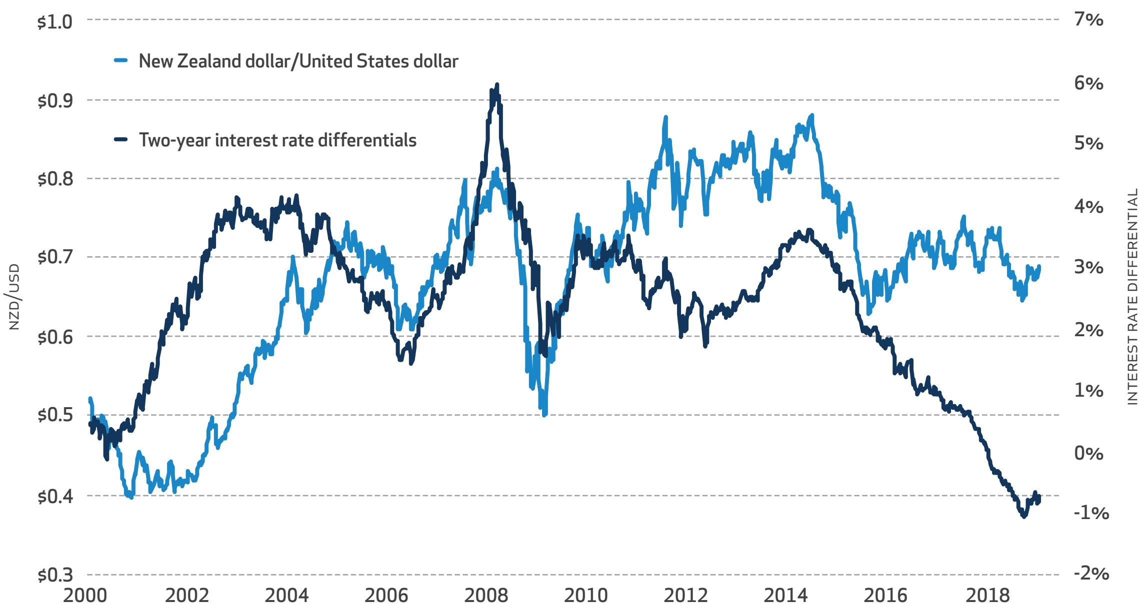


6. Source: Bloomberg, United States Federal Reserve funds rate target, NZ Funds calculations.
7. Source: Bloomberg, Bloomberg Commodity Index, National Bureau of Economic Research. Y axis is shown as a logarithmic scale.

Currency movements

There is growing consensus that the United States dollar will weaken against its major trading partners following a strong run last year. We disagree. Any forecast change in exchange rate needs to take both economies into account. While it is true that the Federal Reserve is likely to moderate the number of interest rate hikes this year, with or without further interest rate rises, holders of United States dollars enjoy a higher interest rate return than either Australian or New Zealand dollar holders. As we see little prospect of interest rate hikes in Australia or New Zealand, we expect our currencies' purchasing power will continue to drift lower, benefiting those who hold a portion of their wealth in United States dollars, as we currently do in clients' portfolios.

New Zealand dollar/United States dollar[8]



8. Source: Bloomberg, NZD/USD spot rate, New Zealand two-year swap rate minus United States two-year swap rate.

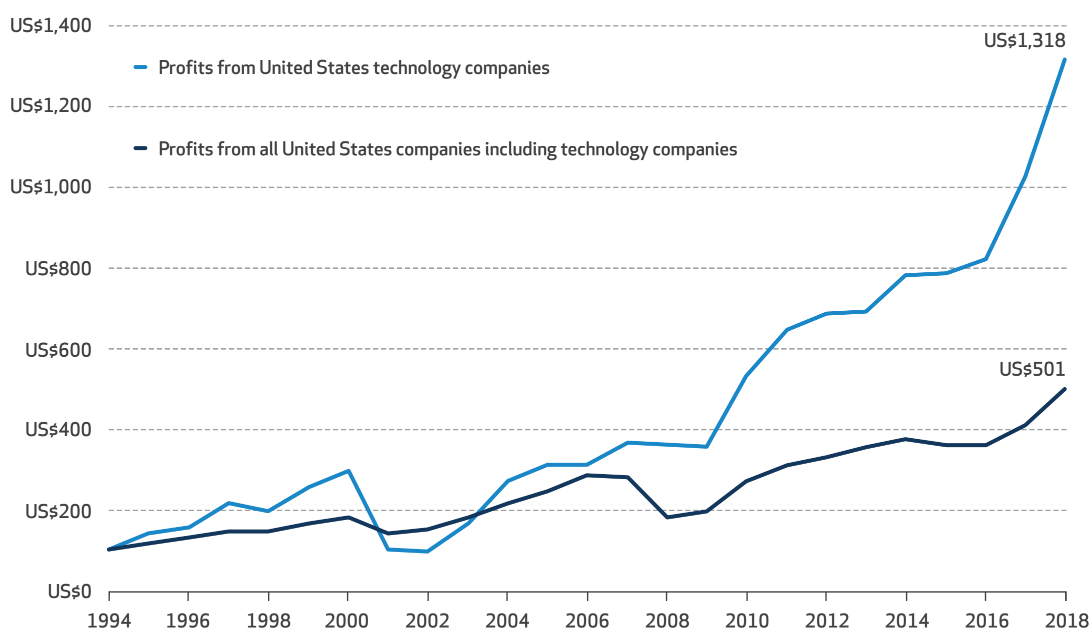
Opportunities in 2019

Growth is where the value is

We have recently finished a deep dive into sector rotation and wish to acknowledge the insights of Goldman Sachs London based team in the following discussion. We have been living in a decade where technology has systematically disrupted traditional industries such as retail, media and, more lately, transportation. Because of our experience of investing in technology in the dot com era, we have been cautious not to place too much emphasis on the sector.

However, the current technology run, unlike its predecessor in 2000, is based on strongly growing earnings and not expectations of future profitability. And while some headwinds are emerging in the form of data regulation, anti-competitive behaviour and the sheer size of some of the players, we believe the late 2018 market correction provided an ideal opportunity to re-enter the technology space. The United States and Chinese listed technology leaders enjoy a forecast growth trajectory of more than twice the wider listed market, for little additional cost to investors based on comparative price earnings ratios.

Technology profits[9]



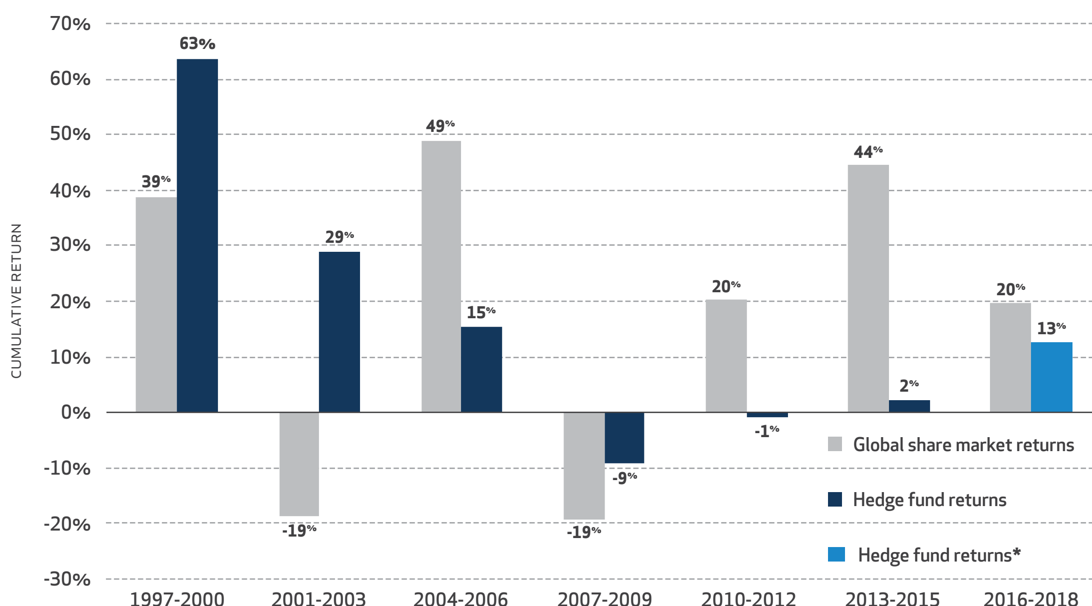
Hedge funds

Over the last twenty years, alternative asset classes – hedge funds, private equity and venture capital – have come to make up a growing portion of professionally managed portfolios. Such 'Alternatives' are now included in sovereign wealth and global pension funds, including the New Zealand Superannuation Fund. For almost a decade now, NZ Funds has included an allocation to hedge funds in clients' portfolios. We favour hedge funds over private equity and venture capital, as the asset class offers liquidity, making it a genuine substitute asset class for long-term investors who do not wish to have their capital 'locked up' for long periods of time.

9. Source: Bloomberg, S&P 500 operating earnings, S&P 500 technology sector operating earnings. Both earnings series rebased to $100 as at 1994.

Our Portfolios contain two types of hedge funds; those specialising in downside mitigation and those that aim to generate share like returns over the long term either with a lower volatility or with returns coming at different times. Historically, the best time to hold hedge funds is when share market returns are either negative or low. As we are only projecting moderate share market gains, we expect our portfolio allocation to Alternatives to make a bigger contribution to clients' portfolios in coming years. As evidenced below, these periods of outperformance can last many years, making Alternatives a valuable addition to professionally managed, well diversified portfolios.

Hedge funds return diversification[10]



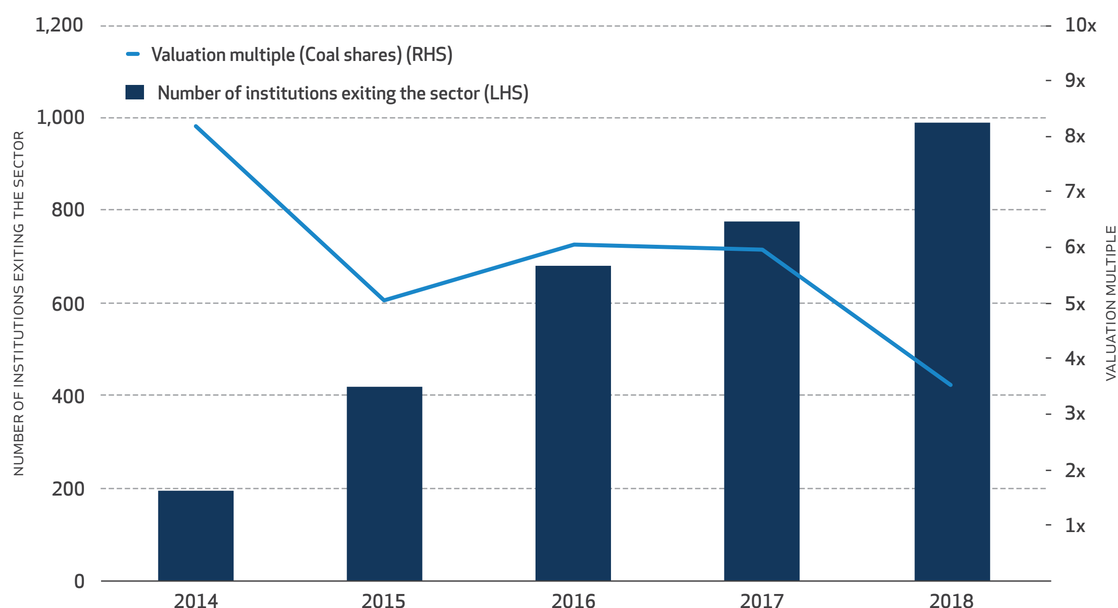
Responsible investing

One of the most exciting developments to occur in finance in recent years has been the emergence of socially responsible investing. As a firm, NZ Funds has invested considerably in the area, internationally through a working relationship with ISS-Ethix, and locally through funding initiatives like our paperless communication push in 2012 which resulted in a donation of over $7,500 in support of the South Island yellow-eyed penguin (the Hoiho). More recently we became the first, and to our knowledge only, KiwiSaver manager in New Zealand to ban unsustainable palm oil producers as part of our socially responsible investment approach.

We anticipated the benefit of adopting a socially responsible approach would accrue to investors over the long term and investors ability to change the world over a shorter period of time would be limited. But recent developments in the coal industry suggest otherwise. Despite withdrawing from the Kyoto Protocol, America's coal producers have seen the market value of their assets collapse and currently face significant hurdles to raising capital at economic prices. We are currently reviewing clients' ownership of other fossil fuel producers. In some cases, we see considerable upside – for example in low carbon emitting LNG producers. In other situations such as the major oil companies, we see significant downside as capital markets continue to allocate funds away from companies which cause harm.

10. Source: MSCI World Index, Hedge Fund Research Global Hedge Fund Index.
*Hedge fund data for 2016 - 2018 is an average of NZ Funds' long/short and macro hedge funds performance.

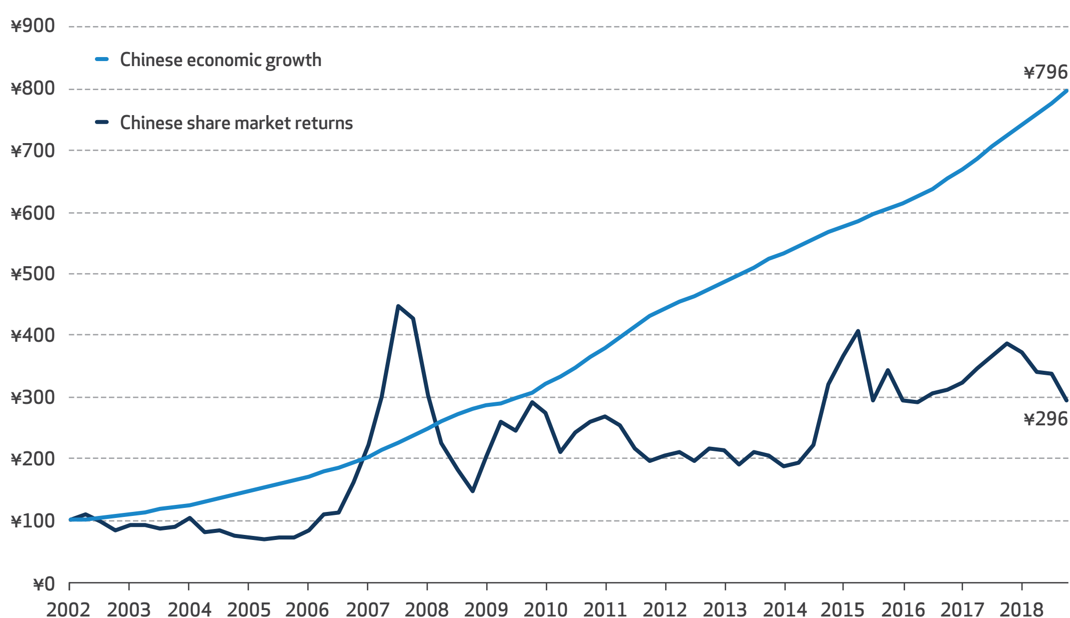
Coal company valuations[11]



China's growth

We see selective opportunities to capitalise on the continued emergence of China as an economic superpower. A decade ago we decided to primarily invest in China through western listed companies such as Yum Brands, Procter & Gamble and Apple. Despite being criticised for not taking a more direct approach, we have been vindicated by the fact that despite a decade of strong economic growth in China, little of that growth has translated into returns for shareholders. Today, China's leading share market index is at approximately the same value as ten years earlier. With continued weak governance standards and heavy state intervention in capital allocation, we expect the listed market as a whole to continue to underperform economic growth. However we have identified a number of investments which we believe can harness China's growth for the benefit of shareholders.

Chinese economic growth[12]



11. Source: FactSet, Divestinvest, 350.org, Goldman Sachs. Valuation multiple is EV/EBITDA.
12. Source: Bloomberg. Chinese share market index CSI300, Nominal GDP, both series rebased to ¥100 in 2002.

Summary

Last year we wrote that the probability of a downturn had increased, but cautioned against the temptation of accumulating cash, postponing investments or putting regular savings or spending programmes on hold in anticipation of the move. We wrote: "It is extraordinarily difficult, if not impossible, to time markets. Years out of the market can result in lower average returns than remaining invested and experiencing a downturn. We therefore recommend clients continue as usual."

Little did we know that 2018 would pan out to be an excellent example of that timing challenge. Over a 13-week period last year global share markets declined 17% from their peak to their trough. Clients who reacted emotionally crystallised their portfolio at depressed prices and missed the subsequent bounce. Since the low on the 24 December, the global share market has already recovered 12%[13], making last year's drop an excellent buying opportunity for clients who regularly contribute to their portfolio.

As discussed, we were disappointed with the performance of clients' portfolios in the second half of 2018. Despite falling a whisker short of triggering our downside mitigation options, our global managers used the pullback to make a number of investments at deeply discounted prices and, as a result, our portfolios have rebounded nicely so far in 2019. We will provide you another detailed update later in the year. In the meantime, you can use myNZFunds to track your investments live, or contact NZ Funds to subscribe to our monthly Portfolio Updates[14]. As always, thank you for continuing to entrust us with your capital.

13. As at the 8 February 2019.
14. By visiting our website at *www.nzfunds.co.nz*.

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