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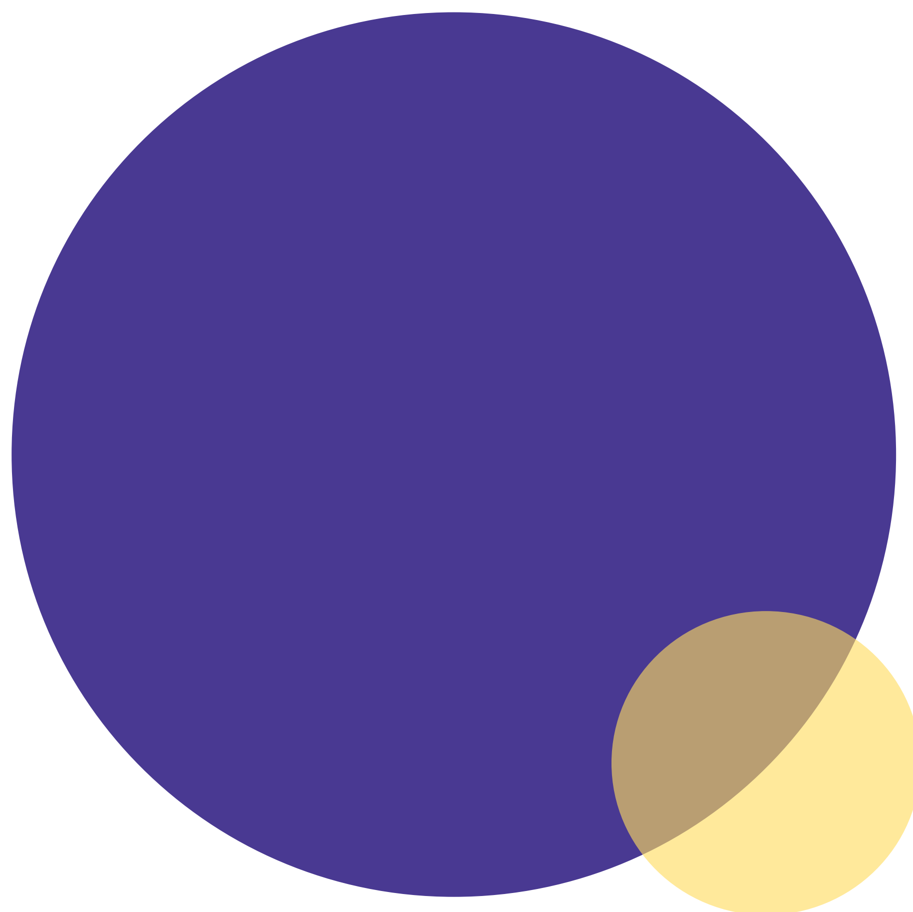


Synergy Investments

Economic Commentary

Markets have been great, but what happens after markets go up?

Synergy portfolios delivered another quarter of good returns to diversified investors. In fact, since Synergy's inception in October 2015, all of its model portfolios have achieved higher returns (after fund manager fees) than we expected based on long run averages.

While investors in the programme may understandably be happy with that outcome, perhaps some may also be questioning "if returns have been so good, are we now due for a period of bad returns?

It's not an unreasonable question, so let's take a step back and look at some facts.

Long term investors know that markets always experience ups and downs. They also know that taking higher risks with their investments generally means three things:

1. Higher returns when markets perform well
2. Lower returns when markets perform poorly
3. Bigger ups and downs along the way (i.e. greater volatility of returns)

Since markets on average go up, taking higher risks over a long time horizon usually allows investors to ride the ups and downs of the markets, and receive an appropriate return for the risks they have taken. This is highlighted in the following chart which shows the very long term returns of the US share market (i.e. the performance of the S&P 500 Index from 1926).

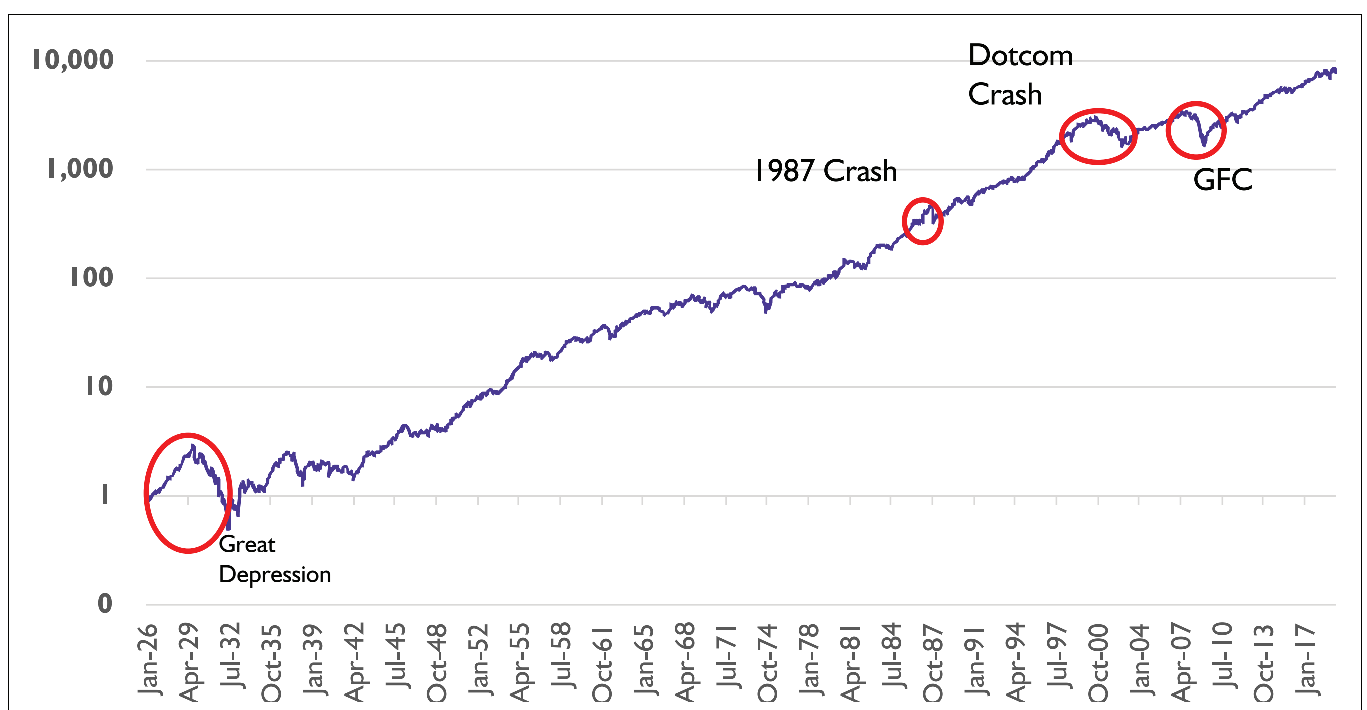
This data is useful for two reasons – it's the longest available financial market data set available, and the US market comprises around 50% of the total global equity market, so its performance tends to have a significant bearing on the performance of most investor portfolios.

The chart (Fig.1) is drawn on a logarithmic scale, which means the size of the up and down movements in the index over time (i.e. the movements in the blue line) represent approximately the same percentage movement anywhere on the graph, regardless of the time period. Therefore, the severity of the drop in the late 1920s tells us that the Great Depression still represents the biggest market fall in the history of the US share market.

But what else does the chart tell us?

1. The US share market has gone up significantly over time. The index has achieved an annualised return of 10.14% p.a. in US dollars since 1926.
2. Despite the seemingly steady gains, it has also experienced plenty of losing periods. The most recent corrections that many of us still remember clearly were the share market crash of 1987, the bursting of the dotcom (technology stock) bubble from 2000 to 2002, and the Global Financial Crisis (GFC) of 2007 to 2008. Importantly, after every correction, the market has subsequently recovered to new highs.
3. We can also see, post GFC, that the US share market has been a very rewarding place to be invested. In fact, the S&P 500 index has gone up +397% (in USD) since March 2009. Incidentally, the New Zealand share market has gained +375% (in NZD) over the same period.

FIG. 1 - S&P 500 INDEX



Markets have been great, but what happens after markets go up?

So, does this mean we should be more worried about a correction?

The short answer is no. We know markets will periodically go down, sometimes by a little and sometimes by a lot, but we don't know when it will happen. Sitting on the sidelines waiting for a correction can often be far more detrimental to your investment fortunes than accepting the normal ups and downs of the markets.

When markets correct downwards, we often remind investors how they have subsequently performed following similar corrections in the past. As the above graph confirms, they always recover.

In this case, we are looking at a recent sequence of winning years. So, a more relevant question today might be "how have markets historically performed in periods immediately following sustained strong performance?".

The answer is found in the table below, which highlights the average return of the S&P 500 Index following a strong rally. For the purposes of this analysis, a rally is considered to be a sustained increase in the value of the index since the last **-20%** decline (Fig. 2).

What we see is that, even after periods of very strong returns, the average subsequent index return is strong as well. For example, there have been 176 separate observations of periods where the S&P Index has gained at least 350%. In the subsequent one, two and three year periods, the average performance of the index has been **10.24%**, **18.99%** and **36.94%** over each respective period.

The learning is that just because markets have been very good recently, we shouldn't presume the next downturn is just around the corner. In fact, the long term evidence of the US share market suggests the best thing to do after a period of strong returns, is nothing!

On average, staying invested and following your plan is likely to deliver far better outcomes than trying to time the next downturn.

FIG. 2 - S&P 500 INDEX

RALLY OF	NUMBER OF OBSERVATIONS	1 YEAR RETURN AFTER RALLY	2 YEAR RETURN AFTER RALLY	3 YEAR RETURN AFTER RALLY
+10%	808	+13.49%	+25.44%	+39.84%
+25%	756	+12.99%	+24.54%	+38.29%
+50%	679	+12.16%	+24.43%	+38.70%
+100%	462	+14.57%	+27.38%	+45.02%
+150%	347	+16.22%	+30.22%	+44.30%
+250%	241	+14.77%	+25.66%	+40.10%
+350%	176	+10.24%	+18.99%	+36.94%
+500%	102	+5.66%	+14.31%	+29.86%

Source: Standard & Poor's Index Services Group. Based on the monthly returns of the S&P 500 Index (gross) US dollars from January 1945 to April 2019.

Key Market Movements

NEW ZEALAND SHARES

+6.82%

The New Zealand share market backed up its impressive start to the year with another strong result in the second quarter. Although indications of a global slowdown raised questions about the ongoing strength of the New Zealand economy, investors in New Zealand shares remained undeterred. A combination of lower interest rates and reduced rate expectations helped enhance the attractiveness of some of the higher yielding companies in the market. The largest beneficiaries over the quarter included Auckland Airport, Mercury, Trustpower and Port of Tauranga which all gained more than 16%. Without having the same attraction from a yield perspective, New Zealand's largest company, a2 Milk, gained 2.5%. Outside the top 50 companies, small biotechnology firm Pacific Edge suffered a -30% decline in its share price after reporting a full year loss of almost $18 million.

Source: S&P/NZX 50 Index, gross with imputation credits

NEW ZEALAND FIXED INTEREST

+1.83%

On 8 May, the Reserve Bank of New Zealand (RBNZ) lowered the Official Cash Rate (OCR) to 1.50%; their first rate adjustment since September 2016. This change was driven by concerns about the weaker global growth outlook and the risks of ongoing subdued growth in New Zealand. Yields on fixed interest securities had already been on a sustained downward path all year. The five year swap rate, a good proxy for market rates in New Zealand, touched a record low of 1.36% on 21 June after beginning the year at 2.23% and beginning the second quarter at 1.71%. Local bond investors benefitted from the reduction in corporate bond yields, with the New Zealand A Grade Corporate Bond Index returning 1.83% for the quarter. The market is currently pricing in further cuts in the OCR (to 1.00%), and the RBNZ underlined this prospect in their 26 June update by indicating a lower OCR may be needed in the future.

Source: S&P/NZX A Grade Corporate Bond Index

NEW ZEALAND PROPERTY

+12.41%

The New Zealand listed property sector enjoyed a great quarter with an increased investor appetite for higher yielding securities providing strong support. After lagging the broader New Zealand share market in the first quarter, roles were reversed from April to June. All seven of New Zealand's largest listed real estate securities performed well, with individual returns ranging from Argosy Property Ltd (+9.1%) to Vital Healthcare Property Trust (+14.6%). With the market assimilating both a projected slowdown in global growth and the potential for further meaningful cuts in New Zealand's OCR, this underpins the current support for the sector.

Source: S&P/NZX All Real Estate Index, gross with imputation credits

AUSTRALIAN SHARES

+8.22%

The Australian share market was one of the leading developed nations during the first quarter with the ASX 200 gaining 7.97% in Australian dollar terms. Large capitalisation stocks in general fared well with communication services and financials the leading sectors. Financials in particular received a boost from the unexpected victory by the Coalition in the federal election. Their Labor opponents, who had been anticipated to win comfortably, had pledged to amend franking credit rules once elected, and this had contributed to weakness in the price of banking shares (and other popular dividend paying shares) in the lead up to the election. With large capitalisation high dividend shares rebounding after the election, the top 50 companies within the Australian market returned a healthy 9.17% in aggregate, while mid capitalisation companies (companies ranked 51 to 100) gained 4.95% and small capitalisation firms (ranked 101+) advanced 3.75%.
Returns to unhedged New Zealand investors were enhanced a little by the New Zealand dollar weakening slightly relative to the Australian dollar over the quarter.

Source: S&P/ASX 200 Index (total return)

Unless otherwise specified, 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.

INTERNATIONAL SHARES

+3.38% (hedged to NZD)
+5.34% (unhedged)

Developed equity markets in general performed solidly during the second quarter. In the USA the S&P 500 set a new high, overcoming a mid-quarter wobble caused by the ongoing uncertainty surrounding USA's trade stance. However, by the end of June, investors were mollified by supporting rhetoric from the Federal Reserve and indications of progress in the trade tensions between USA and China. Eurozone shares advanced, with a sharp correction in May sandwiched between good gains in April and June. European Central Bank (ECB) President Mario Draghi also hinted at further monetary policy easing if the inflation outlook fails to improve. Even the UK market performed positively, despite ongoing Brexit-related uncertainty and the resignation of Prime Minister Theresa May. In general, the widespread reduction in government bond yields and very low interest rates overall, helped reinforce the relative attraction of developed equity markets over the quarter. *Source: MSCI World ex-Australia Index (net div.)*

EMERGING MARKETS SHARES

+2.12%

Emerging market shares generally lagged their developed market counterparts in the second quarter. Trade tensions between USA and China were rekindled in May as talks unexpectedly broke down, and both sides implemented new tariffs. However, hopes for a resumption of talks post the G20 summit in June, and rising expectations that the US Federal Reserve will cut interest rates, both proved supportive later in the period. Russia was one of the best performers in the region, due in part to a strong rally from state-controlled oil company Gazprom. Meanwhile, the Russian central bank cut interest rates by 0.25% in June (to 7.50%), and signalled the potential for further easing. In contrast, China and South Korea disappointed, both impacted by the global trade uncertainty. *Source: MSCI Emerging Markets Index (gross div.)*

INTERNATIONAL FIXED INTEREST

+1.33%

In spite of the low global interest rate environment it was a good quarter for most bond strategies. In the face of slowing global growth projections, broad expectations were that major central banks would maintain very accommodative monetary policy settings, including the possibility of additional US rate cuts. At their respective meetings in mid-June, comments from the US Federal Reserve and European Central Bank confirmed the growing 'dovishness' among policymakers, with both clearing the way for further supportive policy measures if needed. Government bond yields fell markedly through the quarter. The 10 year US Treasury yield fell 0.40% over the period and the 10 year German Bund yield fell 0.26%. The UK 10 year yield fell only 0.17%, in part because the yield actually rose for a time in April on the announcement of an extension to the Brexit deadline and more resilient economic data. In this environment, corporate bonds delivered positive total returns and generally outperformed government bonds. Higher credit quality bonds (i.e. investment grade bonds) tended to benefit more from the falling yields than sub-investment grade securities. The FTSE World Government Bond Index 1-5 Years (hedged to NZD) gained 1.33% in the quarter and the longer duration Bloomberg Barclays Global Aggregate Bond Index (hedged to NZD) rose 2.72%. *Source: FTSE World Government Bond Index 1-5 Years (hedged to NZD)*

INTERNATIONAL PROPERTY

+2.89%

The performance of international property securities generally lagged broad share market returns. Prospects of an increasingly accommodative interest rate environment (i.e. lower rates) typically provides strong support for the sector which often attracts investors motivated by yield considerations. However, the same arguments also support equity investing in general and regular company shares arguably provide greater upside potential. Over the recent quarter it seems that investors were more motivated by the greater upside potential of broader equity markets. Although, as we have seen in the past, investor sentiment related to trade concerns and Brexit considerations can swing quite quickly. The S&P Developed REIT Index gained 1.50% in US dollar terms and the Australian S&P/ASX 300 A-REIT Total Return Index gained 4.12% in Australian dollar terms. A 1.4% weaker New Zealand dollar (relative to the US dollar) increased reported returns to New Zealand investors holding unhedged investments in this asset class.

Source: S&P Developed REIT Index (total return)

The Seven Virtues of Process

Success as an investor starts with the key questions of why, what, where, when and how. Why are you investing? What are your priorities? Where is your destination? When do you hope to get there? But it's the 'how' that's often overlooked.

'How' relates to process. It's not just what you invest in, but the approach you take to investing. This means adopting set guidelines to deal with whatever financial markets, and life generally, might throw at you on the way to where you're going.

Process is critical for several reasons. We've highlighted seven for your consideration:

- First, process means setting pre-agreed rules with your adviser to keep you focused on your goals. Without rules, you may be more likely to act on emotion triggered by the headline of the day or whatever other distraction everyone is talking about.
- The second advantage of having a process is that it can be tied to broad principles. For instance, agreeing that diversification improves the reliability of outcomes may leave you less prone to chasing the latest hot new stock or sector.
- Third, having a process keeps you focused on elements within your control – like dividing your wealth between stocks, bonds, property and cash, diversifying within those categories, rebalancing regularly, and watching costs and taxes.
- Fourth, process is repeatable. The focus is on skill and execution, not on luck or providence. Of course, things will always happen that you didn't anticipate. But your reliance on chance is less with a set process than when you are just winging it.
- Fifth, a process acts as a yardstick. When news breaks, having a process can give you pause for thought. "This news is interesting and diverting but is it sufficient to change how you are proceeding?" your adviser may ask. The answer is usually no.
- Sixth, a process can be personalised. Each person is unique, with different tastes and preferences and risk appetites. Perhaps you feel more comfortable with a larger cushion of cash that can be replenished at regular intervals. If this process keeps you on track and helps you better live with volatility, then it most likely a good process.
- Finally, a process does not have to be set in stone. Circumstances change. Needs evolve. A single process can never incorporate every eventuality. The key point is that the process can be reviewed and adjusted based on experience and what is happening in each individual's life, not to what is going on externally.

Of course, processes work best when they are integrated. Otherwise, a minor change elsewhere can throw you off track. Think of what happens in a restaurant if attention to the quality of ingredients, menu and execution in the kitchen is not matched by attention to quality of service in the dining room.

Likewise, an investor who has agreed with her adviser on following strong processes around her individual plan will not be served well if those managing her money are not delivering on what they said they would do. In contrast, integrated processes that share and maintain a single vision tend to reinforce each other.

Ultimately, process provides structure for your investment journey. The world will always be complex and uncertain, and there will always be a host of potential distractions. But just having a structure in itself can deliver you a level of reassurance.

With a process, you are less likely to pursue the uncontrollable or unrepeatable – whether wasting time and money trying to second-guess markets, chasing last year's winners, or switching your investment strategy based on whatever is fashionable at any one moment.

Instead of trying to ride your luck or intuition, you are methodically and steadily following a repeatable and defensible process that your adviser has designed with your goals, circumstances and preferences at heart.

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