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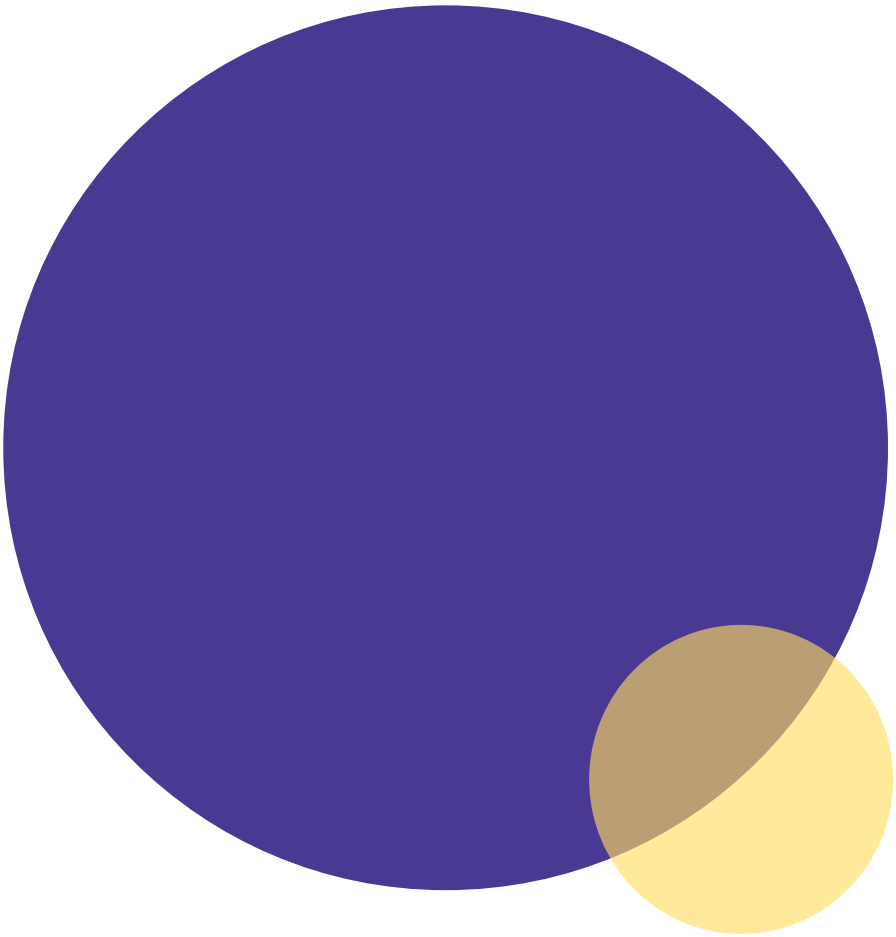

Synergy Investments

Newsletter

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The resilience of investment markets

While the first quarter of 2020 will long be remembered for the global emergence of Covid-19 and an unprecedented market downturn, the second quarter will be remembered for the extraordinary resilience of investment markets.

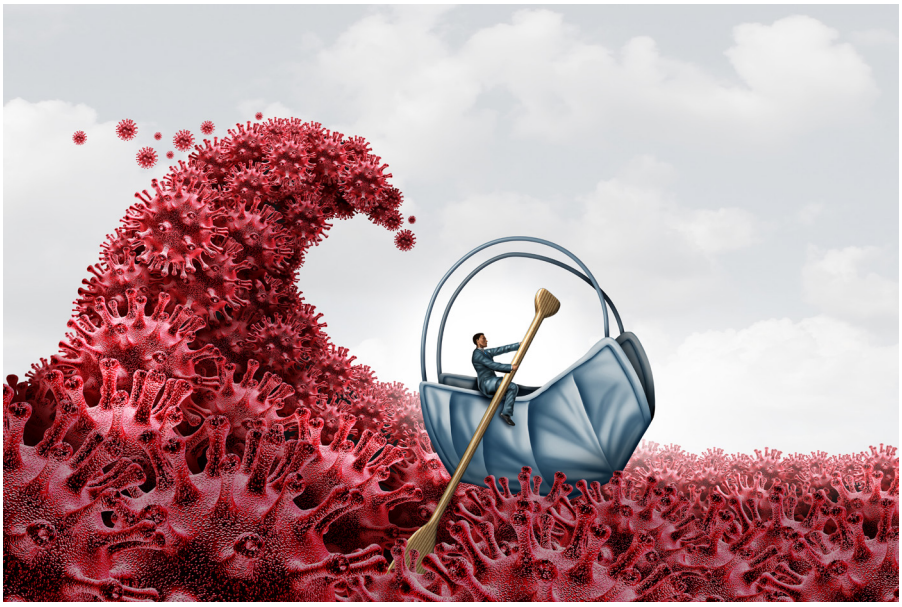
Over the last three months, we witnessed a significant rebound from the first quarter's decline. The turnaround was remarkable not just because of the size and breadth of the investment returns delivered, but also because the global pandemic that drove markets downward with such force in February and March, had not receded. In fact, by almost any measure, the global health crisis triggered by Covid-19 had only intensified.

For many observers, it felt counterintuitive that the markets began to ignore the burgeoning health crisis. Or, for that matter, the growing economic fallout, including sharply higher global unemployment and negative economic growth rates.

However, as we observed in last quarter's newsletter, "whatever shape the recovery ultimately takes, the performance of the share market will be a leading indicator. In other words, share markets will be extremely likely to have commenced their rebound well before any improvement in medical or economic data is evident".

This has unquestionably been the case. What markets appear to have focused on have been the following five elements:

1. Even though we still cannot see an immediate end to the Covid-19 pandemic, there is an underlying expectation that, at some point, this will be controlled (or eliminated) and that business as usual, will return.
2. The general easing of Covid-19 lockdowns internationally, and an associated pick-up in economic activity in the second quarter, helped improve investor sentiment and risk appetites.
3. By the end of March, prices had dropped so far that the future expected returns for many businesses (despite increased short term uncertainty) began to look increasingly attractive.
4. Central governments are clearly committed to providing an unparalleled amount of fiscal and monetary support (via wage subsidies, spending initiatives, interest rate controls, tax breaks, etc) to help engineer an economic recovery.
5. Interest rates are going to be held at extremely low levels, for as long as necessary, to ease the debt burden on individuals and businesses, and to encourage increased spending and investment.



In other words, markets "looked beyond" all the prevailing bad news stories and focused instead on the longer term outlook. When viewed through that lens, investing in risky assets changed from looking unnerving (March) to looking increasingly appealing (April to June).

This explains how global share markets, in particular, staged a sizable rally between April and June (for more details, check out the Key Market Movements in the next section).

When Covid-19 emerged in the early weeks of 2020, it was a giant domino that triggered a series of unimaginable events:

- The grounding of planes
- The closing of borders
- Social distancing and national lockdowns
- Escalating confusion and fear
- An unprecedented market correction
- Massive fiscal and monetary support by governments and central banks

Air New Zealand provides a case study for how unexpected this was and how quickly it evolved. On 27 February, Air New Zealand announced a six month after tax profit of $101 million and expressed confidence they would be able to effectively manage their way through the emerging Covid-19 outbreak.

By April, it had been forced to reduce its network capacity by more than 95% and required an emergency loan facility of $900 million from the New Zealand government. Extraordinary.

Air New Zealand of course wasn't the only business to suddenly encounter significant Covid-related problems. But the point is, if these firms couldn't easily foresee the impact on their own businesses, it highlights something we know only too well - just how difficult it is to correctly forecast the future.

In the first quarter, investors weathered the financial fallout from all of this. In the second quarter, they benefited from their own resilience and the forward-looking nature of markets. In many cases, investor resilience was fortified by communicating with their financial adviser.

Good advice (and smart investing) isn't based on trying to defy the odds. We know that events like Covid-19 will very occasionally come along and, thankfully, we don't need to be able to predict how or where they will strike, or exactly what impact they might have. Instead, we need to focus on making sure that we have a sound long term investment strategy that investors can continue to hold, even when the going gets tough. Because bailing out of a plan at the wrong time, and missing the inevitable rebound, is a setback that can have far more devastating long term consequences.

A key component of any sound long term strategy is to:

- Always be well diversified (minimising your exposure to company-specific risks, or to a single industry or asset class);
- Always take risk in amounts you can tolerate (so you can hold on through periods of heightened uncertainty); and
- Always talk to your adviser if you get concerned or if your plans change.

We don't know what the future holds. Given what we've seen so far this year it would be a brave person who said that they did. But we do know that Covid-19, by many measures, can be described as a one in one hundred year event. We hope that assessment ultimately proves to be accurate.

Key Market Movements

Following the remarkable price action of the first quarter, the investment roller coaster that is 2020 continued from April to June. Markets responded very strongly to ongoing financial stimulus (central banks buying securities), accommodative monetary policy (low interest rates) and an upward revision in expectations about the impact of Covid-19.

Economic data released in April confirmed the severe impact of the lockdown, but as economies re-opened (to varying degrees), many businesses and employees began to get back to work. This led to an improvement in economic and corporate news. Compared with the outlook during the peak of the Covid-19 uncertainty in March, company earnings were generally revised upwards, and unemployment projections were revised downwards. This reduction in uncertainty, and (relative) increase in expected long term global output was positive for almost all risky assets.

The speed of the market recovery was slowed late in the quarter with a second wave of Covid-19 cases in the US, forcing some states to consider reinstating lockdown restrictions. With social unrest and an increase in confirmed cases of Covid-19 globally, an improving sharemarket seemingly highlighted a disconnect between Wall Street and the main street.

However, markets are truly forward looking. Market participants are pricing in long term expectations of global economic growth and each and every firm's participation in that growth. When the quarter began, expectations of economic recovery were frail and weighed down by valid fears of the potential catastrophic impact of Covid-19. But, as social restrictions began to 'flatten the curve' and economies began to slowly reopen, the very worst fears began to be priced out.

Today's bad news isn't nearly so bad when yesterday's news was worse.

INTERNATIONAL SHARES

+18.2% (hedged to NZD)

+10.2% (unhedged)

In sharp contrast to the cacophony of negative returns in the first quarter, most developed market equity indices posted double-digit gains. The US led the charge with the S&P 500 Index (total returns in USD) advancing +20.5% for the quarter. This is only the fourth quarterly gain over +20% in this index since the Great Depression, almost a century ago, and the first since 1998.

In general, smaller capitalisation companies outperformed after lagging the market earlier in the year. Information technology firms continued to outperform with many firms' cashflows unaffected, or even benefiting from the health crisis. Consumer discretionary, materials, and energy sectors also enjoyed good quarters as economic activity picked up. Defensive sectors such as utilities and consumer staples lagged, although these sectors were amongst the better relative performers in the first quarter. The real estate and financial sectors' recoveries were also subdued, and after being among the worst hit in the first quarter, they are now the lagging US market sectors for the year to date.

There was some dispersion among the returns of European nations as each had varying success at containing the virus. In aggregate, the MSCI Europe ex UK gained +15.1%. The recovery for members of the European Union was aided by the European Central Bank expanding its Pandemic Emergency Purchase Programme by a further €600 billion until June 2021 (or until the bank believes the crisis is over).

Britain suffered some of the highest infection rates and endured some of the longest and most severe lockdowns, which weighed on their domestic market, as the UK's FTSE 100 made 'just' +9.1% (in GBP) for the quarter.

In a reversal of the price action in the first quarter, the New Zealand dollar strengthened as foreign investment flowed back into New Zealand. This diminished New Zealand investor gains on unhedged foreign assets.

In New Zealand dollar terms, the MSCI World ex Australia Index delivered a quarterly return of +18.2% on a hedged basis and +10.2% unhedged. Whether looking at hedged or unhedged performance, the returns for this index are again positive over 1, 3, and 5 year periods, while the annualised 10 year returns comfortably exceed 10% p.a.

Source: MSCI World ex-Australia Index (net div.)

EMERGING MARKETS SHARES

+9.3%

Emerging Markets also made strong gains through the quarter, albeit in the face of increasing infection rates in many emerging nations such as Brazil and India. Markets with higher levels of foreign debt did best, with a relative weakening of the US dollar helping to ease their debt servicing obligations.

After a relatively more robust first quarter performance, gains from China were below average in the second quarter, despite the nation's economic recovery continuing and the government delivering further fiscal stimulus. Geopolitical concerns remain, with US-China relations strained by Donald Trump's continued insistence, that the blame for the pandemic can be laid at China's door and hinting at further trade sanctions. China didn't help its cause imposing a law in Hong Kong on 30 June that will empower the arrests of anyone in Hong Kong (citizen or visitor), who has criticised the Chinese Communist Party.

Technology-heavy exporting economies such as South Korea and Taiwan did well in the hopes of a normalisation in global demand, while India was supported by ongoing stimulus from their central bank. Brazil recorded a strong gain, while Russia lagged after reaching an agreement with OPEC to temporarily reduce oil production.

The MSCI Emerging Markets Index produced a quarterly return of +9.3%, for a +0.9% return over the last 12 months.

Source: MSCI Emerging Markets Index (gross div.)

NEW ZEALAND SHARES

+16.9%

Immediately after posting its worst ever single quarter, New Zealand's S&P/NZX 50 Index posted its largest single quarter gain since 1998, advancing +16.9%. New Zealand's three largest listed companies (Fisher & Paykel: +27.2%, a2 Milk: +27.5% and Meridian Energy: +29.3%) were all very strong. Tourism related firms like Air New Zealand (+69%), Tourism Holdings (+97%) and Auckland Airport (+43%) all bounced back significantly from their late March lows, as the relaxing of lockdown restrictions at least restored the ability for kiwis to enjoy domestic tourist activities.

Similar to global trends, firms in the energy sector didn't participate as strongly in the recovery due to compressed prices and profit margins. Listed real estate companies also struggled, in particular those with assets tied to retail space. The economic downturn and increased levels of unemployment will reduce discretionary spending and may compromise some retail outlets' ability to renew leases.

Overall, the S&P/NZX 50 Index advanced in all three months for a +16.9% quarter and leads all asset classes over 1 year (+9.9%) and 10 years (+15.8% per annum).

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

AUSTRALIAN SHARES

+20.8%

The Australian share market was amongst the strongest in the second quarter with the S&P/ASX 200 returning +16.5% in Australian dollar terms. Small capitalisation companies performed even better with the S&P/ASX Small Ordinaries Index rising +23.9%, although still down -9.2% year to date.

Dominated by the materials and financials sectors, it was the miners in the materials sector that led the rebound, as global demand for industrial metals returned. BHP (+24%), Fortescue Metals (+39%) and Newcrest Mining (+37%) were amongst the top performing shares for the quarter. The banks were more subdued with the four largest (Commonwealth Bank, Westpac, NAB, and ANZ) all advancing in the order of +10%.

Former market darling, Telstra, continued its struggles with only a small gain. Large biotech company CSL declined through the quarter, but remains one of the few positive performing large cap stocks on the ASX, over the last 12 months.

Returns to New Zealand investors, were further enhanced by a relatively strong Australian dollar over the quarter, as the NZD / AUD foreign exchange rate pulled back from parity.

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

INTERNATIONAL FIXED INTEREST

+0.6%

With central banks continuing to provide market liquidity, through asset purchasing programmes, and holding interest rates at or near zero, the yields on high quality government bonds were relatively unchanged. The US 10-year government bond traded in a narrow range and ended the quarter effectively unchanged yielding 0.66%. With the Federal Reserve "not even thinking about, thinking about raising rates", this low interest rate environment looks likely to continue.

Conversely, corporate bonds enjoyed a strong quarter. With economic activity showing signs of greater resilience, the prospects of widespread corporate default reduced, enabling the prices of many under stress securities to rally.

In general, it meant a partial reversal of many of the declines seen in March, with the lower credit quality segments of the market outperforming. Even so, credit spreads (the additional yield on bonds backed by riskier issuers) remain elevated.

In aggregate, corporate bonds outperformed higher quality sovereign bonds, and longer duration bonds outperformed shorter duration.

The FTSE World Government Bond Index 1-5 Years (hedged to NZD), posted a +0.6% gain, to take its 12 month return to +3.6%, while the broader Bloomberg Barclays Global Aggregate Bond Index (hedged to NZD), returned +2.4% for the quarter, and +5.7% for the last 12 months.

Source: FTSE World Government Bond Index 1-5 Years (hedged to NZD)

NEW ZEALAND FIXED INTEREST

+3.4%

New Zealand's fixed interest market delivered more action than was generally seen in global markets, with the 10 year New Zealand government bond yield pushing as low as 0.51% in May; with levels never seen before in New Zealand. Through the second half of the quarter, yields increased again and closed the quarter at 0.96%, for a -0.15% decrease since March 31.

This point to point decline in yields meant a price rise for most underlying bonds and, when combined with narrowing credit spreads, resulting in a +3.4% return for the S&P/NZX A-Grade Corporate Bond Index. This is one of the better quarters for this asset class in recent history. The longer duration, but higher quality S&P/NZX NZ Government Bond Index, gained +2.3%.

The Reserve Bank of New Zealand held the Official Cash Rate at the record low 0.25% at all three meetings in the quarter and significantly expanded the Large Scale Asset Purchases ("LSAP") programme on May 13. The LSAP now includes a commitment to purchase up to $60 billion of New Zealand Government bonds, Local Government Funding Agency bonds, and now, Government Inflation-Indexed Bonds in the secondary market. The LSAP aims to keep borrowing costs low and to improve the functioning of the credit markets to help support New Zealand firms navigate the economic uncertainty resulting from the Covid-19 pandemic.

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

Table 1: Asset class returns to 30 June 2020

Asset Class	Index Name	3 months	1 year	3 years	5 years	10 years
New Zealand shares	S&P/NZX 50 Index, (gross with imputation credits)	+16.9%	+9.9%	+15.7%	+16.1%	+15.8%
Australian shares	S&P/ASX 200 Index (total return)	+20.8%	-5.5%	+5.9%	+4.6%	+6.3%
International shares	MSCI World ex Australia Index (net div., hedged to NZD)	+18.2%	+1.9%	+6.7%	+7.7%	+11.9%
	MSCI World ex Australia Index (net div.)	+10.2%	+7.4%	+11.5%	+8.0%	+10.8%
Emerging markets shares	MSCI Emerging Markets Index (gross div.)	+9.3%	+0.9%	+6.7%	+4.3%	+4.3%
New Zealand fixed interest	S&P/NZX A-Grade Corporate Bond Index	+3.4%	+5.8%	+5.7%	+5.2%	+5.8%
International fixed interest	FTSE World Government Bond Index 1-5 Years (hedged to NZD)	+0.6%	+3.6%	+3.0%	+3.1%	+3.7%
New Zealand cash	New Zealand One-Month Bank Bill Yields Index	+0.1%	+0.9%	+1.5%	+1.8%	+2.4%

Unless otherwise specified, all returns are expressed in NZD. Australian shares and Emerging Market shares are invested on an unhedged basis, and therefore returns from these asset classes are susceptible to movement in the value of the NZD. Index returns are before all costs and tax. Returns are annualised for time periods greater than one year.

Top tips for teaching kids about money

If there's one person who understands the importance of teaching kids about financial responsibility, it's Warren Buffett.

Before he became CEO of Berkshire Hathaway, the legendary investor started a handful of small businesses — starting at age six, when he purchased a six-pack of Coke for 25 cents and sold each can for a nickel (5 cents). He also sold magazines and gum from door to door.

"My dad was my greatest inspiration," Buffett said in an interview with CNBC back in 2013. "What I learned at an early age from him was to have the right habits early. Savings was an important lesson he taught me."

When asked what he thinks is the biggest mistake parents make when teaching their kids about money, the billionaire said, "Sometimes parents wait until their kids are in their teens before they start talking about managing money — when they could be starting when their kids are in preschool."

Time is a factor

Yes, you read that right: Preschool. To Buffett's point, researchers have noted that 80% of our brain growth happens by age 3.

One study from Cambridge University found that kids are already able to grasp basic money concepts between the ages of 3 and 4. And by age 7, basic concepts relating to future financial behaviours will typically have developed.

"Most parents already know how important it is to teach their kids about money and how to manage it properly," Buffett acknowledged. But there's a difference between knowing and taking action.

According to a 2018 survey from T. Rowe Price, which gathered responses from 1,014 parents (of children between the ages of 8 to 14) and more than 1,000 young adults (ages 18 to 24), only 4% of parents said they started discussing financial topics with their kids before the age of 5.

Thirty percent of parents started educating their kids about money at age 15 or older, while 14% said they never did at all.

Lessons Buffett taught his own kids

In 2011, Buffett helped launch a children's animated series called "Secret Millionaire's Club," which featured himself as a mentor to a group of students.

There are 26 episodes in the show, and each one tackles a financial lesson, such as how a credit card works or why it's important to track where you put your money.

"I taught all [three] of my kids the lessons taught in 'Secret Millionaires Club,'" Buffett told CNBC. "They are simple lessons meant for business and for life."

Here are a few lessons from the show, along with tips from Buffett on how to teach them to your kids:

1. How to be a flexible thinker

The goal of this lesson is to encourage your kids not to give up just because something doesn't work the first time. The ability to think creatively and outside the box will come in handy when they run into future financial challenges.

Activity ideas:

- Go to an art museum with your kids and discuss the different styles of each painting. Then, invite them to paint something of their own. Have them brainstorm different tools — besides the paintbrush — that can be used (e.g., sponges, cotton swabs, fingers).
- Turn your trash into treasure by challenging your kids to come up with new uses for old things around the house (e.g., bottle caps can double as checker pieces, an empty cereal box can be turned into a magazine holder).

This will help teach them how to think critically, save money and help the environment all at the same time.

2. How to start saving money

As Ben Franklin once said, "A penny saved is a penny earned." To help your kids learn to manage their money, it's important for them to understand the difference between wants and needs.

Activity ideas:

- Give each of your kids two money jars: One for savings and one for spending. Each time they receive money (e.g., as a gift, for allowance, for walking the neighbour's dog), talk to them about how they wish to split the money between savings and spending.
- Have your kids make a list or create a collage from magazine photos of five to ten things they'd like to purchase. Then, go through each item with them and mark whether it's a want or a need (e.g., a new toy is a want, while a new backpack is a need.)

3. How to differentiate between price and value

We've all been guilty of paying more money for a cool brand of shoes or gadget when we could have gotten a similar item that was just as good for a lesser price.

The idea behind this lesson is to help kids understand the different ways advertisers get us to buy their services or products, as well as how to tell what is and what isn't worth paying for.

Activity ideas:

- Make a list of items you need at the supermarket, and then check flyers, newspapers and websites with your kids for items on the list that may be on sale. Compare those prices and see which store offers the best deal for a specific product.
- Pick up a magazine with your kids and choose an ad to evaluate. Ask them: What's being sold? What message is the ad trying to get across? What catches their attention in the ad? How does the ad make them feel? How is it trying to persuade them to buy the product?

4. How to make good decisions

The key to making smart decisions is to think about how different choices can impact future outcomes.

Activity ideas:

- Buffett suggests modeling good decision-making skills and talking to your kids about your decisions as you make them, as well as any resulting domino effect they could have. For example: "We want to buy a new TV, but our heat pump is broken and we need to save money to get it fixed. If we don't, it will be too cold in the house when winter comes. Once the heater pump is repaired, we can think about buying the TV."
- Get your kids into the habit of making good decisions about how to save money. Maybe there's a book they want to buy. Ask them whether they really need it or if they can borrow it from the library.

'It's never too early'

Instilling healthy financial habits in your kids is one of the most important things you can do to help ensure they have a successful future.

"It's never too early," Buffett said in a Q&A with Yahoo Finance in 2013. "Whether it's teaching kids the value of a dollar, the difference between needs and wants or the value of saving — these are all concepts that kids encounter at a very early age, so it's best to help them to understand it."

Adapted for New Zealand readers from an article by Tom Popomaronis, Hawkins Group.

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