Lifestages KiwiSaver Scheme: Investment Commentary

As at 30 September 2018

Funds Administration New Zealand Ltd ("FANZ") is the Manager of the Lifestages range of funds.

Welcome to your report for the period ending 30th September 2018. Once again investors will have noted that their investment portfolio performance seemed to be at odds (in a good way) with the somewhat frenetic media commentary on the state of the investment markets.

This narrative has been driven by a number of factors. These include;

1. Increasing concern about Trump starting a trade war by putting on tariffs on imported goods, especially from China.
2. Strong returns from equity markets (which in turn have been largely driven by technology stocks performance).
3. Rising interest rates in the United States as a strong domestic economy (buoyed by tax cuts) has meant rising employment and inflation.
4. A "chicken little" type commentary from some New Zealand business sectors that business conditions are dire.
5. Remembering the Global Financial Crisis which began in earnest ten years ago, in September 2008.

The election of Trump to the White House in 2017 signalled a world view that put the United States being less focused on "being a good neighbour" than to putting its own explicit interests first. When one adds an Executive culture that is focused on disrupting and reshaping established relationships and alliances rather than a careful, incremental, consensus building approach, then what we are currently seeing being played out by the United States, should be no surprise. Indeed, students of United States history will be aware that this increasingly insular approach by the United States is not a new trend and simply repeats a policy framework used by the United States between the World Wars in the 20th Century. One might argue that, ultimately, that didn't end too well! The period after the Second World War saw the United States putting considerable effort and policy support in to building institutions such as the United Nations and the World Trade Organisation. The current approach by the United States sees a retreat from these types of organisations and a consensus style of management.

The other striking feature of the last reporting period has been the strong performance of equity markets generally, but in particular technology stocks. These stocks (Facebook, Amazon, Apple, Netflix and Google) appear to be ushering in the verge of a profound digital age. Their performance has been nothing short of spectacular. However, whilst we agree with the narrative that there is a substantive and profound change underpinning these investment stories (and others in the same sector), there must be a question as to whether their price (and performance) has got "ahead of itself". Trading at PE valuations in excess of 20 times means any stock in this category is relying on earnings growth to support its price (and future performance). Whilst there's no doubt that we are about to enter into a new digital age, we are concerned about the valuations of these stocks and whether the market can support them in the short term. A well-diversified portfolio (as always) remains the best strategy for investors concerned about this issue.

The US Federal Reserve lifted the US Fed Funds Rate on 13th June 2018 from 1.75% to 2.00%. This was the second hike in 2018, and a continuation in a cycle that began in late 2015. In a post-GFC environment, where interest rates are eventually expected to settle at lower levels, it's natural to ask how far away the US Federal Reserve is to the end of its interest rate cycle. At the same time, in New Zealand, the Official Cash Rate has been on hold at record lows since the end of 2016, and the focus is on the different issue of when a hiking cycle will eventually begin.

In practice, we see the Fed hiking another couple of times in each of 2018 and 2019, and then staying on hold for a prolonged period, perhaps as the momentum of the US economy is finally restrained by the cumulative tightening in monetary conditions from Quantitative Tightening (QT) and interest rate hikes.

Repeating the same analysis for New Zealand draws out similarities and differences. We know that the RBNZ modelling assumptions for the neutral OCR have also been falling (refer to our previous market commentaries where we highlight the Reserve Bank's Research on the falling Neutral Monetary Policy 90 Day Bank Bill Rate), initially as a step-change lower after the GFC and then more gradually through time to sit at around 3.50-4.00%.

Since the GFC, the market's own pricing of the long-run neutral rate (as proxied by the implied market one-year rate five years ahead) has typically sat above the RBNZ neutral estimate. However, like the United States, in recent years these have converged so that the central bank and market are already factoring in a similar resting place for the OCR in around five years' time.

The difference with New Zealand is that the current OCR, at 1.75%, still sits a long way south of the neutral OCR of 3.50-4.00%. For some time now, the RBNZ has used the narrative that the OCR will remain low for a considerable time and that message has been reiterated by the new Governor, Adrian Orr. In New Zealand, while the message that the RBNZ is on hold for now is loud and clear, we are looking for when enough evidence has built to move away from this narrative. In coming months, inflation may rise to 2.0% as higher oil prices and the fall in the New Zealand dollar combine to lift headline CPI inflation.

[1] www.lifestages.co.nz/kiwisaver/kiwisaver-fund-performance/

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KiwiSaver Poua he Oranga

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Historically, the RBNZ would look through currency and oil-driven changes, but a lift in inflation towards 2% may help the process of inflation expectations lifting to become more consistent with target, which the RBNZ would likely welcome. Furthermore, the well-publicised changes in minimum wages and high-profile public sector pay claims are an added factor in the wage and price-setting dynamic to monitor. The RBNZ will have a high threshold of evidence before they signal the commencement of a hiking cycle. But, when the facts change, so will policy stance and interest rate markets. In our portfolios, we are modestly short duration in our fixed interest funds, and underweight bond proxies in our equity funds.

This short duration ties in with a generally positive view of the New Zealand economy. There's no doubt that the New Zealand economy is over the peak GDP growth spurt of 2016. However, there seems no reason why we can't enjoy an economic period with an economy having a long and steady GDP growth rate.

As previously mentioned this month is the Ten-Year Anniversary of the GFC. Like most people, the writer has many memories of this period. The $US600 billion collapse of 158-year-old Lehman Bank remains the biggest bankruptcy in corporate history. Twenty-five thousand people lost their jobs in an instant. It hearalded in the start of the full blown GFC. While the next crisis is unlikely to be a repeat of the GFC, it will almost certainly echo its effects. The triggers will be different, and are by definition unknowable. But it will be just as scary and just as sudden when it does eventually happen.

I'd like to leave you with a comment from our investor comment from October 2008, which is as true today as it was ten years ago.

> "Perhaps the key message for investors is that the continued focus on quality, liquidity and diversification are the keys to successful investing in any environment.....
>
> One last part of advice: mute the TV, turn off radio and disregard newspaper reports. If you'd been devouring the wildly oscillating financial news on a daily basis (and let's face it, it's pretty compelling stuff!), then stop!... Your portfolio report represents the reality of the last six months."

Hear, hear!

Once again, thanks for the opportunity to work alongside you to help you achieve your financial goals. We appreciate your support and look forward to being of service to you in the future. Please do contact us if you have questions at all

Kind Regards,

Graham Duston
Executive Director
FANZ Private Wealth (FANZ)
Subsidiary of SBS Group

For details on the funds, you should go to our website[1] and look at the fund's latest performance information and fund updates (KiwiSaver Document Library).

Performance

Fund	Unit price	6 month	1 year	2 years p.a.
Lifestages High Growth Fund	1.326286	10.93%	13.29%	13.39%
Lifestages Income Fund	1.070950	0.63%	0.77%	0.93%
Lifestages Growth Portfolio*	1.752016	11.39%	12.90%	11.76%
Lifestages Capital Stable Portfolio*	2.999179	3.59%	4.90%	4.62%

Returns are after management fees but before tax and member fees.
*The Lifestages Capital Stable Portfolio and the Lifestages Growth Portfolio are closed to new investors.

[1] www.lifestages.co.nz/kiwisaver/kiwisaver-fund-performance/

Funds Administration New Zealand Limited is the issuer of the Lifestages Kiwisaver Scheme.
The product disclosure statement for the Lifestages Kiwisaver Scheme is available at www.companiesoffice.co.nz/disclose (search for 'Lifestages Kiwisaver Scheme').