

Lyford Investment Management Winter Update

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Overall, the three months from April to June represented another good period for investors in risky assets.

Although, as per usual, a critique of the global environment over the period doesn't provide an obvious explanation of why that should be the case. Some of the largest issues facing markets remained as unresolved at the end of the quarter as they had been at the start. In that category were –

- what sort of Brexit deal (if any) the UK government will end up securing;
- the outlook for global interest rates and inflation;
- if there is ever going to be an end to the US/China trade war; and
- if there is an end to the trade war, what will be left standing when the smoke clears?

Equity investors brushed aside any uncertainties as global share markets were largely positive over the quarter.

This should only remind us that the reason markets, in aggregate, go up is often unrelated to these sorts of issues. It's usually not about politics, the direction of interest rates, economic growth rates, or even conflict. Yes, those elements (and others) can each influence investor behaviour and, to that end, they can have some short term impact on whether prices are being bid higher or lower. However, the more common reason markets go up is that global commerce continues to function, even when times are uncertain.

Regardless of what Donald Trump tweets, McDonald's continues to sell Big Macs. Regardless of whether or not the UK remains in

the European Union or the trade war ends, we will continue to put petrol in our cars and pay for our phones, food, entertainment and clothing.

Of course, the actions of central bankers, politicians and regulators can all have an impact on whether we feel more or less confident about what lies ahead. That can be very important, as it can influence what (and how much) people are prepared to spend their money on. If the future looks much less certain, we might decide to cut back on luxuries and save a little bit more. Perhaps we carpool. Perhaps we have a staycation rather than a vacation.

But overall, unless uncertainty and fears are so high that we

significantly change our collective consumer behaviour, most of us will generally continue to live our lives tomorrow in much the same way as we do today. And the businesses and service providers that we utilise in our day to day lives will continue to benefit.

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Maintaining momentum from the first quarter rebound, Australasian share markets again delivered strong gains.

The New Zealand share market¹ posted a healthy 6.8% for the quarter, although this time lagging neighbouring Australia², which returned 8.0%. The Australian market received a twin boost in May and June with a surprise Coalition win in the federal election followed by a 0.25% interest rate cut.

Most major developed share markets also performed well, with the USA³ achieving a solid 4.3%. This was broadly in line with average 4.9% returns across developed European⁴ share markets. In fact, the most notable laggard amongst developed nations was Japan⁵ which delivered a disappointing -1.6%. Japanese auto makers with factories in Mexico were hurt during the quarter as the USA announced new Mexican tariffs. To put the Japanese performance in perspective, even the UK⁶ market, still restless under the long shadow of an uncertain Brexit divorce, returned 3.3%.

Emerging market⁷ countries displayed a much wider spread of individual returns and advanced 0.7% for the quarter in aggregate. The sizable Chinese market lost ground which pulled the broader emerging Asian region into the red, while emerging nations across Europe and the Middle East generally performed strongly.

Global bond markets also had a good quarter and delivered better returns than we might have expected given the low level of global interest rates. Bond returns benefited from a widespread decline in global yields throughout the quarter, due largely to global inflation expectations slowly receding.

What has surprised many central banks in the last few years has been the conspicuous absence of inflationary pressures despite a decade of quite extraordinary monetary policy stimulus. This year has been no different. Despite rising oil prices and hopes of a global trade expansion following Chinese credit stimulus, the global growth outlook has again overpromised and underdelivered.

In fact, the OECD is now projecting lower growth next year in the USA, China, Japan, the Eurozone, UK, Australia and New Zealand. They expect growth rates to remain positive in each of these areas but at lower levels than are being experienced at present, and almost certainly lower than the respective central banks would ideally like to see.

Not surprisingly, with a backdrop of weaker global growth the pricing in developed bond markets is effectively ruling out the prospect of a sustained outbreak of inflation any time soon. It is these falling market expectations of both growth and inflation that go a long way to explaining why bond yields are now loitering at the lower end of their recent ranges.

American and Australian yields fell the most during the quarter. After surprising the markets by benching their planned rate hike programme in the first quarter, the US Federal Reserve followed up in the second quarter by altering their narrative towards a clear easing bias. Australia went one better by actually cutting their cash rate by 0.25% in June, their first rate adjustment of any kind in almost three years.

With sovereign yields across Europe, UK and Japan also drifting lower, the returns of the World Government Bond Index⁸ and the Global Aggregate Bond Index⁹ were up a healthy 1.33% and 2.72% respectively for the quarter.

Unable to swim against the tide, New Zealand policy makers also signalled their caution with respect to the projected slowdown in global growth. In May the Reserve Bank of New Zealand lowered the Official Cash Rate to a record low of 1.5%, citing concerns about the global growth outlook and the prospects for future employment growth in New Zealand. On the back of the decline in local rates, the New Zealand Corporate A Grade Bond Index¹⁰ gained 1.83% in the quarter.



What all of this means for investors is mixed.

Lower interest rates directly reduce the returns we can reasonably expect, at least in the near term, from cash, bonds and term deposits. In fact, that's the continuation of a longer term trend. A dozen years ago, when six month term deposit rates in New Zealand averaged 7.8% and inflation averaged 2.4%, adopting an investment strategy built around term deposit investing may have been a valid approach. But today, with six month term deposits averaging 3.2% and inflation running at 1.5%, you can quickly see how returns have been squeezed as interest rates have fallen.

If an investor was taxed at 17.5% in each scenario, then after deducting tax and inflation, the real return from adopting a six month term deposit strategy has fallen from 4.04% to 1.14% in just 12 years. In other words, the real inflation-adjusted income of the strategy has fallen by almost three quarters.

Whilst this would not have been a great development for someone reliant solely on investment in fixed interest assets, the news for diversified portfolio investors has been, and continues to be, much better. Low interest rates mean low borrowing costs, and this is generally regarded as being supportive of riskier assets, such as equities.

Perhaps we have seen some element of this in the recent performance of the New Zealand¹ share market. The very long run average return of the New Zealand share market is a little under 10% pa. However, its annualised return over the last six years to end December 2018 – a period of much lower interest rates – has been 15.1% pa.

While we shouldn't attribute all of this extra return to the lower interest rate environment, it's difficult to think that it hasn't at least had a positive influence. Of course, investing in shares brings higher risks and investors, as always, need to balance their return requirements against their willingness and capacity for risk.

We cannot predict the future, or when and how the prevailing issues occupying the minds of news agencies, governments and investors will all be resolved. But one thing we can be sure of is that when the prevailing issues are finally resolved, new issues will have emerged to take their place.

As investors, we should try not to be overly distracted by these issues as most will tend to have little direct bearing on our investment portfolio.



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We should instead take a measure of comfort in the traditional resilience of global commerce and focus on the things that we can control – developing and maintaining a long term investment strategy, keeping costs low, and taking appropriate and persistent exposures to sources of higher long term expected returns.

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- 1 S&P/NZX 50 Index (gross with imputation)
 - 2 S&P/ASX 200 Index (total return in AUD)
 - 3 S&P 500 Index (total return in USD)
 - 4 MSCI Europe Index (gross dividend in USD)
 - 5 MSCI Japan Index (gross dividend in JPY)
 - 6 MSCI UK Index (gross dividend in GBP)
 - 7 MSCI Emerging Markets Index (gross dividend in USD)
 - 8 FTSE World Government Bond Index 1-5 Years, hedged to NZD
 - 9 Bloomberg Barclays Global Aggregate Bond Index, hedged to NZD
 - 10 S&P/NZX A-Grade Corporate Bond Index

Key market movements for the quarter



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)*



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 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)*

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.

Spend to maximise your happiness

The purchasing of material possessions makes us happy, but the feeling wears off, sometimes with astonishing speed.

Recently we heard about someone with a family member in their late 80s moving to new but smaller accommodation. As the family converged to help, they found so much more than could possibly fit into the new place. They found many loved treasures, well-worn and used items, but also kitchen equipment long forgotten, tools idle for years, hats never worn, jewellery never adorned. They found stuff, lots and lots of stuff. Even after several rounds of giving away to charity and friends, there was still more stuff than was possibly needed.

That got us thinking about money, stuff and happiness.

Most people seek happiness. Some economists even think happiness is the best indicator of the health of a society. However, while money can make us happier, studies show that after our basic needs are met, it doesn't make us that much happier.

A 1978 study¹ compared lottery winners in the United States with a control group that didn't win money.

Not surprisingly, the lottery winners did report more happiness, initially, but over time there was very little difference between them and the control group. What's more, the lottery winners actually reported the least enjoyment in simple activities.

The New York Magazine ran an interesting article entitled "The Science of Us" where the author Melissa Dahl said,

"The thrill of winning the lottery will itself wear off. If all things are judged by the extent to which they depart from a baseline of past experience, gradually even the most positive events will cease to have impact as they themselves are absorbed into the new baseline against which further events are judged".

That got us thinking about money, stuff and happiness.



Basically, we adjust to our new reality very quickly. Once we do, positive feelings come from unexpected improvements from the new reality, and negative feelings come from unexpected losses from the new reality. But just being at the new reality eventually ceases to feel special. It just feels... normal.

Dr. Thomas Gilovich, a psychology professor at Cornell University has been studying the question of money and happiness for over two decades. Gilovich says, "One of the enemies of happiness is adaptation. We buy things to make us happy, and we succeed. But only for a while. New things are exciting to us at first, but then we adapt to them."

This is why some people buy things they don't need, or even use. The purchasing of material possessions makes us happy, but the feeling wears off, sometimes with astonishing speed. The need to recapture this feeling can be strong and the cycle continues, whether or not there is a need or even space to put the new things.

There are a number of reasons why material possessions don't permanently improve our happiness. Our tastes change, fashions change, possessions often require maintenance and someone else always has more.

So, what can we do?

Well, we are not making a case against spending. The old adage is true; you can't take money with you when you go. But the truth is you can't take your material possessions either. The answer might be to try to target your spending on ways to maximise your happiness, rather than on just accumulating more stuff. With that in mind, the following ideas might be worth more than a second thought.

1. Spend on experiences not things:

Research has shown² that after the fact, we enjoy our memories of good experiences rather than the things we have bought but don't really need. Experiences come in every shape and size, but our favourites are often the ones that remind us of being young. For those with a love of animals and photography, then a trip to Africa may be in order. Dreamed of being an astronaut? Perhaps a trip to Kennedy Space Center. If cricket is your passion, then the World Cup every four years is a must.

2. Spend money to be social and learn skills:

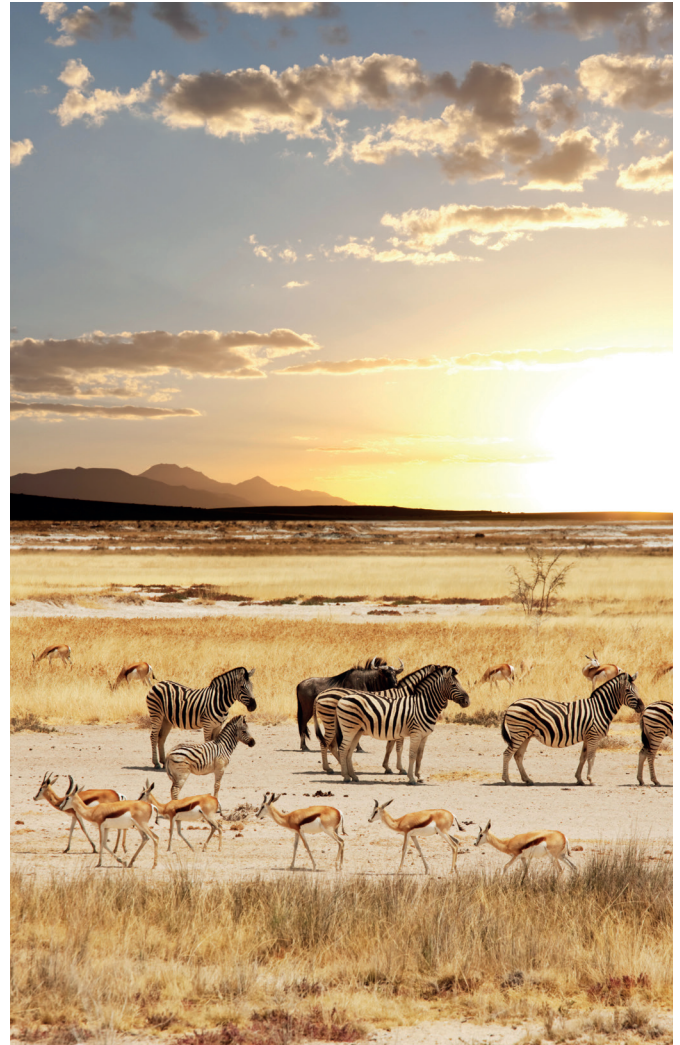
Good relationships make human beings happy and fulfilled³, so consider spending money enhancing relationships in social settings. This could be related to learning a new skill such as a painting or pottery class where there is an opportunity to meet people and form new friendships. Joining a golf club or taking up a gym membership is a way to meet people with similar interests and stay fit. Spend money doing activities around and with other people.

3. Spend money to volunteer and share with others:

There are many wonderful causes in the world so find one that aligns with your own views and ideals. Spending time and money supporting those causes can give incredible joy⁴ and lead to strong and lasting relationships.

Striving for happiness is a pursuit that everyone shares but perhaps not many of us think too deeply about. And while the list of the ways to maximise your happiness is surely longer than these three suggestions, what they have in common is that each requires a level of contemplation or planning.

The first step is to realise that the true measurement of happiness is not in the volume of stuff cluttering up your garage, it's much more commonly found in the quality and vitality of the relationships you develop with others, and the mutual shared experiences you enjoy along the way.



1 http://pages.ucsd.edu/~nchristenfeld/Happiness_Readings_files/Class%203%20-%20Brickman%201978.pdf

2 A good summary of this research is found at <https://www.forbes.com/sites/travisbradberry/2016/08/09/why-you-should-spend-your-money-on-experiences-not-things/#626121486520>

3 One major study on this theme is found here <https://www.tandfonline.com/doi/abs/10.1080/17439760601069051?journalCode=rpos20#.VczqTVNVikp>

4 A good summary of this science is found here <https://www.livescience.com/2376-key-happiness-give-money.html>

Disclosure statements are available on request and free of charge.