Economic and Market Commentary March Quarter 2024

Overview

Large cap global equities performed very strongly again over the quarter despite the soft global economic environment.

International equity markets rallied strongly again over the March quarter as the tech rally rolled on and started spreading to other parts of the market. Hot on the heels of the so-called "magnificent seven" US-based tech stocks which have been firing on the AI boom (up around 50% since Jan 2022) we now have the European "granolas"[1] stocks. These are up a mere 43% over the same period and comprise mainly large cap pharmaceuticals and luxury brands, as well as Dutch-listed AMSL, the only company that can make the machines required to manufacture the most advanced chips being used for AI applications. Elsewhere, performances have been more subdued. NZ equities and fixed income, for example, had lacklustre returns (see Figure 1).

As in our previous update, on the economic front the US economy remains a bright spot with around three-quarters of US companies' earnings beating analyst estimates. Europe and the UK remain weak. New Zealand's economy has been in mild recession over much of 2023, and on a per-capita basis its performance was amongst the worst in the OECD (see Figure 2) over the second half of 2023. Unfortunately, indicators suggest conditions are getting worse rather than better. On the other hand, Chinese economic data has been better than expected of late and this, along with the ongoing Russian occupation of Ukraine, has helped underpin a range of commodity prices.

Market roundup

Gains were strongest in US equities over the past year, in part reflecting the relative strength of the US economy and the AI boom underway.

All asset classes enjoyed positive returns in the quarter. As mentioned, global equities led the pack with a 10.5% return on an NZD hedged basis, and a 15% return in NZD terms given the 4.5% or so fall in the value of the Kiwi over the period. Australian and emerging market equities also had a strong quarter, with returns of around 6.5% and 8.5% respectively. Trailing the pack, NZ equities returned only around 3% over the quarter and year to March given most of the largest stocks on our market are utility and infrastructure-type investments are sensitive to NZ economic growth and interest rates.

More interest rate sensitive parts of the market, including listed property, infrastructure, NZ equities and standard duration bonds took a breather this quarter.

Listed global property on an NZD hedged basis was top of the pack last quarter but was flat in the March quarter. Global infrastructure fared a little better returning 3% over the quarter. Similar to property, while fixed income had very strong returns in the December quarter, they were flat over March as markets backed-off in their conviction that that interest rates will be aggressively cut over 2024, causing marked-to-market declines in bond prices.

Global investment grade bonds returned to 3.8% for the year to March, below the current running yields on global bonds of around 6%. In contrast, short duration global investment grade bonds have fared much better, returning from 6 to over 8% over the year depending on their geographic exposure.

[1] GSK, Roche, ASML, Nestle, Novertis, Novo Nordisk, LÓreal, LVMH, Astra Zeneca, SAP, Sanofi

Benchmarking performances

Benchmarks are tools used to assess the performance of portfolios that we offer.

Benchmarks are crucial tools to enable the investor to tackle the following key questions:

1. Is my investment strategy delivering the long-term returns required to meet my core financial goal?
2. Is my portfolio performing well?
3. Are the individual funds in my portfolio performing well?

Different benchmarks are used to answer different questions.

Below we provide an overview of the different benchmarks we use to address these different questions.

Meeting core financial goals

An investor's allocation to growth (risk) versus defensive (less risky) assets is a function of the long term return they require to meet their financial goals and spending needs. In general, three benchmarks are commonly used to for this **long-term requirement**:

The most important benchmark for an investor is the long-term return requirement.

I. **A fixed return**, e.g. an expected long-term return of 7% net of fees. This expectation Is calculated by estimating expected returns for all asset classes that the investor has funds in, then weighting these asset class returns by the investor's Strategic Asset Allocation (SAA).

II. **Cash + X%**, where x% is estimated as the SAA weighted expectation of each asset classes return versus cash over the longer term. For example, for a balanced portfolio we expect a 2.5% p.a. better than cash return over the longer term.

III. **CPI inflation + X%**. For example, assuming inflation is 2% over the long term, we expect X to be around 4.5% p.a. for a balanced portfolio.

Three variants of this benchmark are used in practice to reflect different types of investors

Which benchmark is used above usually depends on the type of investor. A CPI inflation + x% benchmark makes sense for most charities and foundations because their aim is to maintain the real or inflation adjusted value of their portfolio after costs and making distributions and grants. Cash + X% benchmarks are more often used by investors with relatively high spending needs whose focus is seeking to add value over and above holding cash. In contrast, a long term expected return number is most often used by investors building their portfolio to meet future spending needs.

Performance against the required return benchmark is best compared over a medium-term time horizon.

Actual performance of a portfolio should be compared against these benchmarks over a medium-term time horizon as given the volatility in markets it is unrealistic for the benchmark to be met or exceeded every year.[2]

[2] Ideally benchmark returns are adjusted for capital inflows and outflows of the investor so that the timing of investment flows does not impact on relative performances. In practice this is often difficult to calculate, so time rather than money-weighted returns are used for performance calculations.

A common industry practice is hence to compare the performance of a portfolio over rolling 3 to 5-year periods.

Benchmarks used to assess portfolio performances

As with assessing how a portfolio is meeting its long-term financial goals different benchmarks can be used to assess how our portfolios are performing, with each giving different information. Below we outline the benchmarks we use to assess portfolio performances in our quarterly review processes:

Portfolio benchmarks include a Reference Portfolio benchmark, a SAA weighted benchmark, and a Peer group benchmark.

I. **Reference portfolio benchmark** – Popularised in New Zealand by the NZ Superannuation Fund, this very simple benchmark comprises low-cost passive exposures to global and NZ equities and bonds only, with weights corresponding to the growth versus defensive mix of a portfolio. Comparing this return to actual portfolio performances enables us to see whether the combination of our asset allocation and fund manager selection choices are adding value.

II. **SAA weighted benchmark** – This is calculated from benchmark asset class returns and their SAA weights in a portfolio. The difference between this return and actual portfolio returns reflect the value-add of our fund manager selections. In contrast, the difference between the Reference portfolio and SAA weighted benchmark returns let us know how our asset allocation choices are performing.

All of these benchmarks are used in our review processes to test the value-add of our asset allocation and fund manager selection choices.

III. **Peer group benchmark** - We also compare performances of the portfolios we offer against a comparable 'peer group' average in the marketplace. Unfortunately, the data does not exist to enable us to compare performance of the portfolios we offer against portfolios that other Adviser firms offer. Instead, we use the next best alternative, which is to compare performance of each portfolio we offer against KiwiSaver and other multi-asset class funds in the marketplace with a similar risk profile.

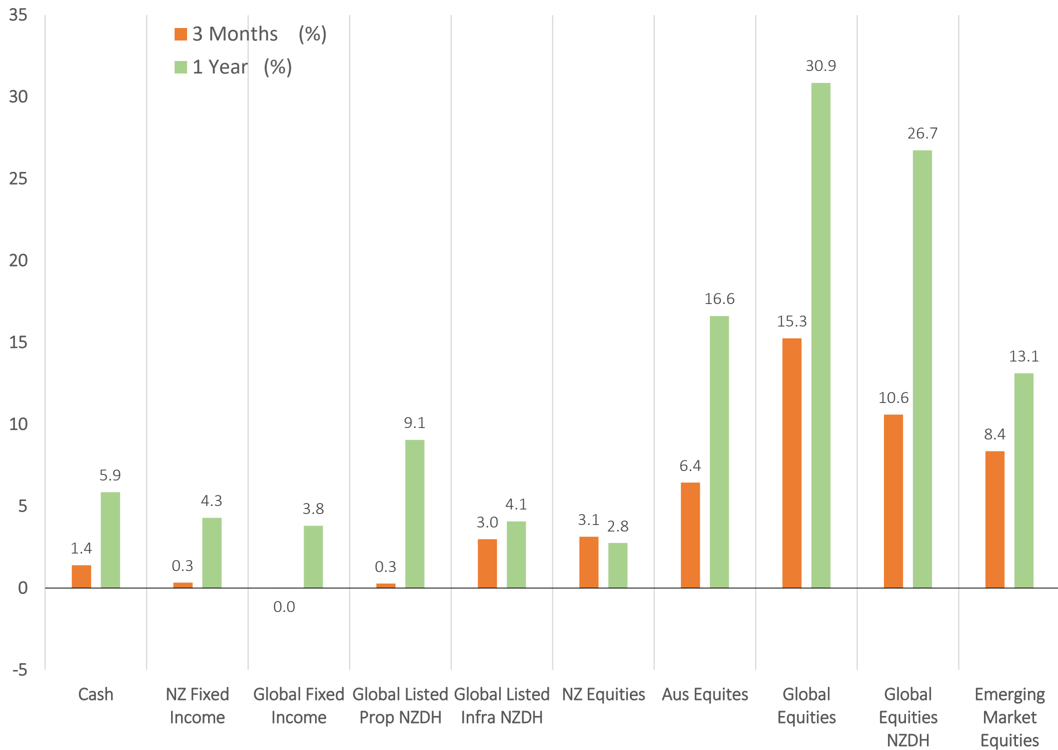
As with assessing performance against long term financial goals, the time horizon also matters here. We do not expect to add value every quarter, but we do aim to add value over a medium-term (3 to 5 year) time horizon. Any area where this is not occurring sets our agenda for further scrutiny and debate.

Benchmarks used to assess individual fund manager performances

Individual fund manager benchmarks mirror what we look at for portfolio level benchmarking.

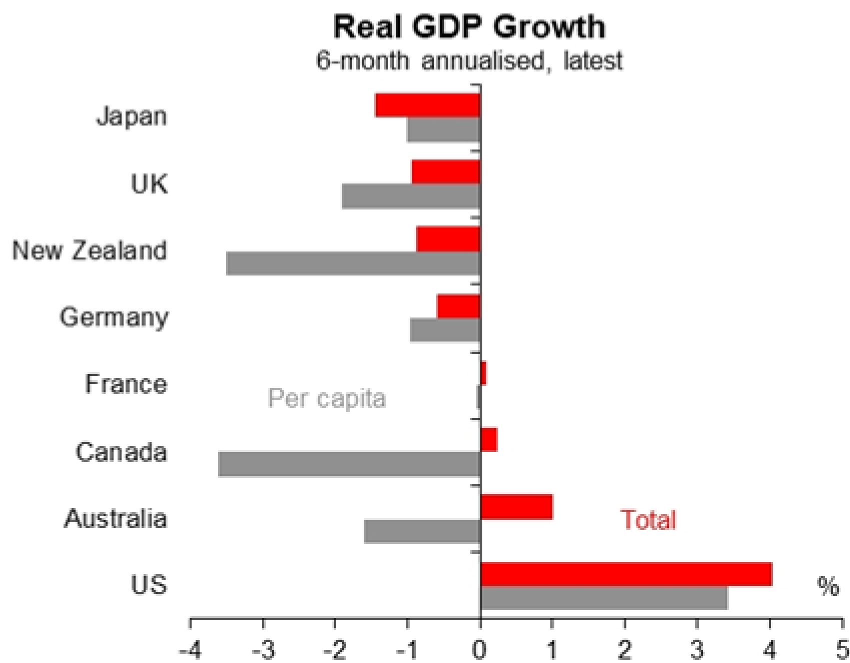
Our approach to benchmarking individual fund manager performances mirrors the approach we take to look at overall portfolio performance. We compare performance of each fund manager against an appropriate asset class benchmark, and a peer group of similar funds. Funds that fail to perform at least in line with peer group averages and their asset class benchmarks over the medium-term are placed on 'watch' in our quarterly review process. Such a fund will likely be replaced if we lose conviction in their ability to turn around the under-performance.

Figure 1: Some very strong performances in the March quarter



Source: Morningstar Direct, MyFiduciary

Figure 2: Real GDP Growth – 2H23



Source: Schroders Asset Management