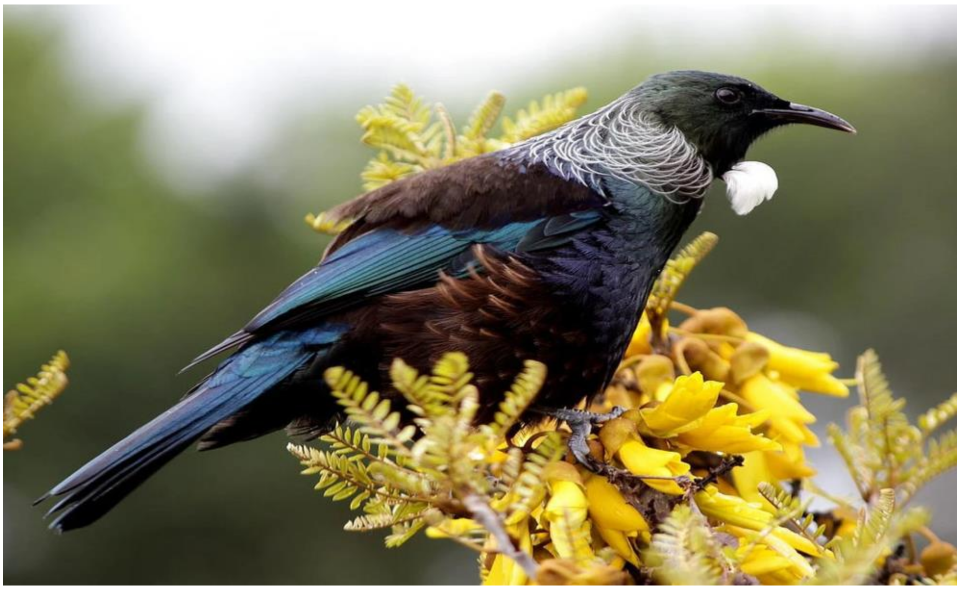
Bradley Nuttall Nelson Spring Update



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Investment Market Review

An investor following the daily financial headlines, in the past quarter, might have encountered plenty to worry about – from a resurgent pandemic, to spiking inflation, to worries about Chinese debt, and to speculation about central bank tapering of policy stimulus.

Despite the market concerns, the third quarter delivered modest positive returns to investors with diversified portfolios.

While it's human nature to enjoy seeing the value of your investment portfolio increase quickly, it's also not reasonable for us to expect large gains each quarter. In fact, if markets get too far ahead of themselves, it's likely to increase the chances of a future correction. In that context, a small positive return can be sometimes more reassuring than a large one.

Following a tepid June quarter the New Zealand equity market accelerated in September, exceeding 5% in this quarter. International equity markets ended the quarter more or less where they began.

Concerns over the US debt ceiling and accelerating inflation weighed in on developed markets. Meanwhile emerging markets had a torrid quarter, which began with the Chinese government's crackdown on private education and technology companies and ended with burgeoning concerns over the Evergrande Group. These concerns particularly hurt Asian markets and those with exposure to materials sectors.

Evergrande is China's second largest property developer and has historically significantly leveraged itself. As a result of the Chinese government's "three red lines" announcements in 2020, limiting borrowing based on debt to cash, debt to equity and debt to asset metrics, fears have been increasing over the company's credit worthiness.

Given the size of the company, concerns mounted about the likelihood of it defaulting on payments potentially leading to a "Leeman Brothers" moment for global markets. So far, these fears have yet to materialise, maintaining a level of fragility.

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Despite these concerns business growth has been very strong in a number of markets. The number of initial public offerings (IPO's) in the first nine months of the calendar year is the highest it has been since the dot-com bubble of 2000. More than 2000 IPO's have raised US$ 421 billion in the year-to-date.

Likewise, interest in cryptocurrency is again on the rise, with Bitcoin recently passing the US$ 62,000 mark, doubling from its July level.

The International Monetary Fund in its October World Economic Outlook dramatically revised up its prediction for global growth in 2022 from 4.4% (in its previous April report) to 4.9%. This revision upwards has almost entirely come from the strengthening outlook for developed economies. The US, in particular, is now forecast to grow 5.2% next year. The outlook for emerging economies while a little better is essentially unchanged.

Bond Markets

The New Zealand fixed interest market for the September quarter again posted negative results in the wake of rising interest rates. This brings the 12 month return for the S&P/NZX New Zealand Government Bond Index 12 month return to -7.2%, while the broader S & P/NZX A- Grade Bond Index fell by -4.1% over the same period.

Longer term figures for bond market indices now look more in line with running yields. In prior years, the bond return figures included substantial market gains, despite the bonds having furnished relatively low yields.

Such market gains are symptomatic of the falling interest rate environment that we have experience for a number of years. With these market gains now having reversed out, the medium term returns now reflect a more modest return profile from fixed income between 2% to 3% p.a.

International bond investors have thus far been somewhat cushioned from the expectations of interest rate rises. The FTSE World Government Bond Index 1-5 Years (hedged to NZD) was flat for the quarter although it too has now entered negative territory, -0.1%, over the last twelve months.

At the time of writing this newsletter the yield on 10-year government bonds had risen to 2.4% in New Zealand and 1.7% in the United States. While these rates are undeniably low, some prospects for positive returns appear now imminent for bond investments.

Inflation temporary or permanent?

The consumer price inflation index in the UK rose by 3.2% year-on-year in August, the highest annual rise in nearly a decade. This was 1.2% above the July figure, making it the biggest month on month rise since records began in 1997.

Inflation in the US is running at 5.3% and here in New Zealand it is also approaching 5%.

The question that policymakers and market participants are now grappling with - are these price rises likely to be temporary or something more permanent?

An understanding of supply and demand shocks is important when considering the permanency or otherwise of the current inflation expectations. The assessment of supply or demand shock in the context of the COVID crisis is a special case because unlike an ordinary crisis, where the depression in economic activity is widespread and all prices move in tandem, the COVID crisis has affected output and prices differently across sectors. On this occasion inflation has tended to be narrow, affecting sectors such as, food, energy and motor vehicles, as opposed to an across-the-board increase in prices.

A key factor influencing whether the current rise in inflation will be temporary or permanent relates to tensions in the labour market There is a clear link between the rate of unemployment levels and wage inflation. The lower the rate of unemployment the higher the rate of inflation and vice versa. While this relationship is not directly linked, its implications apply over time.

The New Zealand Statistics Department reported in its June report that the number of people unemployed fell 12.4 percent (down 17,000 people) over the quarter to reach 117,000 – the same level as in June 2020. This was the largest quarterly percentage fall in unemployment since the Household Labour Force Survey (HLFS) began in 1986. When the boarders open and the tourism industry starts again, watch this space.

Key Market movements For the Quarter

The quarter started on a positive note for most markets, however, gains generally eased in September amid concerns of rising inflation, market instability in China and energy shortages in Europe.

The New Zealand share market performed better than most developed markets with the economic growth rate of 2.8% in the second quarter reported to be much stronger than expected.

5.2%	**New Zealand Shares** New Zealand was one of the better performing global developed share markets with the index returning 5.2%. With underlying economic conditions are still broadly favourable and the market" looking through" the ongoing CVOID uncertainties, saw the larger companies, within the index performed better than the smaller capitalisation firms. The most significant contributions came from companies in both the health care and industrial sectors. In the healthcare sector, it was Pacific Edge leading the way with a gain of 24.4% following a strong interest in a retail placement to help support their US growth strategy. Ryman Healthcare also performed strongly up 15% after announcing record first quarter sales and continued expansion in Melbourne. In the industrial sector, the continuation of a stellar year for Mainfreight saw that share price advance a further 26.6%. Z energy also had a good quarter being up 25%. All sectors made a positive contribution over the quarter except for the consumer discretionary sector, where the increase lockdown restrictions impacted most. Sky city entertainment was down -6.8% for the quarter. :*Source: S&P/NZX 50 Index (Gross Imputation credits)*
-1.3%	**New Zealand Fixed Interest** The Reserve Bank of New Zealand at its 18 August 2021 meeting once again elected to leave the official cash rate at 0.25% however, it was only the recent return to level IV lockdown that deferred the anticipated increase in interest rates. The Monetary Policy Committee advised this was only a delay due to the sudden increase in health uncertainties and not a change in their planned approach. This was subsequently verified on 6 October, when they announced an increase in the New Zealand Official Cash rate from 0.25% to 0.5%. Faced with clear signalling about inflation concerns and higher interest rates, the NZ 10 year government bond rate yield, after bottoming out at 1.49% in late July, rose steadily through August and September to close the quarter at 2.01%. This led to negative quarter returns for both the corporate and government bond indices. The S & P/NZX A- Grade Bond Index fell -1.3% for the quarter, while the longer duration but higher quality S & P/NZX Government Bond Index fell -1.2% for the quarter. *Source: S&P/NZX A Grade Corporate Bond Index*
3.2%	**New Zealand Property** Despite concerns of rising inflation and interest rates, the New Zealand Property Index returned to positive figures over the September quarter of 3.2%. New Zealand listed property's YTD returns has been the lowest of the equities at 1.0%, closely followed by New Zealand shares YTD at 1.4%. The highest returning asset class YTD has been Global REIT's at 22.6%. Argosy, Goodman and Precinct properties were the highest returning trust's recording 5.0%, 5.7% and 6.0% respectively. Investore and Kiwi Property continue with their less than positive returns while Vital Healthcare returns eased from the previous quarter of 7.4% to 0-4%.. *Source: S&P/NZX All Real Estate Index.*

-0.7%	**Australian Shares** Despite the September sell-off, the Australian share market also returned a positive quarter in local currency terms, with the S & P /ASX 200 index gaining 1.8%. In contrast to the New Zealand market, the largest companies generally struggled over the quarter while good returns were provided by mid-and small capitalisation companies. The materials / mining sector cause the largest drag on performance, with market heavyweights BHP and Fortescue Metals returning -17% and -26.9% respectively due to significantly weaker iron ore prices. Offsetting this was a positive contribution from all other sectors and in particular, a good performance from the important sizeable financial sector, where a number of firms record a strong double-digit return including Clearview Wealth 38%, Challenger 18% and Suncorp 17.4%. Returns to unhedged New Zealand investors were slightly negative due to a depreciation in the Australian dollar over the quarter. *Source: S&P/ASX 200 Index (Total Return).*
0.5% (hedged to NZD) **+1.3%** (unhedged)	**International Shares** In the USA, the flagship S & P 500 index (total returns in USD) was in line with the broad market, gaining 0.6% for the quarter. Strong company earnings supported the index through July and August, but growth and inflation concern late in the quarter saw US shares retrace their gains in September. European markets followed a similar pattern, with weakness in the period due to rising energy prices and concerns that supply chain bottlenecks would drive inflation higher. Although the headline returns for USA and Europe were similar, the drivers of returned varied quite markedly. In the USA, leading performers where the large capitalisation companies in the financial and utility sectors leading the way. In Europe, it was small companies that generally outperformed, with the energy sector, in particular, recording strong gains. After generally lagging over the last couple of years, the UK market performed a little better than its European peers with the MSCI UK Index gaining 2.2%. Increased merger and acquisition activity helped drive market sentiment overall, while weakening economic indicators were otherwise reflected in a wide dispersion in company returns across sectors. All of these results paled next to the Japanese market where the MSCI Japan index increased by 5.3% with corporate profit results, purchase orders and capital expenditure plans all relatively strong. In New Zealand dollar terms, the MSCI World ex Australia Index delivered a quarterly return of +0.5% on a hedged basis and +1.3% unhedged. The rolling 12-month return for the New Zealand dollar hedged index was +28.4%, while the unhedged index gained +23.4%. *Source: MSCI World ex-Australia Index (net div.).*

-6.8%	**Emerging Markets** Emerging market equities struggled in the third quarter which saw a sell-off in Chinese shares, concerns over continued supply chain disruptions and worries over the implications of higher food and energy prices in some markets. Regulatory actions in China were the initial trigger for market weakness. These were compounded by the re-imposition of some COVID restrictions, power shortages and worries about possible systemic financial risks associated with the potential collapse of Chinese property developer Evergrande. Brazil was also weak as above target inflation continue to rise and the central bank there responded with further interest rate hikes, while the South Korean market was impacted by falling prices for computer components as well as supply chain concerns. In contrast net energy exporters generally outperformed, most notably Columbia, Russia, Kuwait, Saudi Arabia, Qatar and the U.A.E. in unhedged New Zealand dollar terms, the MSCI Emerging Markets Index produced a quarterly return of -6.8% and 13.6 % return over the last 12 months. *Source: MSCI Emerging Markets Index (gross div.)*
0.0%	**International fixed interest** The US 10-year Treasury Bond yield finished the quarter at 1.49%, only one basis point higher than that closed in June. Yields initially fell, as the rapid economic recovery appeared to be moderating. However, as the market's focus turned to rising inflation and the prospect of the withdrawal of monetary policy support, yields rose back to the levels seen at the start of the quarter. The Federal Reserve also recalibrated expectations regarding the ongoing asset purchase programme suggesting they could commence a tapering of asset purchases as early as November 2021 and completed by mid-2022, earlier than originally expected. The UK 10-year yield increased from 0.72% to 1.02% with the move occurring in September. There was clear signalling from the Bank of England policymakers that rate rises might be warranted before the end of the year. Recent economic indicators came out worse than expected, while year-on-year consumer price inflation rose to 3.2% in August the highest since 2012. The German 10-year yield was one basis point lower at -0.19% while at least 10-year yield finished 0.04% higher at 0.86%. Despite of worries about inflation and higher energy prices, economic activity continued at a robust pace across Europe. In August, Eurozone inflation recorded a decade high of 3.4% p.a. With little overall movement and international yield curves over the quarter, returns for high-quality, low duration bonds were largely flat, while investment-grade and high yielding credit securities generally outperformed government bonds. The FTSE World Government Bond Index 1-5 Years (hedged to NZD) made +0.0% for the quarter and -0.0% over the last 12 months. The broader Bloomberg Barclays Global Aggregate Bond Index (hedged to NZD) returned +0.1% for the quarter. *Source: FTSE World Government Bond Index 1-5 Years (hedged to NZD.)*
1.4%	**International Property** International property markets delivered positive returns during the third quarter, as the gradual reopening of various economies around the world continued to benefit a sector hit hard by strict lockdown measures in the wake of the COVID pandemic. Amid improving economies, the demand for commercial real estate continues to recover, but the recovery is uneven across property types and geographic markets. There is strong recovery in the multifamily, industrial, and retail property markets, while the recovery has not been as robust in the office and hotel property markets. High transmission of Delta variant cases in 97% of counties has held back the return of workers to the office and business and recreational travel. *Source: S&P Developed REIT Index*

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Asset Class Returns To 30 September 2021

Asset Class	Index Name	3 mths	1 year	3 years	5 years	10 years
New Zealand shares	S&P/NZX 50 Index, (gross with imputation credits)	+5.2%	+13.7%	+13.2%	+13.5%	+16.1%
New Zealand property	S&P /NZX All Real Estate Index (Gross)	3.2%	9.6%	12.2%	9.9%	12.1%
Australian shares	S&P/ASX 200 Index (total return)	-0.7%	+26.3%	+8.2%	+10.3%	+8.7%
International shares	MSCI World ex Australia Index (net div., hedged to NZD)	+0.5%	+28.4%	+12.0%	+13.8%	+14.7%
	MSCI World ex Australia Index (net div.)	+1.3%	+23.4%	+11.7%	+15.1%	+14.0%
Emerging markets shares	MSCI Emerging Markets Index (gross div.)	-6.8%	+13.6%	+7.5%	+10.8%	+7.5%
International property	S&P Global REIT Index (Gross div.)	1.4%	27.3%	6.9%	6.9%	11.0%
New Zealand fixed interest	S&P/NZX A-Grade Corporate Bond Index	-1.3%	-4.1%	+2.9%	+3.1%	+4.5%
International fixed interest	FTSE World Government Bond Index 1-5 Years (hedged to NZD)	+0.0%	-0.1%	+2.5%	+2.0%	+3.2%
New Zealand cash	New Zealand One-Month Bank Bill Yields Index	+0.1%	+0.3%	+0.9%	+1.3%	+2.1%

Unless otherwise specified, all returns are expressed in NZD. We assume 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.

Irrational Bias

Let's say someone asks you a benign question such as, "Are there more or less than 100 countries in Africa?" What would your answer be?

Most people would say, "less", and they'd be right.
You are then asked a follow-up question, "So how many countries are there in Africa?"

As you may have realised, the question is a set up. By first asking you if there are more than 100 countries, you are being "anchored" to a number.

Although you know the number sounds implausibly high, by stating number as part of the question, evidence suggests that it will influence your next guess. By the way there are 54 countries in Africa.

Two well-known psychologists, Amos Tversky and Nobel prize winner Daniel Kahneman showed this in a paper titled, "Judgement Under Uncertainty: Heuristics and Biases". The paper was published in the Journal of Science and showed that even random information, such as the last two digits of your phone number or the outcome of a spinning wheel could affect someone's guess as to how many countries are in Africa.

According to Investopedia, anchoring is "a behavioural finance term, to describe an irrational bias towards an arbitrary benchmark figure". Perhaps a better definition is provided by the Corporate Finance Institute that says, anchoring bias occurs when people relied too much on pre-existing information or their first information they find when making a decision".

If you have travelled in the Middle East, anchoring is the adopted sales approach in the markets. A colleague saw an artefact he liked and asked the boy tending the shop what was the cost? The price given was absurdly high. When turning to walk away, the boy called out with a steep discount. The haggling began and the friend walked away with the artefact thinking he had negotiated a discount in the order of 75%, only to find out later that he had paid double the going price.

In New Zealand, there is one prominent consumer goods store where everything… everything… always appears on sale. Now, if every item you sell at your store is at a sale price, then the sale price is'nt the sale price at all…. it's the real price. But it feels good to think you got it on sale, doesn't it? This is also a form of anchoring.

Anchoring for investors takes many forms and we have experienced first-hand a number of situations where this has occurred. A client had a significant amount of money sitting in the UK which they transferred to their portfolio but didn't what to convert the funds to New Zealand dollars with the exchange rate close to 2:1 ($2 NZD for £1). Their anchor point in this instance, was the exchange rate of 3:1 which hasn't been at that favourable rate since 2006.

In this example there was a relatively simple solution. Rather than converting the pounds to another currency we invested most of their monies in pound denominated international

equity funds, thus deferring the need to switch while providing the option to switch the currency when rates were considered more favourable

A regular anchoring behaviour we see is when shares are purchased and their share price subsequently drops. The common response to which is "we don't want to sell them at a loss, so we'll hold onto them until they at least reach their original cost". Equity markets are about returns, no costs. Although this thinking is very much fuzzy logic, somehow it seems very sensible. The concept of opportunity cost never seems to enter consideration.

So how do you avoid anchoring bias? Unfortunately, it is very difficult. Anchoring bias is one of the most common and well researched of all cognitive biases. Essentially, going with the bias feels good and intuitive. Countering one's biases feels awkward.
The most common method to overcome the effect of anchoring is experience. For example, if we knew from experience what artefacts in the Middle Eastern shops should cost, one would be less likely to overpay. In such examples it is inexperience that allowed the anchor to be so influential.

When we talk with clients, we try to work through all the anchors they have regarding recent market activity or prior investing experiences. If necessary, we help articulate the arguments and provide the evidence that leads to making prudent term investment choices.

While not saying that we aren't influenced by anchoring ourselves, years of experience teaches one practical wisdom, caution, processes and governance which provide the framework for developing well researched and evidence-based term investment strategies.

The recently enjoyed high equity market returns and significant houses prices increases, will tend to anchor expectations on future returns, or will they?