fisherfunds

Fisher Funds Market Insights

Contents

Overview
Global markets take a breather after a strong start to the year 3

New Zealand Equities
Defensive investments performed strongly while others show promise in a challenging environment.. 5

Australian Equities
A steady quarter with some strong performers in our portfolio 7

Select International Equities
Markets impacted by the re-acceleration in medium and long-term interest rates.. 9

New Zealand Cash & Fixed Interest
Higher yields bode well for fixed interest returns going forward 11

Property & Infrastructure Fund
Challenging September for property and infrastructure equities 12

Direct Property
Industrial assets continue to offer the highest return outlook 14

Market Movements
as at 30 September 2023 15

Contributors this month

Ashley Gardyne
Chief Investment Officer

Robbie Urquhart
Senior Portfolio Manager

David McLeish
Senior Portfolio Manager

Matt Peek
Portfolio Manager

Sam Dickie
Senior Portfolio Manager

Brent Buchanan
Head of Direct Property

The information provided in this document is not personalised for your particular situation or circumstances and is intended to be general in nature. Despite any references to "you" or "your", any opinions or recommendations in this document are made without specific consideration of your personal investment goals or financial situation. You should contact an Authorised Financial Adviser if you need personalised financial advice. All opinions reflect our judgement on the date of this report and are subject to change without notice. The information contained in this publication should not be used as a basis for making an investment decision about any particular company. Product Disclosure Statements for our products are available on our website fisherfunds.co.nz or phone 0508 347 437.

© 2023 Fisher Institutional. All rights reserved.

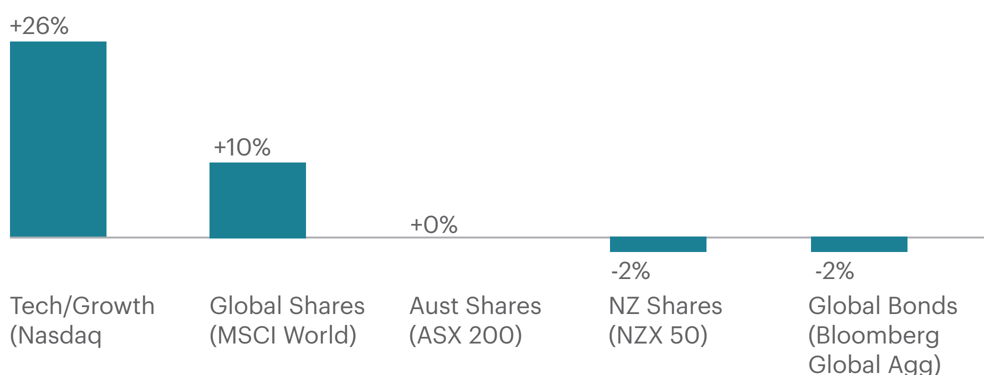
Global markets take a breather after a strong start to the year

Ashley Gardyne, Chief Investment Officer

After a very strong six months, global share markets (as measured by the MSCI World Index, excluding dividends) fell -3.8% in Q3. The market weakness was perversely driven by strong economic data, which spurred concern that central banks may hold interest rates higher for longer to slow the economy and reduce inflationary pressures. Despite the recent sell-off, global share markets are still up +9.6% year-to-date.

While broad global indices have gained this year, this hides a lot of underlying dispersion by sector and market. Much of this year's gains have resulted from the rapid rebound in technology stocks, and when these companies are excluded, many share markets have made only modest, if any, gains. Bond markets have had another weak year, with the Bloomberg Global Aggregate Index down -2.2% year to date.

Performance of global markets year to date



Source: Bloomberg

The New Zealand share market has lagged foreign markets in 2023, which in part can be explained by the weaker domestic economic environment. While US economic data has shown surprising resilience, New Zealand is facing a more challenging environment due to high mortgage rates, the decline in house prices, and weak consumer and business confidence.

Resilient global economy, or just too early to tell?

Despite the rapid pace of interest rate hikes around much of the globe, economic growth and employment has been much more resilient than economists feared earlier in the year.

In the US, the world's largest economy, recent data highlighted that GDP grew at a +2.4% annualised rate in Q2, retail sales continued to grow steadily, and consumer confidence has rebounded from recent lows. This underlying resilience in the US economy drove interest rates sharply higher during the quarter, with 10-year government bond yields reaching fresh decade highs in both the US and New Zealand.

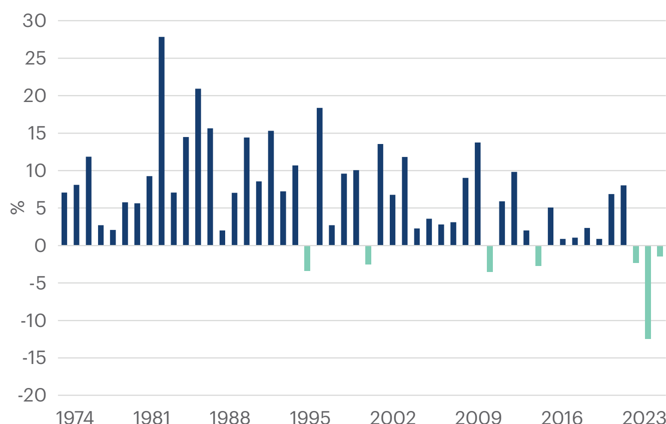
The decline in share markets has been partly driven by fears that central banks may overreact to this short-term economic data, and underappreciate the pain that consumers currently feel. As we know from history, hikes in central bank interest rates take several quarters (often up to 18 months) to have their full effect, as consumers refix mortgages and adjust their spending accordingly. Holding interest rates higher than needed throughout 2024 could ultimately lead to a recession. We are already seeing some of the effects of higher interest rates, with increasing loan arrears in many markets as well as lower housing turnover and a slight uptick in unemployment.

Fixed income weakness, but improved return prospects

While global share markets have rebounded this year, fixed income hasn't yet followed suit. The continued increases in interest rates have resulted in fixed income benchmarks like the Bloomberg US Treasury Index going backwards again this year. This is the first time in recorded history that we have had three years in a row of negative fixed-income returns.

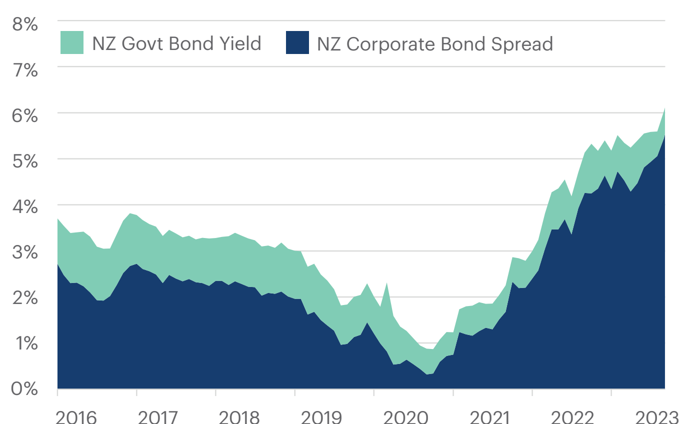
Three years ago interest rates were near zero, so bond investors didn't expect much in the way of return, but the unexpected jump in rates from decade-lows to decade-highs resulted in a sell-off that few investors anticipated. While this journey has been rough for fixed income investors, the current yields on offer (combined with subsiding inflation) set the scene for much better fixed income returns in the years ahead.

US Treasury bonds – 3 years of negative returns



Source: Bloomberg

Decade high corporate bond yields



Source: Bloomberg

Equities have rallied, but valuations outside of tech look reasonable

While broad market indices have been strong this year, this strength has been driven by a handful of large tech companies. In the US, just seven companies have driven the bulk of market gains this year (Apple, Microsoft, Alphabet, Meta, Amazon, Nvidia, and Tesla). Excluding these companies, market valuations look reasonable compared with their long-term averages.

The chart below shows the price-to-earnings multiple of the Equal Weight S&P 500 Index (which gives the big tech companies the same weight as all other stocks). On this basis, market valuations for the average listed company are in-line with, or below, their long-term averages.

US equity market valuations
(forward price-to-earnings multiple)

Source: Bloomberg

Outlook

2023 was always going to be a year of uncertainty in markets. Would inflation eventually subside, or remain stubbornly high? Would central bank interest rate hikes cause a recession? Or would low unemployment and healthy consumer spending cushion the economy and result in a soft landing?

So far this year the economy seems to be holding together better than expected, inflation is heading in the right direction, and markets have stabilised. While we aren't out of the woods, the outlook has improved compared to this time last year. Interest rates are higher (which is good for savers), share valuations still look reasonable, and as we search global markets, we are still encouraged by the investment opportunities that we're finding.

Defensive investments performed strongly while others show promise in a challenging environment

Matt Peek, Portfolio Manager, New Zealand Equities

Overall, we have increased our exposure to defensive companies over the last 12 months. We also remain positive about our defensive companies that are finding it tough right now – these companies are generally showing signs that they are performing well against the tough backdrop and taking share from competitors. This bodes well for when the headwinds abate.

The New Zealand market's performance in the global context

It was a tough quarter for global share markets with the MSCI World Index (including dividends) fell -3.5%, the US S&P 500 Index down -3.3%, and the Australian S&P/ASX 200 Index down -0.8%. This is largely due to the expectation of prolonged higher interest rates. During the quarter, the key barometer for long-term interest rates, the US 10-year Treasury yield, increased from 3.8% to 4.6% and New Zealand rates followed suit by a similar amount. While company earnings will dictate returns over time, sharp changes like this in economic conditions can be the primary driver in any given quarter (positively or negatively).

New Zealand shares lagged other markets partly because the local economic climate remained tougher than offshore. The increases in mortgage rates have a greater impact on New Zealand households than in other countries such as the US, where households tend to have their rate locked in for 30 years. The August reporting season saw the outlook for many Kiwi companies reduced because of tepid demand, but also persistent cost inflation and higher interest costs.

Defensive companies outperformed in a tough environment for New Zealand businesses

The more resilient performers in the quarter were generally the more defensive businesses in the portfolio, including our holdings in Infratil and Contact Energy.

> We have increased our exposure to defensive companies.

Infrastructure investment company Infratil noted at its annual meeting that it is tracking towards the top end of its profit guidance for the year ahead.

Electricity company Contact Energy delivered a strong finish to its financial year and has a promising outlook for the new year. Part of the uplift is coming from retail and commercial customer pricing, where Contact has been below competitors' pricing and has had more room for increases. The company will see its newly built Tauhara geothermal plant begin to contribute to earnings from 2024, replacing more expensive gas generation. The company expects a new long-term supply agreement to be reached with the Tiwai Point aluminium smelter in around the same timeframe. This would further increase earnings given the low prevailing contracted price, which could result in an increase to its dividend.

Other strong returns came from travel software provider Serko (+15%), whose share price continued to perform strongly following its positive annual meeting update in June.

Retirement village operator Summerset (+8%) proved its weak Q2 sales performance was an anomaly by delivering a much-improved result for Q3. Despite the pressure on house prices since late 2021, Summerset has been able to hold its pricing and capture margins from sold developments. It continues to see strong demand for its offerings.

Several companies felt the challenges of the domestic economic environment

Several of our economically exposed companies, particularly those with domestic New Zealand exposures, were not immune from the more challenging environment.

Mainfreight

Mainfreight (-8%) provided a Q1 update at its annual meeting, which was weaker than expected due to lower freight volumes through its network. Mainfreight is addressing this through a renewed focus on costs at the branch level, which has seen it effectively manage profit margins in previous downcycles.

Freightways

Trading conditions in Freightways (+0.2%) core courier business remained challenging, with volumes in the six months to June averaging around 2% lower than the same period in 2022. Underlying volumes in the economy have been weaker (down by 5% to 6%). However, the company is winning customers from competitors with its superior delivery performance.

Vulcan Steel

Vulcan Steel (-6%) has seen slower market conditions in their New Zealand steel distribution business, with its Australian business performing better. It attributes this to the combination of higher interest rates and customers holding off on major projects ahead of the election. Positively, the company stated its number of Active Trading Accounts has reached record levels, which means it is continuing to gain customers from competitors.

a2 Milk

a2 Milk (-15%) has continued to be a clear leader in the China infant formula category, taking market share in its key sales channels and improving brand awareness to new highs. However, this strong execution is being blunted by fewer births in China which is weighing on its sales and profit growth.

Fisher & Paykel, Infratil's Longroad Energy, and Vista showcased their businesses in the US

Three portfolio companies with meaningful US businesses hosted investor days in September.

Infratil's portfolio company Longroad has major projects in the pipeline

Longroad is looking to develop its significant pipeline of renewable electricity projects in the US, largely solar with battery storage. This pipeline will play a role in decarbonising the US economy. Longroad's team has developed a large portfolio of renewable asset development projects, now totalling 28 gigawatts. This is almost three times the size of New Zealand's entire installed electricity generation capacity!

By building out its pipeline and signing long-term Power Purchase Agreements, Longroad expects to grow operating earnings threefold to around US$600 million.

We expect Longroad to become a significantly larger part of the Infratil portfolio as they execute these projects and their earnings come online. The Infratil team has also proven it is adept in crystallising value from platforms like Longroad, such as Tilt Renewables and One New Zealand's tower asset infrastructure.

Fisher & Paykel Healthcare

The investor event of Fisher & Paykel Healthcare (-12%) coincided with the official opening of its third manufacturing building in Mexico. A key highlight was observing the team's culture and their focus on continuous improvement. Employees, or 'collaborators' as they are referred to internally, showcased the company's Business Excellence Model, with thousands of small projects annually expected to contribute to improvement.

The company expects to lift gross margins from current inflation-impacted levels of 59% back towards its target of 65%, which has been achieved previously.

A 'symposium' style discussion with several clinicians demonstrated it still has a long runway for adoption of its Optiflow nasal high flow therapy in hospitals in the US. This included citing superior patient outcomes, a reduced need to escalate patients to intensive care, and reduced healthcare costs.

They also have growth potential from their anaesthesia applications, and longer term for greater use of home respiratory support for patients with chronic obstructive pulmonary disease.

Vista

Cinema software business Vista (-17%) hosted an investor presentation at a Hollywood theatre. The presentation reiterated the ongoing recovery of the cinema industry. They also emphasised that industry participants will continue to modernise their software technology, although each operator would time this differently.

Vista reiterated its 2025 aspirations and provided new details to illustrate progress towards these targets. While they remain confident of their medium-term targets, they will need to demonstrate progress in 2024 with 'runs on the board' to see investor confidence match their own.

A steady quarter with some strong performers in our portfolio

Robbie Urquhart, Senior Portfolio Manager, Australian Equities

The Australian economy

The Australian 10-year Government bond rate rose sharply in September from 4.0% to 4.5%. This followed economic indicators which suggested that, while inflation has come down, it is proving to be stickier than the Reserve Bank of Australia (RBA) anticipated. So, while the interest rate hikes by the RBA may be close to peaking, it could be some time before cost pressures for households are alleviated through interest rate cuts.

Gyrations in inflation and interest rates may impact equities in the near term. However, the predominant long-term driver of our companies' returns will likely be their ability to grow their earnings and widen the economic moats around their businesses.

After years of work and development, Audinate's video product suite is showing promise

Networked audio company, Audinate's (+46% in A$) share price rose strongly on the back of easing supply chain restrictions for its audio products. This led to over 50% revenue growth in 2022/23. Augmenting its audio product revenue, Audinate recorded over US$3m in revenue from its nascent video division and noted that it has made a large number of design wins in the video market. This lays the groundwork for strong revenue and earnings growth in the future.

Importantly, Audinate has also reached sufficient size and scale now that it can grow customer numbers and revenue without having to spend as much on business functionality to support this growth. This has led to an inflection in its profitability.

Strong early contribution to the portfolio from new addition, Johns Lyng Group

We added Johns Lyng Group to the portfolio in Q3, and the Group returned +25% in the short period we have owned the shares. This performance was helped by strong financial results delivered in August.

Johns Lyng Group is Australia's leading provider of insurance building and restoration services. Through its network of 14,000 subcontractors, it provides repair and restoration work for properties damaged by insurable events including impact, weather, and fire events. It is also a top five strata management provider in Australia and has a nascent US repair and restoration business.

> We added Johns Lyng Group to the portfolio.

It is the largest service provider of insurance repair work in what is a fragmented market in Australia. Its national and regional scale afford it the ability to respond quickly, and provide make-safe work and repairs reliably, efficiently and effectively. Its smaller competitors do not have the capacity to respond in the same way. This scale advantage has enabled it to grow its share of the Australian repair and restoration market.

We are attracted by the non-discretionary nature of Johns Lyng's revenue. Insurance repairs are not linked to the economic cycle. They have to be completed when insurance events occur. This baseload of day-to-day repair and maintenance work is also complimented by make-safe and cleanup work resulting from large catastrophe events like the northern rivers floods and Australian bush fires. This offers a countercyclical upside to our portfolio from the economic devastation caused by such events.

Johns Lyng's strong performance-based culture has been key to its growth. They operate an equity partnership model, where the majority of its 130+ subsidiary businesses are partially owned by management. This creates a strong alignment with shareholders.

Good stewardship by our advertising business management teams enabled a strong Q3 for these shareholdings

Signs that the Australian economy is slowing have weighed on advertising businesses during the year. However, management teams across our advertising businesses have all demonstrated that they are managing the aspects of their businesses that are within their control very well.

oOH!Media advertising rebounded in Q3

Outdoor advertising business oOH!Media was weak during May and June. Happily, it rebounded +21% during Q3. In delivering a credible set of financial results in August, it referenced strong revenue growth and market share gains across a number of its advertising formats. Management also kept cost growth in check, bolstering overall profitability.

Although oOH!Media operates in a cyclical industry, outdoor advertising formats in Australia continue to take market share from other traditional media formats (such as linear TV). This will be driven by ongoing digitisation of its asset base, increasingly sophisticated audience measurement and greater programmatic trading of out-of-home inventory giving advertisers confidence of the return on their spend and more flexibility. As such, we think oOH!Media will continue growing its earnings structurally through time.

Shares in our classified advertising businesses all rose: Carsales, REA Group, and Seek

Share prices of our classified advertising businesses, Carsales (+18.6%), REA Group (+8.4%) and SEEK (+2.6%), also all rose in Q3. The resilience of their earnings in the face of a more mixed economic environment was evident in each of their financial results. All three companies have lifted their prices meaningfully, offsetting inflationary pressures and the softer advertising environment.

In addition, Carsales has recently invested heavily in expanding its presence in the US and Brazilian markets. In August it delivered a strong set of financial results. This highlighted the value of having an earnings base that is now widely diversified across many countries, including Australia, South Korea, the US, and Brazil.

A tough Q3 for our healthcare investments

Our key healthcare investments, CSL (-9%), Nanosonics (-11%), and Remed (-28%) all fell for different reasons in Q3.

CSL is recovering

CSL had already provided earnings guidance to the market in June. Its result, when delivered in August, was no surprise to the market.

However, during Q3, a competitor of CSL's announced positive trial results for the treatment of the acquired autoimmune disease, CIDP, and this was taken negatively by the market. That said, this is not expected to materially dent the demand for CSL's plasma-based therapies.

Also, as we mentioned in the Q2 update, although CSL's post-pandemic earnings recovery has taken longer than investors would like, its earnings are growing strongly. This likely provides the company with some helpful tailwinds which should assist earnings growth and margin recovery through 2023/24.

Nanosonics experienced strong growth but delayed a new product

In their financial results release in August, Nanosonics reported strong growth in sales of Trophon installations. However, it again pushed out the timeline for the regulatory submission and potential launch of its endoscope cleaning product (Coris), which was disappointing.

Resmed

Resmed's share price fell in response to the market's focus on the potential impact of semaglutide obesity drugs such as Ozempic and Mounjaro on its business. Obesity and heart disease are comorbidities of obstructive sleep apnea (OSA). To the extent that obesity drugs can have a positive impact on these comorbidities, they might reduce the size of Resmed's potential OSA market. These drugs have captured the market's attention, and its assessment for Resmed is adverse (judging by the fall in the share price).

> Obesity drugs need to overcome numerous hurdles.

It is early days for Resmed, but our initial view is that the long-term impact on their earnings prospects will likely be modest. Obesity drugs need to overcome numerous hurdles to widely displace Resmed's OSA products. These hurdles include adherence challenges over the long term for patients (when they stop taking the drugs, the weight returns); the amount of muscle (as opposed to fat) that is lost and implications for the overall health of patients; reimbursement regulations (the drugs aren't cheap). Moreover, OSA is not necessarily caused by a weight problem. Even in the US, the world's most developed OSA market, less than 20% of sufferers are diagnosed and treated.

Consequently, we maintain the view that Resmed has a long growth runway ahead despite the potential impact from obesity drugs. We will continue to monitor developments.

Markets impacted by the re-acceleration in medium and long-term interest rates

Sam Dickie, Senior Portfolio Manager, Select International Equities

Global market backdrop: Higher interest rates and growth with trends reversing

After a strong start to the year and Q3, global equity markets sold off around 10% into the end of the quarter as medium and long-term interest rates re-accelerated. US bond yields, as a proxy for global interest rates, are making fresh 16-year highs. This was concerning for investors because US inflation peaked way back in October 2022 and has since fallen from 9% to 3%. However as we know, medium-dated and long-dated interest rates are not just a function of inflation, they are also a function of growth.

US economic data has been on the upside for a couple of months now. The recession everyone feared hasn't materialised and the US reported 2.4% GDP growth for Q2 – a long way from recession.

> The recession everyone feared hasn't materialised.

However, this re-acceleration in growth and interest rates may prove to be reflexive. The lagged impact of central bank rate hikes over the last 12 months will likely add to the stress caused by the increase in medium-term borrowing rates for corporates and consumers. This combination will likely blunt the growth recovery the market has become excited about.

Trends have reversed with underperformers now outperforming

This economic backdrop caused the trends we have seen in the last few months to reverse – the biggest outperformers became the biggest underperformers and vice versa. The US, Nasdaq, and global growth stocks underperformed. Europe, the UK, China, and global value stocks outperformed.

We saw trends reverse in sector performance too as the energy sector was the top performer for the quarter, on the back of an almost 30% rise in oil. This was partly due to higher demand (positive) but primarily due to lower supply as OPEC+ sharply cut output (negative). Banks also sharply outperformed as yield curves steepened again.

Portfolio update

Alphabet saw better earnings than expected

Alphabet (+9%) reported better-than-expected earnings. The highlights were digital advertising, market growth, and incremental monetisation benefits from AI. AI was the key theme at the company's annual Google Cloud Next conference. The conference showcased Google's new AI tech and partnerships, a new version of its custom-build AI chips, as well as AI updates to its enterprise cloud service and software suite. Google has started selling its AI-powered tools for corporate Gmail accounts and other workplace software at US$30 per month, on par with the price Microsoft is charging for its AI-powered copilot within Office 365.

Our three new additions performed well – Danaher, UnitedHealth Groups, MSCI

All three of our new additions performed well during the quarter: Danaher(+3.4%), UnitedHealth Group (+5.3%), and MSCI (+10%).

MSCI reported their Q2 earnings

MSCI reported their Q2 earnings during this quarter. MSCI beat expectations on revenue and earnings, showing continued resilience in its core index business. Management came out with very positive commentary and conviction on their important growth segments: ESG and Climate. These segments grew better than expected and were the source of stock weakness in Q1.

Impressively, MSCI's climate products grew 70% in Q2. Given the share price weakness post Q1, management showed good capital allocation discipline and bought back $468 million worth of shares. The positive stock market environment in 2023 so far has seen MSCI's asset-based-fee inflows turn positive this year, and the segment grew revenue 13% year on year in Q2.

Medical devices are facing new challenges in the market

Edwards Lifesciences (-27%) sold-off on a weaker than expected earnings update. This occurred alongside a wider decline in the medical device sector driven by concerns about new obesity drugs, also known as 'GLP-1s'. The iShares Medical Device ETF was also down for the quarter (-14%).

One analyst described sentiment on medical devices as the worst it's been since the Global Financial Crisis of 2008. While Edwards Lifesciences increased its full-year guidance during the quarter, the market was expecting a larger increase as surgical procedure growth recovered post-¬COVID. Management believes this is a simply a timing issue due to the complex diagnosis and referral pathways for structural heart disease and that underlying demand is still strong.

But the bigger story for medical device companies this quarter was around GLP-1's and the release of the SELECT clinical trial data which showed that the Wegovy GLP-1 reduced major adverse cardiovascular events by 20% in obese people. Obesity costs the US healthcare system an estimated US$173 billion a year. Reducing obesity levels could have an impact on healthcare companies that are treating the downstream impacts, in particular medical device companies.

Quantifying the potential impact on individual medical device companies is challenging, especially as they are likely to be years away. And it is still not clear how widespread the uptake of these obesity drugs will be, given the high cost and potential side effects. That said, GLP-1s will likely be a strong headwind for healthcare companies.

We are watching this situation closely for any impact on our existing healthcare stocks (particularly our medical device names: Edwards Lifesciences and Boston Scientific), while also looking for potential opportunities.

We exited our investment in Dollar General

We exited Dollar General during the quarter due to lack of clarity over its steady state earnings and lower confidence in management. The company's operations had been optimised to run on a very lean labour force. Over-earning during COVID masked the fact that there was insufficient labour to handle greater volumes of inventory throughput and greater inventory complexity as the company added more discretionary and fresh produce items. Competitors are taking market share from Dollar General as insufficient labour in the stores has weakened the customer experience. Dollar General's high operating and financial leverage also puts the pace of its store rollout at risk.

We continue monitoring US discount retail dynamics. Meanwhile we're redeploying capital into better risk–reward opportunities elsewhere.

We exited our investment in NVR

We exited homebuilder NVR during the quarter because we see better value elsewhere. We bought NVR in May 2021. The company has since delivered a +15% p.a. return vs. +4% return from the S&P 500 Index.

Our rationale for exit is around new orders and profit margins which drive NVR's fundamentals. NVR's runway for new orders in the company's active development communities has shrunk in recent years. NVR's gross margins are at all-time highs given recent appreciation in house prices, and we see downside risk to market consensus expectations for margins to remain at elevated levels for the next 3 years.

We will continue monitoring these dynamics closely.

Higher yields bode well for fixed interest returns going forward

David McLeish, Senior Portfolio Manager, New Zealand Cash & Fixed Interest

The Reserve Bank of New Zealand twice left the Official Cash Rate (OCR) unchanged at 5.5% (the first pause since late 2021). The Bank saw no reason to further increase rates as they had begun to see cooling macroeconomic indicators.

However, toward the end of September, offshore interest rates increased as investors anticipated central banks will maintain policy rates at or near existing levels for longer. This caused gyrations locally with the 30-year New Zealand government bond yield increasing from 4.7% to 5.5% over the quarter. While a rise in interest rates is painful in the short term, today's higher yields bode well for fixed interest returns going forward.

Long and variable lags

Regular readers will recall that we believe changes in central bank interest rates impact the economy with a lag and that lag is typically between 12 to 24 months.

There are numerous reasons why household and businesses adjust slowly to changes in interest rates but essentially, there are 'frictions' within a monetary economy that lead to a lagged response. This includes the structure of nominal contracts – not least debt contracts. For example, in New Zealand, households tend to favour one- or two-year fixed interest rate periods when borrowing money to buy a home or refinance existing home loans.

While households with fixed rate home loans have had shelter from the recent increase in interest rates, higher debt servicing costs lurk on the horizon as these fixed rates expire. Resetting to a higher mortgage rate will result in mortgage payments increasing and less money flowing into other parts of the economy.

A bumpy road lies ahead

We continue to believe the rise of interest rates over the past year will reduce aggregate demand and the rate of inflation. It will be a bumpy road with twists and turns as households and businesses move forward in search of smoother terrain.

Ultimately, higher interest rates today will pave the way for reduced interest rates tomorrow.

> High yields on offer today bode well for future returns.

Remaining patient given uniqueness of the business cycle

We moved the Fisher Institutional New Zealand Fixed Interest Fund to a small overweight duration position during September as it became clearer that New Zealand economic indicators were deteriorating, while bond yields remained elevated.

The team remains focused on uncovering compelling relative value opportunities across sectors and industries. The high yields on offer today bode well for future returns.

Challenging September for property and infrastructure equities

Sam Dickie, Senior Portfolio Manager, Property & Infrastructure Fund

Global market backdrop: Higher interest rates and growth with trends reversing

Global equity markets sold off around 10% into the end of the quarter, resulting in -3.4% performance for the overall quarter. The key driver was increasing US bond yields, as a proxy for global interest rates, making fresh 16-year highs. Our benchmark, which is more sensitive to interest rates than global equity markets in general, underperformed global equities with a -5.4% return. We underperformed the benchmark (-6.3% return), which reflected our greater weighting to infrastructure stocks compared to benchmark.

On a sector basis, global utilities and Chinese infrastructure stocks were the weakest performers in the S&P Global Infrastructure Index (-7.3%), whilst a strong update from logistics property operator Goodman Group drove relative outperformance for the Australian property benchmark (-2.9%). New Zealand property was -5.7% for the quarter.

> Global utilities and Chinese infrastructure stocks were the weakest performers.

Portfolio update

Infratil has big projects in the pipeline

Longroad Energy is a key asset of Infratil (+0.6%). Company management highlighted a significantly larger pipeline of new projects – 28.5 gigawatts (GW), up 200% over the past 2 years, although it maintained the same development plan (6 GW by 2026). The pipeline is underpinned by US$380 billion of government support for the industry and a long-term supply agreement with First Solar. Longroad aims to achieve a threefold increase in EBITDA earnings, targeting a growth to US$600 million, while only having 3% of market share in the US.

The core investment thesis for Longroad remains, backing a very talented and aligned management team to execute the generational energy transition in the US, with government support providing tailwinds for the industry generally. Over time, we expect Longroad to become a significantly larger part of the Infratil portfolio.

Tough September for US mobile tower investments, Crown Castle and American Tower

September was a tough month for our US mobile tower investments Crown Castle (-16.3%) and American Tower (-13.5%).

Investors became concerned about interest rates being higher for longer. The towers, like their key telecom carrier customers, have leveraged balance sheets and will face higher interest burdens in such an environment. Valuation multiples for high growth companies like the towers also trend lower in a higher for longer environment.

In July both operators reported Q2 earnings that beat expectations, and American Tower lifted 2023 guidance. Despite this, the market paid more attention to Crown Castle's comments regarding lower incremental tower leasing activity which will impact 2024 earnings and beyond.

We downgraded our positions in both Crown Castle and American Tower in early July, reflecting concerns on valuation, slower leasing, and an increasing interest burden.

Our US railroad investments Norfolk Southern and Union Pacific continue to restore service levels

Our US railroad investments Norfolk Southern (-4.9%) and Union Pacific (+2.1%) continue to focus on restoring service levels to improve efficiency and drive volume growth. They are doing this against a cyclical decline in demand, and increased competition from truck transport as the pricing gap between truck and rail has narrowed.

Norfolk Southern reported Q2 earnings in July, missing sell-side expectations and reducing full-year guidance (revenue now -3% vs flat previously). They have had challenges restoring service levels due to the East Palestine accident earlier this year.

Union Pacific announced the appointment of Jim Vena as CEO. Jim is an industry veteran, with a strong track record of driving efficiency and profitable growth at Canadian National for over 40 years, and more recently was COO at UNP until 2020. The market reaction to Jim's appointment was very positive.

In August we took the opportunity to reduce our Union Pacific position and add to Norfolk Southern due to the relative valuation attractiveness.

Goodman Group has a strong outlook

Goodman Group (+5.7%) announced its second half result in August, which was in line with expectations. Before the result, the market had become concerned with the sustainability of Goodman's development Work in Progress ('WIP'). Goodman saw a change in WIP as industrial warehousing demand accelerated during the pandemic, caused by changes in e-commerce penetration. At the result Goodman highlighted that the WIP remains robust, with datacentres now accounting for 30% of WIP. Datacentres attract higher margins than other project types and have strong demand tailwinds. With the durability of Goodman's WIP reinforced, the market gained increased confidence in development and asset management earnings growth.

Earlier this year we reduced our position size due to concerns on valuation and development WIP.

However, we were happy to be proven wrong and see evidence of a longer runway for growth in one of our key positions.

Others in the portfolio had a challenging quarter

The ASX 200 Property Index declined overall (-2.9%), despite Goodman Group's strong update. Earnings downgrades were larger than expected, with a key feature being increased levels of hedging. These increased levels brought forward the earnings impact of rising interest rates and provided more certainty going forward.

Arena REIT (-9.5%) outperformed Charter Hall Social Infrastructure (-12.9%) with Arena's conservative balance sheet and internalised management structure providing ballast in an uncertain environment.

Dexus (-6.4%), also underperformed the broader index, which is heavily influenced by Goodman Group (31% weight).

We have been adding to Arena and reducing our exposure to Charter Hall and Dexus this year, reflecting the dynamic between them.

We sold our position in Altice France

We sold our fund's position in Altice France, a telecommunication business with a leading market position in France. While the group has an attractive business profile, recent operational trends have been under pressure. This partly reflects an increase in price competition within European internet and mobile markets. The group also has several debt maturities to refinance over the coming years which will increase cash interest costs.

As such, we exited the investment but will maintain a close eye on business trends to ensure we are ready to reinvest into the group should our assessment of the risk–return balance change in the future.

Industrial assets continue to offer the highest return outlook

Brent Buchanan, Head of Direct Property

The Fund aims to deliver a consistent, above-average, long-term total investment return by providing security of income, preserving capital value, and offering the potential for capital gain. We invest in an established and diversified portfolio of quality New Zealand retail, office and industrial properties.

Flight to quality

Market activity has picked up and will continue to do so towards the year-end.

For CBD offices, there are anecdotal examples of tenants vacating at lease expiry and moving to smaller offices in newer assets. This flight to quality favours prime office assets, which have seen vacancy rates fall over the year. However, overall, total office absorption for 2023 remains negative, reflecting current work from home (WFH) trends, and the outlook is challenged.

> Flight to quality favours prime office assets.

Rents from malls have risen due to CPI-based rent review mechanisms, even as national retail sales soften. Rising rents and falling sales put retailers under pressure.

At the Fund's Merivale Mall and Bayfair, spending has remained resilient, and retailer occupancy rates are high. For example, Bayfair customer spending has risen by 25% compared to 2022. These strong sales have continued to attract quality retailers to the mall, as reflected by its 99.4% occupancy rate.

At only 0.5%, Auckland's industrial vacancy rate is one of the lowest in the world, resulting in very strong rental growth. Our own industrial portfolio is 100% occupied and has an average lease term of over seven years.

But despite the above, an underlying tone of a slowing economy remains, which will, in time, drive up vacancy rates across all sectors. Therefore, retaining high occupancy, controlling costs, and driving earnings is key. One benefit for owners may be a reduction in interest rates in late 2024, reducing the current burden on leveraged property owners.

Additional Opportunities

We continue to explore additional investment opportunities across all property sectors. While offering the lowest initial yields, industrial assets continue to offer the highest return outlook.

The Fund reduced its office weighting from 35% in 2018 to 14% by early 2020 via a series of disposals. This was on the thesis of aging stock, increasing capital requirements, and better returns in other sectors. Our remaining office exposure includes the New Zealand Police HQ - but their occupation as a First Responder, means they do not utilise WFH.

Market Movements

as at 30 September 2023

Bond Indices	Closing Values	Changes over: 3 Mths %	6 Mths %	12 Mths %
S&P Global LargeMidCap ($NZ)	N/A	-1.3	7.3	14.4
USA - S & P 500	9247	-3.3	5.2	21.6
USA - Nasdaq	16002	-3.9	8.6	26.1
Japan - Topix	3898	2.5	17.3	29.8
UK - FTSE100	8078	2.2	1.9	14.7
Germany - DAX	15387	-4.7	-1.6	27.0
France - CAC40	21548	-3.4	0.0	27.7
HK - Hang Seng	58498	-4.2	-10.0	7.2
Australia - S & P 200	88350	-0.8	0.2	13.5
NZ-S&P/NZX 50 Gross Index (inc imp credits)	14140	-4.8	-4.5	3.0
Market Volatility - VIX	17.5	28.9	-6.3	-44.6

Property		%	%	%
S&P/NZX All Real Estate (inc imp credits)	1601.6	-5.5	-2.4	-3.9
S&P Global Infrastructure Index (70% Hedged NZD)	6359.4	-5.9	-5.9	3.3

Ten Year Bonds	%	Yield Changes		
USA	4.59	0.78	1.11	0.76
Japan	0.76	0.37	0.44	0.52
United Kingdom	4.40	-0.01	0.88	0.26
Australia	4.49	0.47	1.19	0.60
New Zealand	5.35	0.69	1.16	1.05

90-Day Interest Rates	%	Yield Changes		
USA	5.55	0.12	0.70	2.22
Japan	0.07	0.00	0.00	0.02
United Kingdom	5.41	0.02	0.99	2.06
Australia	4.14	-0.22	0.44	1.08
New Zealand	5.74	0.03	0.51	1.89

Market Movements

as at 30 September 2023

Bond Indices	Closing Values	Changes over:		
		3 Mths %	6 Mths %	12 Mths %
S&P/NZX Bank Bills 90-Day	782.84	1.43	2.74	4.89
Bloomberg Global Aggregate Index (Hedged NZD)	N/A	-1.82	-1.75	1.67
Bloomberg NZBond Infl 0+ Yr Index	5441.58	-3.09	-3.81	3.45
Bloomberg NZBond Composite 0+ Yr Index	1452.16	-1.62	-2.19	0.25

Hedge Funds & Commodities		%	%	%
HFRX Global Hedge Fund Index (USD)	N/A	N/A	N/A	N/A
DJ-UBS Commodity Index Total Return	237	4.7	2.0	-1.3
Gold (US$/ounce)	1848.10	-3.8	-6.1	11.2
Oil (US$/barrel)	95.31	27.9	20.4	7.2

Currencies		%	%	%
NZD / USD	0.6009	-1.9	-4.0	6.2
NZD / EUR	0.5675	1.1	-1.5	-1.7
NZD / GBP	0.4923	2.2	-2.7	-2.8
NZD / AUD	0.9310	1.2	-0.3	5.8
NZD / YEN	89.66	1.3	7.7	9.5
Trade Weighted Index	70.75	-0.1	-0.7	3.4

*Total Return Indices. Indices are net of offshore tax.
Source: Thomson Reuters Datastream

fisherfunds

Contact: Private Bag 93502,
Takapuna, Auckland 0740
0508 347 437
enquiries@fisherfunds.co.nz