Fisher Funds Market Insights

December 2023 Quarter

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Markets rebound in 2023: A promising prelude to 2024?

Ashley Gardyne, Chief Investment Officer

The final stretch of 2023 painted a vibrant picture for investors, with equity markets soaring in November and December and taking gains for the year to 23% for global equity markets. The remarkable turnaround from 2022 stems from cooling inflation and central banks signalling interest rate cuts may be on the cards for 2024. As is often the case in markets, investors that were disciplined and stuck with their strategy were rewarded in 2023.

Strong fund performance in 2023

The solid fund performance in 2023 was supported by strong fundamental performance by our portfolio companies. Despite the rebound in markets, and as you will read in the Portfolio Manager updates, the team are still finding plenty of attractive new investment opportunities in the market – which leaves us cautiously optimistic about the outlook for 2024.

Soft landing hopes boost sentiment

After a strong start to 2023, followed by a rocky September and October, markets rebounded spectacularly in the final months of the year. The MSCI World Index surged 15% in November and December alone, as did markets in the US (14%), New Zealand (10%), and Australia (13%). For the full year, global markets surged 23%.

Global bonds, which were still underwater for the year at the end of October, went on to rise 9% in the last two months of the year and ended up gaining 6% for the year (after two years of losses).

This bullish sentiment hinges on the narrative of an economic soft landing – a slowdown without a recession. Current data in the US seems to support this optimism. US inflation, once a fiery beast, had been tamed to 3.1% year-on-year by November, down from over 9% and inching towards the Fed's 2% target. Simultaneously, GDP grew at a robust 5.2% annualised rate in the third quarter – a long way from recession territory.

Central banks, once inflation hawks, seem to be changing their tune. The US Federal Reserve's December statement suggested a shift towards balancing inflation control with employment preservation, hinting at potential rate cuts next year. This stands in stark contrast to their single-minded inflation focus earlier in 2023.

Market backdrop supportive, but beware of short-term predictions

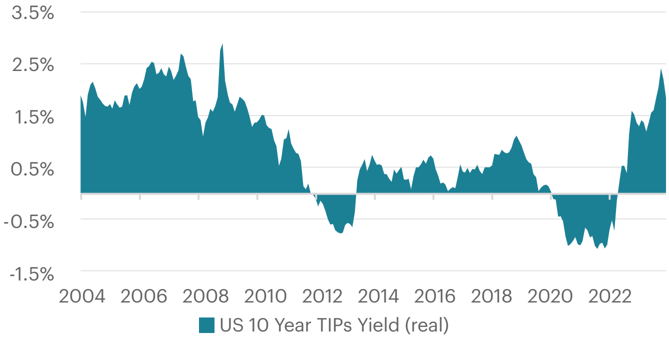
This time last year investors were pessimistic about the ability of central banks to rein in inflation, and there was a widespread view that many economies would fall into recession in 2023. But the worst fears rarely play out in markets, and most countries have so far avoided a recession, as low unemployment and wage growth have supported consumer spending. In hindsight, early 2023 was a great time to be investing, with global share markets gaining 23% for the year.

That said, interest rate increases take several quarters (often up to 18 months) to have their full effect, which means there is still likely to be more economic fallout from this interest rate hiking cycle. We are already seeing signs of a weaker consumer in many countries around the world, and while the chances of an economic soft landing have increased, there are still risks that could derail economies and markets.

The flipside of economic uncertainty is often more reasonable market valuations, and that seems to be the case in many markets this time around - with bond yields and asset valuations appearing reasonable and helping compensate for this uncertainty.

Long term real interest rates are much higher than they were a year ago. With inflation subsiding, bond investors now have the prospect of positive real returns (ie. after inflation) for the first time since the start of the COVID pandemic. As the chart shows, the real yield on US 10-year Treasury Inflation-Protected Securities (TIPs) is currently c.1.7% – the highest level since 2009.

Inflation adjusted bond yields haven't been higher for over a decade



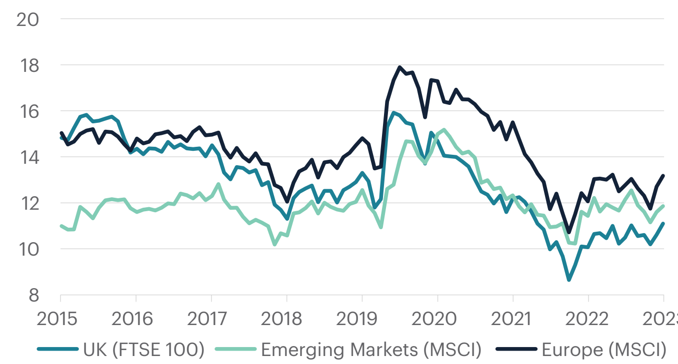
Source: Bloomberg

While equity markets moved higher in 2023, this was largely due to a handful of large-cap growth stocks (Apple, Microsoft, Alphabet, Meta, Amazon, Nvidia and Tesla). Excluding these companies, the US market would have gained only c.2% for the year. Corporate earnings also proved resilient in 2023, meaning that market valuations excluding these big technology companies are still in-line with or below long-term averages, as can be seen in the charts below.

US market trading in-line with long-term averages, despite 2023 rally (forward P/E multiple)

Source: Bloomberg

Europe and Emerging Markets trading below or in-line with averages (forward P/E multiple)



Source: Bloomberg

None of this is a prediction of how markets may perform in the short-term. It is just to say that the economic backdrop is more supportive than it was a year ago, and that market valuation levels still look reasonable relative to their history.

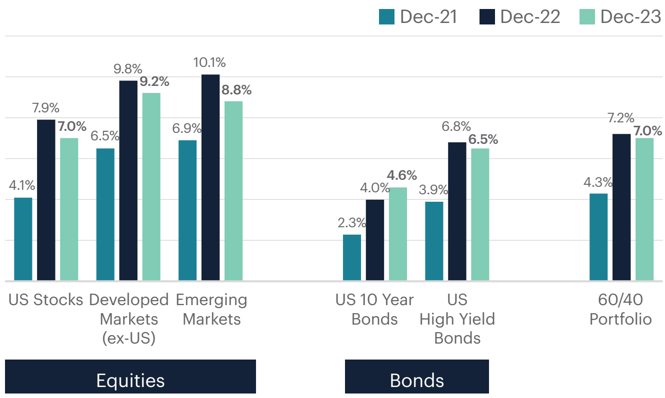
Longer-term prognosis

While short term market predictions are notoriously unreliable, longer term asset class forecasts tend to be far more reliable. Returns over longer periods are driven more by the growth in the economy, corporate earnings and the dividends companies pay. Short term sentiment driven changes in valuation multiples have less of an impact.

In December each year JP Morgan publishes detailed forecasts of expected asset class returns over the following 10 years. The most recent report shows that while expected long-term returns have come down slightly from last year's predictions, the current environment of higher interest rates and lower valuation multiples sees them forecasting materially better returns than they did two years ago (and returns broadly in-line with the long-term history).

This is another reason we remain optimistic about the outlook for long-term investors.

JP Morgan long term market returns forecasts



Source: JP Morgan Asset Management

2023 saw improved returns despite a tough NZ market

Matt Peek, Portfolio Manager, New Zealand Equities

The year's performance was underpinned by strong returns from software businesses Xero (+60% total return) and Serko (+80%). These companies delivered continued growth with a greater emphasis on profitability, as we have discussed in previous quarterly updates. Infratil (+18%) also performed well, courtesy of its growth infrastructure assets. Summerset (+13%) rebounded too, as sentiment around the housing market recovered and it demonstrated its ability to profitably develop retirement living communities in a challenging environment.

Highlights in the December quarter included Vista, F&P Healthcare, and Mainfreight

Cinema software company Vista (+15% in the quarter) was another good news story.

We previously said it would take 'runs on the board' to lift investor confidence in Vista's strategy to transition cinema exhibitor customers to its digital and cloud products. Within weeks, the company announced several existing customers had signed up to its new product suite, including Vue (Europe), Pathé (France), Major Cineplex (Southeast Asia), and Cinépolis (Spain). Vista is clearly gaining traction, and these wins will help convince undecided customers, delivering further momentum to its sales pipeline. The company remains confident of achieving its medium-term ambitions, which suggests its shares remain undervalued.

> Cinema software company Vista was another good news story.

Fisher & Paykel Healthcare (+10%) delivered first half revenue and net profit slightly ahead of guidance issued in August, supporting its longer-term earnings trajectory. New products underpinned growth across both the Hospital and Homecare divisions, with obstructive sleep apnea masks and anaesthesia products being the standout growth contributors.

Mainfreight (+8%) saw its share price recover strongly after releasing its first half result. The result showed a marked improvement in the second quarter, following a weak first quarter trading update in July. Despite the subdued trading environment, the New Zealand and Australian Transport businesses are performing better than a year ago due to winning new customers.

In Mainfreight's Air & Ocean freight forwarding business, weekly profits have returned to a consistent level after spiking in the last couple of years. This shows the business can maintain profitability well above pre-COVID levels. The team is also confident that it can grow from this level through its long-term organic growth strategy now that trading conditions have 'normalised'.

New Zealand lagged in 2023, both in share market returns and economically

New Zealand equity returns lagged key markets in 2023, with the US S&P 500 up +26.3%, and Australia's ASX 200 up +12.4%.

Generally speaking, Kiwi companies struggled during the year. Around 70% of companies in the NZX 50 benchmark index saw 2023 earnings expectations fall. Cost pressures and higher interest costs even impacted many so-called 'defensive' companies. It was a particularly tough time for any company exposed to discretionary spend.

Our companies that are exposed to the New Zealand economy, like Mainfreight, Freightways, and Vulcan Steel, struggled to take enough market share to offset lower same-customer volumes. Economic growth in New Zealand is running lower than the US and Australia, and we're seeing a similar degree of weakness in retail sales, house prices, and construction.

Rising interest rates were a handbrake on Kiwi consumers and companies for much of the year. The direction of interest rates changed abruptly in the December quarter, with key interest rates such as

10-year government bond yields dropping sharply. We're seeing increasing evidence that this restrictive monetary policy (of high interest rates) has done its job, and confidence is growing in a return towards target levels of inflation.

Looking into our crystal ball, what might 2024 hold?

Last year, we noted that sentiment shifts can be a powerful driver of returns in any short-term period. For example, retirement village operators had been out of favour, but their depressed share prices rebounded as the outlook for the Kiwi housing market improved over 2023.

So, what sentiment shifts might we see over the next year? While it still seems tough going in New Zealand today, fast forward a year and we may well see an improved trading environment for the likes of Vulcan Steel and Freightways. As interest rates subside, the appetite for consumers to spend and businesses to invest will grow. These companies have been busy adding customers and refining their offerings to maximise their performance in an economic rebound.

One disappointing performer, where sentiment is at a low ebb, is Oyster Bay wine maker Delegat (-21%). A combination of cost pressures and customers reducing stock has impacted Delegat's earnings expectations, although the business remains strongly profitable. Net profit of $57 – 61 million is expected in the current financial year – similar to last year.

The share price decline has been disproportionate to the reduction in Delegat's earnings power. Plus, underlying growth remains solid: retail sales growth in the key US market are still running strong at 9%, despite the tough retail environment. Management has a credible strategy to reprioritise its most profitable sales channels, increase pricing, and substitute third-party grapes with their own as more of its own vineyards come online. This strategy should gradually improve profit margins, which together with continued sales growth could lift sentiment.

Whatever surprises the next year has in store, we remain confident that the fund holds a balanced portfolio of New Zealand's highest quality companies – companies with wide economic moats and strong medium- to long-term growth prospects. That's why we're excited for 2024 and beyond.

A pleasing Q4 caps off a strong year of returns

Robbie Urquhart, Senior Portfolio Manager, Australian Equities

A volatile Q4 drove home the wisdom of the late and great Charlie Munger: 'The big money is not in the buying and selling, but in the waiting.'

We stuck to our guns in the quarter, while staying alert to new opportunities

Adding to Charlie Munger's comment, the past two years have shown how timing investment decisions using short-term market predictions is an exercise fraught with regret.

In Q4, the Fund first fell -7% over October, before rebounding +17% during November and December. Some company-specific factors exacerbated the volatility of returns, but shifts in global interest rates played the biggest part in this reversal, as concern about inflationary pressures first rose and then receded. The Australian 10-Year Government Bond yield initially spiked to a 12-month high of 4.95% in early November, before falling sharply by 1% to finish the year at 3.95%. Global central bank commentary suggests that the interest rate hiking cycle is more or less over, which buoyed equities into year-end.

> We stay focused on our investment process.

Reacting to amplified market pessimism in October could have been costly. But rather than investing based on short-term predictions, we stay focused on our investment process. We continuously cross-check our long-term investment theses for each company we hold in the portfolio to gauge whether any changes warrant buying or selling shares.

We don't predict short-term share price movements, but we will take advantage when attractive prices align with our investment process of investing in high quality and growing companies. Q4 gave us some good opportunities in this regard, as this update shows below.

However, our research suggests that, for many of our portfolio holdings, not much fundamentally changed during Q4. The returns generated by our larger holdings in particular – such as WiseTech (+16% in AUD$ in Q4), CSL (+14%) and Carsales (+11%) – lay more in the 'waiting' than the 'buying' or 'selling'.

Companies with earnings exposed to the economic cycle benefited the most from improving inflation and interest rates in Q4

Quarterly earning guidance in November from building materials manufacturer James Hardie (+38%) was materially above market expectations. James Hardie is outperforming the broader building products market in the US. It has also increased its selling prices and is benefiting from falling input costs – translating into record profit margins and cash generation. The company is well positioned to benefit from an improvement in US and Australasian housing construction and renovation activity.

Online employment classified advertising company SEEK (+21%) and real estate classified advertising business REA (+17%) also benefited. The improving outlook is expected to be positive for employment activity and, through falling interest rates, the housing market. oOH!Media, the leading outdoor advertising media company in Australia, likewise benefited from easing concerns about the economic slowdown, rising +17% in Q4.

Our investing process also selects for companies with protective economic moats

The profitability of these companies is partially tied to the economic cycle. However, each of them also benefits from an economic moat that provides some protection for profits during economic downturns. This additional consideration is core to our investment process. Critically, these businesses also benefit from structural earnings growth tailwinds. This means that, even if their earnings are in some ways cyclical, their profits should continue growing over time – bolstering their longer-term return prospects.

For example, James Hardie benefits from a scale advantage as the largest fibre cement siding manufacturer in the US and Australia. This scale advantage provides it with a cost advantage over smaller competitors. In addition, fibre cement as a product is taking structural share from other house cladding products, like vinyl.

As leaders in their categories of classifieds, SEEK and REA benefit from having strong network effect moats. Employers and house vendors have to advertise through SEEK & REA, because that's where 'the eyeballs' of job seekers and house buyers are. This advantage provides both companies with pricing power, which supports their earnings growth through the economic cycle.

oOH!Media has a smaller moat than James Hardie, SEEK, and REA. However, as a category, outdoor advertising continues to win share from other traditional advertising formats. This, too, supports oOH!Media's earnings growth over time.

Growing pains weighed on the performance of some portfolio companies

Credit Corp (-16%) and PWR Holdings (-11%), our worst performers in Q4, were both impacted by disappointing market updates.

Credit Corp specialises in buying portfolios of bad debts incurred by consumers (Purchased Debt Ledgers or 'PDLs') from the likes of banks and utilities. Credit Corp is well established in Australia and has been expanding into the US. In October it announced an AUD$64 million impairment to the carrying value of its US PDL assets. The share price initially fell 38%, reducing its equity value by AUD$500 million. We discussed the cause of the impairment with management. The impairment was contained to US PDLs purchased during 2022, before the deterioration in economic conditions.

Credit Corp management (who we rate highly) have since taken prudent steps to adapt to the economic environment. As such, we think the intrinsic earnings potential for the company remains solid. In particular, we think Credit Corp retains good medium-term growth prospects in the US market. We took advantage of the fall in the share price to add to our position. Pleasingly, the share price has since rebounded strongly.

PWR Holdings produces cooling solutions for high-end combustion engine and electric vehicle ('EV') manufacturers (such as Formula 1 teams). In November, PWR announced that it had withdrawn from commercial negotiations with a European customer. PWR had been working with the customer for 2 years to develop battery cold plates for a high-volume EV production programme, but commercial terms acceptable to PWR could not be reached with the customer.

We rely on management to protect shareholders when negotiating the terms of these contracts, and we take comfort knowing that CEO Kees Weel, as the largest shareholder in the company, is well aligned with our interests. So, while disappointing, we think PWR has shown ironclad commercial discipline in withdrawing from this contract. PWR has numerous other programmes at various stages of negotiation in its growth pipeline, and we expect these contracts to underpin earnings growth in future years.

Equity volatility provided some attractive investment opportunities

As well as adding to our Credit Corp shareholding, share price volatility gave us the opportunity to add PEXA to the portfolio.

PEXA operates the only e-conveyancing property exchange in Australia. Close to 100% of Australian property refinancing and over 90% of sale and purchase transactions are processed through the electronic PEXA Exchange. PEXA has reinvested cash generated from this very dominant domestic position into building a presence in the UK market. The market was disappointed by the slow pace of expansion in the UK (which was evident in a Q4 trading update) leading to a sharp fall in its share price. We added PEXA to the portfolio and bought shares aggressively following this fall.

> We added PEXA to the portfolio

To help fund the PEXA purchases, we exited our Westpac shareholding. Westpac has been underperforming its competitors in Australia and we felt our return prospects were better with PEXA.

In PEXA's case, the investment opportunity proved fleeting. The share price rose rapidly around 20% in the few weeks after we began buying shares, to a level that we felt priced in a strong acceleration in UK growth prospects. We think this earnings growth is likely to be harder won and will take time. Therefore, in an unusual move for us, we banked the profits and exited the position after this rebound. We would rather wait for more evidence of improvement in the UK before buying shares or remaining invested at current prices.

Following the strong share price performance, we also felt the risk-return for James Hardie, REA, Carsales, and Audinate (+20%) was looking more evenly balanced and trimmed our shareholdings in these companies.

Conversely, we added to our CSL shareholding when the equity market fell during October. CSL remains our largest shareholding. It is one of the highest quality healthcare companies in Australia, and it has a long earnings growth runway in front of it.

Strong finish to a strong year for markets and the portfolio

Sam Dickie, Senior Portfolio Manager, Select International Equities

The market began the year concerned about a hard economic landing. Worse than that, it was concerned about a slowdown in growth amidst high and sticky inflation, and, therefore, ongoing higher interest rates. Now, the market has ended the year excited about a soft economic landing, declaring victory on inflation, and enjoying a much lower interest rate environment.

The changeable global market backdrop steadied towards year-end

The interplay between growth, inflation, and interest rates dictated equity market performance in 2023. The first two quarters of the year showed a brighter than expected economic growth outlook, fairly sharp disinflation, and stable interest rates. But the September quarter was almost a complete reversal – reflecting concerns that robust growth was making inflation a little bit stickier than the market had expected. In the final quarter of 2023, the market's interpretation of the economic backdrop was much rosier.

We have continued to upgrade the quality of the portfolio. The Fund's average quality and growth characteristics, as captured via our STEEPP framework, has improved over the year. This helped the international growth portfolio outperform its benchmark amidst the changeable macro backdrop and shifting sector leadership throughout the year.

Portfolio update

Gartner (+31%), the leading IT research business was well up for the quarter. It reported a reacceleration in new business wins after several quarters of cautious spending by its tech vendor customers. Margins were again the standout contributor – well ahead of expectations – as the company continued to reduce its cost base following the pandemic. We had increased our target weighting of Gartner by around 50% (from 4% to 6%) throughout 2023, as we believed the market was too concerned by what we saw as a temporary slow-down.

Salesforce (+30%) had a strong quarter and reported solid earnings at the end of November. Salesforce met revenue expectations, but its operating profit margin was the standout in the quarter. The company continues to expand margins rapidly as it undergoes a period of expense growth rationalisation – like other companies in the tech space. Operating profit margins have expanded to 17.2%, up from 5.9% a year ago. This demonstrates the very high incremental margins for the business and its ability to protect profits when sales growth slows.

> Salesforce had a strong quarter

Floor & Decor (+23%) benefited from expectations of lower interest rates and improving real estate metrics in Q4. The underperformance of Floor & Decor's stock during Q3 gave us the opportunity to increase our weighting in the company. We believed the market was too focused on the short-term macro environment and was missing the large growth runway ahead of the company.

Alibaba (-10%) and Tencent (-4%) were two of our worst performers in the quarter, as the Chinese stock market continued to struggle against a tough economic backdrop. We exited Alibaba during the quarter on concerns around increased competition. We also exited PayPal (+5%), one of our other laggards for the quarter. These exits are discussed further below.

Entries to the portfolio

During the quarter, we added two high quality medical equipment companies, Intuitive Surgical and Dexcom. Both companies have revolutionised how disease is treated and managed. Intuitive is the leading manufacturer of soft-tissue surgical robotics, used to help surgeons perform minimally invasive surgical procedures. Dexcom develops, manufactures, and distributes continuous glucose monitoring (CGM) devices for people with diabetes.

Both companies are leaders in their respective markets, have large, addressable markets with long runways for growth, and benefit from wide economic moats. We took the opportunity to add them to the portfolio, as both companies sold off through the second half of this year on GLP-1 weight loss drug concerns.

We exited Dollar General (DG) in September due to a lack of clarity over its steady state earnings and lower confidence in management. Then, in early October, DG announced that former CEO Todd Vasos was returning as CEO after retiring in 2022. Vasos successfully led DG as CEO for 7 years before retiring and held senior roles for several years before becoming CEO. Vasos spoke with analysts and investors soon after his reappointment, giving strong confidence around containment of the current investment cycle, longer-term margins, and earnings power. As a result, our two main reasons for exiting have changed for the better, and we have added DG back to our portfolio at a 2% weighting.

Exits from the portfolio

We exited Alibaba during the quarter. Alibaba has faced several years of increased competition from both live-streaming companies like Douyin and Kuaishou, and low-cost e-commerce companies like Pinduoduo. Against a tough economic backdrop, competition in the China e-commerce sector has stepped up recently – forcing Alibaba to increase investment in user engagement and 'price competitiveness'. This not only impacts revenue growth, but also necessitates further investment, creating uncertainty around the company's ability to improve margins.

We also exited PayPal during the quarter, due to concerns around competition and share loss. PayPal had an early lead in e-commerce payments due its trusted brand, security, and its reputation as the most frictionless checkout option. This was more important in the early days of e-commerce, when consumers and merchants had less faith in online transactions, and PayPal could bridge the gap. But these advantages have eroded, and the company is facing stiff competition from multiple players – such as Apple Pay, Shop Pay, and Amazon's Buy with Prime.

The sun is shining again on fixed income investments

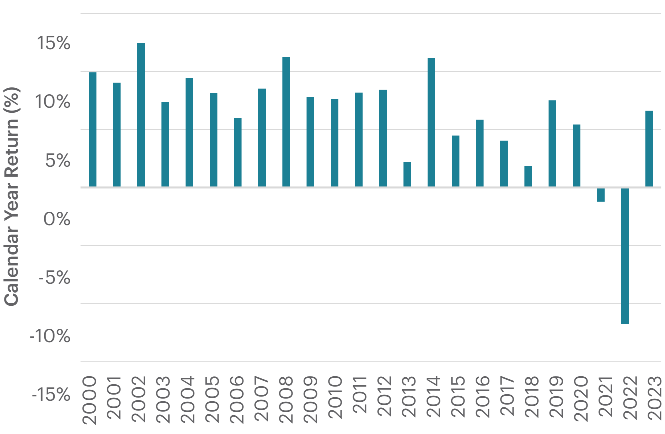
David McLeish, Senior Portfolio Manager, Cash & Fixed Interest

The sharp rise in interest rates which caused fixed income asset prices to tumble throughout 2021 and 2022 has given way to a much brighter environment for this once-beleaguered asset class. And with yields still as high as they are, we believe this positive momentum could extend well into 2024.

The winter thaw

Investor selling of fixed interest assets peaked at around the same time as inflation did across much of the developed world in late-2022.

After an uncharacteristically cold snap normal business resumed in 2023



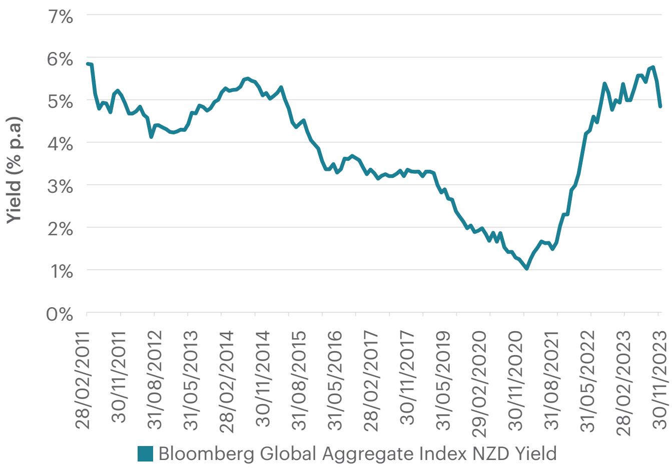
Source: Bloomberg

However, it was not until this last quarter that the data suggests investors have finally begun stepping back into the bond market with conviction.

Better late than never

We think that's a wise decision. Despite the strong year we've had, the asset class remains attractively priced when looking through a wider multi-year lens.

Interest has returned to the global fixed interest market



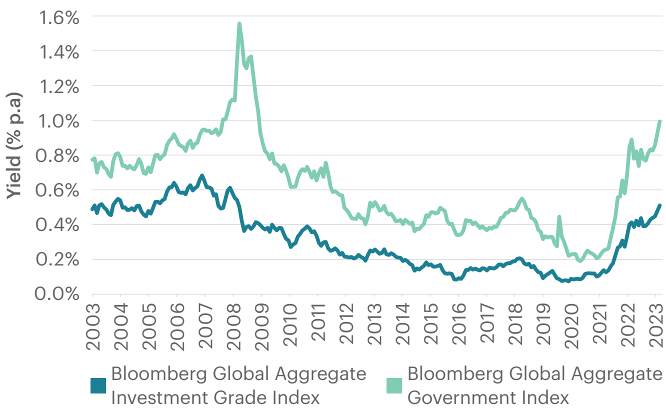
Source: Bloomberg, Fisher Funds

What's more, as you will read below, our investment team are still finding many opportunities that we believe have the potential to strongly outperform the broader market.

Why interest has returned to fixed interest

But it's not just the absolute level of income which is attractive. Today, the average yield per unit of interest rate risk (AKA duration) is also elevated – meaning returns, when adjusted for risk, are excellent.

Fixed interest now offers historically attractive risk-adjusted returns



Source: Bloomberg, Fisher Funds

In fact, the level of risk-adjusted returns now on offer across the fixed income market are around two times higher than their average over the last 20 years.

The last time they were this alluring, in 2008, the Bloomberg Global Aggregate Index generated a 10% return, followed by four further years of returns over 7% per annum.

The importance of picking your spots

As the global economy transitions through each phase of a business cycle, different areas of the bond market perform differently. For example, government bonds typically rise in value during an economic downturn, while high yield bonds often fall; floating rate notes mostly outperform fixed rate bonds in a recovery; and so on.

These performance differences are a constant challenge for fixed income investors to navigate. But they are especially difficult when the typical evolution of the business cycle has been disrupted by such an extreme, irregular event as the global pandemic.

Balancing the right mix of quality, maturity, industry, and geographic exposures within a portfolio has rarely been more challenging for non-professional fixed income investors than it is today.

A slow-growth, disinflationary world is a favourable backdrop for bonds

We expect that the global economy will continue to be weighed down by high interest rates and that inflation will wane further this year. This is likely to be a positive backdrop for bonds, as interest rates begin to reverse course and head lower.

This is why we have positioned the portfolio with more interest rate exposure (that is, duration) than normal – so that it stands to benefit more in a falling interest rate environment.

We also believe the defensive qualities of medium-term, high-quality corporate and asset-backed bonds should produce particularly strong returns – should our cautious macroeconomic outlook play out.

Opportunities abound

TR Group – New Zealand's leading truck and trailer leasing business – revved up the local corporate bond market with its latest bond issue this past quarter. We've maintained a close working relationship with the team over the past few years, and we continued to support their business by participating in this transaction.

Their strong track record and runway for growth, alongside a healthy coupon of 7.2%, represented good value in our opinion. So, we backed up the truck to ensure the portfolio maintained its exposure to the company ahead of another of their bonds maturing early this year.

Positive quarter for property and infrastructure equities

Sam Dickie, Senior Portfolio Manager, Property & Infrastructure Fund

Global markets rose +11.5% in December, offsetting weakness in the September quarter. Market moves were supported by falling long-term interest rates, with the 10-year US government bond yield falling 69 basis points, while equivalent New Zealand and Australia bond yields fell 98 and 53 basis points respectively.

Developed markets outperformed, with US equities up +11.7% compared to Emerging Market equities, up +7.8%. This trend was observed in infrastructure too, with many Chinese stocks again among the worst performing in the S&P Global Infrastructure index. The overall index rose +10.9% for the quarter, lower than global equities. Property was the strongest performing sector in the S&P500, up +18.8%, while Australian property increased +16.6%. The strong performance of property generally can be attributed to lower interest rates, while the Australian property index also benefited from robust prospects for Goodman Group. New Zealand property was a laggard (+6.5%); October's election of a National party led coalition confirmed unfavourable tax treatment for the New Zealand property sector.

Portfolio update

Our US tower investments, Crown Castle (+26.9%) and American Tower (+33.7%) both enjoyed a strong quarter, supported by lower US bond yields and improving investor sentiment. Activist investor Elliot Management signed an agreement with Crown Castle to implement board change and a review of its problematic small cells and fibre segment. The market welcomed this news, given the segment's sluggish earnings trajectory. Management change also featured in the quarter, with American Tower's CEO being replaced by the COO, and Crown Castle's CEO and CFO announcing their departure. Overall tower sentiment has improved recently, with investors getting better visibility on the bottom of the tower leasing cycle and increasing confidence that interest rates are peaking.

Australian property stocks rallied 16.6% during the quarter, outperforming the ASX200 (+8.4%). A 53 basis point fall in the Australian 10 Year Government Bond rate helped, as investors gained more comfort with property companies' balance sheets and ability to fund their development plans. This performance partly reflected a reversal of a period of underperformance. Dexus (+8.9%) hosted an investor day during the quarter, highlighting plans to diversify its asset mix (including reducing office assets from 71% to less than 50% of its portfolio) and increase its exposure to funds management. Goodman Group (+18.7%) continues to outperform the benchmark, thanks to structural growth from datacentre demand (offsetting some softness in logistics demand) and modest gearing levels.

Infratil (-1.1%) reported its half-year result. There were few surprises, and Infratil narrowed the range for full-year earnings guidance, while modestly upgrading (+2%) at the mid-point. Longroad Energy's independent valuation was broadly flat. Anecdotally, this may have surprised some in the market who were hoping for a boost in valuation on the back of progress discussed at the September investor day. Infratil expects to invest further equity in CDC and Longroad in 2025, and other renewable energy platforms may also require further investment as they scale up activities. This investment is a sign of confidence; Infratil targets low- to mid-teens equity returns on portfolio investments, and international assets earn a performance fee when equity returns exceed 12%. Overall, we saw little in the result to change our view, and we remain confident in management's execution.

Port of Tauranga (-4.8%) held its AGM in October and provided earnings guidance for 2024, which was 11% below market expectations. September quarter container volumes were 21% lower than the previous year. This owed largely to lower transhipment volumes, as shipping companies changed their routes amid significant COVID-era disruption. Containerised imports were also down 23% on the previous year, with key culprits being higher rail costs (making Port of Auckland more attractive) and overall weak consumer demand. There were some offsets to the downturn, with September quarter log volumes up 33% on the previous year due to early harvesting of logs damaged by Cyclone Gabrielle. We believe the environment for pricing remains favourable, with Port of Auckland recently making significant pricing increases, which Port of Tauranga has typically followed. Overall, we were disappointed with the update given management recently (in August) provided forecasts for container and log volumes which they have not materially changed.

Listed property sector responds positively to falling 10-year NZ rates

Brent Buchanan, Head of Direct Property

The December return reflects the Fund's regular income yield, along with a marginal loss in capital value following 50% of the portfolio being independently revalued at the end of the year. The value movement was not due to any change in our earnings outlook, as our revenue growth remains positive, occupancy is over 95%, and operating cost pressures continue to ease.

However, some markets take time to adjust to the changing interest rate environment and to fully reflect the higher cost of capital. It was a marginal lift in the risk rate/capitalisation rate applied across the property industry as a whole - that resulted in our value shift.

Industrial sector cap rates have moved up 0.25% from six months ago, as investors seek higher initial returns from property. On our latest values, the margin between our portfolio's long-term forecast return versus government long bond yields has widened to c3.75%.

Our average industrial cap rate of 5.64%, compares to CBRE's last estimate for prime Auckland industrial yields of 5.65% and secondary yields at 6.20%. Secondary yields are expanding proportionally more than prime (as is always the case as the market softens). Our latest valuations compare favourably to our peers, some of whom have seen portfolio devaluations of 6%-10% over the same period, due to asset-specific risks (e.g tenant concerns, lack of revenue growth, and escalating capital costs).

Market review

The markets were very favourable over December, with 10-year NZ rates easing from their peak of 5.6% in October to 4.4% by year-end. The listed property sector responded positively to this, posting another strong month as REITS outperformed the NZX and recovered last year's losses. The rise in REIT prices, coupled with an easing in NTA values, means that the NTA discounts evident three months ago, have closed materially.

Owners are weathering higher short-term interest rates, with rental growth assisting in the payment of increased debt costs. Rates look likely to fall in 2024, while low vacancy rates (at least within the sectors we primarily invest in) continue to prevail.

Transactional activity was at a decade low in 2023, with sales primarily undertaken by developers looking to exit projects on completion and recycle capital. We anticipate activity returning strongly in 2024, as both retail and office assets are reintroduced to the market, so providing increased transparency over investor appetite. Low-leveraged /opportunistic buyers will be particularly active this year.

Portfolio activity

Our focus is on delivering growing revenue streams, undertaking prudent capital management, and capturing future capital gains. The retail investments are performing well, and our December sales figures (to be released mid-January) will likely underscore the attractiveness of owning quality retail assets. The pace of rent escalation in the industrial sector is beginning to taper (as anticipated), but we still have additional avenues to enhance earnings.

Our 2023 acquisitions have all held (or risen in) value post-settlement in an otherwise softening market. Our objective for 2024 is to continue to execute transactions successfully.

Market Movements

as at 31 December 2023

Bond Indices	Closing Values	Changes over: 3 Mths %	6 Mths %	12 Mths %
S&P Global LargeMidCap ($NZ)	N/A	5.4	4.1	22.8
USA - S & P 500	10328	11.7	8.0	26.3
USA - Nasdaq	18209	13.8	9.3	44.6
Japan - Topix	3978	2.0	4.5	28.3
UK - FTSE100	8265	2.3	4.5	7.9
Germany - DAX	16752	8.9	3.7	20.3
France - CAC40	22825	5.9	2.3	20.1
HK - Hang Seng	56218	-3.9	-7.9	-10.5
Australia - S & P 200	95767	8.4	7.6	12.4
NZ-S&P/NZX 50 Gross Index (inc imp credits)	14748	4.3	-0.7	3.5
Market Volatility - VIX	12.5	-28.9	-8.4	-42.5

Property		%	%	%
S&P/NZX All Real Estate (inc imp credits)	1708.4	6.7	0.8	6.2
S&P Global Infrastructure Index (70% Hedged NZD)	6823.0	7.3	1.0	0.0

Ten Year Bonds	%	Yield Changes		
USA	3.88	-0.71	0.07	0.00
Japan	0.61	-0.15	0.22	0.19
United Kingdom	3.53	-0.87	-0.88	-0.13
Australia	3.96	-0.53	-0.07	-0.10
New Zealand	4.37	-0.99	-0.30	-0.09

90-Day Interest Rates	%	Yield Changes		
USA	5.40	-0.15	-0.03	0.98
Japan	0.08	0.01	0.01	0.02
United Kingdom	5.32	-0.08	-0.07	1.45
Australia	4.35	0.21	-0.01	1.07
New Zealand	5.64	-0.10	-0.07	0.99

Market Movements
as at 31 December 2023

Bond Indices	Closing Values	Changes over: 3 Mths %	6 Mths %	12 Mths %
S&P/NZX Bank Bills 90-Day	794.15	1.44	2.89	5.39
Bloomberg Global Aggregate Index (Hedged NZD)	N/A	5.67	3.75	6.59
Bloomberg NZBond Infl 0+ Yr Index	5866.11	7.80	4.47	0.00
Bloomberg NZBond Composite 0+ Yr Index	1539.38	6.01	4.29	0.00

Hedge Funds & Commodities		%	%	%
HFRX Global Hedge Fund Index (USD)	#N/A	#N/A	#N/A	#N/A
DJ-UBS Commodity Index Total Return	226	-4.6	-0.1	-7.9
Gold (US$/ounce)	2062.40	11.6	7.4	13.3
Oil (US$/barrel)	77.69	-19.0	4.3	-6.2

Currencies		%	%	%
NZD / USD	0.6332	5.4	3.3	0.1
NZD / EUR	0.5732	1.0	2.1	-3.3
NZD / GBP	0.4967	0.9	3.1	-5.5
NZD / AUD	0.9279	-0.3	0.8	-0.5
NZD / YEN	89.26	-0.4	0.8	7.0
Trade Weighted Index	72.61	2.6	2.5	0.3

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

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