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Fisher Funds Premium Service

Quarterly Update – April 2024

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Buoyant offshore markets drive investor returns despite weak domestic economy

Ashley Gardyne, Chief Investment Officer

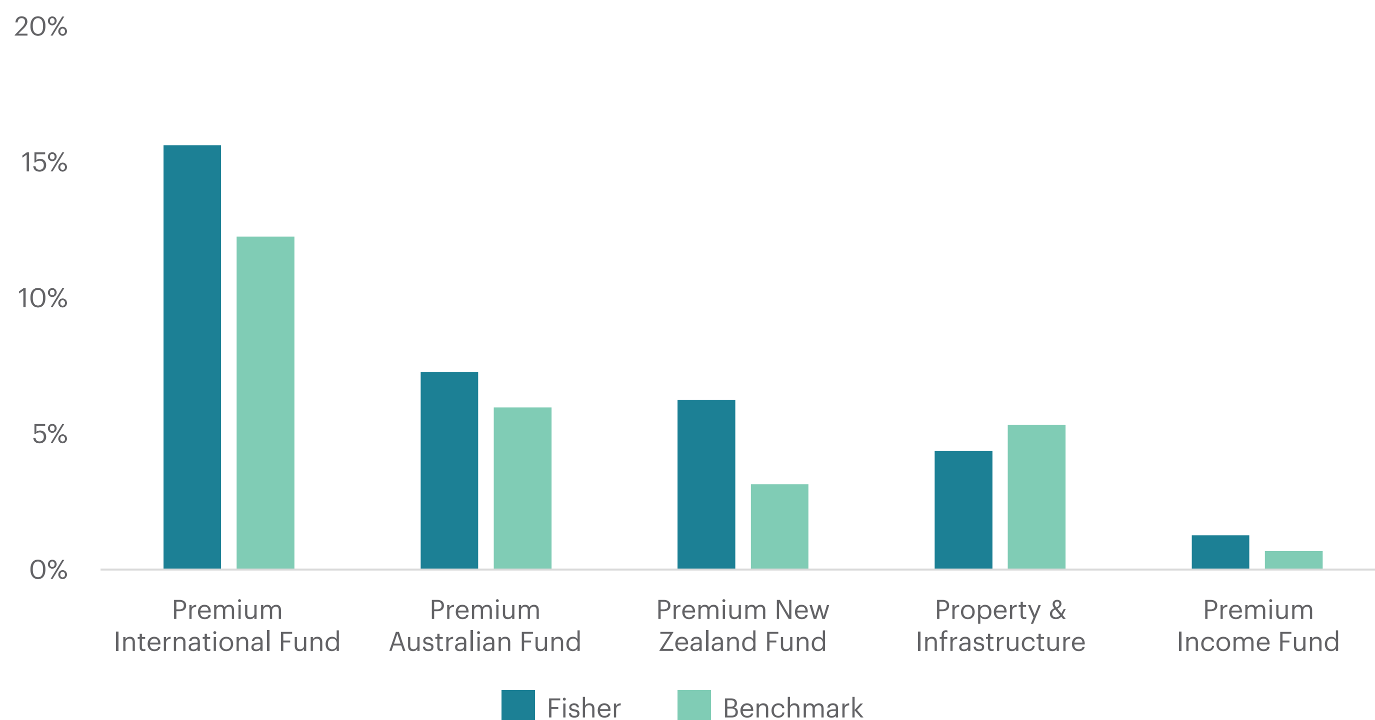
After a strong rebound in 2023, global share markets continued their surge in the first quarter of 2024. This offshore strength generated solid returns for investors across most of our strategies, despite a weaker domestic economy and share market.

Strong quarter for fund performance

Global equity markets have followed on from their strong run in 2023 with a buoyant first quarter. The MSCI World Index gained 8.5% for the quarter, while the US S&P 500 and European STOXX 600 Index gained 10.2% and 7.0% respectively. The US market has been supported by an improving economic outlook and a supportive Federal Reserve, which is signalling that interest rate cuts may be coming soon.

Our Premium Service funds have had a strong quarter against this backdrop, with notable gains from our Premium International and Premium Australian funds – gaining 15.6% and 7.3% respectively. Despite the more sluggish backdrop in the New Zealand equity market, our Premium New Zealand Fund also gained 6.2% for the quarter, 3.1% ahead of the NZX 50 Index.

Premium Fund Performance — Q1 2024



Source: Fisher Funds

Share markets reflect different economic and monetary policies

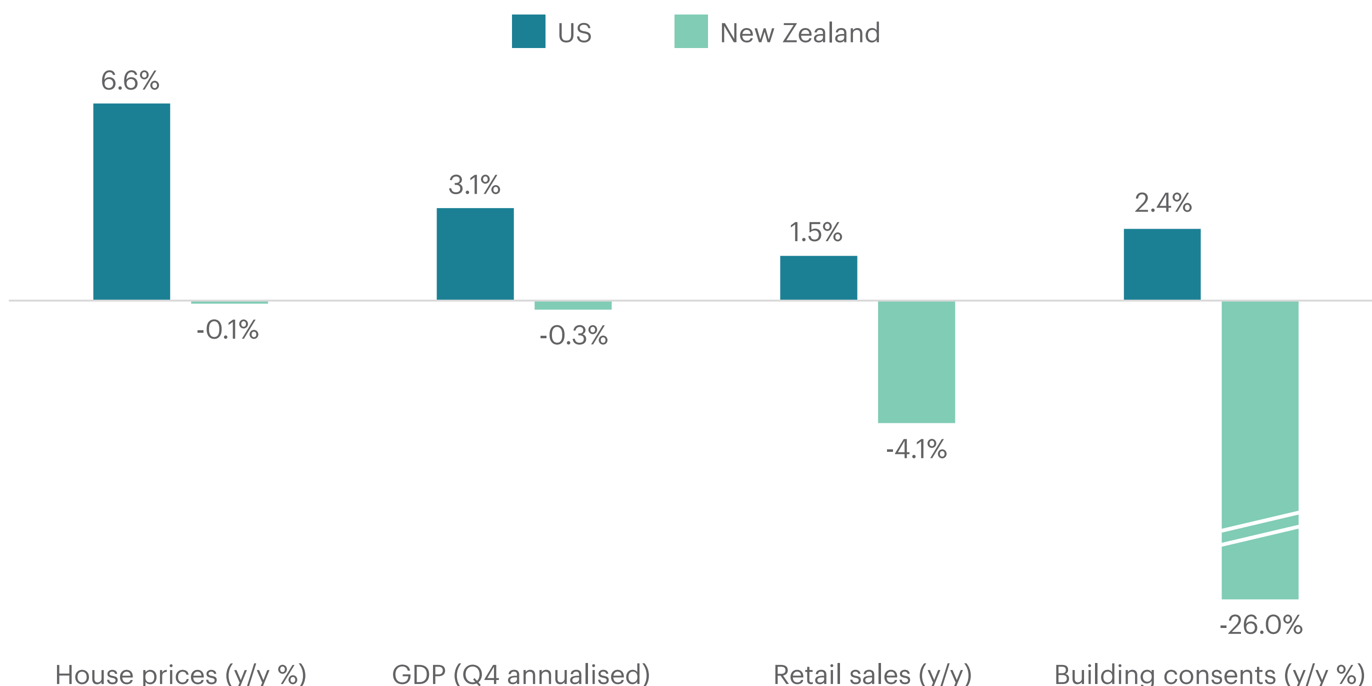
The strength in global share markets contrasts starkly with the NZX, which gained just 2.8% in Q1. Looking over the last twelve months, the divergence between the US and New Zealand share markets is even more pronounced, with the S&P 500 up 27.9% against the NZX 50, which is up only 1.9%.

Some of this divergence can be explained by differing economic outcomes – but the Reserve Bank of New Zealand's (RBNZ) increasingly divergent monetary policy stance is also a factor.

The US continues to report solid economic data and stable inflation, and, in its most recent corporate earnings season, has also shown surprising resilience and growth in its corporate sector. US GDP grew at an annualised rate of 3.1% in Q4 of 2023. Unemployment remains near all-time lows at 3.9%, and house prices are still pushing higher (up 7% year on year). The average company in the S&P 500 grew earnings by 7% in the fourth quarter of 2023. All considered, the data out of the US is increasingly pointing to a soft landing.

Meanwhile, New Zealand's latest earnings season and economic data has not been as pleasant. GDP shrunk 0.1% for the December quarter compared with the September quarter, which also shrunk 0.3%. Some economists define this as a recession. Regardless of definition, the data clearly shows that New Zealand's economy isn't in the same good shape as the US – despite being bailed out by record net migration. On a per capita basis the picture is even more concerning, with GDP per capita now 4% lower than mid-2022 levels. The situation is stretched for many households, and quick action is required to avoid a more severe downturn.

Taking the temperature of the New Zealand and US economies



Source: Bloomberg, tradingeconomics.com

The RBNZ's divergent approach to monetary policy

In both New Zealand and the US, inflation has dropped significantly over the last 18 months. The underlying drivers of inflationary pressure – like supply chain stress and energy prices – have also eased in both markets.

At the 28 February Official Cash Rate (OCR) announcement, the RBNZ held the key interest rate at 5.5%, insisting that the OCR needed to stay at a 'restrictive level for a sustained period of time'.

Contrast this with the US Federal Reserve (the Fed) who recently held interest rates for the fifth consecutive meeting but indicated that they expect to cut interest rates 2 – 3 times this year. Forecasts in the RBNZ's Monetary Policy Statement show no expectation of interest rate cuts until mid-2025.

The Federal Reserve's approach is in stark contrast to the RBNZ's, especially when considering the strength of the US economy. Given their economy is growing steadily, while ours is contracting, you would expect the roles of the two central banks to be reversed.

A central bank pivot is needed to steer clear of risks

Both central banks look at similar data sets when making decisions (data which is often out of date at the time of interest rate announcements), but the Federal Reserve appears to be more forward-looking than the RBNZ. They seem more willing to balance the underlying factors impacting supply, demand, and prices – rather than anchoring solely on historical data.

By not taking a broader view of the underlying economic fundamentals and supply and demand drivers, the RBNZ risks missing the forest for the trees and being overly restrictive. Taken too far, the potential consequences are obvious. Risks include increasing unemployment, increasing defaults by borrowers, destabilising the financial system and, as a result, increasing requirements for financial support from the government. We hope the RBNZ will start to see the growing case for rate cuts before our economy sustains further damage.

A rosy global investment outlook outweighs domestic headwinds

With all of this said – and somewhat counterintuitively – New Zealand investors shouldn't be overly concerned with the impact of the domestic economy on their investments.

Most of our diversified strategies have far more exposure to global investments than domestic investments. This is by design: it ensures New Zealanders have diversification away from the country where they live, work, and own property. And there are simply more attractive investment opportunities offshore, in industries we can't easily access domestically. Even in our New Zealand share portfolios, many of our investments (like Fisher & Paykel Healthcare) have the bulk of their revenue and growth opportunities offshore — meaning they aren't significantly impacted by the ups and downs of the New Zealand economy. In fact, many New Zealand companies benefit from a weaker NZ dollar in tumultuous economic times.

We continue to monitor the domestic economy closely. The RBNZ will eventually dial back its restrictive interest rate policy, and we hope to see growth and stability return after a short period of consolidation. However, as always, we are also positioning our portfolios in a way we think will deliver good results for investors over the long term, irrespective of the domestic economy.

Quality growth companies deliver when the economic tide goes out

Matt Peek, Portfolio Manager, Premium New Zealand Fund

The New Zealand economic environment remains challenging, but the portfolio's quality and internationally focused growth companies have been outperforming.

The March quarter was a positive start to the year for the Premium New Zealand Fund, up +6.2% compared to the +3.1% return of the S&P/NZX50G index.

The quarter's performance featured strong returns from several portfolio companies, led by China-focused infant formula maker **a2 Milk** (+47% total return in the quarter), cinema software provider **Vista** (+21%), and small business software company **Xero** (+19%). A number of large positions also made solid contributions, particularly **Summerset** (+13%), **Fisher & Paykel Healthcare** (+9%), **Infratil** (+9%), and **Contact Energy** (+10%). A meaningful detractor during the period was **Ryman Healthcare** (-23%).

Most of our companies delivered solid report cards in a difficult environment

As legendary investor Warren Buffett tells us in one of his most famous sayings, 'A rising tide floats all boats ... only when the tide goes out do you discover who's been swimming naked.' That certainly feels like the case for New Zealand's current economic downturn.

During the quarter, many companies — both in the portfolio and the broader New Zealand share market — released financial results or provided trading updates. We were pleased to see most of the portfolio deliver solid results against this backdrop, while many other companies (companies we have deliberately chosen not to invest in) struggled.

Looking outside the portfolio, the likes of The Warehouse and Fletcher Building saw strong growth in 2021 and 2022, largely driven by favourable macroeconomic conditions. However, they are now starting to underperform better-run rivals, as consumers have tightened their proverbial belts in 2023 and into 2024. The Warehouse was caught skinny-dipping and decided to shut its online portal, 'The Market', and sell off outdoor equipment retailer Torpedo7 for $1.

By contrast, it has been encouraging to see portfolio companies a2 Milk and Summerset performing well, despite difficult market conditions.

During the quarter, China-focused infant formula maker a2 Milk released its half-year result. Revenue and earnings were above plan, and the company increased revenue guidance for the full financial year, despite the falling number of births in China. a2 has seen a smooth transition to its new Chinese Label product formulation and has continued to take share in most market segments, with brand health metrics showing continuous improvement.

Summerset's share price has meaningfully outperformed the other three listed retirement village operators so far in 2024. The company continues to do a better job building and selling its retirement living proposition than its rivals, despite ongoing softness in the New Zealand housing market. It is also delivering attractive development margins and recycling cash into new developments, enabling it to confidently increase its build rate while other operators struggle to manage indebted balance sheets.

For example, Ryman Healthcare, the other retirement village operator in our portfolio, disappointingly reduced its underlying profit guidance, with new sales expectations revised down around 20%. Ryman is working through some near-term challenges: an unprecedented four main buildings are under construction, hampering the immediate value proposition for prospective residents at these villages.

Recent results updates also highlighted the value of portfolio companies that have grown into Australia, with several seeing less challenging economic conditions there. **Freightways** (+6%) and **Vulcan Steel** (+12%) are key examples. Both companies have also added new customers to mitigate weaker market conditions.

Our structural growth companies continue to deliver impressive performance

Our investment approach gravitates to quality companies that have wide moats and long runways for growth. As a result, many of our portfolio companies have truly international businesses — rather than relying solely on the New Zealand market. They also tend to tap into structural growth trends, and so can be less affected by cyclical economic factors than other New Zealand-centric companies, such as The Warehouse, Fletcher Building, SkyCity, Sky TV, Air New Zealand, and My Food Bag.

The chart below maps the portfolio companies on two illustrative axes: their economic exposure from the cyclical to the structural, and their reach from New Zealand to the rest of the world.

Illustrative chart of the portfolio's exposure to structural growth companies and businesses reaching beyond New Zealand

Note: We consider all our companies (such as Mainfreight, Delegat, and Summerset) have longer term structural growth opportunities, but they are positioned to the left to highlight that they are not immune to a slower economic environment. Source: Fisher Funds

Xero hosted its inaugural investor day, providing an in-depth update on its strategy for the next 3 years and aspirations for future growth. The company aspires to double revenue and achieve the 'Rule of 40' (meaning the sum of its revenue growth rate and cashflow margin exceed 40).

Under its revised strategy, Xero is increasingly focused on where it wants to win, coining the '3 x 3' concept to describe its approach. With 3 x 3, Xero is targeting micro and small businesses across its three key growth markets (Australia, UK, and the USA), and across the three core jobs businesses need to get done (accounting, payments, and payroll). The team demonstrated an improved rate of product development in the USA market, with major upgrades in direct bank feeds, sales tax, and payments integrations. The calibre of Xero's wider leadership team was a highlight of the day. The team has been turbo-charged through the addition of several team members with world-class experience and specialist capabilities since the appointment of Sukhinder Singh Cassidy as CEO.

During the quarter, Infratil updated the market on progress at its portfolio company, Canberra Data Centres (CDC). CDC has signed significant new contracts and is accelerating development to support growth, which has been boosted by demand from AI-based computing. As a result of its strong organic growth over time, CDC has become the largest asset in Infratil's portfolio — but CDC still expects to double in size within two years, and to be over four times its current size by 2029.

It was pleasing to see strong returns from cinema software company Vista. Vista's share price performance reflects a solid 2023 result ahead of expectations, and a growing appreciation of its progress against its medium-term strategy. This strategy involves progressively transitioning its cinema exhibitor customers to its next generation Digital and 'Vista Cloud' products. Maiden revenue guidance for 2024 was in line with expectations and represents recurring revenue growth of 8-12%, which, when combined with much lower cost growth (it expects $10 million of annualised savings from its recent organisational restructure), should see operating profits grow strongly.

Finally, Fisher & Paykel Healthcare released updated guidance for its 2024 financial year late in the quarter. The company guided to higher revenue and underlying profit after tax in the second half of the year than previously expected, by 3% and 5% respectively. The quality of the update was solid, with Fisher & Paykel's hospital consumables and OSA masks both experiencing stronger underlying sales growth than the company anticipated back in November, when guidance was last communicated.

A stable economic environment and strong company performance made for a good start to 2024

Robbie Urquhart, Senior Portfolio Manager, Premium Australian Fund

Robust earnings growth from our technology companies and a resilient global economy underpinned the outperformance of the Australian Premium fund, which rose +7.3% in Q1 against a +6.0% lift in the benchmark index.

Macro-economic indicators further stabilised during a Q1 with no major shocks to the system. The Australian 10 Year Government Bond yield ended March at 3.96% – in line with where it started the year. The March reading pointed to a 3.7% unemployment rate in Australia – relatively well-contained. And, unsurprisingly, the Reserve Bank of Australia (RBA) left interest rates unchanged at 4.35%. The debate has now shifted to 'when' the first rate cut will be, rather than 'if' the RBA will increase interest rates again this cycle.

Against this stable backdrop, company earnings reports were the predominant driver of share prices in the quarter. A small handful of our portfolio companies, including **Domino's** (-25% in A$ in Q1) and **Nanosonics** (-38%), fell on disappointing earnings updates. This was more than offset by strong earnings growth and positive outlooks from several of our technology and internet-related businesses. These companies are well-positioned to benefit from continued growth in demand for software solutions and increasing adoption of artificial intelligence (AI) by businesses globally.

We have consequently increased our weighting in companies like **Wisetech** (+25%) and **Xero** (+19%), and we've added a new tech company, **Atlassian** (-18%), to our portfolio.

The stable economic environment also supported our bank shareholdings, with **ANZ** (+13%), **NAB** (+13%), and CBA (+10%) all rising strongly in the period. The banks are benefiting from a favourable interest rate backdrop, coupled with a benign economic environment keeping bad debts in check.

> We've added Atlassian to our Portfolio.

Pathways out of a tough period for Domino's and Nanosonics

Our portfolio laggards were impacted by company rather than market-specific factors. Their respective management teams are working hard to address this weak performance.

MedTech company Nanosonics reported half-year revenues for 2024 that fell 4% against the prior corresponding period. This was related to lower-than-expected Trophon unit replacements in its key North American market. Ongoing capital budgetary pressures in the US hospital system have led hospitals to put off purchasing new medical equipment. Encouragingly, Nanosonics saw some of those customers replace their units in January. Nevertheless, management remain concerned about the near-term prospects of a full recovery in the run-rate of Trophon replacements.

Domino's poor earnings result was a consequence of soft trading conditions in two key markets: Japan and France. The weakness of the Japanese division was put down to poor execution by the Domino's team. Talking to management, we've taken some comfort from what they're doing to remediate this. We expect better performance out of Japan in the next 12 months.

Weakness in the French division reflects a competitive operating environment for fast food businesses, exacerbated by local challenges with the company's French management team. Domino's has taken steps to address these shortcomings, however any meaningful recovery is likely to take time. We're spending time with Domino's European management team in May to explore these challenges in more depth.

Domino's has successfully implemented its 'high volume, great value' franchised growth strategy in multiple countries over many years. Indeed, the ANZ and German divisions have registered strong growth in same-store sales in recent months. Addressing the operational challenges in both Japan and France could drive meaningful longer-term earnings upside for the company.

Robust earnings growth evidence of the wide economic moats underpinning our tech investments

Our technology and internet investments had a particularly pleasing Q1.

Wisetech's revenue grew 32% in the first half of 2024. This reflects increased uptake of its Cargowise software platform amongst its core freight forwarder customer base. In signs that its economic moat continues to widen, Wisetech signed three more customers up to global rollouts of Cargowise, including Sinotrans – another top 25 freight forwarder. Wisetech now counts 13 of the top 25 global freight forwarders as customers. They highlighted how these companies are growing substantially faster than their peers who aren't using Wisetech's software. This bodes well for additional customer contracts in the future.

> Xero has sharpened it's focus

Xero held its (well-received) inaugural investor day a year after CEO Sukhinder Singh Cassidy began with the company. Xero has sharpened its focus as an organisation. It is targeting three key products (core accounting, payments, and payroll solutions) in three key growth markets (US, UK, and Australia) for businesses with 1-20 employees. Xero is more confident in investing in the US market given the substantial product development progress it has achieved in a short space of time under Diya Jolly – Xero's new head of product. It has also begun integrating AI-based tools into its product suite, in the form of JAX (Just Ask Xero). JAX is expected to significantly improve productivity for customers upon its commercial release, once testing is complete.

NextDC's (+30%) share price benefited from the rapid rise in demand for data centre capacity, as developers continue to expand AI functionality for businesses. In the last year, NextDC has signed additional deals with leading cloud computing platforms. It grew its contract book by 76%, which helped the company deliver strong revenue growth of 31% in the first half of 2024.

Our internet classified advertising investments in **CAR Group** (+17%) and **REA Group** (+4%) also performed well, having delivered solid earnings growth. This growth was aided by strong price increases (reflecting their broad economic moats) and good cost control by the management teams. Employment advertising company **SEEK** (-5.4%) also delivered a credible result, although near-term concerns about rising unemployment weighed on its share price performance. Pleasingly, SEEK completed a major unification of its underlying software platform across its ANZ and Asian divisions on budget and ahead of time. This move gives Seek the flexibility to roll out innovations developed in one geographic market into its other jurisdictions at pace. This bodes well for future growth.

Atlassian – critical for customers and benefitting from technology innovation

We added Atlassian to the portfolio during Q1. Atlassian is an Australian-founded and headquartered global software business. It develops software that helps primarily information technology (IT) teams organize & manage projects. Atlassian's 'Jira' software is the leading project tracking tool for software development teams globally. More recently, it has broadened its target market to include IT teams and the wider employee workforce. As more workplaces have adopted a collaborative approach, coordinating different teams has become a vital service. Atlassian's suite of products provides best-in-class solutions for coordinating teams and projects across an organisation.

Atlassian's share price sank in Q1, despite delivering a strong quarterly trading update, accompanied by an upgrade to its FY24 revenue guidance. The market took a negative view on the composition of that growth. Atlassian is in the process of moving its customers from using its software locally, via on-premise servers, to either its data centre or cloud services. Atlassian also stopped providing support for the on-premise version of its product in February. The market is concerned this will cause a slowdown in near-term growth as customers adapt to these changes.

The structural shift for customers from on-premise to cloud based versions of the software they use rarely happens in a linear fashion. Over the years, we've observed several software companies registering volatile earnings growth through these structural migrations. Invariably, once the wave of customer migrations is completed, the underlying strength of the company's earnings growth becomes more apparent – and this is reflected in an improved share price performance. We think this will likely be the case for Atlassian.

With our investment philosophy centred on achieving outsized returns over the longer term – rather than worrying about near-term earnings noise – we're happy to be patient. We've used this period of share price weakness as an opportunity to establish a meaningful position in a great Australian technology company.

The global stock market rally broadens beyond tech

Sam Dickie, Senior Portfolio Manager, Premium International Fund

The Premium International Growth Fund ended the quarter up +15.6%, compared with our global benchmark which was up +12.2%.

In 2023, stock market returns were driven primarily by technology companies (the Nasdaq was up 56% versus the S&P500's equal weighted 11% rise) and especially the 'Magnificent 7' (Meta, Amazon, Alphabet, Microsoft, Nvidia, Apple and Tesla). But so far in 2024, returns have been driven by a much broader mix of stocks. The Nasdaq is up 10%, less than the S&P500, and the Magnificent 7 is only up +8%. Globally, banks and industrial companies are up as much or more than tech. This is healthy.

This broadening out of the stock market rally has been driven at least partially by an ongoing lift in global economic growth expectations. These expectations are led from the front by the US. Economists in the States began the year thinking US growth for 2024 would be around 1% – now that's up to 2.2% and climbing. However, there are no free lunches. The US 10 Year Treasury Bond (as a proxy for global interest rates) has reacted: it started the year well below 4% and is now at 4.3% and rising.

Portfolio update

Meta (+45%) continued its recent track record of delivering stronger than expected earnings results. Meta's short-form video format Reels was a headwind to revenue growth while it was being introduced but is becoming a tailwind as the company ramps up monetisation. Meta's investment in AI capabilities has driven more user time spent on its 'Family of Apps' (Facebook, Instagram, WhatsApp, and Messenger), and delivered more efficient advertising tools for its customers. 2023 was the company's 'year of efficiency', and Meta has executed it very well, with operating income margins expanded from 25% in 2022 to 35% in 2023.

Importantly, the company signalled this cost control will continue, as a more streamlined company makes for quicker and more effective decision-making. Meta initiated its first dividend, sending a positive signal to investors that, while the company continues to invest for growth (i.e. the 'Metaverse'), it will be measured.

Edwards Lifesciences (+25%) benefited from two positive announcements during the quarter. Firstly, one of Edwards' competitors announced a delay in its anticipated entry into the US transcatheter aortic valve replacement (TAVR) market. Edwards is the global leader in replacement heart valves, with around 70% market share in the US. The competitor's delay highlights the challenges in replicating Edwards' strong clinical outcomes, given the company's market-leading innovation. Edwards also enjoys the advantage of surgeon experience, as their valves have effectively been standard in treatment for over a decade.

> Edwards is the global leader in replacement heart valves

The second positive announcement was the early approval of Edwards' tricuspid heart valve replacement system. This device is the first of its kind and opens up a new treatment for a largely untreated population of patients with tricuspid regurgitation.

Amazon (+19%) invested another $2.75 billion (now $4 billion in total) into Anthropic, a leading AI start-up. Anthropic will use Amazon Web Services' (AWS) custom Trainium and Inferentia chips to build, train, and deploy its large language models. Amazon's Q4 operating income came in 26% higher than expected, and it guided to next quarter operating income above expectations. AWS, Amazon's cloud computing platform, reaccelerated revenue growth after a year where customers have been optimising or cutting their spend. Amazon's high-margin advertising business also reaccelerated revenue growth in the quarter to 26%. After a multi-year investment phase, Amazon is now harvesting the valuable assets it built during the pandemic – in particular, its expanded logistics infrastructure. This is driving rapid margin expansion and operating income growth.

Icon (+19%), the leading clinical research organisation (CRO), was among our best performers for the quarter, after a positive earnings result and management commentary on end-market demand generated confidence in its medium-term growth prospects. Management's positive tone was a turnaround from their more cautious view in early January, which saw CRO stocks fall around 10%. Icon's new project pipeline continues to grow, driven by strong underlying R&D spend in its large pharmaceutical customer base, a slow but steady recovery in biotech demand, and new business wins driving market share gains.

Floor & Décor (+16%) delivered a better-than-expected quarterly result. It also benefited from positive sentiment in March, as existing home sales in the US came in unexpectedly strong. Rising existing home sales benefit Floor & Décor, as consumers moving homes are more likely to renovate their flooring. The company continues to take market share thanks to its superior value proposition for customers – wider selection at cheaper prices, and best in-stock availability.

Dollar Tree (-6%) declined following a disappointing earnings result. The core Dollar Tree banner continues to grow ahead of expectations. However, it is still facing headwinds on two fronts: a struggling, low-income consumer base, and increased investment as the rollout of several growth initiatives intended to grow its market share continues. These initiatives were overshadowed by the announced closure of up to 1,000 Family Dollar stores (around 13% of the store base). While management is working on several initiatives to improve the Family Dollar stores, it decided these 1,000 mostly unprofitable stores would not generate an acceptable return.

We think the company is taking the right actions. While we have a more measured view than management on its ability to turn the Family Dollar business around, we don't share the negativity of the market, which seems to believe that a successful turnaround is almost impossible.

Portfolio activity

We continued to add to our positions in **Intuitive Surgical** and **Dexcom**. Intuitive received FDA approval for its next generation da Vinci 5 soft-tissue surgical robot, which will improve ergonomic comfort for surgeons and measure the force they're applying in real-time to reduce tissue trauma. Dexcom received US FDA approval for Stelo, its first continuous glucose monitoring (CGM) device for non-insulin using diabetics. Stelo further lengthens the growth runway for Dexcom. The company has dominated the CGM market for more acute type 1 and type 2 diabetics (meaning those with intensive insulin usage). And it has been increasingly turning its attention to the less acute type 2 non-intensive insulin market, and now the non-insulin diabetic market. These markets are 10 – 20 times the size of its traditional markets and are much less penetrated.

A positive quarter for Property and Infrastructure equities

Sam Dickie, Senior Portfolio Manager, Premium Property & Infrastructure Fund

The Premium Property & Infrastructure Fund finished the quarter up +4.3%, underperforming its benchmark index, which was up +5.3%.

Global markets rose during the quarter, supported by stronger economic growth. Bond yields increased modestly, reflecting resilient economies, but this was not enough to hold shares back. Australian property stocks (+17%) were the standout during the quarter, supported by strength in Goodman Group. New Zealand Property (flat) and global infrastructure shares (+1.3%) lagged global shares (+3.2%) – a reminder of the interest-rate-sensitive nature of property and infrastructure equities.

Australian property stocks were the standout

Portfolio update

Goodman Group (GMG) (+34%) announced first half 2024 results that beat expectations. Management lifted its full year guidance to 11% growth, above medium-term target levels. GMG is continuing its momentum in data centres, expanding its land bank and securing increased levels of power. GMG's recent inclusion in a widely followed property index has led to significant demand for shares from exchange traded funds (ETFs), which has also supported its share price.

Zurich Airport (+17%) reported its 2023 full year result, which didn't feature any major surprises. The dividend was 8% ahead of expectations, supported by a lift in payout ratio and strong business cash flows. Management's 2024 guidance was conservative – particularly regarding traffic forecasts, which they place at 95% of 2019 levels, despite summer capacity approaching 100%. On regulation, the company advised that it did not expect new tariffs until 2026 or 2027. This timing better aligns with future lumpy investments, lowering the chance of tariff reductions in the next regulatory period.

Norfolk Southern (+8%) became the subject of activist investor interest, with a group led by Ancora disclosing a shareholding, then publishing a presentation advocating for change, and proposing new management and directors. At the end of the quarter – and in response to activist pressure – Norfolk Southern appointed well-regarded industry veteran John Orr as COO. The market welcomed this; share price performance was strong, despite management reporting underwhelming Q4 results in February. We reduced our position during the quarter, in part because the risk/reward proposition was less compelling after the recent share price rally.

Auckland Airport (-4%) reported first half earnings and maintained guidance for full year 2024 earnings. Strength in the retail business and higher levels of interest capitalisation offset headwinds from costs (namely wage inflation and workforce efficiency, rates, and insurance) and a maturing passenger recovery. Chinese capacity is being meaningfully restored, which is supporting retail operations at the airport. Management noted that spend rates for Chinese travellers are below pre-COVID levels, though it's too early to say if this is a temporary or structural change.

Crown Castle (-7%) reported fourth quarter earnings in line with expectations. Guidance for 2024, originally issued in October 2023, was also maintained. Crown Castle was tight lipped on the review of its fibre and small cell business, including the possibility of divestment. We think a sale is unlikely, as it would involve a significant cut to the dividend and the potential sale price may be significantly below Crown Castle's invested capital. We decreased our position in Crown Castle during the quarter, reflecting our concerns with balance sheet and management transition.

American Tower (-9%) announced the sale of its India business to private equity for total proceeds of US$2.0 – 2.5 billion. This is a disappointing result relative to the amount invested in the India business (the sale represents roughly half the original investment), but we welcome the clarity and balance sheet flexibility that comes with exiting India. The level of proceeds broadly met market expectations.

Portfolio activity

Entries to the portfolio:

Canadian Pacific Kansas City (CP) is a North American railroad with a unique network spanning Canada, USA, and Mexico. Last year, Canadian Pacific and Kansas City Southern merged to form CP. The merger creates not only a unique network, but also opportunities for growth by offering trade connections; increasing supply chain visibility; and reducing cost, friction, and transit times for customers. CP expects 10 – 20% earnings per share growth over the next 5 years, and we foresee a long tail to CP's growth, supported by thematics like nearshoring.

We also added Mexican airports **Grupo Aeroportuario del Sureste (ASUR)** and **Grupo Aeroportuario del Centro Norte (OMA)**. We're attracted to the structural growth story, supported by a growing Mexican middle-class, long-term conversion of travellers from bus to air, and economic tailwinds from nearshoring supply chains (moving them from distant Asia to next door North America). The airports operate a 'dual-till' regulatory structure, with regulated rates of return averaging 14% for the aeronautical business and uncapped for the commercial business (things like duty-free stores).

Exits from the portfolio:

We exited our small position in K**iwi Income Property Group** during the quarter. Kiwi Income faces headwinds in its core retail and office markets (particularly the work-from-home trend). Management is re-positioning the portfolio into areas such as build-to-rent housing, however, we were concerned about their ability to create value doing so.

Anticipating a slower pace in New Zealand – not a slam on the brakes

David McLeish, Senior Portfolio Manager, Premium Income Fund

The Premium Income Fund had a strong quarter, generating a +1.3% return , while its benchmark returned +0.7%. We remain positive about the outlook for fixed income returns, as we think the inflation rate will continue to fall, leading eventually to lower interest rates and higher bond prices.

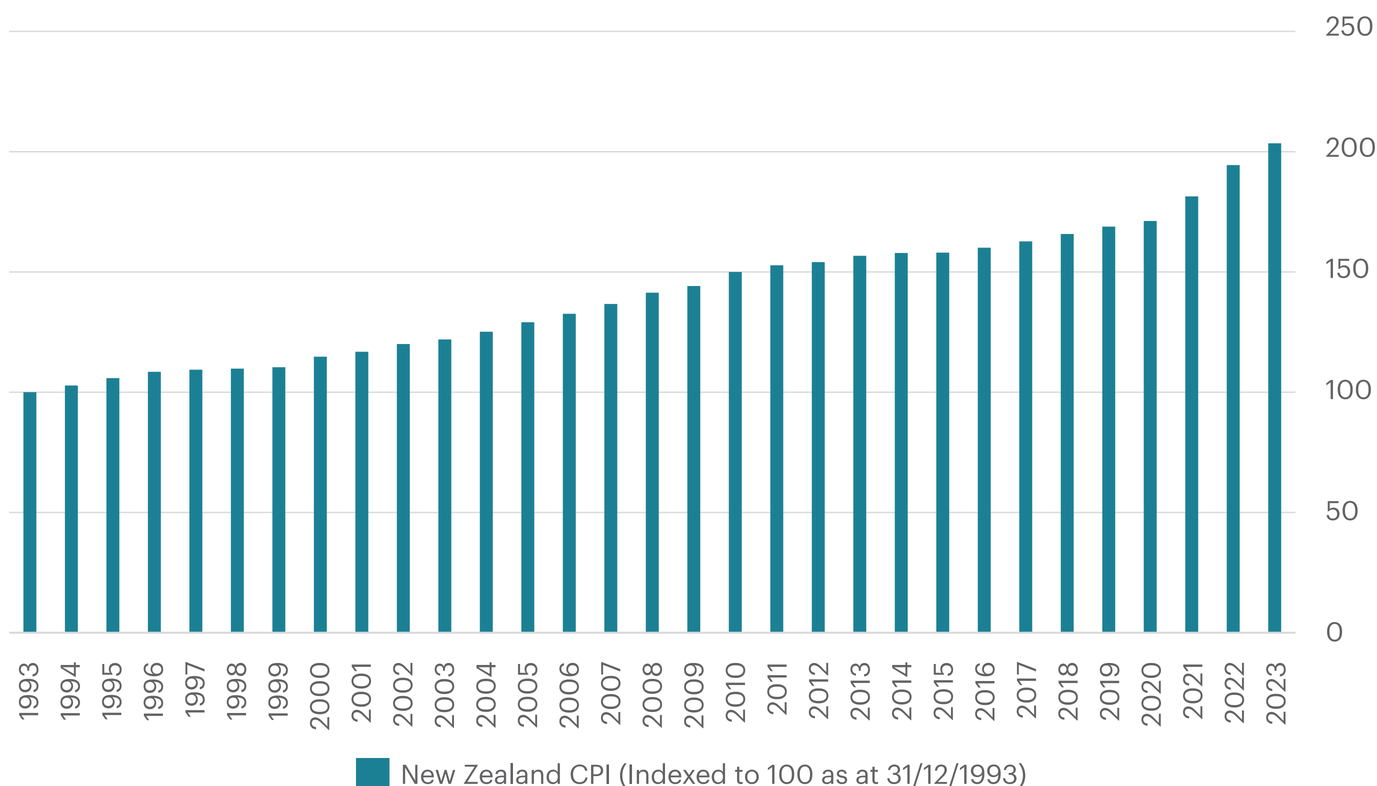
A reminder: the inflation rate is falling but prices aren't

We believe the inflation rate has peaked for the current business cycle. But a decline in the inflation rate doesn't mean falling prices. Inflation is an increase in the price level or average price level of goods and services in an economy. That is, if the inflation rate is positive, the price level is increasing.

Say the inflation rate falls from 5% to 2.5%. At both 5% and 2.5%, prices are increasing – but the speed of the increase is slower at the 2.5% inflation rate. An environment where the rate at which prices are increasing slows is called dis¬inflation.

The chart below shows the average level of prices in New Zealand over the past three decades, as measured by the consumer price index (CPI). It shows the price level typically rises from one year to the next.

New Zealand CPI Index from 1993 to 2023



Source: Bloomberg and Stats NZ

While we expect the inflation rate to remain positive, we do anticipate it will continue to fall from the peak levels that occurred during 2022, meaning price increases will slow.

This is undoubtedly good news for household budgets. However, in our view, the continued rise in the average level of prices of goods and services in an economy will still curb demand– especially as higher prices are coinciding with higher interest rates, which is increasing debt servicing costs.

Eventually, higher interest rates get into all the cracks of the economic machine: we don't expect a sharp slam on the brake pedal, but we do expect a slower pace of activity.

Slower growth is good for bonds

Eventually, we expect the inflation rate to settle around the 2% target set by most global central banks. A rate closer to 2% will create a positive backdrop for bonds, as it will pave the way for interest rates to fall and set the conditions for a revival of demand.

As such, we have positioned the portfolio for a drop in the level of interest rates: that is, the Fund has more interest rate exposure (i.e., duration) relative to history, so it stands to benefit more in a falling interest rate environment.

Even though we think economic growth will slow – and there could be bumps in the road over the coming year – companies with defensive business models and strong balance sheets remain sound fixed interest investments. In addition, selective asset-backed bonds should continue to generate attractive income flows in the near term.

As a result, we like pockets of the corporate credit universe, and continue to dig into corporate bonds and uncover hidden gems.

Portfolio update

We added bonds issued by **Chorus** to the fund during the quarter. The company has defensive qualities – returns on its assets are determined mainly by regulatory settings, rather than the forces of competition. Chorus continues to add fibre connections to its network and the executive team recently announced a proposal to expand the network. This signals that the demand for data and connectivity remains a structural tailwind for Chorus.

Asset-backed securities issued by **ScotPac** were another new addition to the fund. ScotPac operates in Australia and New Zealand offering financing facilities for small to medium-sized businesses for working capital and critical business assets (like small trucks, trailers, etc). We were impressed with the company's track record and management's 'pathological hatred of losing money'! This comment reflects the company's conservative underwriting policies which, in addition to relatively attractive credit spreads, gave us the confidence to invest.

Motor Trade Finance (MTF) – a Dunedin success story – revved up the local asset-backed securities market with a term securitisation transaction. MTF has been in the business of financing cars for over 50 years, and its branch-based business model – meaning a face-to-face approach – allows the group to truly understand its customers. This has resulted in market-leading credit performance. We invested in the new debt securities issued by the group, and we look forward to supporting MTF in its work enabling people to get to jobs, education centres, and community events.

Offsetting the above additions, we exited certain European bank subordinated bonds. Fundamentals within the European banking sector are encouraging, with aggregate profitability and capital metrics positive relative to their history. However, in our judgement, credit spreads on the subordinated bonds we sold more than reflected these positive underlying trends. We continue to monitor this segment of global credit markets and could reinvest in the future – when the risk-return balance is more favourable.

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