Financial Prosperity Partners

Portfolio Comment

For Quarter Ending 30 June 2023

gets you where you want to be

Financial Prosperity Partners

Welcome to the Quarterly Portfolio Comment, designed to inform you about the performance of our preferred Integral Master Trust portfolio and the unique way it is structured. Read on.

Portfolio Returns to 30 June 2023					
IMT Portfolio	3-mth	6-mth	1-year (pa)	3-years (pa)	10-years (pa)
Defensive Fund	0.64%	2.28%	2.60%	-0.97%	2.01%
Diversified 40 Fund	3.48%	7.81%	8.86%	4.95%	5.58%
Diversified 60 Fund	4.89%	10.54%	11.79%	7.80%	7.26%
Global Equities Fund	7.23%	15.34%	17.07%	13.02%	10.48%
Focused Growth Fund	9.13%	19.74%	19.29%	N/A	N/A

Portfolio returns are calculated gross of tax and fees and gross of all management costs, but include the underlying investment fees and expenses. Returns for greater than one year are "per annum". Further information about returns can be found in the quarterly Fund Updates located at nzbritannia.co.nz. Before making any decision to acquire any product offered by the Integral Master Trust, you should consider the information contained in the Product Disclosure Statement. Past performance is no guarantee of future performance. The Focused Growth Fund adopted its current investment strategy in July 2021.

Other funds adjusted their asset allocations in July 2021 to take great account of environmental, societal and governance aspects. This has resulted, for example, in those funds down-weighting to large global emission producers, without detrimental effects to returns. In addition, the asset allocations have been adjusted to more accurately reflect market weightings around the world.

World Indices	As at 30 June 2023	As at 31 March 2023	As at 30 December 2022
Dow Jones Industrial Average	34,407.60	33,274.15	33,147.25
S&P 500	4450.38	4,109.31	3,839.50
NYSE Composite	15,875.91	15,374.91	15,184.31
Russell 2000 Index	1,888.73	1,802.48	1,761.25
FTSE 100 Index	7,531.53	7,631.74	7,451.74
S&P/ASX 300	7,157.40	7,132.90	7,002.60
S&P/NZX 20 Index	7,499.52	7,516.55	7,255.94

Indexes are presented for illustrative purposes to demonstrate how the markets have generally performed recently. You cannot invest into an index. Past performance is not illustrative of future performance and the indices shown above are not the official benchmarks of the Integral Master Trust funds.

Market update

For the second quarter in a row we have seen very strong quarterly growth in share markets and this has flowed through to returns for the IMT's funds.

Global share markets continued to recover from the losses they suffered in 2022. Recent performance was driven by a small number of sectors and stocks (especially large US technology companies) with investors enthusiastically piling into companies offering artificial intelligence solutions, although there is starting to be evidence that more companies are now joining the rebound. For reference, large growth companies were one of the worst performing asset classes last year, which highlights the importance of staying invested during volatile times and not focusing on current news headlines, which are often overly negative.

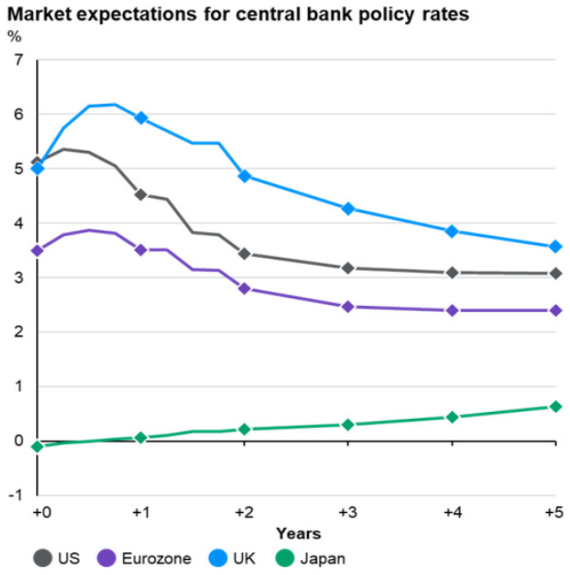
To illustrate how concentrated the returns have been, seven companies (Alphabet, Tesla, Nvidia (a huge US technology company), Apple, Microsoft, Meta (previously Facebook) and Amazon) provided almost three quarters of the US share market return for the 6 months to the end of June. This hyped market is not new. Previously we have seen cryptocurrencies like Bitcoin soaring in price and then rapidly falling again, but we have also seen companies like Apple and Amazon that managed to sustain and justify their rapidly increasing share price over the years. This highlights the need for a well diversified portfolio.

This strong share market performance underlines how the US economy continues to prove its resilience. Its inflation rate has more than halved, but like New Zealand it still suffers from persistent core (excluding energy and food which tend to have very fluctuating prices) inflation. Part of this is due to a tight labour market – with the US unemployment rate remaining close to all-time lows.

In contrast, Chinese growth has stalled. This is driven by major problems in real estate and weak consumption. Currently they are reporting lower new housing starts, property sales and house prices as well as lower spending on goods. Again, this contrast in the fortunes of the two largest economies in the world highlights the importance of diversification across industries and countries, which the IMT provides.

Bond markets were comparatively flat over the quarter as central banks generally transitioned from increasing interest

rates to holding current rates. The RBNZ is currently adopting a "watch, worry, wait" position as it evaluates how the economy handles the higher interest rates, and other central banks look to be taking similar positions (or are near to taking a similar position). The optimistic view is this is a signal that inflation (and consequently interest rates) globally may be nearing their peak.



(Source: Guide to the Markets, June 2023, JP Morgan)

Commodities were last year's star performer but are one of the worst performing asset classes this year. Last year's worst performing asset class, growth stocks, have been this year's best performing asset class. The rapid change in market sentiment demonstrates the importance of diversification within portfolios. With a well-diversified portfolio you can participate in these gains as they arise and not worry about "missing the boat".

Domestically the New Zealand economy entered a technical recession (defined as two consecutive quarters of negative economic growth) so the economy has shrunk during the year, albeit slightly. It is still unclear which other world economies will have recessions at this time.

It is worth remembering that even if an economy enters a recession, share markets will not necessarily follow. Share markets are forward looking – known good and bad news has already been priced in and so it is future expectations and changes to those expectations that drive prices.

As is often the case, there are some opportunities and some risks so it's fair to ask whether it is smarter to wait out the risks. However investors need to accept that risk is a part of investing . If you wait on the sidelines until there are no (apparent) risks, the markets will most likely continue to do what they do best – reward those who take on the risk.

Natural Talent vs Grit

It is reasonable to ask whether you are getting an appropriate return from your investment (in other words, are you being rewarded for the risk you have taken?). In doing so. the next question then becomes: how do you identify a new investment that will perform better than your current investment?

You could decide to investigate those funds which have performed well over the last few years. The 2023 BarclayHedge survey of the top 50 hedge funds (now in its 20th edition) could be one place to start. It has reported that the 50 top performing hedge fund managers beat the S&P 500 total return index by an average of just over 3% per annum over the five years to December 2022[1].

This is very impressive, but as with any quick analysis it raises quite a few more questions. The first should be: if this is the performance of the top 50, how many hedge fund managers are there?

According to an analysis by SigTech in 2021, there were 27,255 active hedge funds globally. What this means is that the odds of you selecting one of the top 50 managers identified by BarclayHedge is 0.18%. Put another way, there is a more than 99.8% chance that you will not select a top 50 manager.

Assuming the likely scenario you have not selected a top 50 manager, what return would you potentially receive? Well, using the same BarclayHedge report, the wider hedge fund universe ended the five-year period with an average return that was 6% per annum lower than the S&P 500[2].

Given these odds and unequal payoffs (less than 1% chance of getting a 3% higher annual return and a 99% change of getting a 6% lower annual return), you could question why investors would even consider this option.

Apart from the usual vice of greed, there is also psychology at play here. Simply put, people have an unconscious bias to prefer innate talent over hard work, even if this leads to a worse situation. This bias applies even if the person making the decision advocates hard work over talent. The effect is that that investors can gravitate toward active star investment managers, even if this leads to a worse investment outcome.

In an investing context, someone with "natural talent" would be following a hedge fund investment approach of picking "winners". Conversely an investment manager who advocates hard work (what we will call "grit") is more likely to advocate a more passive investment approach with consistent investment through the ups and downs.

What is this bias?

To begin, we will examine this bias. Thomas Edison is commonly attributed the quote "genius is one percent inspiration and ninety-nine percent perspiration", and there are many other variations on the sports field: Cristiano Ronaldo, one of the most talented footballers ever said "talent without work is nothing".

Regardless of these sentiments being accepted as common wisdom, the "naturalness bias" (which is an unconscious preference for choosing natural talent over hard work) exists and will dramatically affect how people make decisions.

A couple of experiments help illustrate this bias:

Experiment 1

Researchers[3] took a single piece of music by famous pianist, Gwhyneth Chen, and played it twice to listeners who were led to believe it was by two different pianists. In each instance, the music was identical but listeners were given a different bio of the pianist to accompany each of the two renditions. One bio emphasised the pianist's natural talents while the other outlined the tremendous amount of work they had done which helped them develop their art.

After listening to both pieces of music, the participants had to rate the musician's ability, as well as their chances of future success and employability as a professional musician.

Despite the two recordings being exactly the same, the listeners rated the "natural" pianist higher. However when pianists were asked about what they considered to be the reason for their success most chose effort over talent.

Experiment 2

In a second experiment, two groups of participants were presented with a business plan and a bio for of a fictional entrepreneur. The first group were told a "natural" entrepreneur was the author of the business plan, while the second group were told how the author developed their skills over time through hard work. Again, the business plans were identical but the "natural" entrepreneur received more favourable feedback than the hard worker across all surveyed responses.

The researchers were able to quantify the potential cost of this bias. The study participants were willing to sacrifice about 4.5 years of experience, 8% in management skills, 30 IQ points, and $31,000 in invested capital simply due to the unconscious bias to choose a "natural" entrepreneur.

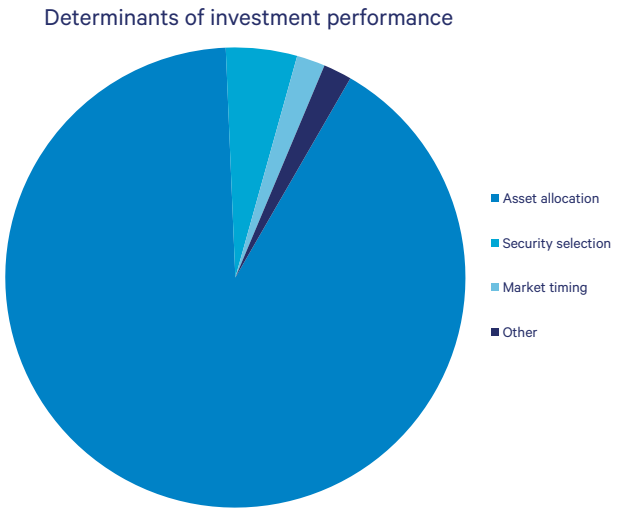
Unexpectedly, a participant's business expertise did little to reduce the naturalness bias. In fact the bias tended to be stronger among those with greater entrepreneurial experience, such as those who had already served as founders or investors.

How does this affect investors?

With such an unconscious preference for those who claim to be "inherently good" at what they do over those who offer persistency, you can understand how investors choose hedge fund managers, even when it is likely to lead to a worse result.

The naturalness bias is part of a wider set of psychological biases that affect many aspects of our lives. Part of the reason for this bias is whether you have a "fixed" or "growth" mindset. A person with a fixed mindset tends to see their own abilities as being set in stone, compared to someone with a growth mindset who sees their abilities as malleable or changeable. Generally, those with a growth mindset are more resilient when setbacks occur and are more likely to persist towards their goals, which commonly leads to better outcomes.

This mindset also affects investors in more than just their selection of an investment manager. An investor's performance is largely attributable to their asset allocation and their "time in the market". Almost all investors will experience times when their chosen investments either excel or underperform. It is very easy to remain invested when times are good, but it is always harder when times are tough. During those hard times, an investor with a fixed mindset may decide to exit their investment. In doing this, they can ensure some bad investment outcomes.



(Source: Brinson, Singer and Beebower, 1991)

Those with a "growth" mindset are better able to be comfortable with embracing hurdles, learning from criticism and persisting when things get difficult. From an investment approach, being resilient enough to ride the ups and downs of the market is fundamental to successful investment, especially leading up to and in retirement.

A growth mindset

This leads to a logical question – how can you improve your growth mindset?

While the differences between a fixed and growth mindset are easy to explain, it is much harder to adopt a new mindset. One of the best ways to start is to focus on the things that you can control or influence, identify any weaknesses and develop a plan from there.

It is necessary to recognise and accept feelings of discomfort and inadequacy, and mindfully make a choice to take actions that are consistent with a growth mindset. This may involve increasing your own abilities or knowledge.

One observation is that learning often requires help, and this is where a financial adviser can assist. They can break what seems to be an overwhelming task into smaller pieces to help determine the correct path forwards. This can help identify where there are any factual misconceptions or biases that will lead to poor outcomes. It will also help with the process of learning by ensuring that topics are in manageable portions.

Having a financial adviser is one of the best ways of ensuring that you do not succumb to these investment biases and put your retirement prospects at risk.

Kind regards

Joy

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[1] An annualised 12.5% vs 9.43% for the S&P 500 total return index
[2] 3.4% vs the 9.43% S&P 500 total return index
[3] Naturals and strivers: Preferences and beliefs about sources of achievement, Tsay & Banaji, 2011