Newsletter: Spring 2006

STUART + CARLYON

Financial advisers for your lifetime goals

Building BRICs into portfolios

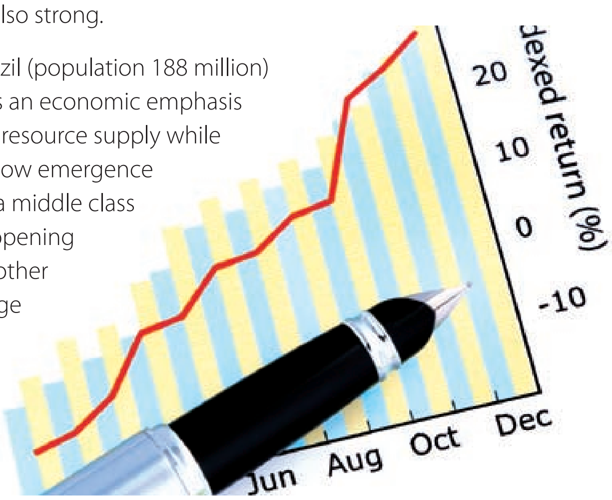
Here's a piece of vanishing Kiwiana. If you look closely at the small print on a can of Watties peaches these days you'll see that the contents don't come from New Zealand at all; they come from China. Welcome to the new BRIC economy.

> "Brazil, Russia, India and China are starting to shake the fortress of the Western Economy."

BRIC economies are those of Brazil, Russia, India and China, and between them, these nations are starting to shake the fortress of the Western Economy. What does this mean for investors?

We heard about this topic at the recent Portfolio Construction Forum in Sydney where keynote speaker Dr Don Stammer, Australian economist and investment strategist, talked about the BRIC-induced changes which, he says are mainly positive for a range of reasons.

In essence these four economies are tugging at the West from different angles. China, in particular, is helping keep global inflation low due to their low manufacturing costs. And while this bodes poorly for once flabby manufacturers such as GM and Ford (both of whom are struggling) the huge Chinese market provides ample hope for the savvier knowledge businesses of the West. Demand for energy and commodities is also strong.



Brazil (population 188 million) has an economic emphasis on resource supply while a slow emergence of a middle class is opening another huge market. Russia has emerged as a major energy supplier, while India's emphasis on technology and education is creating a burgeoning knowledge economy and a booming consumer society. The total population is 1.1 billion people – almost four times greater than the USA.

BRIC economies are strong but not perfect

Another keynote speaker at the Sydney conference was Dr Xisu Wang, a Professor and independent consultant in Beijing who works with foreign companies doing business in China. He gave an insider's perspective on the key risks of investing in China, and explained some of China's current social issues and challenges. Among these:

- The pain involved in moving from a peasant economy, in particular dealing with the rural to urban transition and the widening gap between the rich and the 800 million poor.
- SOEs and their inefficiencies and corruption – with officials holding on to power.
- A change in economic models and a move from Imitation towards genuine Innovation.

> "BRIC economies certainly aren't "all good" and that they'll still need close watching from an investor point of view"

What this says to us is that the BRIC economies certainly aren't "all good" and that they'll still need close watching from an investor point of view.

Lucas Weatherill Strategist at Schroders Singapore told the conference that his firm seeks out companies that, at the end of the day, pay out good dividends. Put simply, a high payout ratio indicates good governance and the ability to raise capital. Even so, in his view, Asia is still the place to invest compared to developed markets which look over-priced.

Overall message

The BRIC (most especially the Chinese) economies are producing more choices for investors and improved returns; however stock selection is extremely important. Risks include political, social stability, corporate governance. The safest advice, we heard, is to invest in companies that supply or export to the BRICs. An example: BHP.

Offshore tax changes – the ongoing saga

A Parliamentary Select Committee is currently hearing submissions on the Tax Bill proposing capital gains tax on offshore shares and new rules for managed funds. There were over 3,600 submissions made; usually a tax bill attracts about 50. Deborah will speak before the Select Committee later in September.

Our key points and suggestions include:

- Over-taxation for low income earners investing in managed funds could be fixed by simply reducing the tax rate for all locked-in super funds.
- Low tax revenue for Government from some overseas investments could be addressed by taxing the higher of 5% of the investment value or the dividends. This is fairer than a "rolling" capital gains tax.

Let's hope sense prevails.

Is KiwiSaver getting too complex?

The KiwiSaver Bill was passed by Parliament on 30 August 2006. In a last minute expedient move, Dr Cullen finally announced some tax concessions, but these are confined to the government scheme:

- Employers can make tax-free contributions but capped at 4% of gross salary.
- After 12 months, half the employee's contribution can go towards paying off the mortgage on their own home.
- Implementation deferred until 1 July 2007.

> "In a last minute expedient move, Dr Cullen finally announced some tax concessions"

In practical terms, the exemption means that an employee on a salary of $50,000 who contributes 4% to a KiwiSaver scheme and whose employer agrees to match the 4%, will save $660 a year in tax.

This is good news but does give KiwiSaver a distinct advantage over, and rather punishes, existing superannuation funds and savings vehicles. We hope the government will allow employers who have offered staff super schemes for many years to also benefit from the tax exemption for contributions. Otherwise, the future of those schemes will be in jeopardy.

The mortgage diversion option will provide mixed messages and will not improve people's savings habits. However, without any tax concessions on the earnings of the super funds themselves, paying off the mortgage first will almost always provide a better return.

Property. There's no such thing as a free lunch

Deborah Carlyon appeared as an expert in the FairGo Money Special in June and talked about the relative merits of saving for retirement, buying an investment property or paying off the home mortgage.

The publicity prompted many inquiries from individuals and families wrestling with just such strategic options. We offer clinic consultations, charged by the hour, and we're finding clients are pleased to pay for unbiased advice. Most just want a simple way to accumulate money for the future and the superannuation debate is confusing them.

Is it any wonder that average income New Zealanders have an almost genetic bias toward property as an investment avenue and an attraction to property investment schemes?

New clients have shown us elaborate spreadsheet presentations based on assumptions that if proven incorrect will expose them to serious losses – made greater because they are using their own home as security for new loans.

There are many property vendors who'll use optimistic assumptions that show rental levels increasing, mortgage interest rates remaining the same and property values increasing at 9% per year. The final icing on the cake is the projected sale of the property with no tax on the capital gain. It all looks too good to be true.

> "Property most certainly has boom times when all the arithmetic looks good. But for the most part it is far less spectacular"

Property most certainly has boom times when all the arithmetic looks good. But for the most part it is far less spectacular, and interest-rate fluctuations and market-dips, (or rental over-supply) are not uncommon events over any 5 – 10 year period.

So before borrowing, property investors need to understand how the variables could change and significantly affect the outcome. And don't forget, with property investment schemes, the property will be managed by the scheme promoters for a fee that skims off a significant amount of the returns.

Any investment must be weighed up in terms of its risks as well as the likely returns. While property has some tax advantages, we remain convinced after more than twenty years in this business that tax, alone, should not be the main criterion for the smart investor. Risk and return are still king.

177 Parnell Road, PO Box 137-154, Parnell, Auckland 1151, New Zealand Phone: 64 9 307 2331 Fax: 64 9 307 2330 www.stuartcarlyon.co.nz