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STUART + CARLYON

Financial advisers for your lifetime goals

How Low Can You Go?

Readers old enough to recall the early 1960s will remember the Chubby Checker dance hit, The Limbo Rock, in which the singer urged us to go under the limbo stick as he crooned: "how low can you go?" Well everyone is asking the financial market the same thing.

Global share markets dropped in a short, sharp, somewhat salutary bump by roughly 20 per cent since late last year. On Wall St the share prices of the independent securities firms have fallen by a whopping 42 per cent. The main revelation of the past few months is just how far these serious financial institutions had moved away from their core business of underwriting, advisory and brokerage and used leverage to go into risky assets like mortgages. They took inordinate amounts of risk to make big profits. Banks, and Bear Stearns was just one of them, threw the book of caution out the window in the mistaken belief that the dream run of the last few years would continue.

Some of these players – here and abroad – simply deserved to go. The old rules of risk and return, as it turned out, never actually changed. But as things settle down the real driver of the market now comes back to the volatile chemistry of confidence and the danger is that the previous irrational exuberance in the markets is going to give way – if it hasn't already – to irrational pessimism.

Put away the sackcloth. The good news is that governments have leapt so quickly into rescue mode. In the UK, Northern Rock bank was bailed out, and the recent Bear Stearns rescue, albeit at fire sale prices, stopped a potential stampede in confidence. There is also every sign that regulatory reforms will be introduced in these twitchy markets to help prevent some of the egregious practices that led to the recent crisis.

The best strategy for investors is a combination of time, patience and a belief that while ups and downs will always happen, individual people, individual companies and ultimately whole economies strive to better themselves. There's absolutely no reason to think that people (whether in the USA, China or New Zealand) will stop working hard, or that companies will stop trying to grow and make profits and that the markets will somehow fail to reflect this fundamental human endeavour.

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Tax Changes That Could Affect You

A raft of changes in the tax regime has affected New Zealand investors.

- **PIE:** The Portfolio Investment Entity allows investment funds to pass on income at the investors' rate which from April 1st is capped at 30 per cent. This is great if your current marginal tax rate is in the 33-39% range.
- **FDR:** The Fair Dividend Rate is the tax rate on certain foreign investment funds (FIFs). Last year the government did a lot of tinkering in this area, and the result is more equitable than their first formula. On FIF investments, you are taxed as if they deliver a 5% income return. But if the investment returns say 6% or 10%, you are not taxed on the income over the 5% threshold. As tax arrangements go, this is pretty good.
- **Comparative Value:** Each year, trusts and individuals can opt out of the FDR formula and go for the Comparative Value method of calculation. If combined income plus gains are under 5% then this formula is better - and if there are losses, you don't need to stump up with any cash for the tax man, regardless of actual FIF income received.

For our clients we'll work out both calculations to show you a clear tax effective choice.

Bonds

In a balanced portfolio, shares or property need to be counterbalanced by fixed interest assets such as Bonds – and it is true that each asset class tends to offset the ups and downs of the others. Right now, with shares down, and property doing a bungee leap, it is disconcerting to see Bonds also

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dropping in value. Aren't they supposed to keep our portfolios on an even keel?

Bonds are something of a hybrid. Where term deposits are purely about fixed-interest, Bonds are tradable instruments which are issued by a borrower to raise capital – a form of commercial IOU. The issuer pays a fixed interest rate, known as the coupon. Usually these rates are sharper than you'll get from term deposits, and that's what makes them attractive as an investment avenue. The tradability gives these bonds some upside also.

As interest rates fall, bond prices rise (because they promise to pay higher than the now going rate.) But the opposite is also true: when interest rates go up, Bonds tend to drop in value because their promised interest rate – the coupon - is lower than the now going rate.

That's what is happening now to bonds purchased a few years ago: they keep paying you coupon interest, but their tradable value has dropped.

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Clearly the current market isn't the greatest time to advertise the capital value of Bonds, but over the medium to long term they take out some of the volatility from any portfolio by delivering a stream of interest income. Also because they're tradable, an investor can sell their Bonds quite readily if they need cash.

As a matter of policy at Stuart + Carlyon, we only ever recommend "A" rated Bonds where the ability to repay capital at maturity is sound (we don't touch those finance companies). We also buy various maturities to help insulate against changing interest rates. The Reserve Bank has pushed interest rates higher and in a world of tight credit conditions, investors also demand a higher rate so now is actually a good time to consider adding more Bonds to your portfolio. New issues are offering over 9% per annum, and if general interest rates fall, well these bonds will rise in capital value.

A Note About Our Approach - No Artificial Sweeteners

There's clearly a high level of investor stress across the New Zealand market, and traumas like Blue Chip and the collapse of so many finance companies have had many people reaching into their top drawers, dragging out their investor scrip and seeking second opinions. We've had many "off the street" appointments with investors who've wanted some explanation for why their investments aren't performing.

Make no mistake; the tide has gone out on everyone to some extent. But one common theme for these visitors is that their portfolios, and even specific products e.g. structured credit, lack simple transparency.

To use a metaphor, these products are like highly processed foods. Where's the flour from? Is that artificial sweetener they use? What are these food colourings? Something is causing an allergic reaction – but what?

The portfolios we put together are more transparent. That's just the way we work. If we don't know the provenance of the investments, then we're not interested. Please give us a call if there is any ingredient in your portfolio you're unsure about.

Sue Baldwin Joins Our Team

One of the very nicest things about running Stuart + Carlyon since 2005 has been the personal support we've received from our clients who have encouraged us and watched us from start-up. Well here's our good news to share. When we began we set a few business targets and we promised ourselves we'd add a fourth member to the team – maybe in the fifth year – when the scale of business reached a certain point. Well we got there a year early, and to top things off, various Government changes have added whole layers of compliance and tax related workload.

So we hereby welcome Sue Baldwin to the team.

She comes with extensive experience in our sector most latterly at Russell Investment Consulting and while Sue has just achieved her requisite financial planning qualifications, over the next 24 months she will be doing the required practical to qualify as a Certified Financial Planner.

Sue has already made a big difference for Susanna, Deborah and Donna by sharing the workload.