Newsletter: Spring 2008

STUART + CARLYON

Financial advisers for your lifetime goals

A huge financial mess. But no cause for panic.

One of the most frequent descriptors we've seen in the financial media this year has been the word "toxic." We've seen toxic loans, toxic write-offs, toxic markets. Oh, and let's not forget the toxic media for even reporting these stories. The finger pointing has gone full circle.

It was the fault of borrowers. It was the fault of lenders. It was the fault of deregulation. It was the fault of Wall Street greed. Well, actually it was all of the above: the whole system failed.

The problem is that financial markets, unlike commodity markets, run almost entirely on confidence. The price of petrol might rise or fall, but most of us continue to use gasoline. But when money markets lose confidence, there's apt to be a freefall. After all, the Dow Jones lost 700 points when the US bailout package failed to go through – but lost even more after the bailout *did* go through. The cash was there: the confidence was not.

And because confidence is such an uncertain commodity a number of questions remain pivotal as we watch events unfold.

- How many bad loans on the brink of defaulting do the world's banks still have?
- How far will house prices fall?
- What will inflation rates do in the wake of such pump-priming activities at the $700 billion bailout in the USA?
- Will company earnings fall?
- What about job security?

Fear of so many "unknowns" can create an emotional response. This has affected newer or younger investors especially those who did not experience 1987 and have never lived through a crash. Should we sell up our investments before they disappear? Or is now the time to buy?

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Our top line advice is to go easy on your spending and start living within your means. In other words don't expose yourself to increased debt.

Second, maintain a long term view with quality investments. Notwithstanding the 1987 crash, which was as bad as the present mess, quality investments performed well for those who rode through that particular quagmire. By the early 1990s Wall St had recovered from the disastrous losses only 4 years earlier. The secret was to invest in sound assets, and to take a long term view. Rubbish assets (all those sub-prime instruments that we avoided such as finance companies and Blue Chip) don't simply dip during a meltdown; they simply disappear taking virtually all their capital with them.

So right now, think about 2012 and where you intend to be after then. Whether you are a saver accumulating funds, or retired and living off your investments, if your portfolio continues to meet your specific needs then don't change anything because of the "market noise," loud as it may be.

At the risk of repeating ourselves, the investments under our care:

- remain well diversified
- pay out good income
- have benefited from offshore currency exposure as the NZD continues to weaken.

For retired clients, our main thrust is maintaining your monthly drawings and conserving your capital.

The newspaper headlines highlight scary falls of 40% for share markets for the year to mid October 2008. Our client portfolios are not immune from the current conditions but considering the negative news, falls in valuations have been cushioned very well by positive currency movements, good investment cash flow and periodic reweighting of portfolios.

Defensive portfolios are down only 1% to 3%; conservative portfolios by 4% to 7%; balanced portfolios by 8% to 11%, and portfolios with a high proportion in overseas shares are down 12% to 15%. Bear in mind, the negatives are only for the last 12 months and follow several years of great performance. Therefore average returns over the past five years are still positive and on track for each risk profile. And from current marked-down prices, future returns look positive too. A lot of good is coming out of the current mess. There's a determination by policy makers and central bankers worldwide to:

- intervene and restore financial liquidity and confidence
- co-operate with unprecedented effort at the highest level
- restore some of the regulations – the checks and balances – that were removed during the past 10 years.

Spotlight on two funds in your portfolio

Platinum International Fund

In a recent conference call, Platinum's fund manager Kerr Nielsen reiterated the market concerns they identified 3 years ago. "Our conservative positioning was based on a long anticipated expectation of current events – and helped the fund to make a marginally positive return. Valuations have come down and some very good companies are becoming more appealing long-term investments at these levels, while speculative stocks will likely be met with disdain for some time in a more cautious world."

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Their approach is to target solid but out-of-favour stocks so they are sitting with 42% of their fund ready for buying opportunities. As Kerr Nielsen told us: "There are some fantastic stocks at great value – some of which are back to 20 year prices." The Platinum International Fund mainly has holdings in industrials like Siemens AG in Germany and Bombardier in Canada and information technology giants including Microsoft and Samsung Electronics. Although they have exposure to the financial sector, they do not have US or UK banks.

Brook Tasman Fund

This is a NZ based fund investing in NZ and Australian shares. For the year ending 30 September Brook managed to limit their return to -6% compared with the market which was down by -27%.

Like Platinum it is not fully invested and has 21% to spend. They are also stock pickers. "In difficult times, we continue to focus on companies with strong balance sheets, good free cash flows and sustainable market positions."

Seeing it close up.

Susanna Stuart was in the USA and Canada when the financial markets reached crisis point and the US Senate sat on the Bush Bailout Plan.

Says Susanna; "Much more than in New Zealand, the economic picture was the lead item in news reports. Everywhere we turned there seemed to be "breaking news!" to hand – the Dow down by this or the Dow down by that."

So is greater financial awareness a good thing or bad thing? "There really did seem to be an air of panic, but on the other hand in the midst of a Presidential campaign the economy has become a real talking point to a degree we don't see in New Zealand. We don't really get to hear our leaders articulate their vision for the economy and the way it operates. I think there's room for our media to put a similar spotlight on how the economy works, especially during the run up to our own election."

The Panic Button and how to recognise it

Now is a good time to check out your own emotional response to the current financial situation. We've noticed that many of our clients are not losing any sleep over the current situation. They've seen it all before, and have parked their portfolio in the "long haul" basket.

But judging by the stock market figures around the world, there's a panic of proportions not seen in 50 years. Between 2003 and 2006 (when the housing bubble was growing) there were only two trading days on Wall Street when the index shifted by more than two percentage points. Plunges and hikes beyond this magnitude have become a standard feature over the past month. Why are things so volatile?

According to psychological studies investors have two responses to uncertainty. For most, the first response is to minimise losses: to sell regardless of one's position. So these people throw the Buy Low/Sell High dictum out the window and sell anyway.

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A smaller but significant group of investors take the opposite response: to try and maximise potential gains. Such traders tend to have an overconfident view of their own investment positions (think back to Nick Leeson and how he single-handedly brought down Barings Bank). They take bold positions, buying up stock in the belief that they'll make a killing.

These two opposing strategies each tend to overreact to market information, or rather lack of market information. In fact detailed studies show that when faced with ambiguous market signals and uncertainty, traders tend to buy and sell more frequently rather than less frequently.

The panic button is pushed and they adopt their aggressive buy and sell strategies which leads to the wild ride on Wall Street.

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A Disclosure Statement is available on request at no cost.