Newsletter: Winter 2008

STUART + CARLYON

Financial advisers for your lifetime goals

Riding out the storm

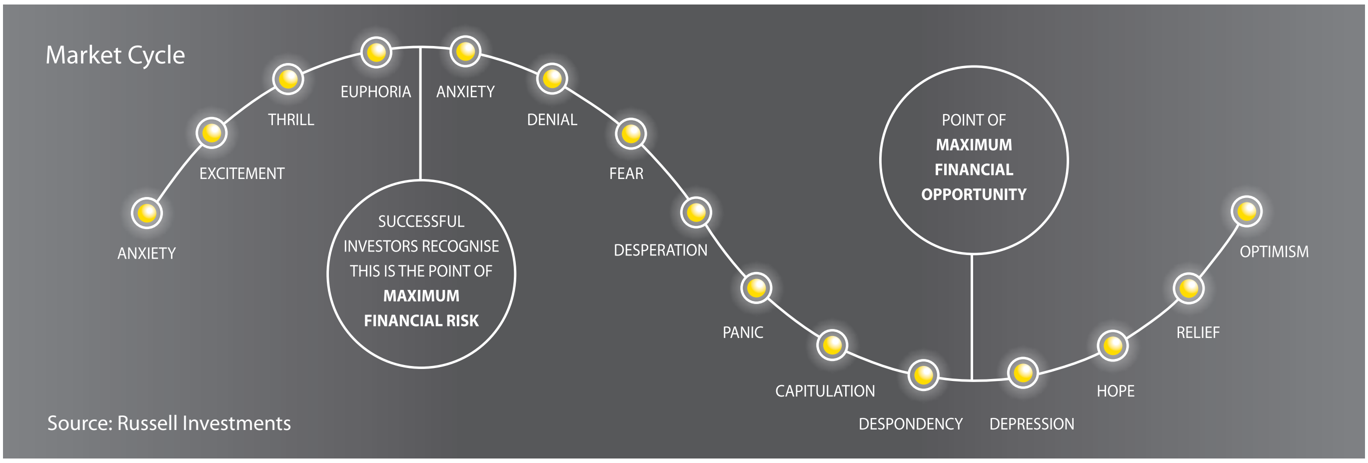
It would make a good Harrison Ford movie: Indy Jones and the Cycle of Doom. You get the picture. Snakes. Evil financial schemers. A huge rolling boulder of debt and a jittery emotional roller-coaster with Indy and us fellow investors hanging on for our dear lives.

The cycle of emotions courtesy of Russell Investments (see below) traces the arc of the movie, and reflects that no matter how rational we try to be, it can be discouraging, alarming and stressful to watch the latest returns.

In this movie we'd like to give away the ending by talking about how we ensure client portfolios stay the course by:

- Keeping cash in hand (not rolled over or reinvested). This acts as a cushion while capital values are down due to market prices.
- Excluding investments that have high borrowings.
- Using "A" rated fixed interest.
- Having liquidity – if you need money you are not locked in. Most of the assets in the portfolios are listed on public stock exchanges making it easy to buy and sell.
- Avoiding finance companies (some 24 have defaulted so far).
- Being underweight in NZ shares for a long time. When the market gets too cheap we'll buy more.

The interest and dividends (cash flow) from your investments help you to ride out the downturn and allow share values to recover.



Real Estate Glossary for our times

One can often gauge the mood of the times by listening to the real estate market. Forced to encapsulate the qualities of a whole property into a mere 50 words, agents – not famous for their literary skills – grasp at the catch phrases and clichés of the day. One day everything is Tuscany (which means the builder put an archway in the hall) and next day the buzz is all about the urban loft lifestyle – which is all about a white-painted box in the city, with no carpet. Exaggerations are par for the course. They're simply part of the game. We all know that "peep of the sea" means that there really isn't any sea view at all unless you stand on a stool and peer out the louvre window in the attic bathroom.

And the handyman's dream, of course is everybody else's nightmare. Here are some recent phrases we've come across lately. These days, between the lines, the language is less about the house and more about the frazzled state of the vendor/agent relationship.

Seldom do home units of this quality come onto the market. Actually there are hundreds and they aren't shifting. Here's another one.

A bold developer with a passion for history. An awful modernist townhouse in cheap materials.

Solid 50s Classic. Not leaky.

Priced to Sell. The price that a competitive real estate agent told the vendor to expect. A rate higher than other agents said they'd probably get. A recipe for disappointment.

Motivated vendor. Nobody came through last week's open home. Now the vendor is on my back.

Vendor willing to meet the market. Okay, now the house has been on the market for 10 weeks and we're trying to wean the vendor down from the high expectations we set in the first place.

Vendor gets Realistic. Four months have passed. The vendor has caved. Asking price has now dropped. Auction has been announced to excite the market.

New. Just Listed! Vendor has switched agent.

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Vendor says Sell. Nothing happened at the auction. Vendor threatens to change real estate agents.

Toxic Media. Remember the newspapers that printed news about the booming market last year? Well now they're reporting the latest trends.

Buy low, sell high. The secret power of G.

When you read the financial pages right now, you'll see very little talk about buying opportunities. Good heavens – what happened to the old mantra of Buy Low – Sell High?

Whether property, or stocks and shares, the best strategy is always to buy near the bottom of the cycle. Then the high income relative to the smaller initial investment provides a good return on its own. And if the income grows over time, eventually prices will increase too.

For our portfolio management we use asset allocation specialist *farrelly's* and their well established forecasting approach. The arithmetic goes like this.

Decompose market returns into 3 elements to forecast how the investment is likely to perform: Return = Y + G + V

Y = the current yield – no forecasting required – at this price, the income return for the next year is known

G = expected growth of earnings – do you expect the investment income to increase or decrease? Think about whether rents or company profits are likely to be under pressure.

V = the value, price or multiple someone is willing to pay for future earnings. This is the "subjective" part – you have no control over it.

This approach focuses not on the uncomfortable experience of recent returns, but on the more rational question of future returns. Where other investors are licking their wounds and stepping out of the market, the forward thinking investor focuses on that precious potential of G – the likely Growth of earnings.

> "Right now, if you can buy assets at a high income yield and you expect the income to be sustained, your cash flow will cushion you from market sentiment..."

Right now, if you can buy assets at a high income yield (because prices have been slashed) and you expect the income to be sustained (ie: dividends won't be slashed too) your cash flow will cushion you from market sentiment (lower prices).

Later, when the income increases and/or other investors eventually drive prices higher (i.e. sentiment improves) your return will be even better. If too high, you can take some profit. *farrelly's* regularly re-calculates its forecasts to identify the times when markets are overpriced too.

That's when we make repositioning recommendations to rebalance your portfolio. It's impossible to time the markets but this method helps us minimize the classic mistake of buying too high and selling low.

More pudding anyone?

How do you summarise the current economy in a fresh way? Answer: you can't. The current economic pudding looks like a blend of recipes that we haven't used since fondue sets were the rage. At the heart of the pudding is a list of recessionary ingredients including high interest rates, low growth and flat-lining job markets. Drizzled over the top is a favourite sauce from the 1970s: inflation mixed with a sweet and rich spice of oil prices.

The current pudding tastes mostly of a readjustment of the financial markets after the credit crunch that resulted from over-zealous lending to poorly-backed borrowers. Forced sales are driving property prices down and the wealth effect is quickly dissipating.

One consequence is that all investment portfolio values are down from the peak of last year. Even good quality assets get marked down – just like your own home – which will most certainly be worth less now than you could have sold it for, a year ago.

The added sauce of oil price hikes merely reminds us, every time we fill up the tank, that things aren't as good as they were a few months ago. The current dessert looks distinctly unappetising.

While we wait for after dinner brandy or a coffee, need we remind readers that the best way to ride things out is to have the following 5 ingredients:

- Little debt. With high interest rates, now is a great time to discharge mortgages.
- Diversified income portfolios. High yielding fixed interest assets and property stocks are attractive.
- An eye for buying opportunities: our portfolios have been very underweight in NZ shares and bargains are beginning to appear.
- Patience. "Old school" investors – those who invest in fundamentals rather than in sexy fad sectors – are on track to achieving their target returns.
- Offshore investments. There is still potential NZ dollar weakness especially against the US and UK. Note the NZD against the AUD already has come off from a high of 91c a year ago to 79c at the time of writing. That's a 13% currency gain!