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The dust settles

Takeouts from the Sydney Portfolio Construction Forum

Fortunately the conference took place a fortnight before the big red dust storm that enveloped Sydney, but our annual attendance at the Portfolio Construction Forum, a large and very well run seminar for investment professionals, at least showed signs that the economic dust is clearing after the economic storm from last year. The question was: are we seeing the beginning of the great Recovery?

The conference was tightly managed, with well-presented papers by a range of speakers from Australia, US, UK and Asia: economists, fund managers, policy advisers, research analysts. They shared a consensus that we're seeing the start of global recovery, but they held quite different views on what form it will take – whether a sharp v-like uptick or something more like a w-shaped roller-coaster ride. In fact there were three competing stories.

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- Proponents of the V shaped recovery subscribe to a “business as usual” approach with the belief that the economy is all up from here.
- The W camp expanded on the “distorted W” theory of a second downturn followed by a protracted period bouncing along flat before rising again – more pain then gain with glimmers of hope interspersed by period of doubt.
- A third group, the “Square Root proponents” believe we have experienced the first uptick, but will falter again before rising then reaching a prolonged plateau of low growth in share prices: a growth graph that looks like the square root symbol.

Who really is to say? The competing models are simply models, and they're each based on past experiences; for example on the stagnating recovery we saw after the oil shocks of the early 70s,

or on the boom that followed the precipitous dot-com bubble almost 10 years ago.

But for all the nuanced guesswork about what form the recovery may take there was general agreement that fairly subdued growth will prevail especially in developed nations where our consumers' appetite for spending has been severely hampered by:

- Rising unemployment
- Decimation of wealth (both house values and superannuation funds)
- High indebtedness and tighter borrowing conditions

This is the flipside of the wealth effect whereby soaring property values make us all feel inordinately confident and willing to invest. We might call the new theme “The Reality Check”.

In such developing nations as Brazil, China, India and Korea the theme is different. They have stronger underlying growth – fast growing consumer classes - but their story is tempered by a softer export market. They can no longer rely on the western consumer to resume buying at the same rate. One prospect: they will increase trade amongst themselves.

As Tony Crescenzi of PIMCO (a large global investment firm) noted in a September Viewpoints article, “the recovery is very fragile, like a small campfire that just can't get going because of the many winds surrounding it”.

What do all these different currents of thought mean for today's investor in New Zealand?

In our view investors and investment managers are both going to be more careful, still a bit jittery even following the storm of 2008. That mood of “reality check” is appropriate, considering how close we came to a complete global recession deeper than anything since World War 2.





The dust, if we return to our metaphor, has settled. When we sweep it away we see what PIMCO's Bill Gross refers to as "the new normal" and we agree. We're going to see:

1. Continuing price readjustment from many assets that were inflated by the excessive borrowing and easy credit prior to the crash. Such credit-fuelled inflation is unlikely to be repeated any time soon.
2. Lenders will be more circumspect and if not, new government regulations will force them to be.
3. We are in for a less hyped period and that is likely to be a good thing as investors will look for sensible long term investments, not get-rich quick or tax loss schemes.

How do we deal with this challenging environment?

Part of the process of going to any conference is to stop, listen and reflect on how one is doing as a professional. Are we on the right track? Are there things we ought to do better?

Actually our conclusion from the conference is that our approach with our clients is on the right track and this stems from our long-held belief in keeping investments quite grounded. Invest in companies that make things – not in companies that swap IOUs and other debt products around! We heard five dominant strategies at the conference, and we were able to check all five boxes.

“Invest in companies that make things – not in companies that swap IOUs and other debt products around...”

1. **For shares and property:** invest in high quality assets with a focus on reliable sources of income growth rather than relying on capital gains.
2. **Understand risk:** Risk is not just about volatility. Understand which are the genuinely defensive assets (for example cash and A rated bonds) for stability and capital preservation, and which are risky assets: shares and property. Don't expect high interest

from defensive assets – otherwise they are actually risky – as we saw with all those finance companies. Downside risk needs to be evaluated before you invest. The fundamental question is: what is the risk of not meeting your future income objectives?

3. **Fashion week is over.** Avoid flavour of the month investment traps.
4. **Proactively manage your portfolio.** Set and forget portfolios may not deliver – while proactive asset allocation means re-weighting your portfolio when assets become expensive or very good value. The world is changing, your portfolio may need to change with it.
5. **Shift toward the developing countries.** Most of the global funds managers we use are increasing their exposure to developing countries either by owning local companies directly or through their exposure via global big brands such as Coca-Cola, Nestlé or Procter & Gamble who are deriving more of their revenues in developing markets.

For art lovers.

Many of our clients have a strong appreciation for art, so here's a tip – a travel tip this time.

You may recall that Kerr Neilson from Sydney based Platinum Asset Management gave a presentation at our client investment briefing in May. On the last day of the Sydney conference we picked up the Australian Financial Review and read with interest an article profiling Kerr and his wife, Judith Neilson and their respective art collecting passions; he collects Persian rugs and Kashan ones in particular while she collects artworks from China.

In August this year she opened her \$10 million art gallery called White Rabbit and it is devoted to contemporary Chinese art. It's located in Chippendale, Sydney - so close to the conference venue. If only we had known! But apparently the gallery is a real must-see.

If you would like a copy of the article, email info@stuartcarlyon.co.nz or phone Donna on 307 2331.



“Global Watch” (2007), acrylic on canvas, by Wang Luyan.
www.whiterabbitcollection.org