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STUART + CARLYON

Financial advisers for your lifetime goals

James Surowiecki finds our recession refreshingly soft

At the recent Auckland Writers & Readers Festival we went to hear James Surowiecki, from New Yorker magazine. His "Financial Page" is one of the sharpest commentaries available on the topical issues of the financial world. In his internet blog he reports how he was really amazed by the big turnout of Aucklanders to the New Yorker sessions at the Festival. He also reflected on the difference of mood between the USA and NZ, labelling his online article: "Recession, With a Difference" (18 May 2009).

> "In effect, it feels like what New Zealand is going through is something closer to a traditional recession..."

"This is the first time I've been out of the USA this year, and the difference in mood between Auckland and New York was noticeable."

Why are we having a soft landing compared to the USA? He lists three reasons including:

1. Our reliance on agriculture exports, where prices have held relatively steady.
2. High interest rates which limited us from indulging in the same borrowing and speculative excesses of the USA.
3. The sheer stability of our big (Aussie owned) banks which control around 80% of assets in New Zealand.

He summed up: "In effect, it feels like what New Zealand is going through is something closer to a traditional recession ...that doesn't have the added dimension of a banking system in crisis. As a result, the sense of anxiety feels more muted—a recent survey found that ninety-one per cent of kiwis still have "faith in the banking system." The contrast to the overpowering sense of worry that's dominated the U.S. since September is striking."

Platinum advice in a corroded marketplace

We were very privileged to have Kerr Neilson from Sydney speak at our investor briefing recently. Over many years he has brought consistently sensible advice and insight and he stands, perhaps especially after the crash, as one of the people well worth listening to in the marketplace. Kerr runs the Platinum International Fund which for Kiwi investors has provided a positive performance. Platinum stands out as a contrarian e.g. it never invested in Western banks.

But taking a contrarian stance involves a lot more than adopting the old Groucho Marx line: "Whatever it is – I'm against it." As Neilson explained; his choices of stock are predicated not only on being dubious of the fads in investment, but on core old-fashioned values – looking for good assets, managed-well, and delivering strong positive yields.

Three identifying characteristics of Platinum's style:

1. Focus on identifying out-of-favour stocks.
2. Doesn't measure itself against the index.
3. Staff remain the majority of shareholders.

At the presentation, he provided a rundown of the market environment and gave examples of the types of companies that Platinum is investing in. He showed how share prices have fallen to such an extent that the income from shares is attractive again. The average dividend yield on the US S&P 500 index is now 3.6% which is above the long term average of 3.2%

In fact he keeps a close eye on yields versus the price of shares. In his view in the period from 1993 to 2007, dividends have been generally lower indicating that prices had reached unsustainable levels. Now with the collapse of the markets the bargains are once more available with weak prices giving Platinum the opportunity to pick up companies that were too expensive before. In Platinum's quarterly report March 2009 they cited a number of new companies they added to the portfolio which they bought at cheap prices:

- One company, Veolia, specialises in water treatment, waste disposal and community transport and holds contracts with public authorities that are decades long. The price is close to that in 2003 and the yield is 7%.
- Kerry Properties: best known for its association with the Shangri La hotel chain, has some of the most attractive rent-earning, dominant sites in the principal cities of China and for a hotel chain very low borrowings at 35 per cent. Platinum sees the potential is being undervalued.

- Canon got too cheap to ignore when it was trading at book value.

We like the solid rationale behind each of Platinum's decisions, and the capacity of Neilson's team to eschew the conventional wisdom that got so many others into a mess by September last year.

Understanding the four sides of risk

We are fielding inquiries from people who are happy to have had their money in the bank but who now wonder what else they should be doing to generate higher returns.

Enter the awkward risk discussion. Nobody really wants to take risk but the reality is that we have been spoiled in New Zealand with very high interest rates for cash in the bank. Now with cash at 3% the bank has reverted to its traditional role as a safe but unexciting "parking place" for your funds while you decide what to do for a higher return.

There are numerous other sources of income, but they involve higher risk than cash. Consider the following questions of risk:

- Longer term fixed interest assets. While a six year A-Grade bond at 7% is better than 3% for cash, should you wait in case the six year interest rates go higher?
- Overseas fixed interest. Bond rates of 6% look attractive – but will this be wiped out by currency losses? Or topped up by currency gains?
- Listed property stocks. Some promise 12% income - but will property values go down further?
- NZ and Australian shares. Many may deliver 5%-8% income - but will share prices fall further? And will dividend payouts go up or down?
- Overseas shares. 3% income; but with share price volatility and currency movements.

It is relatively easy for us to see where investments fit on the basic scale that runs from "defensive" to "risky". That's how we avoided all those awful finance companies. But the more difficult challenge is to help individuals understand their personal risk issues so we can develop a strategy that suits them.

Whether you are saving for retirement or already retired, risk has four main aspects you need to consider:

- Risk required – what level of risk (and return) do you need to achieve your goals – this is a financial projection.
- Risk perceived – how risky does the proposed action feel to you?
- Risk capacity – what can you afford to lose? A financial characteristic.
- Risk tolerance – the risk you would normally choose to take: a personality characteristic.

People act mainly on just three aspects; their perception of the risk involved, their emotional risk tolerance and an evaluation of the worst case outcome - will they survive if something goes wrong? Yet these feelings are often skewed by the prevailing conditions at the time of making the decision. During a boom, people seem willing to take bigger risks. Risks seem remote and unlikely. This year the opposite applies.

To help make things more objective a big part of our job is to assess the fourth *risk required* aspect: marrying up our clients desired goals for retirement income with how much risk they need to take to achieve them. By quantifying this we can then discuss any trade-offs.

Not comfortable saving for 20 years into a share fund for high returns? Then you'll have to spend less and save more for a lower risk strategy.

> "If you do have 20 years to go before retirement, you can afford the risk of market volatility along the way..."

We then discuss *risk capacity* – if you do have 20 years to go before retirement, you can afford the risk of market volatility along the way.

A big element of the risk equation is *risk perceived*. As we've noted, it varies wildly depending on market conditions and our job is always to provide a more objective perspective. Our job is to ensure the natural risk takers don't undermine their long term security and – likewise – to ensure that those who feel uncomfortable about risk can better understand the need to beat the certain risk of inflation.

Investing simply to keep you comfortable on the risk front may result in an unnecessarily low return and may be a problem if inflation rises over time and you don't end up with enough money to live on.

The key is to be comfortable with how you need to invest to achieve your goals and to understand the potential downside so that you don't panic and abandon your strategy when returns turn negative for a while.