HOLM TRUTHS

Down to earth advice for New Zealand savers and investors from independent journalist Mary Holm

SUMMER 2002/03

Lessons From Past Mislead

It's Saturday night, and you've got a choice of two parties to go to. Do you pick the house where they had a great time last night, or the one where they had a quiet Friday evening?

The choice isn't obvious. If the people in the first house turned on a good party once, why not twice? Then again, they might be all partied out. The folk at the other house, who rested up the previous evening, might be in better form tonight.

The situation is similar in investment. You might do well if you put money into last year's best performer. But quite often you won't.

This is not news. Ads and literature about investments frequently warn that "past performance is not necessarily indicative of future results", or words to that effect. But many people take about as much notice as smokers do of warnings on cigarette packets.

Why? Because in other areas – sport, the arts, academic performance – whoever did well last time is more likely than average to do well next time.

But much research shows that the same does not apply to investment.

Before we go further, I'm not talking here about graphs of returns on different types of assets, such as shares, property and bonds, over a decade or more.

IF ONLY WE KNEW

The Economist magazine recently looked at asset performance over the 20th century.

The researchers found that if you had invested $1 at the beginning of 1900 into the best-performing asset type in that year, and then moved your money at the start of every year into that year's winner, by 2000 you would have $1,300 and 12 more zeroes!

That just goes to show the power of compounding high returns over very long periods.

However, if instead you had put your money into the previous year's best performer, your $1 would grow to a mere $290 – with no zeroes.

The story they usually tell – that shares are the most volatile but also tend to produce the highest long-term returns, followed by property – is a valid story.

What I *am* talking about is short-term comparisons between asset types, or between different share funds or other managed funds.

Whenever somebody says, "Property gave the biggest returns last year. Let's move your savings into property," or "This balanced fund was the best in the market last year. Why not put all your new savings into it?", be wary, for two reasons.

The first is that such comparisons are often misleading. A company pushing a product is likely to choose a period that shows it in a good light.

They may also compare a fund's performance with an inappropriate market index (such as the NZSE40 or MSCI world index). The index may cover a different market sector than the fund, such as large companies only.

Or the fund's investments may be riskier than the index. In that case, you would expect the fund to outperform the index in some years but not always. You need to appreciate the fund's riskiness.

Comparisons can also be misleading if one investment excludes fees and taxes, or includes reinvested returns, and another doesn't.

The second reason to be wary about following last year's winner is, quite simply, that the winner isn't any more likely to keep doing well than other alternatives. In some situations, it is more likely to do poorly.

(CONTINUED PAGE 2)

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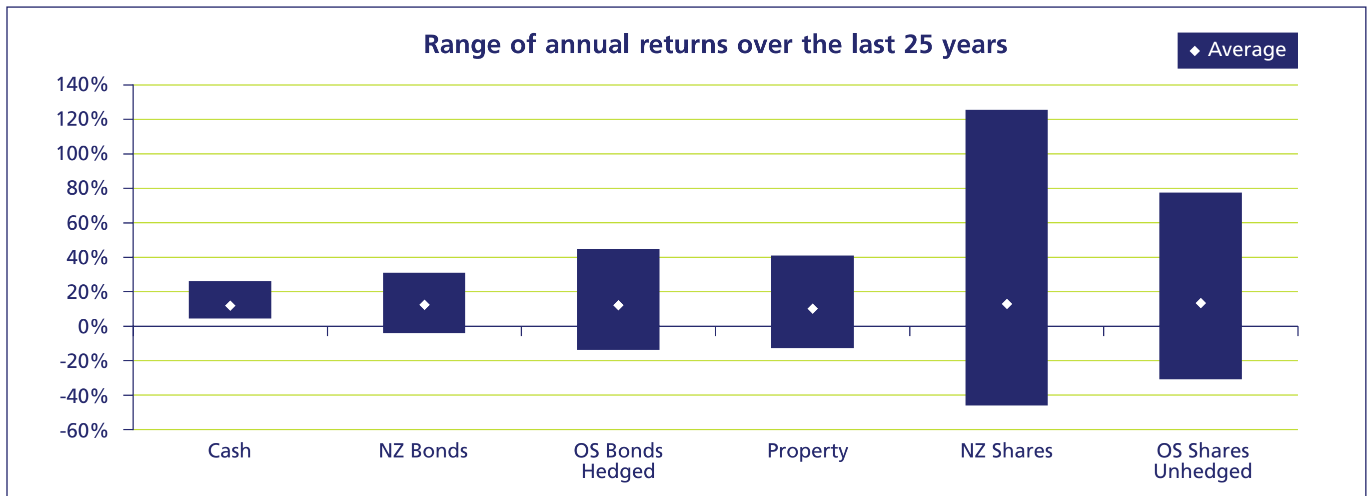

Ten years of returns (%)

Year's best in blue; year's worst in green

YEAR ENDING SEPTEMBER	CASH	NZ BONDS	OVERSEAS BONDS (HEDGED)	PROPERTY	NZ SHARES	OVERSEAS SHARES (UNHEDGED)
2002	5	7	11	9	**11**	*– 30*
2001	6	9	**11**	10	– 4	*– 28*
2000	6	7	7	6	*4*	**37**
1999	5	2	*0*	7	22	**26**
1998	9	11	16	5	*– 29*	**27**
1997	*8*	13	14	10	22	**35**
1996	9	7	**13**	11	9	*6*
1995	9	13	**18**	11	7	*4*
1994	6	*– 4*	– 1	**16**	11	– 2
1993	7	13	15	*– 2*	**41**	17

Winners are also likely losers

The graph shows that the types of assets that tend to do particularly well in some years, notably shares, are also the ones that tend to do badly in other years.

The table shows that each asset type has good and bad years. In the last decade, every asset has been the worst performer at least once, and most have been the best performer at least once. Overseas shares switched dramatically in one year from worst in 1996 to best in 1997, and reversed that from 2000 to 2001. Property also switched from worst in 1993 to best in 1994. Note, too, that in some years the best any asset can manage is 11%; in others it's around 40%.

All the returns include interest or dividends, and are before tax. Property is direct investments made by fund managers.

(LESSONS FROM PAST MISLEAD, CONTINUED)

Some extreme examples:

• The top-performing New Zealand-based international share fund in the year ending March 2001 came dead last just two years earlier. The worst in March 2001? You've guessed it: It was the best performer two years earlier.

• Comparing share market performance in nine developed countries from 1982 to 2001, we find that Canada came last in 1982, first the next year, then last the year after. In 2000, it came first; in 2001 it came last.

Similarly, the US came last in 1994 and first in 1995. Japan did the same a year later.

Seven out of the nine countries, including New Zealand, came last at least once in the period and first at least once.

• In worldwide sharemarkets in 1999, the top four performing industries out of ten broad categories were IT, telecommunications, consumer cyclicals and basic materials. Six months later, they were the bottom four.

OK, I'll admit these are selected cases. There are also plenty of times when good or bad performance persists for a while. But there's no way of knowing, in advance, when this will happen.

Recent Australian research looks at the issue more broadly. Academics assessed about 100 studies done in various countries over the past 20 years.

About half the studies found no relationship between good past and future performance.

In some other studies, there was some relationship, but usually only in the short term.

If you invested on the strength of that knowledge, you would be moving your money around frequently. That would be not only time-consuming, but any gains you made from the strategy would probably be eaten up in brokerage, fees and possibly tax on capital gains.

Over all, the Australians' conclusion was that past performance is not a useful guide for the future. And similar British research came to the same conclusion.

SO...what should you do when confronted with the knowledge that your managed fund, or an asset type in which you are heavily invested, has performed badly recently?

If you shouldn't switch to last year's best performer, how about being a contrarian, and switching to last year's *worst?*

Sometimes that works well. But, according to the Australians, poorly performing funds may be slightly more likely to keep doing badly over the short term.

Presumably they include not only funds investing in areas that happen to be down, but also funds that are poorly run.

Assuming you've chosen your long-term investments wisely, your best bet is to stick with them – although you should, of course, always keep them under review.

That strategy is easier and cheaper than any other. And you've probably got just as good a chance of doing well in the future as you would have if you switched.

Why don't winners stay winners? See back page.

"Bulls make money and bears make money, but pigs seldom do."

Wall Street maxim

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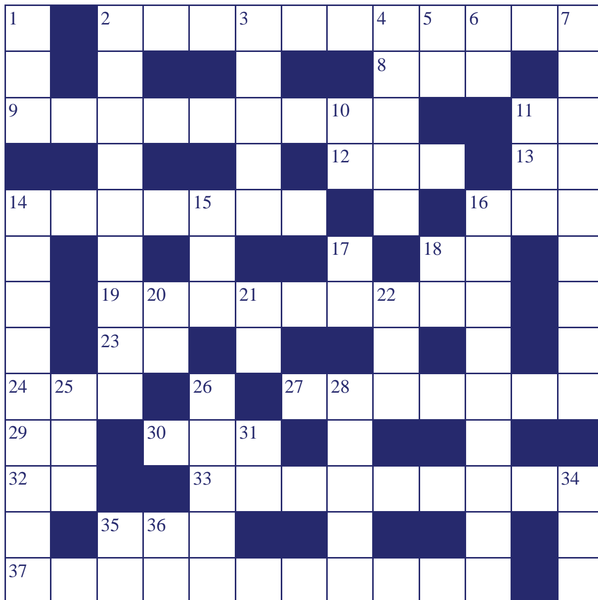

Solution: Back page

HOLM TRUTHS CROSSWORD

Summer 2002/03

ACROSS

2. Invents stem (anagram) (11)
8. Unit of current (3)
9. Making a spending plan (9)
11. Very (2)
12. Lubricant (3)
13. Our queen (abbrev.) (2)
14. A room for the unwell (4,3)
16. Feline (3)
18. Us (2)
19. Dodger of levies (3,6)
23. Printer's measure (2)
24. Of it (3)
27. Applause (7)
29. Not yes (2)
30. French friend (3)
32. Advance, move (2)
33. Ruin canes (anagram) (9)
35. Delve (3)
37. Disposition (11)

DOWN

1. Task (3)
2. Shows (9)
3. More than usual (5)
4. Bewitching (5)
5. Same as 23 across (2)
6. Don't leave car here (abbrev.) (2)
7. Brief period (5,4)
10. Same as 29 across (2)
11. Ocean (3)
14. Mimicking (7,2)
15. Container (3)
16. Inevitable-ness (9)
17. Mother (2)
18. Same as 18 across (2)
20. Morning (abbrev.) (2)
21. For instance (abbrev.) (2)
22. Physician (slang) (3)
25. Also (3)
26. Spanish friend (5)
28. Unkind (5)
31. Not out (2)
34. Facial feature (3)
35. Abbreviation for 22 down (2)
36. Exists (2)

GREAT DEBATE • GREAT DEBATE • GREAT DEBATE

LOW vs HIGH INSURANCE EXCESSES

The people who prefer low excesses on their insurance are probably different personality types from those who prefer high excesses.

Excesses apply to several different types of insurance.

Under your house, contents or car insurance, if you suffer a loss and you have a low excess, you might have to pay the first $100 for repair or replacement. With a high excess, you might pay the first $500.

The word "excess" may not be used for other types of insurance, but the principle is the same.

With disability or loss of income insurance, your payments might start a month after you stop working, or they might not kick in until three months.

With health insurance, you might have coverage for most medical expenses, including visits to a GP, or you might be covered only for major medical costs.

The obvious advantage of low excesses is that, when something goes wrong, you don't have to come up with much money yourself to put it right.

This can be an emotional as well as a financial advantage. If you've suffered a loss, it can be a comfort to know that at least you've got insurance.

And it's easier to budget, knowing you will have to pay a predictable premium plus only small unpredictable amounts if things go wrong.

The obvious disadvantage is that you pay higher premiums. And it's not accurate to say that, over your lifetime, that's likely to be balanced out by your lower excesses.

People with high excesses often don't claim for minor losses, because the loss is less than their excess. Low-excess people, therefore, file claims more often – perhaps twice or three times as often.

To cover that extra work, the insurance company is likely to charge you more, relative to what you're likely to get back, than a high-excess person.

Not only that. While it's comforting to receive payment from an insurance company after a loss, it can be quite a hassle to file a claim, costing you precious time, if not money.

And here's where the different personalities come in.

When people with high excesses suffer a minor loss that is not covered by their insurance, they often observe that at least they don't have to deal with the insurance company.

They repair or replace the item using their own funds, in the knowledge that they've saved money over the years by paying lower premiums.

They might even set up a special "self insurance" account, or perhaps a charity fund, like the one described in the quote on the next page.

Does that sound like you? If so, and you don't currently have high excesses, you might want to look into raising your excesses, and saving money.

But if you would be upset that you can't make a claim, you're better to stick with low excesses.

LOW EXCESS PROS	LOW EXCESS CONS
✓ Losses largely covered	✗ Higher premiums
✓ More budgeting certainty	✗ More hassle
✓ Emotionally easier	✗ Less incentive to be careful

HIGH EXCESS PROS	HIGH EXCESS CONS
✓ Lower premiums	✗ Less coverage
✓ Less hassle	✗ Emotionally negative
✓ A better deal	

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"At the beginning of the year, the professor plans for a generous donation to his favourite charity. Anything untoward that happens in the course of the year – a speeding ticket, replacing a lost possession, an unwanted touch by an impecunious relative – is then charged to the charity account. The system makes the losses painless, because the charity does the paying. The charity receives whatever is left over in the account."

Peter Bernstein in "Against the Gods – the Remarkable Story of Risk"

Why don't winners stay winners?

Fund managers that perform well in one period don't necessarily do well in the next period. Various reasons have been offered. Among them:

• Risk. High performers are likely to be funds that invest in riskier shares or other assets and have had a lucky year.

Because they take more risk, it's also likely that they will do badly in an unlucky year.

• Management style. Many fund managers follow a particular strategy that works well in some business environments, but badly in others.

Some managers favour smaller companies, or hi-tech stock, or New Zealand rather than international shares.

Some concentrate on growth stocks, which have performed well, while others favour value stocks, which seem to be cheap.

In the late 1990s, growth stocks did well. Then value stocks came into their own, although just recently growth seems to have been making a comeback. Who knows what's next?

• Luck. To the extent there is luck in investment choices – and there's probably more luck than many professionals acknowledge – no fund will always do well.

It will be lucky some years; unlucky others. Over the longer haul, its performance might be about average. This is called reversion to the mean, and it happens.

• Manager movement. To the extent there is skill in investment choices, the fund with the best manager will probably keep doing best.

The trouble is that highly successful managers tend to be poached away by other funds.

In New Zealand in particular, where fund manager teams tend to be small, one person's move from one team to another can make a big difference.

• Imitation. If a fund does spectacularly well, other managers will copy it.

• Fund size. If a fund manager is particularly successful, investors who don't know any better tend to move their money into that firm's funds.

Suddenly the fund is bigger and may be harder to administer. Suddenly, too, the manager can't grow all the current holdings equally, because some shares just aren't available in large numbers. This is a particular problem in New Zealand.

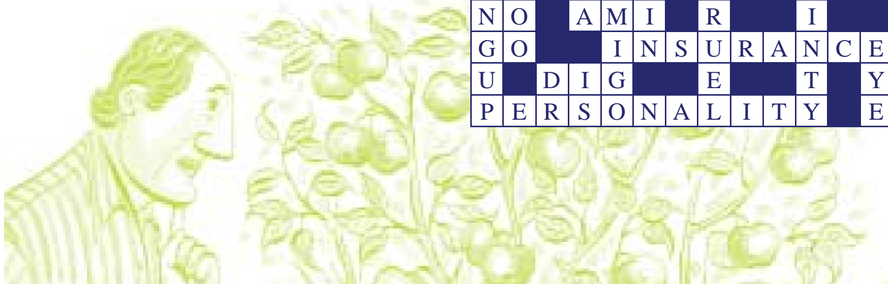
For these sorts of reasons, failure may follow success. Experts advise staying away from any fund that is growing fast.

On the other hand, it also pays to be wary of small funds, which are fairly common in New Zealand.

They can become too small to be economically viable, and are more likely to be taken over by larger funds, leaving investors under entirely new management.

Holm Truths Crossword Solution

J		I	N	V	E	S	T	M	E	N	T	S
O		N			X			A	M	P		H
B	U	D	G	E	T	I	N	G			S	O
		I			R		O	I	L		E	R
S	I	C	K	B	A	Y		C		C	A	T
E		A		O			M		W	E		T
N		T	A	X	E	V	A	D	E	R		E
D		E	M		G			O		T		R
I	T	S		A		A	C	C	L	A	I	M
N	O		A	M	I		R			I		
G	O			I	N	S	U	R	A	N	C	E
U		D	I	G			E			T		Y
P	E	R	S	O	N	A	L	I	T	Y		E



Shining and bombing

A recent New Zealand survey ranked the performances of 14 fund managers' "discretionary" funds – funds in which the managers have full discretion over how the money is invested.

Over five years ending September 1998 through September 2002, every manager's performance varied widely.

• All but one manager ranked in the top 5 in at least one year and in the bottom 5 in at least one year.

• Every manager who came first at least once also ranked in the bottom three at least once. In other words, those who really shone also really bombed.

• In an extreme example of this, one manager came first twice and last twice. In the fifth year, it came second.

• Only one manager was even in the top half in more than three of the years. It achieved this in four years. A cynic might point out that this is about what you would expect if performances were random.

WRITER AND PUBLISHER

Award-winning journalist Mary Holm writes the *Money Matters* column for the NZ Herald and *The Investor* column for about 20 newspapers around New Zealand. She is the author of *Investing Made Simple* (Penguin, $27.95, at good bookstores) and *The REAL Story – Saving and investing now that inflation is under control* (which can be downloaded from www.rbnz.govt.nz. Click on publications). Mary holds a BA in economic history, MA in journalism and MBA in finance. She can be reached at P.O. Box 8520, Symonds Street, Auckland, or by email at maryh@pl.net

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