HOLM TRUTHS

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

WINTER 2003

First Things First

Before you book your holiday accommodation, you need to decide where you're going and how long you will be in each place. Similarly, before you decide which shares, properties, funds, bonds or whatever to invest in, you should decide how much of each type of investment is right for you.

Some research has suggested that this decision – known as asset allocation – is hugely important. Your choice will account for 80 to 90% of your investment results. Decisions on specific investments don't matter nearly as much.

Other researchers have recently challenged that number. But all the experts agree that getting your allocation right makes a big difference.

Which allocation is best for you? It depends on your circumstances – including what pattern of returns you want – and your personality. We'll look at circumstances first.

Start by asking yourself: **When am I likely to spend this money?**

As a rule of thumb, if you expect to spend it in three years or less, you should save in the asset class that the experts call cash – bank term deposits and the like. These are simple, no-fee investments, with virtually no danger that you will lose your money or that its value will fall. And if you choose deposits that mature when you will need the money, you can calculate exactly how much you will have at the end.

VIVE LA DIFFERENCE

The major investment asset groups are shares, property, bonds and cash. But there are also many subgroups.

Shares can be in big or small companies, or varying industries. Property can be residential, commercial or industrial. Bonds can be high- or low-quality, short-term or long-term.

And with each type of asset there are New Zealand and international investments.

It's good to spread your money across a broad range, to the extent that is practicable. However, if your savings are small, that may limit your ability to diversify.

Some savers also invest in gold, options, collectibles or other assets.

While this helps diversification, the quality of investments in these areas varies widely. They are best left to those with some expertise.

If you expect to spend the money in three to ten years, put it into the "bond" asset class, which includes bonds, capital notes and other fixed interest investments.

These are slightly riskier than term deposits – partly because you will tie up much of your money for several

years – but you should earn a higher return. You may have to pay brokerage, but over a longer period it's worth it.

If you have more than ten years in hand, go for diversified investment in shares or property.

The value of these investments will rise and fall, and there's always a possibility that you will lose money. But – provided you are well diversified – the longer you invest in shares or property, the less likely it is that your investments, taken as a whole, will lose value.

Average returns over the long term are higher than on bonds, and shares and property will give you some protection against unexpected inflation.

A related question: **How important is it that I accumulate a specific amount?** *(CONTINUED PAGE 2)*

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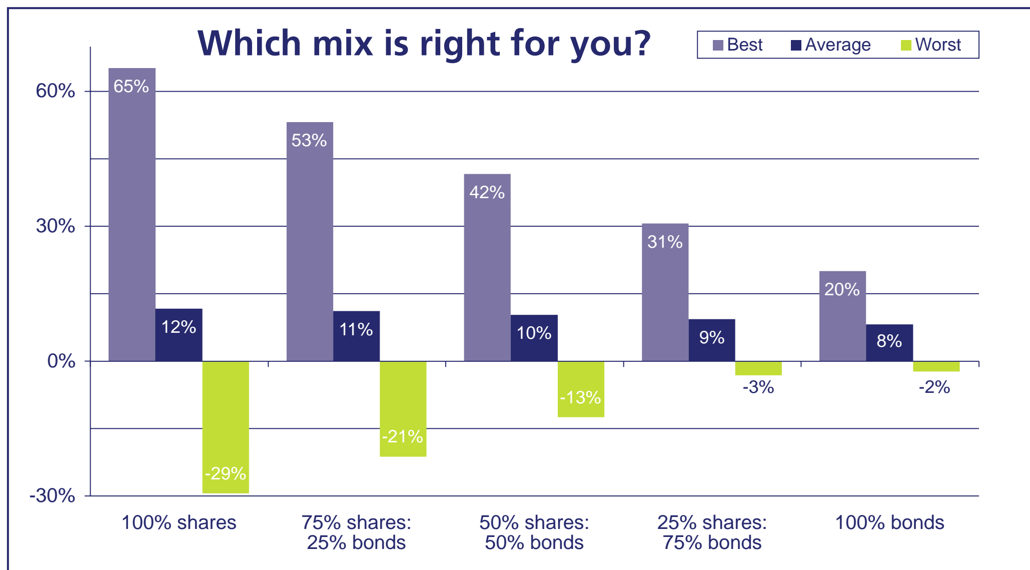

The more shares you hold, the more volatile is your portfolio. As you add bonds, your potential gains and losses are watered down. But you pay a price for this higher degree of certainty. Average returns are lower. And, over the long term, that makes a big difference. In 10 years, $10,000 will grow to $21,600 at 8%, but $31,100 at 12%. In 20 years, it will grow to $46,600 at 8%, but $96,500 – more than twice as much – at 12%.

The graph shows annual returns over the last 25 years after allowing for tax at 33%. One fifth of the shares in each portfolio are NZ and four fifths are overseas shares (which are 50% currency hedged). The bonds are all NZ bonds.

Getting from here to there

What if you need to change your asset mix?

Let's say you started with 80% of your long-term savings in shares and 20% in bonds, to dampen volatility. But shares have fallen to the point that it's now 60% and 40%.

Or perhaps you've decided you can cope with more volatility and want to increase the share weighting in your long-term savings.

The easiest and cheapest way is to direct all your new savings into shares or a share fund.

This might not be enough, though. You might need to set up a programme to regularly sell some of your bonds and buy shares.

The good thing about this is that you will be buying more shares at a time when the market has fallen. So they should be relatively cheap. Keep in mind, though, that you have to pay two lots of brokerage and other transaction costs.

Because of this, you may decide not to sell bonds and buy shares to the extent that you go all the way back to your original 80% and 20%. Instead, keep an eye on market trends. A share market boom might take you the rest of the way without your taking any further action.

As retirement approaches…

…consider your ideal asset mix on retirement day.

At that time, you will probably still want some savings in shares or property, to fund your spending more than ten years into retirement. Remember that your retirement could last 20, or even 30-plus, years.

But short-term money should be in term deposits, and medium-term money in bonds. To get to that point, a decade before retirement, consider putting new savings into bonds and the like.

You may also need to plan to sell some shares or property, and move that money into fixed interest, on a regular basis.

(FIRST THINGS FIRST, CONTINUED)

If you're saving to take a training course, for example, you may need a certain amount for fees and a certain amount for living expenses. There's little flexibility in your goal.

You should stick with cash and bonds, especially if the course is only a few years off.

But if you are saving for an overseas trip, you might invest in shares or property even if you plan to travel in, say, four or five years. If your investments do well, you can stay in top hotels; if not, it will be backpacker lodges.

Overlaying all of this is personality. The question here is: **How much volatility can I cope with?**

Perhaps you enjoy taking a bit of a gamble with your savings. You might invest in shares or property even if you plan to spend the money in six or seven years, or even less.

If you do, though, you should think about what you will do if you strike bad luck and end up with less money than you hoped for – perhaps even less than you put in.

Most people, though, are the opposite, preferring to reduce volatility even on long-term investments.

Back in the late 1990s, when world shares and share funds were performing exceptionally well, many investors felt comfortable with the risks involved.

Since then, though, with international shares going through a particularly bad patch, some of those people have realised that they can't cope with an extended down market.

Because of that recent experience, many savers are now overly cautious, feeling reluctant to put their long-term savings in shares or a share fund.

Think hard before abandoning shares. They have almost always brought in higher long-term returns than other asset types, and that is likely to continue.

Still, if you're inclined to worry about shares – or if you're not prepared to wait ten years after the share market takes a plunge – water down your share investments.

As you do so, though, face the fact that your total returns are likely to be lower, so you will need to save more or retire with less.

To water down, you could simply put some of your savings into fixed interest and, perhaps, property. (Homeowners arguably already have more than enough in property.) Or you could invest in a balanced managed fund that will spread your investments for you.

Whichever you choose, it's important when reviewing your progress to look at the value of your whole portfolio, rather than just, say, the share portion.

When the shares have done badly, other investments will probably offset that. And rest assured that over the years there will be times when shares are the stars of the show.

"Plan for the future, because that's where you are going to spend the rest of your life." Mark Twain

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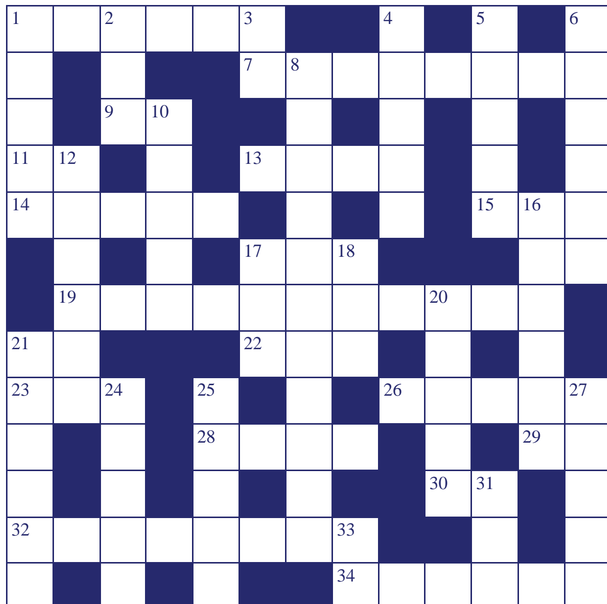

Solution: Back page

HOLM TRUTHS CROSSWORD Winter 2003

ACROSS

1. Production, yield (6)
7. Not usual (8)
9. Note well (abbrev.) (2)
11. Exists (2)
13. Worry (4)
14. Gleaming (5)
15. Sheep (3)
17. Fuss (3)
19. To do with houses (11)
21. Compass point (initials) (2)
22. Big monkey (3)
23. Hallucinogenic drug (initials) (3)
26. Currency, funds (5)
28. 1 of 4 main asset groups (4)
29. Act, carry out (2)
30. Road in a city (abbrev.) (2)
32. See 28 across (8)
34. Consuming (6)

DOWN

1. Fertile spot in desert (5)
2. Light brown (3)
3. Childish thank you (2)
4. Malice (5)
5. Races (anagram) (5)
6. Cut up (6)
8. Bank investment (4,7)
10. See 28 across (5)
12. See 28 across (6)
16. Drooped (6)
17. Woman's name (3)
18. Single (3)
20. Presses clothes (5)
21. Yachts (6)
24. Lure, bait (5)
25. Performed (5)
27. Youthful (5)
31. Three (prefix) (3)
32. You (archaic) (2)

GREAT DEBATE • GREAT DEBATE • GREAT DEBATE

NZ vs INTERNATIONAL SHARES

Most New Zealanders hold more shares in local companies than in international companies, either directly or via managed funds.

But there's a strong case to be made for the opposite – more international shares. And it can be summed up in one word: diversification.

Even if you own a wide range of New Zealand shares, there are many industries not represented on the NZ share market. Examples are car, pharmaceuticals and computer manufacturers.

And you are heavily exposed to a single economy, especially if you also own a home and hold a job in this country.

If disaster should befall New Zealand – such as a severe earthquake or a foot and mouth outbreak – the value of most local shares may plunge.

But if you hold shares in many countries and one suffers a disaster, it won't greatly affect the total value of your savings.

Also, because one country's boom can offset another country's downturn, a diversified investment in international shares is usually less volatile than in NZ shares – despite recent atypical trends.

However, there are counter arguments.

NZ shares tend to pay higher dividends than foreign shares.

In theory, at least, that means that foreign companies retain more of their earnings to be used for expansion, and so their share prices are likely to grow more. If you want income, you can sell some shares.

Still, many people will find receiving dividends is more convenient, cheaper and involves less risk than selling shares.

What's more, New Zealand has dividend imputation, which means that investors don't pay tax on

(CONTINUED PAGE 4)

NZ SHARE PROS	NZ SHARE CONS
☑ Comfort	☒ Small, undiversified market
☑ Easy to invest directly if you wish	☒ Single economy risk
☑ Higher dividends	☒ Lack of diversification from home, job
☑ Dividend imputation	☒ Share funds hold fewer stocks
☑ Cheaper brokerage	☒ Possible currency risk
☑ More accessible information	

INTERNATIONAL SHARE PROS	INTERNATIONAL SHARE CONS
☑ Greater national diversification	☒ Tax complexity
☑ Wider range of industries	☒ Inheritance complexity
☑ Usually less volatility	☒ Lower dividends
☑ Greater liquidity	☒ Information less available
	☒ Possible currency risk

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(*NZ vs INTERNATIONAL SHARES, continued*)

dividends if the company has already paid tax on that money.

If you invest in overseas shares, you don't benefit from imputation. This is not a big deal, however, because overseas dividends are usually small.

On the psychological front, many people are more comfortable investing in familiar local companies, about which they can easily get information – even if that knowledge doesn't necessarily improve their chances of making money.

It's also easier to invest directly in NZ shares, rather than using a managed fund, if that is your preference.

But you shouldn't invest directly unless you have enough to go into at least 10 or 15 shares, and you will need to do more administration than if you use a fund. You will, however, save on fees, and in most cases pay lower taxes.

Directly owning international shares is trickier. You pay more brokerage, and your taxes are more complex. Also, unless you have taken steps to prevent it, ownership of foreign shares can complicate matters after you die.

For these reasons, and also because it's harder to research foreign markets, most people prefer to make their international share investments via a managed fund, probably based in New Zealand.

What about currency risk? Many people say that, if you invest offshore, you are adding to your risk. If the Kiwi dollar falls, your investment will gain, but the reverse will also happen.

This is simplistic. The prices of many of the things we buy – such as travel and imported goods – fluctuate with the value of our dollar.

If the Kiwi dollar drops, pushing up the prices of travel and cars, people with foreign investments are compensated because their investments grow faster. If our dollar rises, the reverse happens.

Far from adding to volatility, putting some money in international shares helps to smooth out the effect of currency fluctuations.

If you haven't got any international shares, you may, in fact, be just as exposed to harm from currency fluctuations as those with all their investments offshore.

So which are better, NZ or international shares? It's best to have some of both. And there's a strong case for more than half your shareholdings to be international.

Putting $s away for a rainy day

We're not talking here about spending that you can anticipate.

If you want a new, or new-to-you, car every five years, you should be putting aside one-fifth of the expected cost (minus trade-in) every year, perhaps in term deposits that mature at the time of your next car purchase. That's not rainy day money, that's budgeting.

But if your car unexpectedly needs an expensive repair job, or you have a crash and there's a large excess on your insurance, you might take that money out of a rainy day fund.

Similarly, you might set aside money to go overseas for a family funeral, or to supplement a redundancy payment.

A rainy day account is for significant spending that you can't predict, or its timing is impossible to predict.

As with asset allocation, how much you put aside depends on your circumstances and personality.

Keep enough that you will probably feel relatively comfortable even when the unexpected occurs. But note that, if you are too cautious, it will cost you over the years. Readily accessible money earns low returns.

Having said that, you don't need to confine yourself to an at-call bank account.

You could earn higher interest in 30-day or longer term deposits, especially if you use a credit card. By the time you have to pay off the card, your deposits may have matured – or at least be close to maturing.

Note, too, that your bank may be willing to reduce the penalty for breaking a term deposit early.

Your chances are better if interest rates happen to be falling. The bank may be pleased to end its obligation to pay what has become relatively high interest.

It's always worth asking your bank, especially if you are a good customer.

"We all know how the size of sums of money appears to vary in a remarkable way, according as they are being paid in or paid out."

Sir Julian Huxley, 1887 - 1975

Holm Truths Crossword Solution

O	U	T	P	U	T			S		S		S
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