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**PROFESSIONAL
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Personal Wealth Management

The benefits of goals-based investing

The aim of a goals-based investment process should be the establishment of an investment strategy which investors find meaningful and capable of judging on their terms, managed in a manner that is cognisant of investors' behavioural biases.

Traditional investment theory and the individual

In 1952, scientist Harry Markowitz published a breakthrough paper that outlined an altogether new approach to investing. Termed 'Modern Portfolio Theory' (MPT), Markowitz's proposition recognised the value of proper diversification and efficient portfolio construction, and remains a core feature of the investment advice offered by many of New Zealand's professional advisers.

"My mind's made up – don't confuse me with the facts."

Despite the logic of Markowitz's proposition, investors in New Zealand have tended to shy away from advice on how to establish efficient portfolios, partly because they feel no compelling need for it but also perhaps due to misunderstanding and misapprehension. It may also be a reflection of our geographic isolation, relatively under-developed financial markets and, until recently, a disparity in tax treatment between investments.

Without obvious symptoms that one's financial independence is at risk, it seems most individual investors will turn their back on advice and instead act on their emotions, intuition and inherited wisdom. Whether they realise it or not, however, this approach generally leads investors to overly conservative or overly risky investment strategies, both of which have the potential to disappoint in terms of achieving financial goals.

Surprisingly perhaps, investors who do obtain advice and establish a "modern diversified portfolio" are not immune from problems either. If their goals have not been clearly defined, or the investment risk they are assuming has not been fully appreciated, disappointment may still follow. The Asian markets crisis of the 1990s, the relentless slide of share markets from 2000 to 2002 and, most recently, the sharp falls associated

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with the credit crisis are painful examples even for investors with well diversified, managed portfolios. Despite giving attention to objectives and matching risk profiles to portfolios, investors still felt vulnerable or indeed overwhelmed by the magnitude of such negative events to take evasive action that is subsequently revealed to be both unnecessary and harmful to their financial position. In doing so investors contradict MPT, which recognises that financial markets will fluctuate but assumes that investors will remain invested and thereby achieve a more rewarding long term financial outcome.

Defining moments like these where negative investment experiences instigate an instinctive, protective (but ultimately more damaging) reaction highlight the single biggest obstacle to successful investment by individuals. That is, irrational behaviour. All investors are to a greater or lesser degree risk averse in that they prefer less risk to more. Observing regular investors behaviour during a period of negative returns suggests what matters to investors is not variability in returns but simply the unpleasant experience of loss.

Whilst academically sound, the biggest shortcoming to MPT is the underlying assumption that the market and therefore investors act in a rational rather than human manner when making investment decisions. For three decades, from the 1950s to the 1990s, the dominant entities practising and implementing Markowitzian theory were large insurance, pension and endowment fund providers. Eventually the investment theory and know-how of these institutional investors was applied to the construction of individual's portfolios, often by these same entities, through the provision of mutual funds or managed funds as they are known in New Zealand.

Institutions are clinical, disciplined and objective in both managing investments and investing themselves. They match assets to specific future liabilities and stay the course. They are likely to be both unwilling and unable to alter a predetermined course of investment action in response to fluctuating investment markets. Humans, unlike institutions, are subject to all the behavioural biases inherent in the human psyche. Unfortunately, in the investment world, adopting these natural behavioural biases will result in the payment of heavy financial penalties.

The impact of major negative investment experiences has, over the last two decades, led investment academics to re-evaluate the traditional modern portfolio approach, particularly as it applies to individuals. This field of study known as behavioural finance theory, analyses the investment decisions of individual investors.

At the risk of over-simplification, behavioural finance theory demonstrates that we cannot expect individual investors to make the same rational decisions as institutional investors as modern portfolio and economic theory assumes. In fact there is strong evidence to suggest that even institutional investors make irrational investment decisions. If this was not the case statistical aberrations such as major market bubbles and crashes, which are simply the collective result of multiple individual decisions, would not happen.

By helping investors avoid behavioural mistakes, which in turn enables them to achieve better investment outcomes, advisers have the opportunity to add considerable value over an investor's lifetime. This value comes less from "beating the market" than from understanding and thereby bettering investors mind sets.

Linking behavioural finance to investors' goals

Accepting then that behavioural finance issues need to be taken account of when advisers are developing investment strategies for individuals, practically, what does this mean for investment advice? The answer to this question lies in the importance of persuading investors to avoid being self-prescriptive or jumping to conclusions about which investment is best for them and, instead, focusing on describing their goals, their preferences, needs and fears.

If the link between an investor's portfolio and their goals is not made explicit, the investor will be easily distracted by volatility and market noise rather than achieving their investment goal. Eventually this can lead to doubts that manifest in destructive, emotionally based decisions rather than rational decisions genuinely based on changed goals, priorities or circumstances.

A useful way to depict the investment portfolio from a behavioural point of view was developed by Meir Statman (1999) by taking a hierarchical view of the goals. Statman proposes a behavioural portfolio with a pyramid structure whereby essential needs form the base, through to upper layers which correspond to discretionary needs, and ultimately aspirational needs which form the apex. Each need category is associated with major investment types. For example, low risk income bearing investments such as bank bills and investment grade bonds provide for essential and more immediate needs, whilst distant and/or discretionary needs may be met from higher risk asset classes such as corporate debt, real estate, shares, growth funds and private equity.

From the perspective of the investor, beginning to see their assets allocated against a list of their needs, rather than one engineered around an ambiguous risk profile and strategic asset allocation, creates a better chance of acceptance and sustainability. By focusing on needs, the investor can be confident their investment plan is developed as a means to an end rather than as an end in itself. In addition, rather than forcing an individual investor to "become rational", an investment framework built and managed in this manner will accommodate their human-ness along the way.

Conclusion

Organising investors' lifestyle goals into categories, rather than into a single diversified portfolio, improves the investment advice process by adapting it to include the evidence of behavioural economics. It grounds investment advice in achieving tangible outcomes rather than investment returns. Finally, advice categories enable investors to compartmentalise the risks being taken with their life savings which enables them to withstand more volatility in longer term needs categories, thereby achieving a better investment outcome.

A cautious approach is required when investing in corporate bonds

The demand for, and availability of, corporate bonds has increased dramatically in recent months as New Zealanders face the reality of a low interest rate environment. As such, many are drawn to the higher returns being offered by retail bonds that are issued by household company names such as Fonterra, Auckland Airport and Tower. They perceive these bonds to be the ideal solution to their investment income needs in these difficult times.

Given that corporate bond defaults in New Zealand are expected to rise over the short to medium term, this is likely to produce investment outcomes for which few investors are prepared. An investment in corporate bonds is not without risk, and investing in companies purely on name recognition is not a prudent strategy. History shows that there have been a number of well-known (and, at the time, supposedly safe) New Zealand companies that have failed, causing equity and bondholders to lose their capital – for example, Feltex, Fortex, Skellerup and DFC.

Corporate bonds are a valid component of a well-diversified portfolio. The proviso is that, before they are purchased, each bond issue must be properly researched. Furthermore, the allocation to corporate bonds should be actively managed so it can be quickly traded should a particular bond become troublesome. Your typical investment manager can add value in the current environment by managing your corporate bond allocation in the following manner:

- 1) Investing only in the higher-rated ('A' and above) investment grade bonds. This limits the likelihood of one of these bonds becoming a 'Fallen Angel', where in a move from investment grade to non-investment grade there is a negative impact on the price.
- 2) Focusing on companies that operate in defensive sectors and are, therefore, less affected by a downturn in economic activity. Defensive sectors include telecoms, utilities and food retailing.
- 3) Conducting a detailed credit analysis. This process focuses on: a) the company's existing debt burden; b) the maturity profile of the company's debt and refinancing risk; c) the company's ability to meet its interest payments; d) its future capital expenditure requirements and commitments; and e) the company's earnings stability.
- 4) Considering the structural aspects, as not all bonds are created equal. Is it senior debt, subordinated debt or 'pseudo equity'? Is it secured against the assets of the company, or is it unsecured? Which entity is borrowing the money – the operating company or a finance arm? Does it have a defined maturity or not? Is the interest rate fixed or floating? If the interest rate is floating, how often is it reset? Does it have change of control protection?
- 5) Actively managing interest rate risk. In the current environment, companies are looking to lock in low interest rates. However, investors are taking on the risk that interest rates may move higher in the future. Although interest rates are likely to remain low for some time they will probably rise over the life of the bond. This may lead to a mark-to-market capital loss being incurred by an investor seeking to sell the bond. By actively managing interest rate risk, the investment manager allows investors to benefit from interest rate falls while also mitigating the effects of interest rate rises.

Interesting facts: New Zealand better placed than most

New Zealand was relatively better placed entering the recession than other advanced countries due to:

- Strong economic growth in the 10 years to 2007. As a result, New Zealand experienced low unemployment and a strong fiscal position.
- The Reserve Bank's monetary and fiscal policies that, while they can't insulate us, are likely to lessen the impact of the recession.
- High interest rates which the Reserve Bank could lower. More than in some countries, the rate cuts have flowed through to mortgage rates and provided economic stimulus.
- A sound and well-capitalised banking sector. The large Australian banking groups, of which the major New Zealand banks are a part, are now among the largest and highest-credit-quality banks in the world.
- Low Government debt. The average advanced country is starting with [government] debt of around 80 percent of GDP. New Zealand's gross debt is around 20 percent and in net terms it has positive financial assets.
- Foreign debt is largely hedged. Banks are almost entirely - and corporate borrowers are very largely - hedged against foreign exchange risk.
- New Zealand's freely floating exchange rate. This is an important buffer against the current, internationally sourced, shock. It cushions the incomes of exporting sectors and encourages the reduction of national debt.

Sources: www.stuff.co.nz, www.rbnz.govt.nz and www.nzherald.co.nz

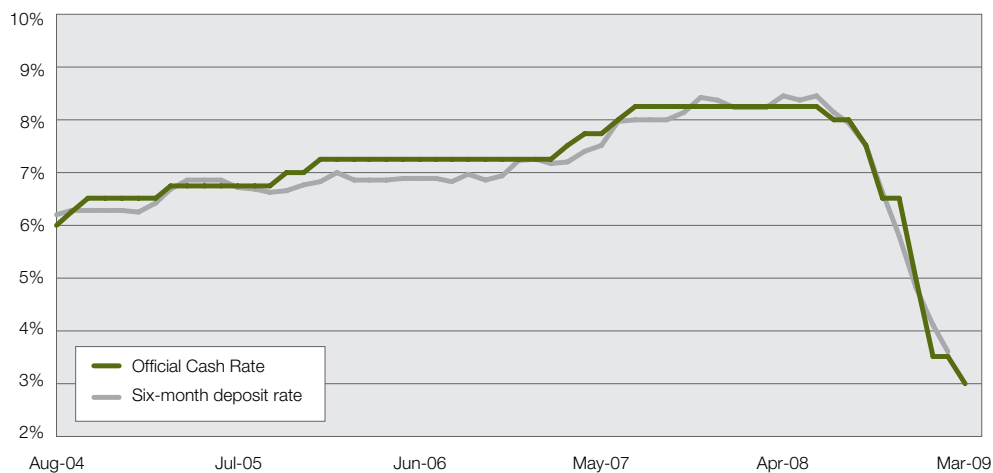
The investor's conundrum

"The mindset of investors simply switched from 'Now we are going to have high returns forever' to 'Now we are going to have low returns forever'."

– Meir Statman, Financial Physicians

New Zealanders are faced with term deposit rates that have halved over the past six months. Six-month term deposit rates peaked at around 8.5% in mid 2008, but have fallen dramatically to around 3.5% in February 2009.

Official Cash Rate (OCR) vs six-month deposit rate



Source: Bloomberg, RBNZ

As a result, investors are now experiencing the following challenges...

- People who have lived within their means and prudently put money aside for the future are wondering how to preserve capital in the current environment.
- Those heading for retirement face the complex calculation of how much they need and what return they can expect.
- Lower interest rates are forcing those in retirement to spend less.

For example, a retired investor will need double the capital value to maintain their after tax interest income.

Year	Capital value required	At an interest rate of	To earn after tax interest income of
2008	\$300,000	8%	\$20,000
2009	\$600,000	4%	\$20,000

Where does this investor get the additional \$300,000 from to maintain their income? Or can they live off half their income from the previous year?

So what is the answer?

- There has never been a more opportune time to seek advice from your financial adviser to review your current situation and help you plan for the future.

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A Disclosure Statement is available upon request and free of charge

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