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Welcome to the Autumn Edition of PAN News

We have some interesting investment ideas to share with you and in this edition we offer some insight on diversification, the new investment tax regime and investing in gold.

History has shown that sound investment strategies lead to better investment returns over time and this year will be no different. Risk management is a fundamental principal of successful investment and diversification is a part of this. It's important to diversify your investments by asset class and the closer you get to retirement the more widely you should spread your savings. This mix of asset classes offers protection from the volatility in any one asset class in any year, reducing your risk and positioning your portfolio for better returns.



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10 minutes on diversification that will change your retirement

Over the past two years investors have lost significant wealth through finance company defaults. The outcome is unfortunate to the extent that much of the loss was avoidable.

These investors made one big mistake. They have failed to diversify across different asset classes. Diversification within an asset class, such as investing in a number of finance companies, only protects an investor from isolated cases such as fraud or bad management. Typically, when a sector has problems, all participants in that sector suffer.

Diversification is usually the first rule any investor learns, but it also the most misunderstood. Owning a portfolio of several different corporate bonds is not a diversified investment strategy. In the future, should inflation re-emerge, such a portfolio may well look as imprudent as a portfolio of finance company debentures looks today.

So how should an investor construct their portfolio to avoid this failure? The first rule in constructing an investment portfolio is that you should choose assets that do not always move in the same direction. The future is uncertain and a portfolio should be able to weather most eventualities. A typical portfolio will therefore include cash, fixed interest, shares, property and commodities.



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There are also some more esoteric asset classes such as antiques, art or historic items. These may have a place in an investor's portfolio, but it is important that the buyer fully understand these assets prior to investing in them.

Over the long term, riskier asset classes such as shares are expected to achieve the best return. However, this long-term investment horizon can be for an extended period of time. For example, over the past 10 years global shares have returned around -1% per annum, predominantly because 10 years ago global shares were overvalued. The fact that an asset class can experience such a long period of underperformance highlights the importance of having different asset classes in a portfolio.

It is also important to recognise that asset classes will perform differently depending on the circumstances. The past 20 years have been characterised by the Reserve Bank single-mindedly targeting a low rate of consumer inflation. During this period of low inflation bond investors enjoyed strong returns. But targeting a single inflation rate is unlikely to be the only focus of the Reserve Bank in the 'post financial crisis world'. The Banks' mandate is likely to be expanded to cover banking regulation, asset inflation and economic stability — consequently inflation may be the lesser of two evils.

This is why real assets such as listed property and commodities are an important diversifier in an appropriately constructed portfolio.

In the 1970s, for example, bonds performed very poorly as inflation significantly eroded their value. Interestingly, returns from most types of shares were also lacklustre as economic growth stalled and governments applied price freezes in an attempt to control inflation. However, commodities performed strongly. Over the 10 year period from 1970 to 1979 commodities rose in value by 586% or 21.2% per annum.

But what are commodities? A commodity is a physical substance, which is typically used in the manufacture of goods or foods. Commodities include wood (forestry), oil, industrial metals (for example copper), precious metals (for example gold) or food basics (such as grain or sugar).

Commodities can either be held directly such as forestry partnerships or via diversified baskets. Interestingly, unlike shares, no one commodity has ever significantly outperformed its peers. Gold is one commodity which has recently gained significant prominence, but its performance during the deflationary 1930s and inflationary 1970s was no better or worse than any of the other commodities such as oil, sugar or copper.

The most common way portfolio managers gain exposure to commodities is via the futures market. One of the main advantages of this market over the physical market is that you do not have to arrange storage for the asset. Commodities are bought and sold, but with a future delivery date. Prior to this delivery date, the contract is moved out to the next delivery

date so that settlement never actually occurs. The last thing a portfolio manager wants is have to arrange for the storage of oil or perishable food commodities.

A portfolio should have around 5% to 15% of its financial assets in commodities. For example, the New Zealand Superannuation Fund had 12.9% in commodities and forestry as at November 2009. Its forestry allocation of 7.5% is arguably too large for a private investor, as the Superannuation Fund has a much longer investment horizon.

As noted, in the 1970s commodities returned 21.2% per annum. A 10% exposure to this asset class at the expense of cash or fixed interest would have improved portfolio returns by around 2% per annum. To put this in context, it could be the difference between an 8% or 10% per annum return for the decade. A \$100,000 investment would turn into \$216,000 if it returned 8% but \$260,000 if it returned 10% — an improvement of \$44,000 or 44% of your original investment.

So how can a private investor get access to commodities? For investors in KiwiSaver or managed funds it is important that their portfolio has an allocation to commodities. A KiwiSaver fund without this allocation risks significant underperformance, should fixed interest or shares produce 1970s-like returns.

A 'do it yourself' or DIY investor is also able to access a diversified basket of commodities by buying an Exchange Traded Fund such as the iShares GSCI Commodity Indexed Trust. This can be bought and sold just like any share.

A diversified portfolio should be diversified across different asset classes and include not just financial assets such as fixed interest or shares, but also real assets such as property and commodities. Only then will the portfolio be able to weather all possible eventualities.

10 minutes on tax that will change your retirement

One of the least understood aspects of KiwiSaver is the entirely new tax code that was designed to go with it. After returns, the level of tax investors pay is the single biggest determinant of how quickly investments grow. In fact, tax should be considered just as important as returns because investors cannot work out what their return is going to be until they have estimated their tax.

Tax complexity is itself a kind of tax. Most investors find tax too confusing to unravel, and as a result, pay far more tax than is necessary over their lifetime. However, all that investors need to know about New Zealand's new investment tax regime can be explained in a paragraph or two.

All KiwiSaver providers are required to use Portfolio Investment Entities, or as they are commonly known, 'PIEs'. All investors fall into one of four PIE tax brackets, which from 1 April 2010 have been set at either: 0%, 12.5%, 21% or 30%. Depending on an investor's personal income level, they must nominate a bracket. Importantly, no investor, irrespective of how much they earn personally, need pay more than 30% tax on their investments. In fact, as the PIE tax rates are so attractive, it is not just KiwiSaver providers who are using PIEs but many banks and managed funds as well.

What is less understood is that the tax rules for each of the major asset classes have also been changed. Investors will know all too well that the attractive looking interest rate advertised in the window of a bank, or when buying a bond is not the rate they receive after investing for a year. This is because tax must be subtracted. But how many investors are aware that if they invest in shares, or New Zealand listed property, they pay little or no tax at all?

This means investors need to consider both the merits of the asset class they are investing in – such as term deposits, bonds or shares – as well as the amount of the return which is taxed. The following table brings the PIE tax rules together with the different tax rules that apply for each type of investment. It is a helpful summary of all that investors need to consider when determining what their after tax-return will be.

How PIE tax rules and the tax rates for different types of investments are combined

Type of investment	What is my expected tax?
Term deposits	Income x PIE tax rate.
Bonds	Income x PIE tax rate.
New Zealand shares	Capital gains are exempt and most dividends are covered by tax the company has already paid (called imputation credits).
New Zealand listed property	Capital gains are exempt and most dividends are covered by tax the company has already paid (called imputation credits).
International shares	Tax calculated by taking 5% of the value of your international investments multiplied by your PIE tax rate.
Commodities	Tax calculated by taking 5% of the value of your international investments multiplied by your PIE tax rate.

These different tax treatments mean that the after-tax return from an investment can be quite different from the before-tax return. Comparing before-tax returns could result in an investor making the wrong investment decision. For example, let us assume that a bond, a New Zealand share and a global share all return 8.0% before tax. Does this mean they all return the same after taking into account tax? No.

An investor on a 21% PIE tax rate would receive 6.32% from the bond investment, 8% on the New Zealand share

investment and 6.95% on the global share investment. It is these returns that an investor should be focusing on.

How might this change New Zealanders' investment decisions? As a nation, New Zealand has always enjoyed higher than average interest rates, which has historically made bank deposits an attractive investment. We have been further discouraged from investing in assets which grow over time because, until the new tax regime was introduced on 1 October 2007, almost all managed funds were taxed at 33%, even if investors in those funds were on personal tax rates of less than 33%! But most significantly, the new tax regime means that investors who play it safe (and therefore have a large allocation to cash and bank deposits) end up paying way more of their return in tax.

Over time, having to pay additional tax can lead to very different financial outcomes. Historically, there has been little financial incentive to weather the ups and downs that come with shares and listed property. Before taking tax into consideration, over the past 20 years, three-month term deposits have averaged 7.5% per annum. Over the same period, New Zealand shares have earned investors 7.2% per annum, New Zealand listed property has earned 7.0% per annum. But, when the new tax regime is applied the numbers change significantly. After tax, returns from three-month term deposits would be only 5.9% per annum, whereas New Zealand shares and listed property would have returned 7.2% per annum and 7.0% per annum.

The latest¹ KiwiSaver statistics show that 82% of KiwiSavers are less than 55 years of age. Even a 55 year old KiwiSaver investor has a life expectancy, and therefore investment horizon, of between 20 to 30 years. Yet, surveys show that just over a third of KiwiSaver allocations are toward conservative default allocations that are predominantly invested in assets such as cash and bonds (which attract the highest tax rates). Many investors would benefit from reconsidering the mix of assets they are exposed to. Over a 20-year period, the difference between average term deposit returns (after tax) and average share market returns (after tax), for a 30% PIE tax investor, is almost a third more capital to enjoy in retirement. Death maybe inevitable, but paying a high level of tax on your investments and being miserable in retirement is not.

Gold - the full story

Every five or ten years a new investment class emerges and we pinch ourselves for not having invested earlier. Everyone sees the risks of the new and popular investment as being relatively low compared to the upside. Or so they think.

Take today's most sought after investment, gold. Gold is permanent and indestructible. There is also the reassuring thought that it has been a currency and store of wealth for centuries. Its total above ground supply is a mere 150,000

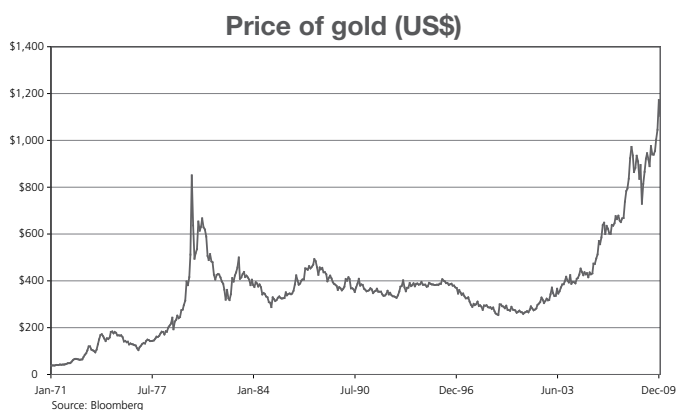
(1) Source: www.kiwisaver.govt.nz, as at 30 November 2009

metric tons. Every year the gold that is mined only increases the total amount of gold in the world by 1.5%, making supply essentially fixed.

Perhaps then the question we should be asking is why not have everything in gold? To answer this question it is essential to gain an appreciation for what happened to gold investors the last time it was in vogue.

Prior to 1971, most currencies were either freely convertible into gold or United States dollars (which in turn were convertible into gold). Central bankers had to theoretically purchase additional gold each time a bank note was printed. Unsurprisingly, the supply of United States dollars in circulation remained relatively constant, as did the price of gold. However, in the mid 1960s the United States became embroiled in a costly and prolonged war – not on terror, but communism.

By the early 1970s, America's borrowing had ballooned. To repay its debts, President Nixon decided to print additional dollars. In order to do this he needed to revoke the right to convert United States dollars into gold. It takes billions of years to make an ounce of gold or a barrel of oil, but now there was nothing stopping the United States government printing a billion dollars overnight. The result was a highly inflationary environment in which gold soared from US\$35 to US\$850 an ounce. Meanwhile, the return from alternative investments such as shares and bonds collapsed as companies struggled with the ever-increasing cost of goods and labour. But the reverse was also to hold true.



In the years following the Fed's decision to control inflation, under Chairman Volker, real investments with earnings, innovators, tenants, plant equipment and dividends rose sharply in value while gold plummeted. In the twenty years following 1980, \$100 invested in gold was only worth \$32, whereas \$100 invested in global shares had grown to \$1,350.

And therein lies the problem with gold. Other than for its intrinsic beauty, gold is a good investment when the printing

presses are whirring or during rare moments of investor panic, which are fleeting. As gold does not earn or yield anything, over the long term it does nothing more than preserve investors' capital against inflation.

Furthermore, its lack of earnings or yield makes it notoriously difficult to value. Nowhere on an ingot does it promise that the price will not fall below US\$1,000 an ounce again. Neither is it a haven of stability. Since 1971, the price of gold has been more volatile than the share market. Lastly, there is the additional complication of gold being valued in United States dollars. For New Zealand investors, much of gold's strong returns in 2008 actually came from the New Zealand dollar dropping in value against the United States dollar. Since 2009, our currency has risen sharply against the greenback, significantly diminishing investors' returns.

The market for gold in the short run is a voting machine requiring money, not intelligence. There is a risk that this short-term voting machine has got ahead of itself, making gold a 'crowded trade'. But in the long run all markets are weighing machines. The more money printed to restart the global economy or repay excessive government borrowing, the higher gold will levitate.

The coming decade may see an unprecedented rise in inflationary pressures from which gold stands to benefit. What we are seeing in gold's price today is the increasing tension between the rapidly depreciating value of paper money and term deposits, and the scarcity of physical assets, be they listed property, monopolistic utility companies or ounces of gold.

There is also the wild card that central banks in emerging markets such as China, Korea and Brazil, which hold less than 2% of their foreign exchange reserves in gold compared to developed nations' 70%, decide to increase their ownership.

Today's investors are stuck between bullion and a hard place. Physical assets such as mortgaged property, shares and commodities are likely to be more volatile than what most New Zealanders in their retirement would feel comfortable with. On the other hand, inflation is an imminent threat to investors who hold their lifetime savings in cash. Gold alone, alluring as it seems, is not the solution.

Investors should instead use it as one component of their retirement strategy, limiting the size of the investment so as not to become a panic-stricken seller in the event of a pullback in gold's recent run-up in price. More sophisticated investors may want to wait for just such a price correction to buy gold or invest in listed, blue-chip mining companies (which incidentally are a way of enjoying both a dividend yield and the rising price of gold).

**For more information and investment research refer to our investment manager's website
www.nzfunds.co.nz**