

Market Commentary

NZFUNDS

GLOBAL SHARES ARE UP 70% SINCE MARCH 2009 SO WHY ARE INVESTORS FEELING DOWN ?

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New Zealand Funds Management's CIO, Michael Lang, explains what he calls the "ugly maths of finance".

Many people don't understand why they are still in a deep hole, even after they have had a year of great returns. At fault is New Zealanders' unhealthy obsession with short-term investment performance and the corresponding risks the investment industry take to participate in it.

Global investment markets are enjoying the largest bounce ever recorded with the NZX50 Index up over 20% since its March 2009 lows and global share market up by more than 70%. Media and the investment industry alike have responded by advertising outsized and short-term investment gains. The inference is that this is a measure of investment skill and should be used when making long-term investment decisions.

The truth is that, for most New Zealanders, it is more important that they avoid big losses than enjoy big gains. This is the ugly maths of finance. Many of us have never heard of it before because it is always sexier to market how much a portfolio is up than it is to market the fact that a portfolio has not suffered a big decline.

Suppose your portfolio showed a 50% gain over the past year. Normally, this would be grounds for celebration but for most people the ugly maths of finance dictates otherwise. The vast majority of New Zealanders who participated in big returns in 2010 also participated in big losses in 2007, 2008 and 2009.

During the Global Financial Crisis, the international share market fell 54% when measured in local currencies. In finance, if your portfolio drops by 50% in value during a bear market, you need a subsequent gain of 100% just to get back to where you started.

As the maths get worse, the more volatile your investments become. The larger the drop, the larger the subsequent gain you need. A 75% fall requires a staggering 300% rise – something which may not occur during an individual's lifetime.

Decline	Recovery required
-10%	11%
-20%	25%
-25%	33%
-30%	43%
-40%	67%
-50%	100%
-60%	150%
-70%	233%
-75%	300%
-80%	400%
-90%	900%

The table above illustrates the importance of minimising losses in the first place. Some investors may only be enjoying modest gains, but if their portfolios did not collapse in value in 2008 and 2009, those gains will immediately go to increasing wealth rather than toward repairing losses for years to come.

The problem is compounded by two important variables the New Zealand investment industry is just coming to grips with: behavioural economics and risk management (or a lack thereof).

Behavioural economics gained prominence in finance when Professor Daniel Kahneman was awarded the Nobel Prize in Economics in 2002 for his work comparing investor's decisions with (what was logical mathematically) the optimal choice. His research uncovered that people base their decisions on what has just happened, not on what is about to happen. Yet it is what is about to happen that affects their wealth.

There is considerable evidence to show that people put money into funds after they have risen, and not when returns are flat or negative. There are two problems with this. Firstly, most investors enter after the initial rise and so they miss out on much of the reported return. Secondly, common sense tells you that something that has just gone up 70% is now more expensive (and is therefore more risky!), not the other way round. Should the fund then fall, the investor will experience all of the losses. This is the price they pay for trying to chase last year's gains.

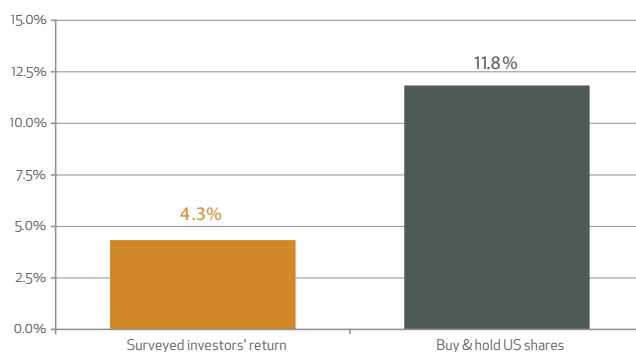
The risk associated with investing in funds capable of delivering spectacular short-term returns is then compounded because few investment managers actually seek to manage share market risk.

Most investment managers use what they term an active investment approach, but in reality they are focused on which shares to buy, rather than whether to buy shares at all. This is because they are required to follow an investment index such as the NZSE50 Index. This restricts them from making decisions such as holding only cash or bonds if there are no attractively priced shares to buy, or from hedging investors' exposure to shares if the market behaves irrationally and collapses in value as occurred in 2007, 2008 and 2009.

New Zealanders, who choose funds based on short-term performance are likely to have an "Alice in Wonderland" type experience. The short-term performance is likely to disappear during the next market downturn, leaving them with nothing but a picture of their fund manager grinning like the Cheshire cat.

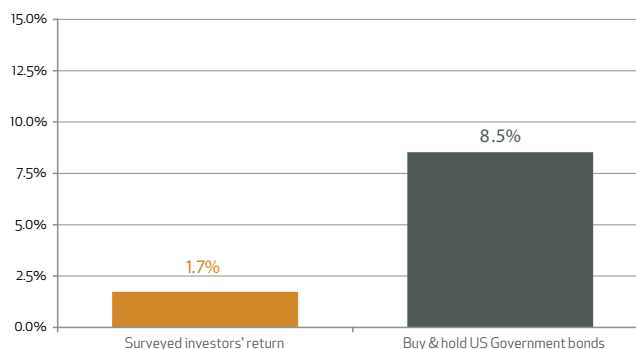
Investors should look for funds that have successfully compounded clients' wealth over long periods of time – in excess of ten years – and that have done so without delivering a rollercoaster ride. Looking at historical returns for each calendar year, rather than using an average return since inception, is particularly helpful for determining the smoothness of the ride. If value has been consistently added, and big losses avoided, then an investor's returns will be determined less by when they entered the fund and more by the time they spent in the fund.

SHARE MARKET 20-YEAR RETURNS (from 1987 to 2006)



Source: 2007 Dalbar QAIB Report. Returns shown are per annum.

GOVERNMENT BONDS 20-YEAR RETURNS (from 1987 to 2006)



Source: 2007 Dalbar QAIB Report. Returns shown are per annum.

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