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In this quarterly report we feature:

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- Asset class returns
- Finance Company sector – credit risk exposed
- Irrational Exuberance – 10 years after Alan Greenspan coined the phrase ‘irrational exuberance’ what returns have the markets delivered to investors.
- Benchmark graphs

## Volatility is back

After the strong 1<sup>st</sup> quarter, international capital markets continued to climb aggressively through April and in early May. May marked the peak of the recent rally, as markets exhibited large swings in value. The volatility was most seen in the emerging market category and spread across the headline world indices. With portfolios down across the globe, returns from offshore assets were boosted by a further fall in the New Zealand dollar – particularly evident in comparison to the Australian currency where the New Zealand dollar depreciated 4.6%. Accordingly the June quarter completed with flat rather than negative results for all but the most aggressive portfolios.

Lessons from the recent volatility:

- Fluctuation in equity asset values is best seen in context: ‘the short term downs are the price of the long term ups’. Long term consolidation is around a trend line that inclines skyward in keeping with economic growth. The long term positive return on capital, represented by the investor ‘equity premium’ is fundamental feature of capital markets. Capitalism would not work any other way.
- Never be swayed by sentiment. Ignore the media headlines that amplify any downward fluctuation by phrasing it in terms of \$’s wiped off asset values – the downside in percentage terms is usually far less dramatic
- Keep to the plan – if you make regular contributions to your portfolio, then keep going – any temporary reduction in asset values represents increased purchasing power. It can be likened to buying new assets at sale prices with your new funds.

The flat quarter is less significant in the context of the fantastic growth exhibited over the relatively short timeframe of the past 3 years as seen in the table of returns below. The feature article *Irrational Exuberance* on page 4 helps to put the market volatility of the past decade into context.

## Asset Class Returns

Returns in New Zealand dollars for key asset classes we track, and which form the core of most client portfolios, are as follows:

<b>NZD Returns to 30 June 2006</b>				
	<b>3 months</b>	<b>1 year</b>	<b>3 year</b>	
Australian Large	4.8%	37.9%	25.8%	p.a.
Australian Value	2.1%	34.7%	30.0%	p.a.
Australian Small	3.0%	38.2%	29.7%	p.a.
Global Large	0.3%	34.0%	15.0%	p.a.
Global Large (NZD Hedged)	-2.0%	20.1%	19.7%	p.a.
Global Value	1.6%	40.3%	22.5%	p.a.
Global Small	-3.5%	38.5%	22.7%	p.a.
Emerging Markets	-5.9%	46.5%	29.3%	p.a.
NZ Equity Portfolio	3.3%	21.9%	22.9%	p.a.
NZ Property	7.1%	20.5%	17.9%	p.a.
DFIT International Bonds (NZD Hedged)	1.5%	3.7%	n/a	
CDO International Bonds (NZD Hedged)	n/a	10.4%	9.2%	p.a.

The returns in the above table bear tangible evidence that **Asset Class investing works**. The markets themselves offer huge opportunity for diversification and will deliver great returns over time. The benchmark graphs that are appended to this report demonstrate the long term returns of asset classes against benchmark indices.

Regrettably most traditional investors will not have experienced investment performance at anything like the above levels. Poor performance, relative to the returns delivered by the broad capital markets, is typically explained by two fundamental and common mistakes:

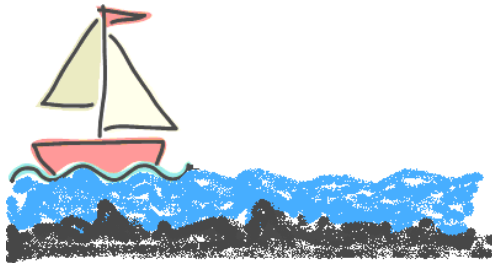
- Attempting to time entry and exit from the market; and
- Concentrated stock selection, and inefficient trading (or churn) of concentrated positions, rather than effective diversification.



**Is the tide going out on finance company sector?**

The recent collapse of National Finance and Provincial Finance, and the warnings of further finance company difficulties, provide an apt reminder of the importance of managing credit risk. In a sense the tide has gone out with respect to the economic conditions that supported a massive expansion of indebtedness in some sectors.

There has been a proliferation of finance company debt issues during the past few years of economic growth and relative prosperity. The temptation for investors has been to chase higher yielding debt instruments usually accepting debenture security against the issuing finance company. Little attention has been paid to the credit worthiness of finance companies and the lending that investor funds have supported. That is the 'credit risk' inherent in the investment.



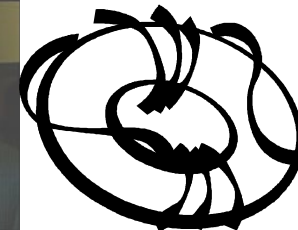
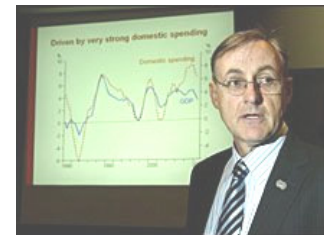
Credit risk with fixed interest securities can be likened to a boat sailing along above the rocks on the seabed below. Above the waves one is relatively unaware of the risk and danger of the rocks below. That is until the tide goes out – usually signalled by a change on economic circumstances - exposing the danger of the rocks below (the credit worthiness of the underlying investments).



**The warning signs have been evident...**

In May KPMG published a survey on the multi billion dollar finance company sector noting the astounding growth in deposits and lending fuelled by the property led economic spurt. Of the 49 finance companies surveyed whose assets exceeded \$50 million, there had been growth of almost 30 per cent in lending for property development and commercial finance and almost 20 per cent for consumer finance. The motor vehicle finance sector that has been at the root of the National Finance and Provincial failures grew at a more modest 4 per cent in the year of the survey. Concern remains with the heavy lending to property developers by finance companies that further problems may be pending as the industry fees the effect of economic tightening.

Reserve Bank governor Alan Bollard made the cautionary statement in May that that *“a combination of rapid growth and comparatively young institutions made part of the finance company sector vulnerable to a worsening economy”*. There is no life line for investors to this sector – in fact unlike registered banks, there is no prudential supervision from the Reserve Bank of finance companies.



Standard & Poors credit analysts are quoted in June as believing that more finance company failures are expected to follow the collapse of Provincial Finance. Subsequently Western Bay Finance is reported to be in talks with a 'white knight' rescuer willing to inject enough money to stave off a receivership. Finance industry observers say Western Bay's difficulties appear to have stemmed from lending on low-value cars, as was the case with Provincial Finance and with National Finance.

More than 15,000 investors nationally now face uncertainty over almost \$400 million in debentures issued by the three abovementioned finance companies, raising fears of a wider rout in the industry.



### ***Vested Interest vs. Independent Advice***

It is worth noting that we do not recommend finance company securities to clients. This is due to the prudent policies that guide all our asset allocation decisions, and the fact that we are positioned to take an objective and completely independent view of securities to optimise client portfolios.

Tragically many investors who will lose money with the collapse of National Finance and Provincial were advised into this lending by brokers and others in the loosely defined category of 'financial advisers'. In fact the favour shown by those who recommended many finance company securities bears a strong correlation to the percentage commissions they receive from the companies themselves for this support. Almost \$10 million in investor funds poured into failing Provincial Finance after it withdrew its prospectus in April, raising questions about the competence of some financial advisers.

This underscores the worth of ensuring the financial advice is you obtain is independent and satisfies a number of key questions for your peace of mind.

The Axiome website ([www.axiome.co.nz](http://www.axiome.co.nz)) has a section entitled "Knowledge is Power" that includes a checklist for successful investing. This encompasses the standards that we suggest all investors should measure service and performance against. One of the key themes is 'Accountability and Performance' and includes the following questions:

- Are you receiving value?
- How transparent are the fees and do you know the true costs?
- Have you identified any embedded and typically undisclosed elements?

We reiterate that we do **not** receive remuneration from any source other than as contracted directly with our clients. We have no vested interest and receive no financial incentive (from commissions or soft dollars) in recommending any particular investment for our clients. Our sole duty of care is to our clients.

### ***Principles for Fixed Interest investing:***

The stress in the finance company sector provides a timely reminder of the guiding principles for a successful investment experience with fixed income products:

- Risk & return are related – there is always added risk associated with seemingly attractive interest rates.
- Beware of advertising. Only months before collapse, National Finance launched a prime-time ad campaign to seduce potential investors with an offer of 10% debenture stock. Similarly, Provincial had heavily advertised on television using Colin Meads to garner their offering with a sense of integrity and solid respectability. Many older people are reported to have been swayed to invest due to the endorsement of Colin Meads.
- The level of increased yield from higher risk bonds and fixed income securities is often not commensurate with the added risk exposure – risk should be added to a portfolio in line with each client's risk tolerance, investment objectives and individual circumstances.
- Take risk you get rewarded for – that most often comes from exposure to company shares or 'equities'. Fixed interest securities and shares complement each other when structuring a portfolio and in combination can reduce the overall risk of the total portfolio. Capital notes and preference shares are examples of financial products that expose the investor to equity risk whilst capping the returns. Equity risk should entitle the investor to the compensating equity premium in return.
- Get independent advice. Ensure you know who is getting paid – our total revenue is solely by direct contract between us and you as our clients.
- Know the credit worthiness of your investment. We recommend that clients only consider investment grade bonds.
- Diversification is essential. There is no pay-off by way of higher returns from taking concentrated positions with one issuer. Diversification is most readily achieved by accessing appropriately rated bond funds.





### Irrational Exuberance - 10 Years of Asset Class Returns

At a black tie dinner in Washington on 5 December 1996, Alan Greenspan, chairman of the Federal Reserve Board, posed a rhetorical question:

*“But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?...”*

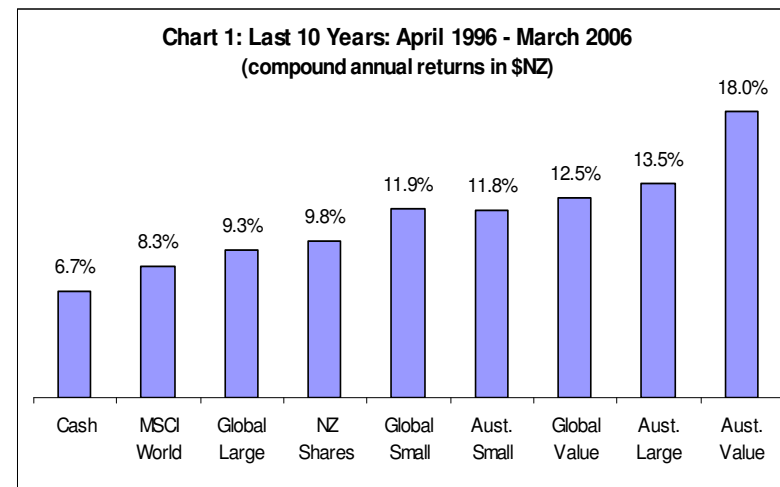
Immediately after this speech the Tokyo stock market fell 3%, Hong Kong 3%, London 4% and 2% in the US.

In July 1996, Yale professor Robert J Shiller, Ph.D. analysed the US market using various dividend, earnings and price ratios – he warned of an overheated US market and advised *“it appears that long run investors should stay out of the market for the next decade”*<sup>1</sup>. In December 1996, in testimony before the Board of Governors of the Federal Reserve System, Shiller’s analysis suggested the share market was about to lose 2/3rds of its value. Shiller went on to publish a best-selling book in 2000 with the title *“Irrational Exuberance”*.

It is now 10 years since Greenspan’s most famous quote entered our language and those dire predictions were made. Many investors feel as though those predictions have come true. But did they? Further, how reliable was the chorus of predictions from a wide range of investment professionals predicting low or negative returns from shares for a prolonged period? Kiwi investors also feel that they have been hit by an appreciating currency. But was it all that bad? Let’s look at the record.

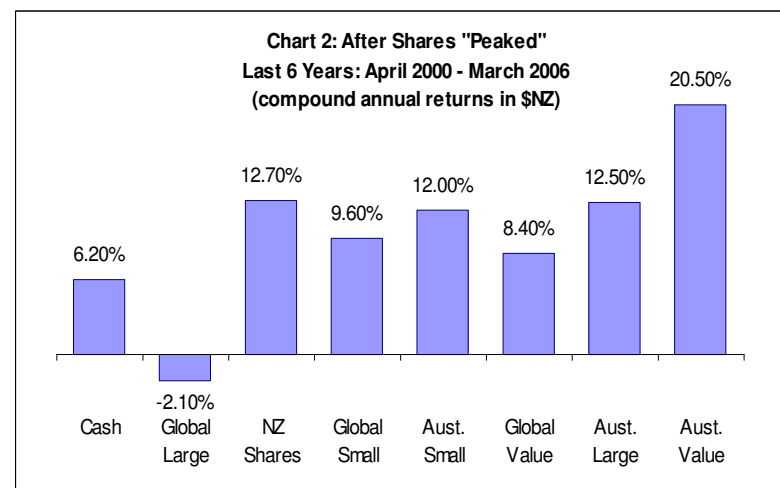
As can be seen in Chart 1, the predictions of a decade-long period of negative returns were wrong. Whilst there has been an ongoing requirement to be diversified (as not all asset classes have performed equally) any thought of exiting the market would have caused investors to miss out on very good returns. In particular, small capitalised company shares have performed largely in line with their long-term returns and Australian value shares have been a stellar performer.

<sup>1</sup> Robert J. Shiller, *Price-Earnings Ratios as Forecasters of Returns: The Stock Market Outlook in 1996.*



### The past 6 years

Now, with reference to Chart 2, let’s look at asset class returns since the share market “bubble” burst in early 2000. In NZ dollar terms, international large company shares have returned less than cash, but other asset classes have performed strongly, particularly Australian and NZ shares.



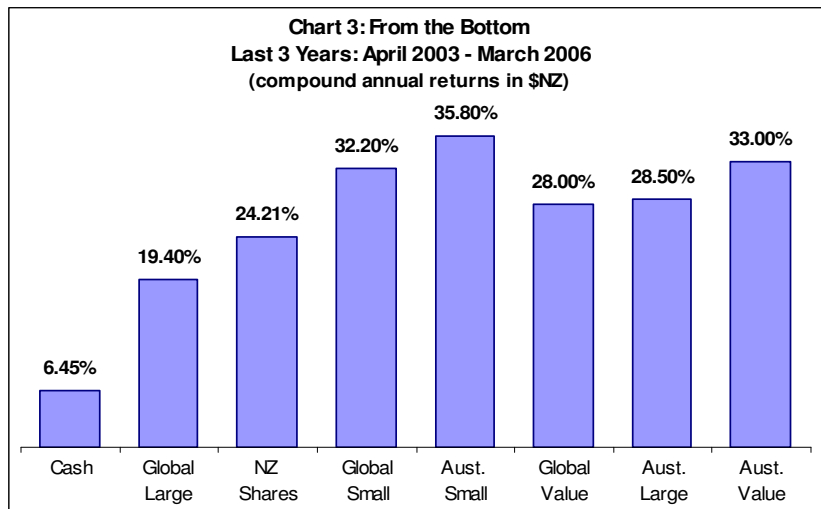


Only with 20/20 hindsight can we see 2000 as the starting point for the 2 ½ year share market downturn. Greenspan and Shiller’s warnings predated the actual decline by 3 years. The additional complexity for NZ investors was the unpredictable impact of the currency - although US markets peaked in March 2000, in NZ dollar terms the peak was not reached until October 2000.

Shiller’s analysis relied on analysis of long term P/E and dividend returns to identify expected market returns. Such analysis is common amongst many industry analysts, particularly share brokers. If it had any value as a timing mechanism, we would see some evidence of its success. Sadly (for investors acting on such advice) there is no demonstrated ability of investors benefiting from efforts to time entry to and exit from markets.

**The past 3 years**

While all the 'doom and gloomers' were scaring investors away from shares, into fixed income and 'alternative investments': companies were still selling goods and services and earning profits. Ultimately company earnings growth has lead to higher share prices.



The last 3 years (Chart 3) has been a truly stellar period for shares and no-one predicted it. Unfortunately, far too many long-term investors have not achieved anything near these returns — not because they weren’t in good index funds (although that’s certainly a factor), but because they weren’t in the market at all or significantly reduced their equity allocations based on all the ‘expert’ predictions.

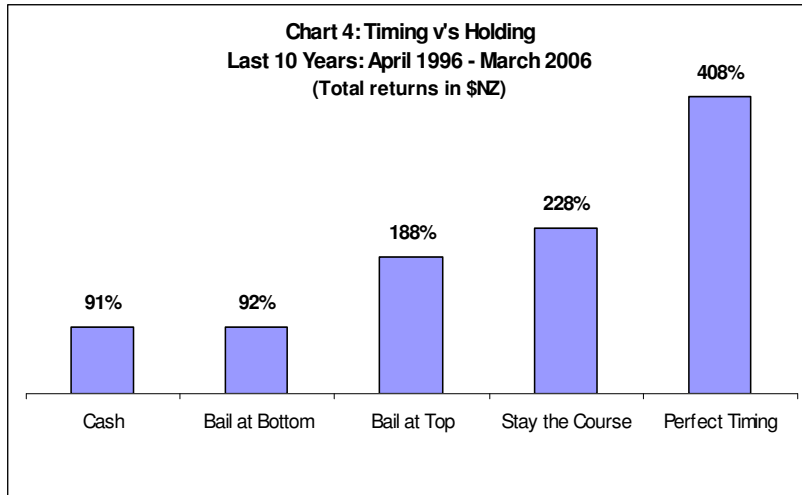
Don’t forget that the previous year (April 2002 to March 2003) had been brutal, with some asset classes declining by 40% (in NZ\$). Many investors thought the big stock party that started in 1982 was over. And much of the recovery in share prices occurred in a short period – in the 7 months from April to October 2003, some asset classes (global small cap. and Aussie value) gained more than 30%, with Australian small caps up by 48% (typical market behavior, by the way).

**What have we learned?**

Micro-analysis of markets can often be intuitively appealing but can lull investors (and advisors) into a false sense of certainty about the market’s future direction. The cost can be significant. Being in markets brings long term rewards, being out of markets can squander wealth as well. To illustrate the point look at Chart 4 below (next page), this shows the returns for a typical asset-class mix of large, value and small cap funds from the DFA suite of index funds shown in the previous charts.

The chart shows the total returns that an investor would have had in the 10 year period under a number of scenarios:

- Staying permanently in cash
- Starting out fully invested but bailing out at the bottom of the market in March 2003 and then moving to cash
- Starting out fully invested but bailing out at when the global markets topped in March 2000 and then moving to cash
- Perfect timing – starting fully invested, moving to cash in March 2001 (i.e. correctly picking the currency as well as the share market peak), then back to equities in March 2003
- Staying the course – staying invested and annually rebalancing



### Conclusion

The lessons are clear, but always need to be reinforced: **Since “perfect timing” is unachievable except by pure luck, investors are better off putting in place appropriate asset allocations based on a personal risk profile and long term objectives. After that, investors should maintain a strict buy-and-hold portfolio apart from periodic rebalancing and any changes arising from changes in risk profile.**

### Acknowledgement

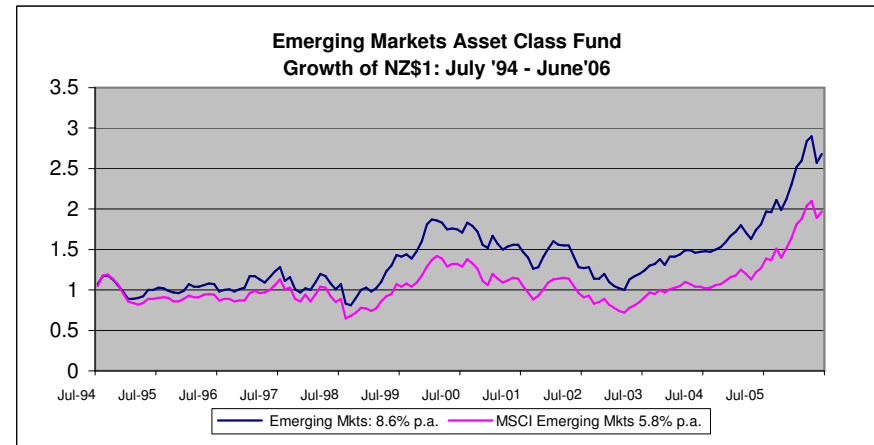
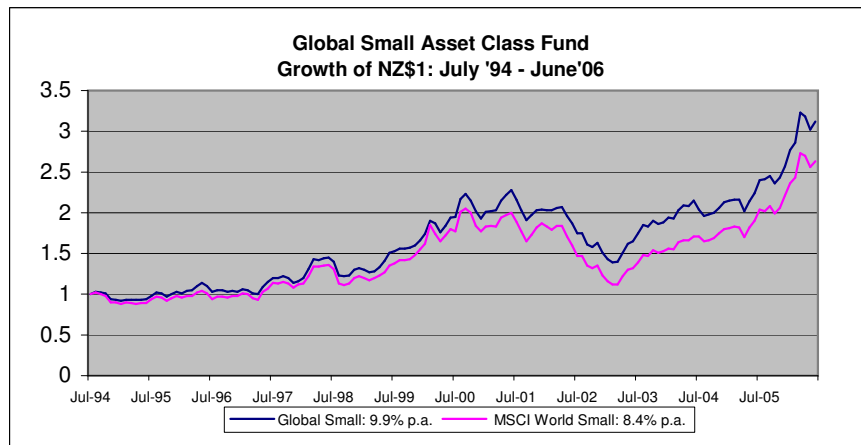
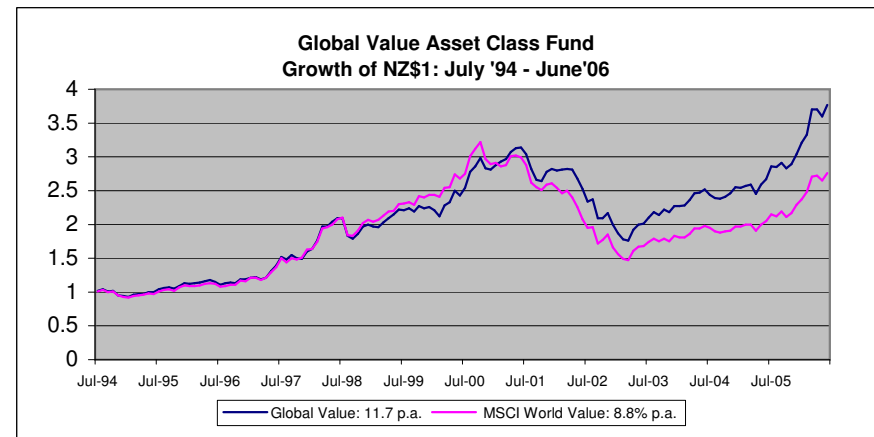
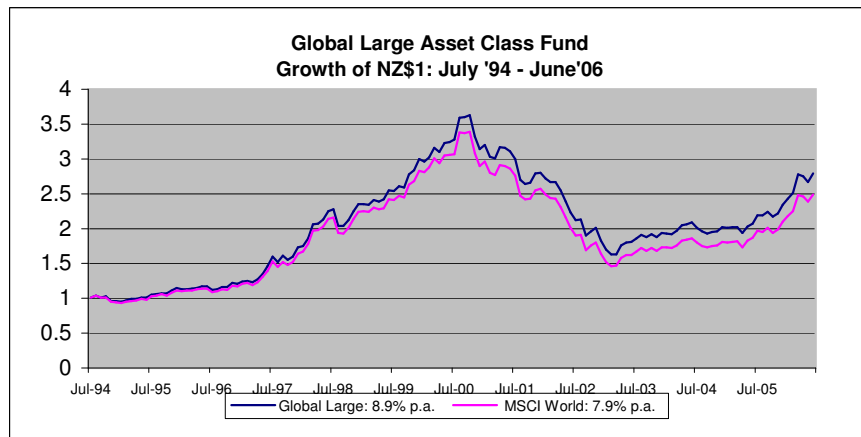
This article and analysis was prepared by *Murray Lazelle* of **Lazelle Financial Services Ltd**, an adviser working in conjunction with Axiome Consultants in Wellington.



### Asset Class Returns versus Benchmarks: July 1994 - June 2006

Each of the funds within Axiome portfolios are tracked below against academically recognised benchmarks. Individually the equity funds represent a particular dimension of the capital markets for which targeted exposure is desired - weighted according to your strategic asset allocation decision. Equity funds and benchmarks are all reflected in New Zealand dollars - unhedged. The diversified fixed interest trust ("DFIT") tracks international high grade bond yields hedged to New Zealand dollars.

These charts are significant in our transparent accountability to clients to deliver targeted elements of market risk and return dimensions. Gains over the benchmark reflect cutting edge portfolio engineering practices, not speculative concentrated bets with client funds. This contrasts with pure index managers that historically track below benchmark, and active funds that are seldom accountable to any independently verifiable benchmarks.





**Asset Class Returns versus Benchmarks: July 1994 - June 2006**

