

JANUARY 2010

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.

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.

DISCLAIMER: THIS DOCUMENT HAS BEEN PROVIDED FOR INFORMATION PURPOSES ONLY. THE CONTENT OF THIS DOCUMENT IS NOT INTENDED AS A SUBSTITUTE FOR SPECIFIC PROFESSIONAL ADVICE ON INVESTMENTS, FINANCIAL PLANNING OR ANY OTHER MATTER.

THE VIEWS EXPRESSED IN THIS DOCUMENT ARE THOSE OF NEW ZEALAND FUNDS MANAGEMENT LIMITED AS AT THE DATE OF THIS DOCUMENT AND ARE BASED ON INFORMATION AND SOURCES BELIEVED BUT NOT WARRANTED TO BE CORRECT. WHILE THE INFORMATION PROVIDED IN THIS DOCUMENT IS STATED ACCURATELY TO THE BEST OF OUR KNOWLEDGE AND BELIEF, NEW ZEALAND FUNDS MANAGEMENT LIMITED, ITS DIRECTORS, EMPLOYEES AND RELATED PARTIES ACCEPT NO LIABILITY OR RESPONSIBILITY FOR ANY LOSS, DAMAGE, CLAIM OR EXPENSE SUFFERED OR INCURRED BY ANY PARTY AS A RESULT OF RELIANCE ON THE INFORMATION PROVIDED AND OPINIONS EXPRESSED IN THIS DOCUMENT, EXCEPT AS REQUIRED BY LAW.