



Learn the lessons past assets teach

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OVER time, asset class returns tend to “mean revert”. This means that if an asset class experiences a period of underperformance, then at some point it will experience a period of outperformance. Historically shares have returned around 9 per cent per annum, suggesting they may be due for a period of outperformance. But underperformance in the noughties might simply reflect their outperformance in the nineties.

The global economy is entering the “tens” with high debt levels both at the private and public level. These debt levels are likely to constrain investment and consequently economic growth. Similarly, inflation is now a bigger risk for investors than it has been over the past decade. Governments facing debt problems may decide a little inflation is helpful in effectively devaluing the debt.

Real assets such as property and commodities tend to outperform in a high inflationary environment. However, this time residential property is entering the decade expensive, which is likely to constrain performance over the next decade.

Commodities are entering the decade reasonably cheap, having underperformed in the 80s and 90s. They are as relevant in today’s climate-conscious society as they were to the smokestack industries of yesteryear. For example, hybrid electric cars require on average twice as much copper as petrol cars, while lithium will become a key commodity

as it is used in the manufacture of lightweight batteries.

The economic recession has arguably improved the outlook for commodities as planned new investment to bring on additional supply of commodities has been postponed. This means demand could easily outpace supply in the short term, resulting in higher commodity prices.

But investing in commodities is a high-risk strategy. Commodities are one of the most volatile asset classes to invest in because supply is fixed in the short term. Any change in demand has to be reflected in a change in price.

In 2008, oil lost more than two-thirds its value as it declined from over US\$145 barrel to less than US\$50 in little more than six months. So while commodities are an important asset class they should be part of a diversified portfolio. The outlook for commodities is positive over the next 10 years but we are still likely to see price swings – too violent for the average investor to stomach.

Diversification alone is not enough to mitigate the volatility of commodities. Allocation to commodities should be actively managed. At some point this decade investors will not want to hold commodities. China is now the largest importer of commodities. If its economic growth slows prices could decline sharply.

If inflation is higher over the next 10 years then investors will be thankful if they have an allocation to commodities. But the outlook is not one way; an actively managed allocation strategy should outperform

over time and also reduce the inevitable price swings that cause so much distress to investors.

Asset classes can take 20 years or longer to “mean revert”, so when making decade projections, picking the previous underperformer is not necessarily the answer. Shares have experienced 20 years of underperformance, so a new decade may not signal a renaissance for them. However, mathematically each decade that goes by with poor returns (and there can be two decades back to back) increases the probability of a decade of very strong share returns. Investors only need one 10-year period of strong returns to make three to four times their money, thereby enjoying a much higher standard of living in their retirement.

The key is to not be financially dependent on the returns from any one asset class.

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ASSET CLASS

	Decade (1999-2009)	After Tax*
Cash	6.27%pa	4.20%pa
NZ Shares	6.19%pa	6.19%pa
Global Shares	-0.73%pa	-0.73%pa
NZ Govt Bonds	6.83%pa	4.58%pa
Property	7.18%pa	7.18%pa
Commodities	5.03%pa	3.38%pa

** Assuming 33% taxpayer and new foreign investment tax regime*

Source: NZ Funds Management