

# Market Commentary

NZFUNDS

## WHY RISKY IS THE NEW SAFE

SEPTEMBER 2011

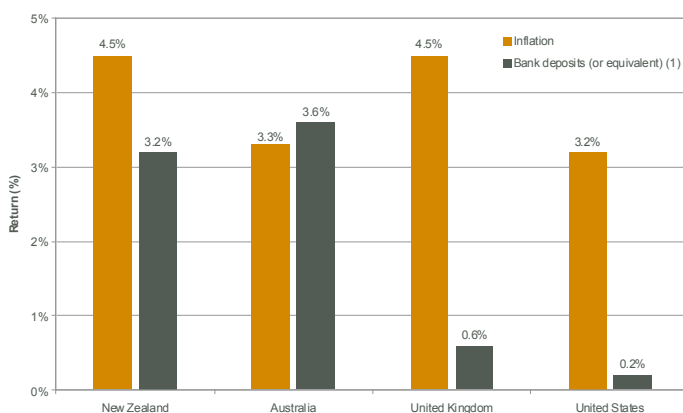
With inflation expectations at medium-term highs, baby boomers need to consider how they might live on two thirds of what they do today in 20 years' time if their investments are to stay "safely" nestled away in bank deposits, Michael Lang of NZ Funds Management explains.

The first of the baby boomers are now beginning to retire. The majority are in good financial health with their wealth the product of the multi-decade rise of domestic property.

But despite this, baby boomers now find themselves in a conundrum. Having participated in the extraordinary rise in house prices, they are freeing up their home equity for investment by downsizing their homes or relocating for retirement. This is creating their conundrum because the primary destination for baby boomers' retirement savings is cash and, in particular, bank deposits.

As global inflation gathers pace, baby boomers are being forced to grapple with a new challenge: that interest rates are now set below the rate of inflation – or 'negative real interest rates' in financial terms. This is a phenomenon that has not occurred since 1987 and it is the most insidious force undermining retirement savings today.

### COMPARISON BETWEEN AFTER TAX BANK DEPOSIT RETURNS AND INFLATION



Source: Bloomberg, NZ Funds Management calculations. Please note: (1) Bank deposit returns are estimates only based on 3-month bank deposits in New Zealand and 3-month cash returns in Australia, the United Kingdom and the United States. Returns are shown after tax, assuming a PIE tax rate of 28%.

In the first quarter of this year the Reserve Bank of New Zealand held wholesale interest rates at 2.5% despite annual inflation hitting 4.5%. In the second quarter inflation hit an annual rate of 5.3% pa and the Reserve Bank continued to hold interest rates at 2.5%.

There is a long list of compelling reasons why retiring New Zealanders are considering bank deposits to be a long-term solution for their retirement. Almost every reason has at its core the fear of a permanent loss of capital and the resulting collapse in retirement lifestyle that would inevitably follow. Unfortunately, there is an old investment adage summing up their conundrum: "Bank deposits are an ideal way to go broke safely".

This is because at the current interest rate, \$30,000 of retirement spending dollars held in bank deposits for 20 years, buy just \$23,170 worth of goods. Baby boomers with bank deposits need to consider how hard it would be to live on two thirds of what they do today. Which aspects of their life would they cut?

With eight to ten times more New Zealand wealth held in term deposits than are held in finance companies, there is a fear that real wealth erosion from term deposits may be much greater than the wealth erosion caused by the melting finance company sector - unless corrective measures are taken on a global scale to suppress today's rising inflation.

Unfortunately, bank deposits not only make for poor long term investments, they are also part of the reason why property prices keep rising. The interest on a bank deposit is largely paid by lending the funds out as a home mortgage. This cycle has driven New Zealand's property prices ever higher. It is a beggar-thy-neighbour cycle that ultimately benefits no one, other than the banks who profit from both deposits and mortgages.

In contrast, an investment through ownership of a business, or fractional ownership via a portfolio of shares and corporate bonds, results in a cycle of ever increasing profits and exports which ultimately benefits the entire nation. Little wonder then that over the long term – after inflation – returns from cash, property, bonds and shares are so markedly different.

During the last century the average return from holding a well diversified portfolio of property (assuming no debt) was 0.4% pa, whereas bonds returned 2.6% pa, and shares (which are perceived to be a risky long-term investment) earned investors approximately 6.4% pa.

Fortunately, avoiding the perceived safety of bank deposits and property for a personalised retirement plan should be much easier for future generations than it currently is for the baby-boomers. This is because the majority of New Zealanders who are following in the baby-boomers footsteps are now, thanks to the encouragement of both Labour and National Governments, investing in professionally managed retirement solutions via KiwiSaver. By the time they reach retirement they will be well versed in the long-term benefits of seeking financial advice and having a professionally managed and well diversified portfolio of assets which includes, but are not limited to, bank deposits.

Short to medium-term volatility, or the movement of one's portfolio value up and down, is the price we pay for the opportunity to protect our savings from inflation. Given time, changing saving habits should not only see individuals grow their wealth instead of having it eroded, but should also result in a more prosperous nation for us all.

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