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In the year 2009 the credit crisis turned into a global financial crisis that shocked us all. But it was also the year in which the market shrugged off a prolonged global recession and finished the year higher than it started. All's well that ends well right? Wrong. For the crisis to be over we first need to solve the symptom which caused it - namely too much debt.

For the past 20 odd years we have all been enjoying the fruits of a secular bull market and its warped our sense of reality. In 1987 interest rates in New Zealand were 16.8% pa having peaked at over 27% pa in 1985 and inflation was running at 9.6% pa. The sharemarket was in tatters and property developers and second home owners were broke.

Luckily for global investors, at the beginning of the decade the Chairman of the Federal Reserve Paul Volcker made it his mission to reduce inflation. He did this by raising interest rates to slow the amount of borrowing. In the years that followed monetary authorities around the world, including our own Reserve Bank, followed suite and forced borrowers to restrict their debt levels through high interest rates. Inflation collapsed from 9.6% pa to 1.0% pa.

With inflation under control, there was no need for 20% pa plus interest rates, so over the past 20 years interest rates in New Zealand and around the world steadily fell. As interest rates fell shares, property and commodities soared in value. Between 1987 and 2007 the New Zealand share market, including dividends, rose 5.5% pa. Property measured by QVNZ appreciated 7.5% pa, bonds returned 8.5%, while oil and gold returned 8.5% pa and 3.7% pa respectively. As Bill Gross, founder of PIMCO – the world's largest bond manager, so aptly says; "We are all children of the bull market".

But trees do not grow to the sky. As bonds, shares, property and commodities rose in value we all became complacent, borrowing far more than was prudent. New Zealanders' household debt grew from \$19 billion to \$177 billion, an eight fold increase. Income only grew by around 200% over the same period. In America between 2000 and 2007 total US credit market debt increased to five times the rate of the nations earnings. Little wonder then that US home prices soared 90% over the same period. In 2007 we reached a global "tipping point" where – despite extremely low interest rates by historical standards – we were unable to afford any more debt. The credit crisis occurred when everyone began to reduce their levels of borrowing at the same time, causing global bonds, shares and property to fall.

The only reason we have not seen 20% unemployment, soup kitchens and widespread bankruptcy is because Governments and central bankers around the world acted in a unified manner to rescue the global economy by nationalising,

guaranteeing and supporting anything and everything. It has worked up to now. Asset prices have resumed levitating. But nothing comes for free. As a consequence New Zealand's Government debt is forecast to rise from 24 per cent of GDP to 36 per cent. America's is forecast to hit 100 per cent, and the United Kingdom a staggering 120 per cent.

Since 2000 we have witnessed extreme volatility in bonds, shares, commodities and property as a direct result of our excessive borrowing. With personal debt levels unchanged today and Government debt levels rising around the world, the global economy is unlikely to resume a healthy rate of economic growth for many years to come.

As markets fluctuate between being stimulated by fiscal and monetary support and correcting as excessive debt levels are unwound, bonds, shares and property prices will continue to be extremely volatile by any measure, on both the upside and the downside. Volatility is probably the last thing the growing portion of New Zealanders who rely on stable investment portfolio for retirement want to read about at Christmas time.

INVESTMENT IMPLICATIONS

The solution is threefold. Firstly, investors should take significantly less risk with money needed in the immediate future, say in the next 5-7 years. This ensures that the capital they do invest for growth can be invested for at least one full economic cycle.

Second, New Zealanders need to learn to diversify by asset class. The closer we get to retirement the more widely we should spread our savings across asset classes. Putting all your savings into four different types of bank deposits or two different rental properties does not count. This is because the investor is still exposed to the volatility of interest rates and inflation in the case of bank deposits, or property prices in the case of rental properties. A wide mix of asset classes will help mitigate the volatility of any one asset class in any one year.

Finally, when investing in any asset class, give some consideration to managing the risk. This can be done with an investment strategy that either protects against the downside or includes expectations that your long term growth investments may well halve in value in the near future. Assuming a worst case scenario like that is likely to see investors' borrow less when investing in property, or allocate less when investing in growth assets such as shares. But it also means that when that asset class does deliver a shocking outcome the investor will be mentally and financially prepared and not feel obligated or forced to sell at the wrong time.

Benjamin Graham, Warren Buffets' tutor, survived the Great Depression using a similar strategy which he called having a "margin of safety". So, by all means invest. In fact it makes a lot of sense to put in place a plan to grow your capital faster than high tax rate term deposits. But the lesson learnt from the last 18 months is to not adjust your mindset because the economy is recovering. Given the potential for ongoing volatility in all asset classes don't forget to incorporate those three little words into everything you do: "margin of safety".

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