MacKay ON MONEY

BY FINANCIAL PLANNER CHRIS MACKAY

In my seventh form year at Hutt High, one of my favourite teachers Claire Marshall, arrived at maths class one day and proceeded to show off her newest treasure – a hand held calculator. We had heard of them and there were a few seriously brilliant maths scholars in that class who perhaps even dreamed of them. In those days the slide rule was the closest legitimate tool for cheating and working out complicated arithmetic puzzles. Engineers would have worked out load bearing factors on the Empire State Building with a trusty slide rule and a sharp pencil. No calculators for those guys. Mrs Marshall's first foray into the mini computer probably cost maybe five per cent or 10 per cent of her salary back in the 70's and so it was a pretty big deal.

Back then at school, there was no way we could take a calculator into an exam. Likewise when I was doing maths and stats at university. Kids through to their 30's nowadays cannot add up a list of numbers nor have the satisfaction of solving a good old fashioned long tot like the ones Doug Howey, headmaster at Waiwhetu Primary School used to delight in challenging us with on a regular basis. In fact, no kid today would sit a maths exam without a calculator. The march of progress eh?

In the early days of my career, I purchased my first calculator and it was an essential business tool for insurance premium calculations and for estimating future superannuation benefits. Crunching numbers was good fun. Back then, I must have had some unresolved issues! Anyway, as it turns out, 20 plus years ago, I met another financial adviser at an overseas conference, who had as part of his wrist watch, a fully operational calculator. Like the geeky guys in that maths class, I dreamed of and lusted after such calculatorial sophistication. So much so, that I saved hard and bought my very own Casio watch with a built in calculator a year or so later.

After the euphoria of purchase, I showed it off to all and sundry by demanding anyone who showed a vague interest to ask me to perform some complicated algorithm. I did this by selective poking of the appropriate numbers with some fine pointy type instrument. It was so small one generally had to do the calculation several times to ensure accuracy. It was easy to push the wrong button and so the novelty wore off long before the clasp did and I went back to my trusty handheld BF 100 financial calculator.

So when I recently read a fat fingered Wall Street share broker had meant to sell a few million shares (a normal trade) in Proctor & Gamble and others but instead pushed the "B" for "Billion" (a colossally abnormal trade) key, which ultimately caused the American and rest of the world markets to panic and drop 10 per cent before ending down about three per cent for the day, I felt a certain amount of sympathy for him/her. I am pleased the world's share markets are not reliant on brokers using screens and buttons the size of my former Casio calculator watch.

Which all leads me nicely to the point of this article.

Financial advisers like to remind their clients share markets do tend to go up over time, generally by more than other investments or asset classes. However, they also tend to go down from time to time. They also sometimes go sideways. And no-one really knows when they are going to do any one of those things. Anyone who tells you they consistently know pretty much when, is generally temporarily lucky or a liar or a witch.

Warren Buffett, America's second richest person and best known investor is CEO of Berkshire Hathaway. He is worth about US$47 Billion! Buffett got there by investing in companies and shares. But the "oracle of Omaha" consistently tells his shareholders he doesn't know what the share markets will do tomorrow, next week, next month, next year, but he does know they will do and what they always have over the long term. They go up. At 79, he is still on behalf of Berkshire Hathaway actively buying other companies or shares in other companies with his business partner Charlie Munger, aged 86 and he says they are both long term investors. In a recent shareholders' letter, he wrote he and Charlie basically loved what they are doing and "tap dance" into the office each day.

So, if the world's cleverest investor doesn't know how the market is going to perform in any given short to medium term period, who does?

There was a thesis created in 1952 which theorised what is now known as "Modern Portfolio Theory".

Wisegeek.com describes "Modern Portfolio Theory as an attempt to optimize the risk-reward of investment portfolios. Created by Professor Harry Markowitz, who earned a Nobel Prize in Economics for the theory, Modern Portfolio Theory introduced the idea of diversification as a tool to lower the risk of [an] entire portfolio without giving up high returns".

One of the issues is one does not know which asset class (NZ shares, Aussie and International shares, NZ or International

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bonds, whatever) is going to do the best in the next period and therefore a diversified portfolio with the appropriate mathematical tweaks and adjustments should have a reduced risk and a higher return.

The analogy is to imagine you were a farmer carrying some of your eggs (hens' bantams' and ducks') in several baskets to the produce market. If one basket was dropped and the bantam eggs broke (eg shares have a terrible year, like in 2008), let's assume your other baskets arrived safely. You haven't lost everything. And with a bit of luck, the remaining eggs may sell for more than you had hoped (eg bond markets do better than normal, again like in 2008). Makes excellent sense.

The first chart is supplied and researched by Grosvenor Investment Services and shows the best performing asset classes (pre tax and in NZ dollars) year by year since 1997 for the years ended December 31.

The conclusion is:

- The top performing asset class often changes from year to year and therefore trying to time the market can be difficult.
- Share markets usually provide the highest returns, but can be volatile and do sometimes generate short and medium term negative returns.
- Holding a well diversified portfolio reduces volatility in returns.
- Keeping your total investment portfolio in NZ cash (a proxy for bank rates) does not make good sense long term.

The second chart again researched by Grosvenor shows the Top Performing share markets since 1997 (in their own currency, i.e. not in NZ dollars).

Conclusions reached are:

- The top performing share market often changes from year to year, and can have high volatility. (UK was the best share performer in our sample in 2008 and produced a negative 31 per cent return!)
- Holding a well diversified share portfolio over different markets reduces volatility within the shares sector.

Last year one of my articles discussed the negative performance of the various world share markets and the economy in general, but concluded they and it would come right. They always do and it always does! If you believe in capitalism, then you have to believe and understand private enterprise works and private and publicly listed companies generally make money and profits. They make a better return on the assets they own by making and selling "widgets" than by cashing up and putting money in the bank. If companies borrow money, then need to earn more than they are paying bankers or bondholders in interest, in order to generate a profit.

If investors consistently and over time can

Asset Class	2009	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
NZ Cash	2.9%	8.0%	8.2%	7.7%	6.8%	6.0%	5.5%	5.6%	5.9%	6.3%	4.4%	7.1%	7.7%
NZ Bonds	1.7%	**15.8%**	3.9%	4.2%	6.9%	5.5%	6.4%	8.7%	4.8%	**11.1%**	0.1%	14.1%	6.8%
NZ Shares	18.9%	-32.6%	-0.3%	20.3%	10.1%	**23.2%**	**25.3%**	0.9%	**13.4%**	-8.0%	13.3%	-4.4%	4.3%
NZ Residential Property	-4.4%	4.0%	9.0%	15.4%	14.2%	17.8%	15.1%	0.0%	3.4%	3.2%	1.2%	1.9%	8.9%
World Bonds	3.5%	15.2%	8.9%	5.5%	9.1%	9.5%	6.3%	**12.1%**	8.2%	10.3%	0.4%	13.0%	12.7%
World Shares	3.9%	-22.2%	-0.3%	15.9%	16.1%	4.0%	5.8%	-36.5%	-11.9%	2.5%	**26.3%**	**37.6%**	**41.1%**
Australian Shares	**41.2%**	-35.3%	**18.5%**	**29.4%**	**21.7%**	21.0%	21.9%	-20.0%	7.2%	6.6%	25.0%	15.8%	11.7%

Data sources include: NZ Cash: NZX Call Index, NZ Bonds: NZX Govt Bond Index, NZ Shares: NZX 50/40 Comp, NZ Residential Property: REINZ, Australia: S&P/ASX 200 (unhedged), World Bonds: Citigroup World Govt Bond (hedged) Index, World Shares: MSCI World Accumulation Index (unhedged). Returns are in NZD and before tax.

Equity Markets	2009	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
NZ	18.9%	-32.8%	-0.3%	20.3%	10.0%	23.2%	25.3%	**0.9%**	**13.4%**	-8.0%	13.3%	-4.4%	4.3%
Australia	37.0%	-38.4%	16.1%	24.2%	22.8%	**28.0%**	14.6%	-8.8%	10.4%	**5.2%**	16.1%	11.6%	12.2%
Japan	5.6%	-41.8%	-12.2%	1.9%	**43.5%**	10.2%	23.8%	-18.3%	-19.6%	-25.5%	58.4%	-7.5%	-20.1%
United States	23.5%	-38.5%	3.5%	13.6%	3.0%	9.0%	26.4%	-23.4%	-13.0%	-10.1%	19.5%	**26.7%**	31.0%
United Kingdom	22.1%	**-31.3%**	3.8%	10.7%	16.7%	7.5%	13.6%	-24.5%	-16.2%	-10.2%	17.8%	14.5%	24.7%
Germany	23.8%	-40.4%	22.3%	22.0%	27.1%	7.3%	**37.1%**	-43.9%	-19.8%	-7.5%	39.1%	17.7%	**47.1%**
Hong Kong	**52.0%**	-48.3%	**39.3%**	**34.2%**	4.5%	13.2%	34.9%	-18.2%	-24.5%	-11.0%	**68.8%**	-6.3%	-20.3%

(Data source: NZ Shares: NZX 50/40 Comp, Australia: S&P/ASX 300, Japan: Topix, USA: S&P 500, Germany: DAX, Hong Kong: Hang Seng)

earn more off monies loaned than productive businesses can make off monies borrowed, the economy would eventually stagnate and collapse.

Consequently in a free economy, returns from the share market (which represents title to a share in profits of productive businesses) can be expected to be considerably higher than return from the debt market.

A similar argument can be advanced for the property sector. Returns from this sector represent (in fundamental terms) the rental stream from plant leased to productive businesses. If investors, consistently and over time, can earn more off the rental stream from buildings leased to productive businesses than the businesses can make from the use of that building, in the end the economy would stagnate and collapse.

In the same way then, we would expect the share market to out perform the commercial property market over time.

One does not become a rich lister by "investing" in the bank. The Todds are not our wealthiest family by not owning companies or shares in companies. Likewise with Graeme Hart, our richest Kiwi. I read the other day Sir Doug Myers of Lion Nathan fame was now richer than the Queen. He achieved that not by saving in the Post Office but by owning shares in a business or businesses. Interesting isn't it the Queen who does own a truck load of property and a bit of crown jewellery, cannot compete with a person owning [shares in] businesses.

Likewise Warren Buffett did not come second to Bill Gates by putting his dough in the bank. And Bill Gates comes first by owning shares in Microsoft. But even Bill has diversified his wealth by having huge investments outside of Microsoft I read a few years back.

Having postulated in favour of share ownership, modern portfolio theory also insists on [researched] diversification in order to minimise risk. You would not have wanted to have had all your wealth in Telecom shares for example whose share price was over $8.00 in 1999 and under the "stewardship" of Theresa Gattung and Paul Reynolds, it is now under $2.00. Diversification within a holding in NZ shares could mean having 10 or 20 Kiwi companies in one's portfolio. An International portfolio might require 100s of companies.

There is a proviso with all this theory.

Diversification is not a fast track to riches. It's slow and it's boring. If you want to make some quick money here are a few "yeah right" tips.

Find a share your "shoe shine" boy promises is going to go through the roof, mortgage your house to the hilt, buy up large and wait till it goes up to where you thought, maybe even a bit higher if you are feeling greedy, and then sell out having made a killing. Easy eh?

Likewise with commercial property, here's what you do. Find an untenanted property, crunch the vendor or buy from the mortgagee, again by mortgaging your house to the hilt and borrowing as much as the bank or other financier will lend on the property, find a long term tenant, sign them up, and then flog the building off, having made a huge capital gain. Yeah right!

Or become a property developer and borrow as much as possible on top of all your wealth. Then develop some apartments or a seaside subdivision or some flash hotel and then flog them all off for a massive profit. Piece of cake!

Children and adults ask your grandparents before you attempt any of the above.

By the way – do not plan on too much sleep during the months or years it all takes to pan out. And buy some testerone pills because you will need to develop some very big goolies to go along with your rollercoaster ride to riches or ruin.

As a well known property owner (not developer) says, property developers usually end up going broke and we know there are 100s of them at present doing precisely that.

High risk, get rich quick schemes do not work for 99.9 per cent of Kiwis.

For most of us who are happier to minimise risk, the diversification approach seems pretty damn smart.

Oh and what happened to those bright buggers in the seventh form? One of them I know did ok. He was part of a high tech Hutt company which had a public share float a few years back. Rumour has it he made a cool $5 million!

(The above are generalised comments only and should not be taken as personalised advice. A Disclosure Statement is available on request and free of charge.)