HOLM TRUTHS

Down to earth advice for savers and investors from independent investment commentator Mary Holm

SUMMER 2004

Scattering the seeds

A fairy godmother has given you some mysterious seeds that will grow into trees bearing golden fruit. But she disappears before you can ask what sort of soil they like, and how much sun and how much water. Where do you plant them?

It would be best to try a variety of spots, ranging from sand, full sun and little water to rich earth, shade and lots of water. Some seeds won't grow and some will grow reluctantly, but others will thrive.

You won't end up with as much golden fruit as if you planted the whole lot in the best place, but you'll do much better than if you planted them all in the worst place.

The same applies to diversification in investment – the spreading of your money over many different shares, or many different properties, bonds or whatever you are investing in. True, you won't end up with all your money in a winner. And that's why some people dismiss diversification as boring. Indeed, if you look on investment as a game or a bit of a gamble, you won't want to diversify.

Most people, though, would rather miss out on the chance to back only winners in exchange for the knowledge that they won't back only losers.

This is not only psychologically appealing, but it's mathematically smart. Let's say – to keep the sums easy – that the average return on shares is 10% a year.

A single company might get into deep trouble or do brilliantly. If you put all your money in just one share, its annual return could easily be anywhere from minus 40% to plus 60%, which averages out, over time, at 10%.

But if you invest in many different shares, when one does particularly badly or well, that will probably be cancelled out by other shares moving in the opposite direction. The range for the whole portfolio is likely to be much smaller – say from minus 20% to plus 40%.

The total volatility is lower – and hence the risk that prices will be extremely low when you want to get out of shares. But you've still got the same 10% average return.

Hang on a minute. What about the investment maxim: risk and expected return go together, and if you raise or lower one, you raise or lower the other?

With diversification that doesn't apply. You can lower your volatility without lowering your expected return.

(CONTINUED PAGE 2)

WHERE OUR FAIRY TALE FALLS DOWN

Seeds of golden fruit trees and investment dollars might be similar to start with. But once your seedlings started to grow, you would probably be wise to transplant some of the weaker ones to wherever the stronger ones were growing.

Even so, it would be a mistake to move all the seedlings to one spot. You never know when that spot might be hit by a storm or a landslide or a car crashing through a fence.

In investment, the argument for maintaining the status quo is even stronger. It would be foolish to move money from the investments that have performed badly to the ones that have performed well, for two reasons:

- *Last year's top performers won't necessarily do well this year. In fact, there's a good chance they've become overpriced and they will perform worse than average.*
- *Moving from one investment to another costs you brokerage and other transaction costs, and you might also be taxed on your capital gains.*

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(SCATTERING THE SEEDS, CONTINUED)

It's like having your cake and eating it. And that's why practically all big fund managers are widely diversified. You're silly not to copy them.

So how do you go about diversifying different types of assets?

Fixed interest

Even with high-quality bonds, it's best to invest over several companies in different industries.

With finance company debentures and the like, which are more likely to go wrong, diversification is particularly important.

It's also a good idea to spread your money over fixed interest investments of different durations. Some might mature in six months, others in five years.

That way, if interest rates rise in future, you won't have all your money tied up at what have become lower rates. And if interest rates fall in future, you will still have some money tied up in what have become relatively high rates.

Property

If you want to invest in rental properties, it's best to buy them in different areas and different types of buildings.

Homeowners will get better diversification still if they go into commercial properties, such as office buildings, shops and factories.

For most people, this is feasible only through shares in property companies or property funds. If you go into these investments, take care that the fees are reasonable, that there is a wide variety of properties in the company or fund, and that you can exit easily and at a fair price.

Note, too, that most property funds listed on the stock exchange borrow to invest, which boosts potential returns but also boosts risk.

Shares

This is where diversification really comes into its own. It's relatively easy to invest in lots of different companies, either directly or via a share fund.

Look for variety in industries, company size and geography, and be wary of funds that are dominated by one or a few shares. It's preferable if the weighting of the different companies is fairly even.

It's best, too, to be in a variety of economies. Consider putting more than half your share money into overseas shares or – to keep things simpler – an overseas share fund.

"Money is like muck, not good except it be spread."

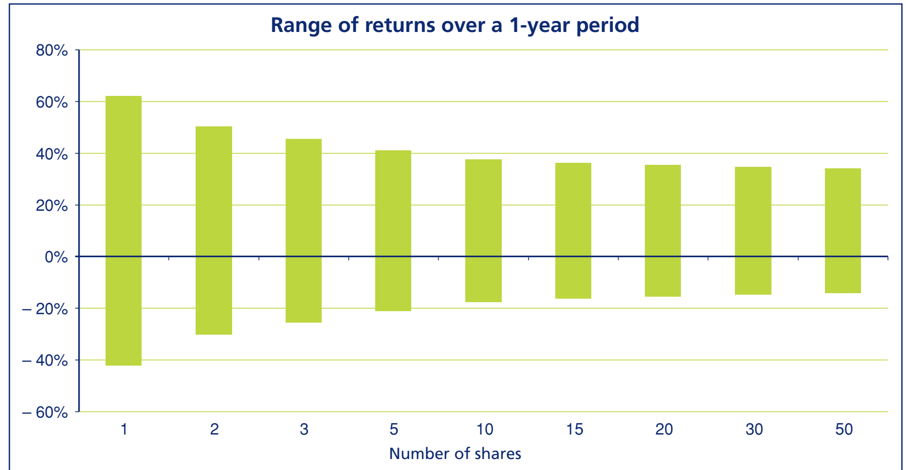
Francis Bacon 1561 - 1626

HE ASKED FOR IT

Wall Street analyst Dan Niles recalls that a man threatened him with bodily harm after Niles downgraded his recommendation on Dell Computer shares.

As a result of the downgrade, the share price fell, wiping out the man's savings for his children's tertiary education, Reuters reports. The man wanted to take it out on Niles, but whose fault was it really? Anybody who puts important savings like that into a single share is asking for trouble.

MORE SHARES REDUCE VOLATILITY



By increasing your shareholding from one to five shares, you considerably reduce the range of likely total returns over a single year. Boosting your portfolio to ten shares reduces volatility still more. Beyond that, the gains are smaller. (The expected annual return is 10%, including dividends.)

REDUCE RISK BY INVESTING ACROSS MANY DIFFERENT INDUSTRIES

If you invest in only one or two industries, they may perform well one year but badly the next. The following tables show the different industry categories in the MSCI world share index, ranked by performance.

1999/2000	2000/2001
1. Information technology	1. Consumer staples
2. Telecommunications	2. Health care
3. Consumer discretionary	3. Utilities
4. Industrials	4. Energy
5. Energy	5. Financials
6. Materials	6. Materials
7. Financials	7. Industrials
8. Utilities	8. Consumer discretionary
9. Health care	9. Telecommunications
10. Consumer staples	10. Information technology

World share markets switched abruptly from boom in 1999/2000 to bust in 2000/01, and industrial performance was virtually turned upside down. The top four performers in the first year became the bottom four. And the bottom three performers became the top three.

2002/2003	2003/2004
1. Consumer staples	1. Financials
2. Energy	2. Materials
3. Health care	3. Information technology
4. Utilities	4. Consumer discretionary
5. Materials	5. Industrials
6. Financials	6. Utilities
7. Telecommunications	7. Telecommunications
8. Industrials	8. Energy
9. Consumer discretionary	9. Consumer staples
10. Information technology	10. Health care

The change from 2002/03 to 2003/04 wasn't quite so dramatic. Still, the top three performers became the bottom three. And the bottom two moved up to third and fourth places.

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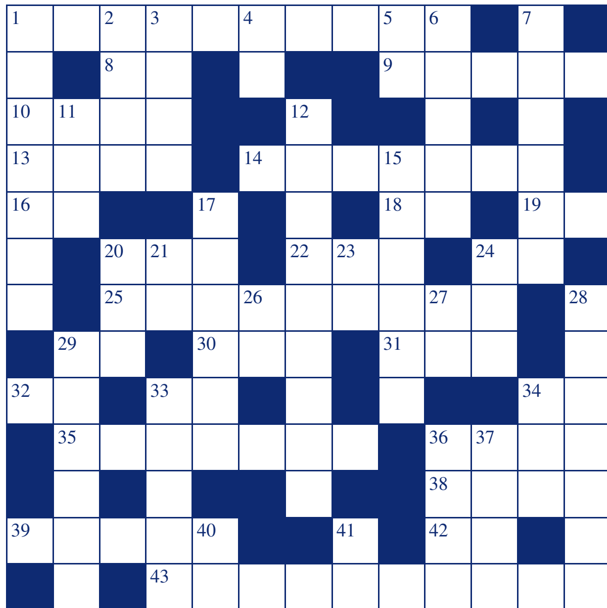

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HOLM TRUTHS CROSSWORD SUMMER 2004/05

ACROSS

1. Fluctuation (10)
8. Bovine animal (2)
9. Shore (5)
10. A flower (4)
13. _ _ _ _ of March (4)
14. No longer working (7)
16. Newspaper chief (abbrev.) (2)
18. Upon (2)
19. Not out (2)
20. Sole (3)
22. Weapon (3)
24. Type of electricity (initials) (2)
25. To vary (9)
29. About (2)
30. Period (3)
31. Take to court (3)
32. Not she or it (2)
33. Dad (2)
34. School sports class (initials) (2)
35. Rich (7)
36. Light coloured (4)
38. Region (4)
39. Rough (5)
42. In other words (initials) (2)
43. Gather (10)

DOWN

1. Wide range (7)
2. Not win (4)
3. Wood chopping tools (4)
4. Not he or she (2)
5. A disease (abbrev.) (2)
6. Long for (5)
7. Sour (6)
11. Strange (3)
12. School subject (9)
15. Change into ions (6)
17. Uncover (6)
20. Poem (3)
21. Big NZ island (initials) (2)
23. You and me (2)
24. Yes in Scotland (3)
26. Our queen (initials) (2)
27. Kung _ _ (2)
28. In the middle (7)
29. Warder (anagram) (6)
33. Black and white bear (5)
34. Pastry dish (3)
36. Not succeed (4)
37. Same as 38 across (4)
40. Old name for European alliance (initials) (2)
41. Printer's measure (2)

Dear Mary:

We met at 50 about 18 months ago, with expensive baggage.

However, we've done a major push to turn things around – including selling one car to kick-start regular savings, buying vegetables through a co-op, and halving our insurance premiums. I have also joined the government super scheme (though opting, in confusion, for the ASB's cash fund may have been a mistake).

My salary is about $60,000 before tax, and my partner's $50,000. He also makes about $8,000 from a small business, and we net about $7,000 from renting out a flat attached to our house. The last teenager should be let loose by 2007.

We figure we will need at least $500,000 saved in 15 years. Most of our money is now going into the mortgage, which will be paid off in four years (the house is worth about $450,000). But we also save about $100 a week.

How should we proceed from here?

Dear Reader:

You've made a great start by taking the time to assess your situation.

Before you go any further, though, do you really need to save a full $500,000?

Let's look first at your expected income right before retirement. (We'll assume that any pay rises and rent increases you get in the next 15 years will match inflation, so we can work in today's dollars.)

> ✉ **Some people over-save for retirement.**
>
> ✉ **For longer-term savings, use shares and property.**
>
> ✉ **Repaying your mortgage beats most investments.**

If the two of you continue to earn the same as now, your pre-retirement income will be about $93,000 after tax.

And if you follow your current plan, in retirement you can expect the following after-tax annual income:

- NZ Superannuation (from age 65), $19,900.
- Rent from the flat, $5,500.
- Annuity from the State Sector Retirement Savings Scheme (SSRSS), $3,600. (See "What is an annuity?" on page 4.)
- Annuity from $100 a week savings (expected to grow to $95,600 by retirement), $5,300.
- Annuity from extra $500,000 of savings, $27,500.
- Total: $61,800 net.

Your retirement income, then, will be about two thirds of pre-retirement income.

That sounds OK. But don't forget that, until retirement, a good chunk of your income is going into your mortgage and savings. In fact, if you accumulate $500,000 – which would require saving about $39,000 a year if you start in four years, after paying off the mortgage – you will end up with considerably more spending money after retirement than before.

You might expect to spend more in retirement, on travel and so on. But many retirees find they save as much from not working – in clothes, travel expenses, lunches and so on – as the extra they spend.

What's more, we haven't allowed for your partner's either selling his small business at retirement or continuing it. Either way, that would make you even better off.

Perhaps you're planning to give up too much now for future comfort. Perhaps you should save somewhat less and enjoy life more in the meantime.

Think about that over the next few years. Meantime, there are more immediate steps to take.

Firstly, the SSRSS. Good on you for joining. For every dollar you contribute, your employer also contributes a dollar. Any super scheme with an employer subsidy, even if they are putting in only 50c for every $1, is hard to beat.

You're right, though, that the ASB's cash fund is not for you. Given that you have 15 years until retirement, you'd do better to switch

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> ## *"People in the West are always getting ready to live."*
>
> Chinese Proverb

(FROM THE MAILBOX, ***CONTINUED)***

to a fund that includes shares and property.

Returns in such a fund will be more volatile, and they are highly likely to be negative in some years. But over ten years or more you will almost certainly do better in ASB's Balanced fund (60% shares and property) or, if you're brave, the Growth fund (80% shares and property.)

How much should you put into the SSRSS? Only as much as your employer will match. Beyond that, I suggest you put all your savings into your mortgage – which might enable you to pay it off in less than four years.

Why? Let's say the interest on your mortgage is 8%. Repaying it improves your wealth in exactly the same way as earning 8%, after fees and taxes, in an investment.

You've got a good chance of doing that in the employer-subsidised savings scheme, but much less of a chance, year in and year out, with unsubsidised contributions, or in any other investment.

Any investment that has a chance of netting more than 8% would have to be in shares or property. And it would be risky and somewhat time-consuming, whereas repaying your mortgage is risk-free and easy.

There's one exception to the putting-it-all-on-the-mortgage rule: You should probably have an emergency cash fund in bank term deposits, unless you have access to cash from another source.

Experts say that fund should be two months' after-tax pay – about $15,500 for you two. You might want to put your $100 a week towards that and, after it's built up, switch that money to mortgage repayment.

Once the mortgage is paid off, it's time to concentrate on saving your $500,000 – or less.

If you decide it might be better to aim at $250,000, halve the $39,000 a year of required savings and halve the $27,500 annuity payment. For other goals, you can make similar proportionate adjustments.

Footnotes:

- Make sure you have adequate death and disability insurance before your retirement.
- We have assumed NZ Super will remain at current levels. For your age group, that is probably reasonable.
- In this article and in "What is an annuity?", all the calculations assume that savings grow at 2.5% a year, after fees, taxes and inflation.

WHAT IS AN ANNUITY?

If you buy an annuity from an insurance company, you give them a lump sum in exchange for regular payments until you die.

Currently, in New Zealand, annuities are not a particularly good deal, although that might change in future.

In the meantime, you can do it yourself, roughly. Using an appropriate annuity calculator – which incorporates the life expectancies of men and women at different ages – you can work out how much you can take out of your savings each year so that it will dwindle to nothing by the time you are expected to die.

In the case of our "From the Mailbox" correspondent, her SSRSS savings are expected to grow to about $66,200 by retirement, if she contributes 3% of her pay and so does her employer.

With that lump sum at retirement, she could take out $3,600 a year.

With all three annuities, we've allowed for payments to rise with inflation, but they are presented here in today's dollars for simplicity. Also, payments will continue until both spouses have died – if they live to their life expectancies.

They might, of course, live longer. As they spend their savings, they will need to keep an eye on how things are turning out. If it seems likely they will both celebrate their 90th or even 100th birthdays, they will need to slow down their spending.

Other readers can check out where they stand by using the calculators on www.sorted.org.nz or other websites, or by consulting a good financial adviser.

INFO ON STATE SECTOR SCHEME

Government employees looking for advice on the options within the new State Sector Retirement Savings Scheme may find it helpful to read a paper on the internet.

Written by MCA, actuaries and consultants, the paper is aimed at employees. It can be found at www.mcanz.co.nz/news/default.htm

Holm Truths Crossword Solution

V	O	L	A	T	I	L	I	T	Y		A	
A		O	X		T			B	E	A	C	H
R	O	S	E			G			A		I	
I	D	E	S		R	E	T	I	R	E	D	
E	D			R		O		O	N		I	N
T		O	N	E		G	U	N		A	C	
Y		D	I	V	E	R	S	I	F	Y		A
	R	E		E	R	A		S	U	E		V
H	E		P	A		P		E			P	E
	W	E	A	L	T	H	Y		F	A	I	R
	A		N			Y			A	R	E	A
C	R	U	D	E			E		I	E		G
	D		A	C	C	U	M	U	L	A	T	E

WRITER AND PUBLISHER

Award-winning journalist Mary Holm writes the *Money* column for the NZ Herald and *The Investor* column in the Waikato Times, Dominion Post, Christchurch Press, Otago Daily Times and other major newspapers. She runs seminars, is the author of *Investing Made Simple* (Penguin, $27.95, at good bookstores), *Snakes and Ladders – A guide to risk for savers and investors* and *The REAL Story – Saving and investing now that inflation is under control* (both of which can be downloaded from www.rbnz.govt.nz). Mary holds a BA in economic history, MA in journalism and MBA in finance.

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