HOLM TRUTHS
Down to earth advice for New Zealand savers and investors from independent journalist Mary Holm

AUTUMN 2003

Emotions and Investing

Feelings affect most things you do. And quite right, too! Should you let them affect your investment decisions?

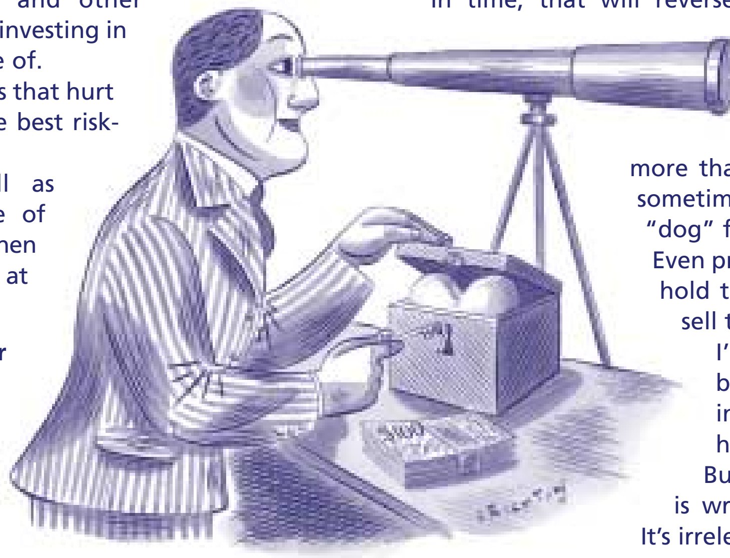
To some extent, yes. It's important to feel comfortable about your savings. And, if you have a positive attitude, you're likely to save more.

But a growing body of research shows that emotions, prejudices, limited vision and other psychological factors affect investing in ways you may not be aware of.

This can lead to decisions that hurt your chances of getting the best risk-adjusted returns you can.

It's helpful – as well as fascinating – to be aware of what's going on. You may then modify your behaviour or at least make allowances for it.

Some common investor foibles:



Over-confidence

About 80% of people think they are above average at driving, and investing may be similar.

People tend to remember their good investments and give themselves credit for them. The poor investments were bad luck, best forgotten!

Over-confidence can lead to too little diversification. If you've picked good investments, why hedge your bets? Because your selections might, in fact, not be so hot.

THE ROLL OF COINS

Delegates at a conference were given a roll of five-cent coins. They were told they could either pay five cents every time they entered the conference room, or give up the whole roll and receive a pass that let them come and go as they pleased.

Almost everyone paid up front – even though the alternative would have cost them only about half as much, says a report in Financial Alert magazine.

The conclusion: Most people want to minimise risk. They may pay quite a high price for comfort and certainty.

But is this correct? Would the results have been the same with $2 coins? Some people probably couldn't be bothered paying on each entry for the sake of gaining a few 5 cent pieces!

Also, see "How do you respond to risk?" on the next page.

Also, when inexperienced investors start an investment, they often don't appreciate that they will sometimes do badly.

Currently this is not so true of share investors, because of the terrible recent performance in world shares. But it may well be true of recent property investors.

In time, that will reverse. Both markets have their down periods.

Fear of regret

Many investors don't want to sell unless they can get more than the purchase price – and sometimes end up sticking with a "dog" for years.

Even professional managers tend to hold their losers for too long and sell their winners too quickly.

I'm not saying you should bail out of well chosen investments just because they have bad years.

But if you realise an investment is wrong for you, get out of it. It's irrelevant what you paid for it.

Following the crowd

You may feel it's not so bad to make a loss if everyone else does. It may be less embarrassing, but there's no logic to that.

You're more likely to do well if you buy when others are selling and sell when others are buying. Or, in many cases, just buy and hold.

Sticking with the status quo

If you were starting now, would you have your current portfolio? If not, why have you got it?

Many people spend more time deciding which clothes to buy than which investments to make. Put a bit of time into your investments now and you'll be able to buy many more clothes later! *(CONTINUED PAGE 2)*

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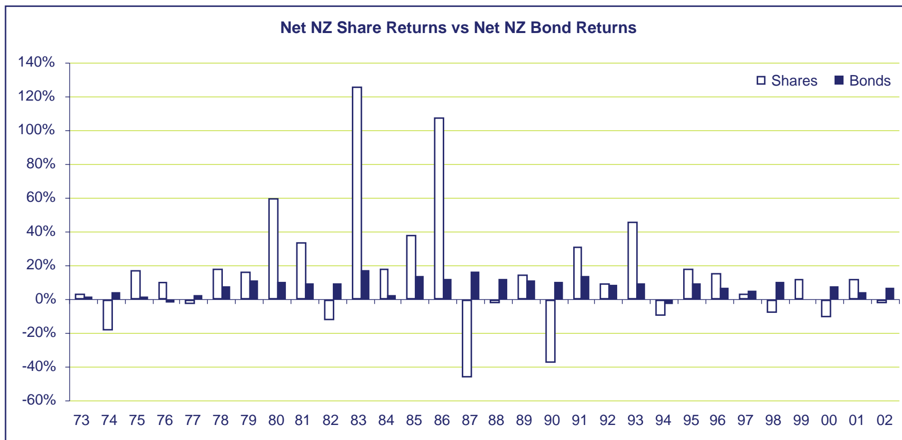
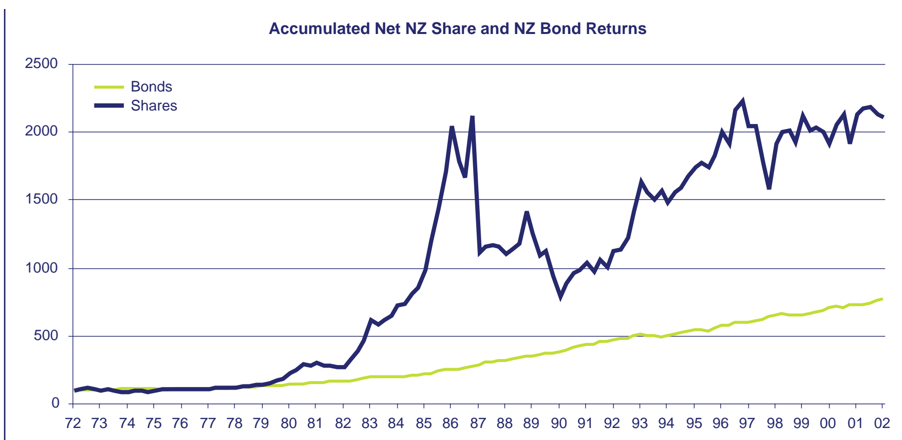


It's all in the way you look at life.

Let's say you're deciding how much of your *long-term* savings to put into shares. Look at the top graph and decide. Now look at the bottom graph and decide. If you came up with different answers, you're in good company. US superannuation fund managers were shown similar graphs. After looking at the first, they chose 40% in shares. After looking at the second, they switched to 90%. The same data presented differently can lead to startlingly different conclusions.



How do you respond to risk?

1. Would you prefer me to give you:
(a) $1,000 or
(b) $2,000 or zero, depending on a toss of a coin?

2. Would you prefer me to take from you:
(a) $1,000 or
(b) $2,000 or zero, depending on a toss of a coin?

There are no correct answers. But if you were behaving rationally, you would always choose (a). The two options have the same average expected return, of $1,000, but (b) is riskier. According to rational theory, nobody will take more risk unless they expect more reward.

However, US finance strategist Jack Gray says about a third of people choose (b) for question 1. When they see themselves getting something for nothing, they like to take a risk.

What's more, about two-thirds choose (b) for question 2. Many people are prepared to take a risk to try to avoid a loss.

Apparently, people feel more negatively about loss than they feel positively about gain.

(EMOTIONS AND INVESTING, CONTINUED)

Emotional attachment

People often keep investments they have inherited or been given. This is partly a status quo issue. But you might also feel disloyal if you sell.

If the investment is unsuitable for you, wouldn't the giver prefer you to do something else with the money?

Being over-informed

Having lots of information makes some investors over-confident. But others are overwhelmed. After doing research, they can't decide which move to make and so do nothing.

If you've narrowed your options down to two or three, perhaps you should just allocate your money among them rather than agonising over which might be best.

Short sightedness

People put too much weight on the recent past. After a bad market, they overestimate the chances of another bad year. The reverse is true after a good market.

Economist Richard Thaler once suggested investors should be banned from reviewing their progress more than once every five years. But many investors receive quarterly statements, and some check their progress daily.

Put more weight on how you've done over the last five or ten years than over the last three months.

Seeing patterns

It's often useful to see patterns in data. Sometimes, though, people see patterns that are there by mere coincidence.

Around the time of the 1929 Wall Street Crash, for example, observers noted a close correlation between New York and London share prices and levels of solar radiation.

The frame-up

People respond to how things are framed. They don't like an investment that has losses one year in 10 as much as one that has gains nine years in 10!

Given a choice of a share fund and a bond fund in a super scheme, investors tend to put half their money in each. Given a choice of a fund of big NZ shares, a fund of small NZ shares, a world share fund and a bond fund, they will tend to put a quarter in each, ending up with much more in shares. See also "It's all in the way…" on this page.

Selective listening

Most people like to have their pre-judgements confirmed. If, instead, you challenged your thinking, you would learn more.

Can't see the forest …

Investors tend to look at the performance of individual parts of their portfolio instead of the whole thing.

If you've diversified to average out the movements of different investments, let that work for you.

"Experience is the name everyone gives to their mistakes."

Oscar Wilde, 1854-1900, in "Definitions of a Cynic"

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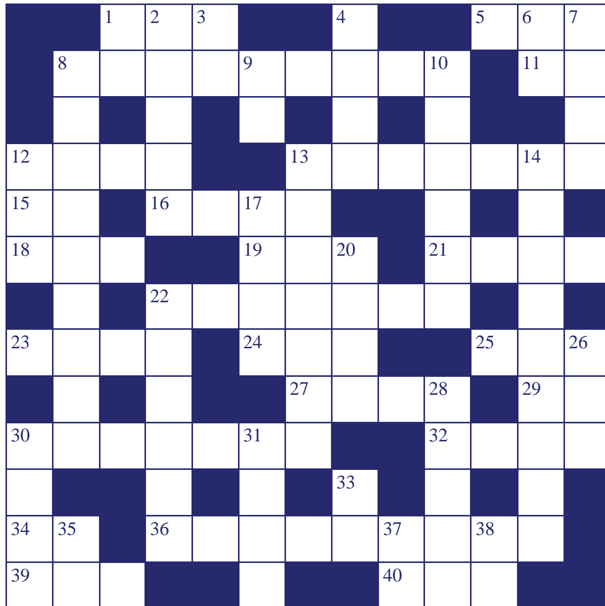

Solution: Back page

HOLM TRUTHS CROSSWORD

Autumn 2003

ACROSS

1. Super power (initials) (3)
5. Drinking vessel (3)
8. Way of conducting oneself (9)
11. Dad (2)
12. Ours (anagram) (4)
13. Words on grave (7)
15. All right (2)
16. Dutch cheese (4)
18. Gamble (3)
19. Boy's name (3)
21. Uncommon (4)
22. Model or design (7)
23. Girl's name (4)
24. Take a chair (3)
25. Not his (3)
27. Piggy noise (4)
29. Not from (2)
30. Piece of land (7)
32. Pacific island (4)
34. Not yes (2)
36. Feeling sorrow (9)
39. Finish (3)
40. Boy's name (abbrev.) (3)

DOWN

1. Old school exam (abbrev.) (2)
2. Stock (5)
3. Drivers' organisation (abbrev.) (2)
4. Liquid food (4)
6. Not down (2)
7. Track (4)
8. Transaction fee (9)
9. Against (abbrev.) (2)
10. Come back (6)
12. Cry (3)
13. Feeling (7)
14. Purple tea (anagram) (9)
17. Music, drama, literature etc. (3)
20. Abominable snowman (4)
22. Minister (6)
26. Fish eggs (3)
28. Piece of cutlery (5)
30. Of sound mind (4)
31. Drunken revelry (4)
33. Myself (2)
35. Not off (2)
37. Bank investment (abbrev.) (2)
38. Plural of 33 down (2)

GREAT DEBATE • GREAT DEBATE • GREAT DEBATE

TERM DEPOSITS vs CORPORATE BONDS

New Zealanders tend to put too much money in term deposits. One relatively low-risk alternative, that has two big advantages, is corporate bonds.

The advantages: bonds pay a higher return, and you can sell them whenever you want to.

Corporate bonds are issued by companies that want to raise money, perhaps for expansion. A typical bond, when it is first issued, costs $1000, $5000 or $10,000.

Interest is usually paid twice a year. All going well, at the end of, say, five years, you get your money back.

Common first cousins to corporate bonds are capital notes, which carry somewhat higher risk because they rank behind bonds if the company fails.

Capital notes usually have an election date. At that time, the investor may decide whether to renew the investment at a new interest rate or take shares in the company – although sometimes it's the company that makes that decision.

Those shares may be issued at a slight discount to the market price, to allow for the fact that many investors will sell them right away, to get cash, and will have to pay share brokerage.

Some capital notes are perpetual. They have no maturity date, and their interest rate changes yearly. When you want your money back, you sell the notes.

The interest rate on corporate bonds or capital notes – called a coupon rate – varies, with riskier companies paying a higher rate.

This is because, if the company got into financial trouble, bondholders could lose some or all of their money.

That doesn't happen often. Bondholders have higher security than shareholders, so a company must pay back all its bonds before shareholders get a cent.

Nevertheless, some companies, such as Fortex and Skellerup, have defaulted on their bonds.

To keep that risk minimal, stick with "investment grade" bonds, which have a credit rating of BBB minus or better. Neither Fortex nor Skellerup was investment grade.

Many bonds are listed on the Stock Exchange. You can buy or sell a listed bond, via a stockbroker, at any time during its term. You could, for instance, buy one that has just a couple of years to run.

Generally, though, investors get a better deal if they buy when a bond is first issued. You won't pay brokerage. And the issuer normally pays slightly higher interest than might be expected to ensure the bonds sell.

(CONTINUED PAGE 4)

TERM DEPOSIT PROS	TERM DEPOSIT CONS
✓ Close to risk-free	✗ Lower interest
✓ Wide choice of terms and amounts	✗ Early withdrawal penalty
✓ Simple and accessible	

CORPORATE BOND PROS	CORPORATE BOND CONS
✓ Higher interest	✗ Riskier
✓ Can be sold at any time	✗ More limited choice
	✗ Possible brokerage to buy and sell

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(TERM DEPOSITS VS CORPORATE BONDS, CONTINUED)

If you buy after the bond has been issued, you will probably get a different return from the coupon rate.

And if you sell before maturity, you will probably receive a different amount from the face value. (See "Why do bond returns …" below.)

This uncertainty adds another element of risk to bonds. However, you can reduce the risk by varying the maturity dates of your bonds.

Or you can eliminate any worry about your bonds changing value by holding until maturity.

For most small investors, buying at issue and holding to maturity is the best strategy. It's comforting to know, though, that if you unexpectedly need the money, you can sell without penalty and, perhaps, at a profit.

When should you use term deposits, and when corporate bonds?

If you expect to use the money within the next year or so, term deposits are more suitable. They are simple to buy, you can invest any amount above a minimum, and there's a wider choice of terms. You also avoid brokerage.

For longer term investment, if you can cope with more risk, bonds are worthwhile. Over long periods, even a slightly higher interest rate can make a big difference to how your savings grow.

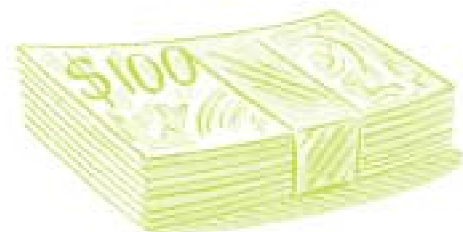
An example: Assuming that you reinvest your interest, $5,000 at 4% after tax grows to $7,400 in ten years; at 6% it grows to almost $9,000. Over 20 years, the difference is even bigger. At 4%, you'd have nearly $11,000; at 6% you'd have more than $16,000.

For more information:

www.interest.co.nz has interest rates and other information on term deposits and bonds.

www.debtmarket.co.nz has info on Stock Exchange listed bonds

www.bondwatch.co.nz rates bonds according to publicly available information. Note, though, that the service relies on that information being correct. It does not do audits.



Why do bond returns and values go up and down?

Because market interest rates change.

Let's say you buy a newly issued five-year $1,000 bond, with a coupon rate of 9%. You will get $90 a year in interest and your $1,000 back in five years.

However, after two years you need the money, so you sell.

At that time, interest on three-year bonds in companies of similar riskiness is 7%.

Your bond, with its coupon rate well above market interest rates, looks attractive. You can sell it for more than $1,000. In fact, you get $1,050.

The buyer will get $90 a year in interest – more than the $70 he would have got from another company. But he paid $50 extra, and will get back only $1,000 at the end of the three years.

For him, the gain roughly equals the loss. He ends up with about a 7% return, which is the current market rate.

Meanwhile, lucky you have made an extra $50. Your total return ends up being not 9% but about 11.5% a year. (Note, though, that the $50 capital gain is income for tax purposes.)

Conclusion: If interest rates fall, bondholders who sell before maturity do well.

But the opposite is true if rates rise.

If you want to sell a 9% bond before maturity when interest rates are 11%, nobody will want it unless they can pay less than $1000.

You might get around $950. Your total return, then, has been considerably less than 9%.

If interest rates rise, bondholders who sell before maturity do badly.

Check out that penalty

If you want to take your money out of a term deposit before maturity date, you will have to pay a penalty.

These penalties are calculated in a variety of ways.

It's worth noting that if market interest rates have fallen since your term deposit started, the bank may be willing to reduce the early repayment penalty.

That's because they would rather not be paying out higher-than-market interest.

"Gentlemen prefer bonds"

Andrew Mellon

Holm Truths Crossword Solution

		U	S	A			S			C	U	P
	B	E	H	A	V	I	O	U	R		P	A
	R		A		S		U		E			T
S	O	U	R			E	P	I	T	A	P	H
O	K		E	D	A	M			U		E	
B	E	T			R	O	Y		R	A	R	E
	R		P	A	T	T	E	R	N		P	
S	A	R	A		S	I	T			H	E	R
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WRITER AND PUBLISHER

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