HOLM TRUTHS

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

Winter 2001

Free lunch a rewarding spread

Your rich uncle has given you $100 to spend on a day at the racetrack. Do you put all the money on one horse in one race, or spread it around on several, throughout the day?

While most of us would back more than one nag, some would go for the All Or Nothing thrill.

But let's say, now, that the uncle has turned nasty. He's forcing you to bet your house, your savings and investments – almost everything you own – on the horses.

With that much at stake, I reckon almost all of us would back quite a few horses, boosting our chances that at least one will win.

It should be much the same with savings. It's fine to blow a small amount on something like a lottery. It might be a "stupidity tax", as one statistician calls it, but it's entertaining.

But when it comes to serious saving, it's wise to spread your money around.

Experts often explain diversification by saying you don't want to have all your eggs in one basket, in case it's dropped. But there's more to it than that.

Unless you're quite a risk taker, the chances are that you'll never lose the lot in an investment. Most people, though, have some investments – such as shares or property – that rise and fall in value.

And while you're happy about the rises, large falls make you uneasy. You don't know where you stand. If you need to cash up in a hurry, you might be caught in a down period and get very little.

On the other hand, if you avoid all investments that fluctuate widely, you probably won't do as well. Over the long term, more volatile investments tend to bring in higher average returns.

Fortunately, you don't have to choose between high volatility and high return or low volatility and low return.

Through the magic of diversification – which one economist describes as the only free lunch you can get – you can have high returns and relatively low volatility.

All the big institutions that handle billions of dollars make the most of diversification. You're silly not to do likewise.

How does it work? You simply spread your money across different volatile assets that tend not to move up and down at the same time. Often, one rise will cancel out another fall.

The easiest way to do this is to invest part of your savings in shares, part in property, and part in fixed interest

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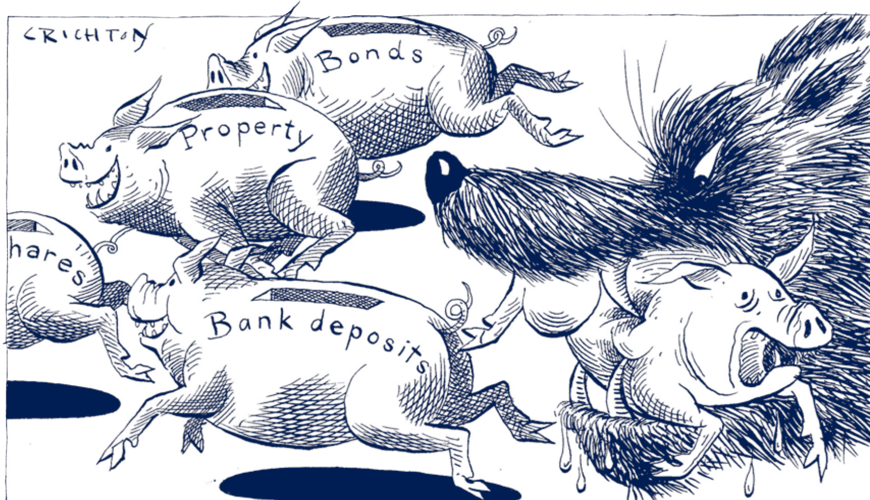


A DOLLAR EACH WAY

Diversification is a winner not just in investment, but also in other areas of money management.

If, for instance, you can't decide whether to take a fixed or variable rate mortgage, consider borrowing some of each.

Whichever way interest rates move, you won't be stuck with all of your loan at a relatively high rate.

The situation is similar if you are planning to buy foreign exchange, perhaps for a trip. Nobody knows which way the New Zealand dollar will move. But if you want to avoid swapping all your money at a particularly disadvantageous rate, you can exchange some money several months before the trip, and some at the time of the trip.

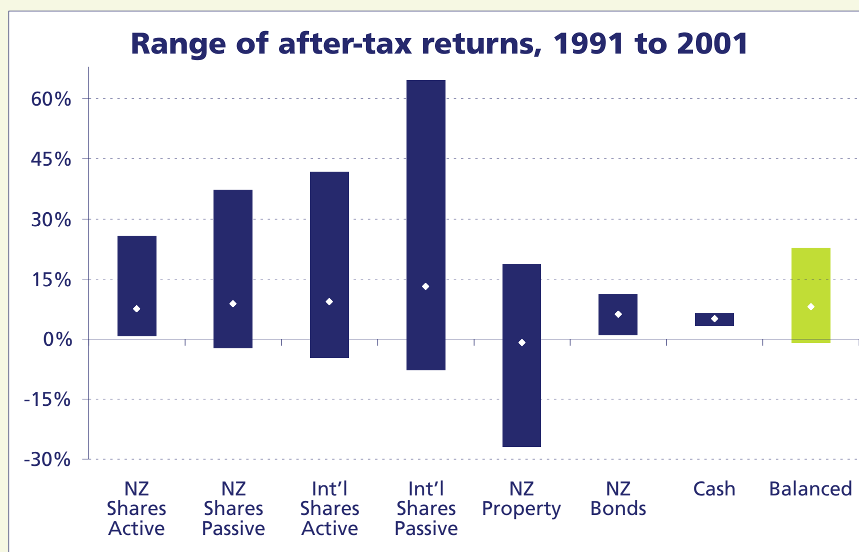
Returns on investments in international or New Zealand shares or property cover a much wider range than returns on bonds or cash. In some years you'll do well in shares or property; in others you'll do badly.

If you invest in a range of different sectors – either by going into a balanced fund or by spreading your money over several different types of assets – you will avoid some of that volatility.

The graph shows returns for years ending March 31, for someone in the 33% tax bracket. The white diamonds show average annual returns over the last 10 years.

Note the wider range of returns for passive share investment (investing in an index fund) compared with active share investment (investing in a share fund in which the managers choose which shares to buy and sell).

This is because index funds don't pay tax on capital gains, or deduct tax on capital losses. They therefore do better in good years and worse in bad years.



(FREE LUNCH A REWARDING SPREAD, CONTINUED)

investments. Some people add collectibles, forestry, gold, ostriches, pork bellies, options or futures... The list is endless. Whether these extras are worth the hassle may depend largely on luck.

But even if you just stick with the basics, you can gain much from diversification, especially if you also diversify within each asset group.

Here's how:

Fixed interest

Let's say you don't need your money for two years, and you can choose between a six-month term deposit that pays 5% interest, or a two-year deposit that pays 6%.

The two-year one seems better. But you might regret choosing it if, six months down the track, all interest rates have risen.

You can reduce the effect of making the wrong choice by putting half your money in the shorter term investment, and half in the longer one.

You can also diversify by making fixed-interest investments with various institutions.

That might not seem necessary for bank deposits. But if you're going for the higher returns offered by corporate bonds and so on – investments that occasionally go horribly wrong – you'll lower your risk by spreading your money around.

Property

Many experts say that most people have more than enough money in property via their own home.

That's often why they argue against rental property. If you're renting out a house, you've probably got too much money in the one housing market.

If you want to stick with property, you'll be more diversified in commercial property.

And you'll lower your risks considerably by spreading your money over many commercial properties.

You can do this by investing in a diversified property fund or in shares in a company that owns many properties.

Shares

In many ways, shares are the easiest type of asset to diversify.

Investing relatively small amounts, you can own shares in companies of different sizes, in different industries and in different countries. (There'll be more on diversifying internationally in a later issue of Holm Truths.)

The simplest way to diversify your share holdings is to invest in a managed fund that holds shares. (See The Great Debate)

It's also good to spread your share purchases out over time, so that you don't buy the lot at a time that turns out to be a market peak.

Balancing Act

One simple way to diversify is by investing in a balanced fund.

These funds, offered by most fund managers and superannuation schemes, usually invest in New Zealand and international shares, property, fixed interest and cash.

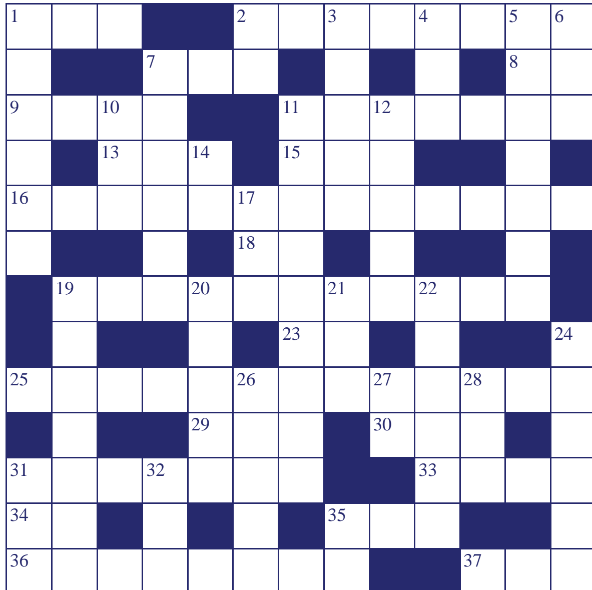
Keeping in mind any other investments you have, choose a fund that has the right balance of assets for you.

If you can't cope with the idea of the value of your investment rising and falling, go for a fund with less in shares and property.

Over the long term, though, the returns on such a fund probably won't be as high as on a fund with more volatile investments.

Money does make all the difference.
If you have two jobs and you're rich, you have diversified interests.
If you have two jobs and you're poor, you're moonlighting."

Anonymous



HOLM TRUTHS CROSSWORD Winter 2001

ACROSS

1. Utilise (3)
2. Logical (8)
7. In a play, or used to play billiards (3)
8. 8th May 1945 was _ _ Day (abbrev.) (2)
9. Girl's name (4)
11. Acted, reacted (7)
13. Good news for mining shareholders (3)
15. Grande or de Janeiro (3)
16. Type of home loan (5,8)
18. Not bad (2)
19. Piggy investment (4,7)
23. About (2)
25. Type of fixed interest investment (9,4)
29. Tooth on rim of a wheel or gear (3)
30. Tonic water's mate (3)
31. Small spot on bird's egg (7)
33. Falling sharemarket (4)
34. What the young save for (abbrev.) (2)
35. Buzzy (3)
36. Fissure in glacier (8)
37. Not hers (3)

DOWN

1. Elevate (6)
2. Same as 23 across (2)
3. Of them (5)
4. Eggs (3)
5. Retaliates on behalf of a friend (7)
6. Guided, went in front (3)
7. What a CV describes (6)
10. Clothes for feet (US) (3)
11. Trading fee (9)
12. Traveller's accommodation (5)
14. Man's name (abbrev.) (2)
17. Crowd, throng (3)
19. Grow rich (7)
20. Rap, criticise (5)
21. Rent (3)
22. What you would do with 30 across (6)
24. Loves (6)
26. Parts in a play (5)
27. For example (abbrev.) (2)
28. Undesirable number of shares to hold (3)
31. Society (abbrev.) (3)
32. Canterbury Television (abbrev.) (3)
35. Exist (2)

Solution: Back page

GREAT DEBATE • GREAT DEBATE • GREAT DEBATE

SHARES vs SHARE FUNDS

Share funds were born to make the most of diversification.

Until they came into existence, over the last few decades, the only way to invest in shares was to buy them directly.

For those who had a million dollars to invest, it was easy to spread their money over a large number of companies, and so reduce risk.

But people with much less money found that rules about minimum shareholdings, and higher brokerage for buying and selling small lots, made it difficult and expensive to acquire a varied share portfolio.

What's more, many people didn't want to bother with all the dividends, share splits, rights issues, and what-have-you that come with a large portfolio.

Enter share funds, in the form of unit trusts, group investment funds, investment trusts, super scheme share funds and so on.

Through them, you can put your money into just one investment, but still gain the benefits of owning many – sometimes hundreds – of shares.

What's more, in "active" share funds, a manager is doing the research and choosing which shares to buy and sell on your behalf.

You can select a manager that is more or less aggressive, or follows a certain investment "philosophy" that appeals to you.

Or you can go into an "index" fund, which simply invests in all the shares in a market index, and so is cheaper to run.

In either type of share fund, you benefit from the fact that the fund managers are trading shares in much larger quantities than you would. This means that brokerage and other costs are lower per share.

It all sounds great. However, there are some drawbacks to share funds.

For one thing, the very lack of paper work and research that is a plus for some investors is a minus for others.

They enjoy reading up about shares and following the markets. While they may not benefit much from their research – the big

(CONTINUED PAGE 4)

SHARE PROS	SHARE CONS
✓ An enjoyable hobby	✗ Less diversification
✓ Annual meetings – have your say	✗ More research
✓ Get annual reports	✗ Lots of paperwork
✓ Can be very lucky.	✗ Can be very unlucky.

SHARE FUND PROS	SHARE FUND CONS
✓ Generally better diversification	✗ Have to pay fees
✓ Less paper work	✗ Sometimes pay higher taxes
✓ Less research	✗ Some poorly diversified.
✓ Lower brokerage.	

(GREAT DEBATE, CONTINUED)

institutions tend to make any gains from new information before individuals get a chance – they will sometimes get lucky.

In any case, they find running their share portfolio, and perhaps having their say at company annual meetings, an absorbing hobby.

There are also financial arguments against share funds, particularly those investing in New Zealand shares.

Many funds, particularly the active ones, charge relatively high entry and ongoing fees. Also, active funds are taxed on the capital gains they make. This eats into their returns.

Index funds charge lower fees and do not pay tax on capital gains. However, most index funds of New Zealand shares invest in the biggest 10, biggest 30 or biggest 40 shares – or some variation similar to that.

Because Telecom is so dominant in the New Zealand market, it carries heavy weight in these funds. This reduces the benefits of diversification.

There are some New Zealand index funds that invest in middle-sized companies or property shares, so they exclude Telecom. But not every investor wants to concentrate on those market sectors.

For all these reasons, some experts suggest investing directly in, say, ten or more New Zealand shares rather than using a share fund.

Others, though, say that for all their drawbacks, it's simpler to invest in a fund of New Zealand shares.

And for people with amounts too small to buy reasonable parcels of at least ten shares, share funds are the only way to get broad diversification.

The situation is different for international shares.

All the experts agree that at least half your share holdings, and perhaps much more, should be offshore.

But if you buy international shares directly, tax and other complications arise. It's much easier to hold international shares in a New Zealand-based share fund.

Occasional large gains seem to sustain the interest of investors and gamblers for longer periods of time than consistent small winnings. That response is typical of investors who look on investing as a game, and who fail to diversify; diversification is boring. Well-informed investors diversify because they do not believe that investing is a form of entertainment."

Peter Bernstein in *"Against the Gods – the Remarkable Story of Risk"*.

One-share wonders

Many New Zealanders hold shares in just one company. It's a diversification nightmare.

"That's me. But it's not my fault," I can hear you saying. "I inherited them." Or "I got them through an employee share scheme".

Other excuses: You acquired the shares when your electricity company listed, or your insurance company demutualised, or a neighbour gave you a hot tip that didn't turn out to be so hot.

You might, in fact, have a good reason to hold on to your single share. Sometimes, in employee share schemes, a condition of getting the shares cheap is that you can't sell them for a certain period.

And if you inherited the shares, you may feel that selling them would be somehow disloyal, or would cut ties with the past.

In that case, though, think about what the person who left them to you would want. Chances are they would rather you sold the shares and did something meaningful with the money, such as using it for education or a deposit on a house.

In most other cases, people continue to hold single shares out of lethargy, or for rather irrational reasons – "I got them for nothing, they're a good little savings extra, and if I sold them the money would just disappear on groceries."

If that sounds like you, consider this: If somebody gave you $1000, or whatever your one-share holding is worth, would you go out and buy those shares with the money?

Almost certainly not. So what are you doing with the shares?

Sell them. And don't let the money disappear on groceries. Put it into a share fund or some other more suitable investment.

Holm Truths Crossword Solution

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

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