Investing in

knowledge

History doesn't repeat but it rhymes – Mark Twain

Q3/16

The clouds are gathering for HOUSE PRICES

WE ALL KNOW THE AGE OLD ADAGE OF "WHAT GOES UP MUST COME DOWN". THIS APPLIES TO ALMOST ANYTHING WE THINK ABOUT, BUT FOR DECADES IT DOES NOT SEEM TO HAVE APPLIED TO AUCKLAND HOUSE PRICES. HOWEVER, THERE ARE SUFFICIENT CLOUDS ON THE HORIZON TO INDICATE THAT THINGS MAY SHORTLY CHANGE.

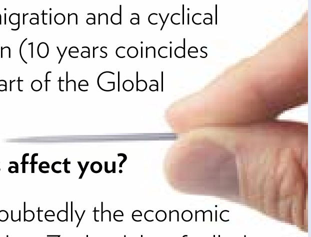
However, should we be worried as after all, this is an Auckland problem and one of particular concern to Auckland first home buyers?

When might the housing boom end?

Unfortunately, we do not have a crystal ball so we need to look to events elsewhere in the world and bow to the collective wisdom of some pretty smart experts in New Zealand.

Building supply is a blunt instrument. It takes years to gear up to start to meet demand and then it takes years to slow down. Because of the inability to exactly meet demand, there will inevitably be a house oversupply situation once migration has slowed, interest rates have nudged up, access to mortgages has tightened, house supply has expanded, and the confidence level of the public has fallen. All these factors can lead to falling house prices.

Gordon Edington, a director in property consultancy firm Prendos, believes things will unravel in 2018/19. He believes the stimulus for a fall will be a combination of increased house supply, rising interest rates, reduced migration and a cyclical 10-year downturn (10 years coincides with the 2008 start of the Global Financial Crisis).



How might this affect you?

Auckland is undoubtedly the economic powerhouse of New Zealand. It is fuelled by massive levels of household debt. When house prices rise, owners feel good and will consume more, believing they can add the new debt to their house mortgage and rising house prices will pay it off one day. When house prices fall, the credit cards stop coming out and a downturn occurs. This spending reduction affects all

GENERATION WEALTH MANAGEMENT

Albany Office
PO Box 64001, Botany, Manukau 2163
TEL. 09 448 5083
EMAIL. albany@generationwealth.co.nz

Botany Office
PO Box 64001, Botany, Manukau 2163
TEL. 09 272 9030
EMAIL. botany@generationwealth.co.nz

Pukekohe Office
PO Box 66, Pukekohe 2340
TEL. 09 238 3322
EMAIL. pukekohe@generationwealth.co.nz

THREE FINANCIAL RULES TO TEACH YOUR KIDS

I often think about the money tips I wish someone had given me twenty years ago. I reckon I can boil most of it down to three key pieces of advice, which I will do my best to drum into my own children. Firstly, spend less than you earn. Secondly, never borrow money to buy depreciating assets. Thirdly, start saving or investing as early as you can. Arming young people with a few basic (but important) concepts will make their financial journey a little smoother.

Inside

of New Zealand. If this spending reduction coincides with a global cyclical downturn, then it becomes a double whammy and many parts of our economy slow – overtime is reduced, people may be laid off, tenants struggle to pay rents, migration slows, and young people return home to live with parents. All this leads to falling house prices and also falling rents.

IT IS DIFFICULT TO PREDICT HOW MUCH HOUSE PRICES IN AUCKLAND AND ELSEWHERE COULD POSSIBLY FALL.

However, things don't stop there. The banks will want increased equity in the houses they are financing, they may want borrowers to start paying off capital rather than just sitting on 'interest only loans', and interest rates might rise.

About this time, any changes to tax rules made by the government in 2017 to slow house price appreciation will start to kick in and those who borrowed heavily to buy rental properties could be hit badly.

It is difficult to predict how much house prices in Auckland and elsewhere could possibly fall. We have seen property values decline in parts of Asia, the USA, Canada, UK and Europe by 50-60% during the GFC. A number of economists believe Auckland house prices are 40% or more overvalued, but that does not necessarily translate into a fall of that size in Auckland. Statistics produced by First New Zealand Capital in early 2016 indicate that a price fall of 13-17%, based upon historical falls in New Zealand, would be more likely.

Those who are not heavily indebted or are debt free, need not worry excessively. Your house price may drop, but provided you have a well-diversified investment portfolio and your house is not part of your retirement planning, then you just ride it out knowing that you will be worth a little less on paper than what you were during the boom.

For those who have massive mortgages or who have recently purchased, then things could be very messy. It is important debt levels be reduced while interest rates are low and you focus on building up liquidity in a diversified investment portfolio so that if the banks demand a sudden debt reduction, you have money available in your non-KiwiSaver scheme investment portfolio to make this payment.

If you own a rental property and the yield on it is 3% or less (based on current market value and assuming it is debt free) then talk to us about whether now is a good time to consider selling it and diversifying your overall investment portfolio. If you are planning to sell a property, it is always better to do it in a buoyant market rather than a declining one.

BE BOLD WHEN OTHERS ARE FEARFUL

We have seen many times this year where being bold in the investment markets when others are fearful can potentially lead to you making a good capital gain over time. The investment markets are like a yoyo. They will always go up and down and the shorter the timeframe in which you look at the markets, the bigger the yoyo movements seem to be.

A classic example of this was June. The world was holding its breath around Brexit. Investment markets like certainty and when investors around the world do not know what will happen (ie: would Britain stay in the EU or leave), then they tend to sell investments that could be impacted by the UK leaving the EU and place their money into safe investments such as US dollars. Selling on a large scale, as occurred in June, results in share prices falling. If you are a positive thinker and believe that the sun will come up the next day and that the world will not go to hell in a handcart, then it makes sense to use surplus cash to invest into a diversified portfolio and select the funds with a higher proportion of shares in them. We do not recommend you use managed funds to speculate (ie; buying with the intention of selling shortly for a good capital gain). Money invested into funds with a higher proportion in shares should be saved for the medium- to long-term. However, investing in June when the unit prices were cheap is like going to the supermarket and buying items when they are on special.

THE INVESTMENT MARKETS ARE LIKE A YOYO. THEY WILL ALWAYS GO UP AND DOWN...

If an investment was a good one in May and was worth hypothetically $1.00, and it fell in June to 70 cents, then provided the quality of the investment has not gone down, it is like buying the investment on special. This is what fund managers, like the ones we recommend, do all the time.

We are here to talk you through any issues or concerns and assist you to select the right investment funds for your particular risk profile and goals.

Life's tips/1

"To be an investor you must be a believer in a better tomorrow."

– Benjamin Graham

Summing up

- House values could fall by 13-17%, some say 40%.
- Should you keep your rental property, or sell now?
- Consider using surplus cash to buy shares cheap.

Chasing performance is not always a SMART MOVE

HAVE YOU EVER WONDERED WHY YOUR INVESTMENT DOES NOT SEEM TO REFLECT THE SAME EARNING RATE AS WHAT IS PUBLISHED IN THE PAPER, ONLINE OR IN SOME GLOSSY DOCUMENT?

Morningstar has recently released analysis indicating New Zealand investors generally fall below published fund performance figures. Tim Murphy, Morningstar's Head of Manager Research, suggests the 'fear and greed' behavioural cycle is the cause of this underperformance. The Morningstar NZ research – which matches findings in other jurisdictions – found the 'behavioural gap' where people tend to buy and sell on recent fund performance results, can materially affect actual investor returns.

1. **Think long-term:** Decide when you actually want to use some or all of this money. If it is not until years into the future, then avoid the short-term market noise and hype. Is the actual investment or the asset class likely to rise over the long-term? If no, then avoid it. If yes, then invest in and stick with it for the duration or until the fundamentals around that investment or asset class change.
2. **Be realistic on your expectations:** The period from 2009 – 2015 was exceptionally good for shares and fixed interest funds. This saw year on year growth well above long-term averages. Eventually shares reach full value plus interest rates bottom and from that point, total returns (income and capital gain) fall and for periods can be negative. Work with your financial adviser to identify what sort of return you need to achieve your financial goals and avoid the temptation to chase the highest performing investment or managed fund. In this part of the market cycle, getting a higher return will often involve taking more risk. We recommend you revert to thinking about the 30-year average return on asset classes rather than the average return over the past five years.
3. **Avoid the lemming effect:** Lemmings are often remembered as those little rodents who blindly follow one another and jump off cliffs to their death. Unfortunately, humans also like to follow the herd and do what others are currently doing. If the markets go up, then the media publicise this and more and more investors buy what has increased in price believing that it will keep rising forever. Conversely, when markets fall, the media publicise the perils of being invested into this or that and consequently, a number of investors sell at heavily discounted rates – and by doing so, they may wipe out much of the gain from when they purchased the investment. Disciplined active fund managers will look at falls in market prices as an opportunity to buy quality assets and when prices rise to what they regard as being overpriced, then they sell some or all of that overpriced asset. This is counter to what the average mum and dad investor working by themselves tend to do.
4. **Check timeframes:** When comparing your investment return to the published investment return, check that you are comparing the right time period. Your report may be for a period 1 April to 31 March yet the performance you are looking at online may be for a different 12 month period. In today's volatile market just one month can make a significant difference to the 12 month performance.
5. **Dollar cost averaging alters the investment return:** The published investment performance is based on 100% of the investment being made on day one of the investment period and being in the fund until the last day of that published period. However, dollar cost averaging is where you are adding money to that investment on a regular basis (often monthly). This means that at the end of the reporting period, the total amount in the fund is not what has been there for the entire reporting period. Over time, dollar cost averaging tends to reduce your investment risk and improve your returns but it does take a number of years before this is obviouss.

Give us a call and we can work through what is the right fund for you, your family and friends.

Summing up

- Who can you turn to for investment research? Us.
- Calculate your risk profile, and then calculate what returns you want.

THE DOWNSIDE OF PAST PERFORMANCE

"90% OF WHAT PASSES FOR BRILLIANCE OR INCOMPETENCE IN INVESTING IS THE EBB AND FLOW OF INVESTMENT STYLE." – JEREMY GRANTHAM

The typical fund pitch book has some combination of the following:

- Our team has X years of combined experience.
- Our track record set against the S&P 500 is as follows...

I understand the need to point out market experience and past performance. The market provides a running scorecard of investment successes and failures. I just think far too many people in the finance industry overestimate the role of skill and underestimate the role of luck on their results. There can actually be a downside to using past performance as one of your main metrics when choosing a money manager:

- A great track record can attract the wrong types of investors who are only into chasing fads.
- Past performance without context can be useless because the investment style, market environment and assets under management when that performance was earned are all very important factors, especially if it was created over a relatively short period of time.
- Past performance is no substitute for how a specific process will play out in the future.
- Overconfidence following a run of outperformance can cloud the decision-making ability of even the best investors and incentives can change after money managers have established a decent track record.
- Performance is often confused with process, which is the only thing that matters going forward.

That's another problem with a focus on past performance when vetting an investment opportunity — you potentially limit yourself to those who have an established track record.

One of my favorite stories on this involves David Swensen, arguably one of the greatest investors of all-time. Swensen's track record running Yale's endowment fund is unmatched in the institutional investment industry and spans more than three decades. He didn't exactly have the greatest track record when hired for this now prestigious position. In fact, he had no track record at all and no experience whatsoever in portfolio management. Here's the story, as told by Peter Bernstein:

> *Lehman Brothers lured Swensen away from Salomon Brothers, but the stint at Lehman would turn out to be brief. One day Tobin and Brainard called from New Haven to talk Swensen into taking over the management of the Yale endowment fund, a position that had been open for some time. Swensen balked, complaining, "I don't know anything about portfolio management." His former professors refused to take no for an answer. "That doesn't mater," they told him. "We always thought you were a smart guy, and Yale needs you." As a loyal Yale alumnus, they insisted, Swensen was obliged to take on the job. There are lots of jokes about economists and their hilarious failures at forecasting, but Swensen's track record goes a long way to demonstrate that Tobin and Brainard knew what they were doing when they flattered him into taking a position he never thought he would hold, much less aspire to. Swallowing an 80 percent cut in pay, Swensen said yes to Tobin and Brainard, and moved himself back to New Haven. His salary is now a respectable one by most standards, but far below what the major players at thousands of hedge funds and other investment organizations take home for their efforts. For Swensen, this job has been a labor of love.*

The fact that Swensen took such a huge pay cut to leave Wall Street to take a job for his alma mater says a lot about his character. Sure, they were taking a chance on him, but he was taking a big career risk as well. Obviously, Swensen is an outlier of sorts in that he eventually went on to basically master the art of institutional investing. But had his former professors based their entire search process on past performance alone they never would have considered their former protege.

Past performance is overrated while process and a person or organization's character are extremely underrated. I'm always suspicious when performance is the entire reason for choosing a strategy, fund, portfolio manager or adviser. People and process are much more important when trying to figure out how performance will play out in the future.

Life's tips/2

"It's not what you own that will send you bust but what you owe."

– *Anon*

Next step

••• See us about the best investment options for you.

GENERATION WEALTH MANAGEMENT