Market Commentary

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FINANCIAL PLANS MUST PROTECT AGAINST "REAL WORLD INFLATION"

APRIL 2011

The present debate about whether financial markets are experiencing inflation or deflation is irrelevant for New Zealanders in retirement, says investment manager at NZ Funds Management, Michael Lang. Instead investors should focus on "meflation" or price increases that affect them.

"Most economists don't expect inflation to arrive anytime soon", Lang says. "But try paying less for your power bill this year, or at the supermarket when you check out and you will get a lesson in power of inflation."

"While economists obsess over deflation, inflation rates for food and household energy have risen 5.29 per cent and 3.95 per cent per annum respectively over the last five years. In total that equates to between a 20-30 per cent increase in the cost of the necessities of life," says Lang.

As a consequence New Zealanders who are serious about surviving the twenty plus years they are likely to be in retirement from 65 to 85 years of age should get serious about ensuring their portfolios are well positioned to withstand the impact of everyday inflation on their hard-earned money, before it is too late.

"The nature of inflation is that it sneaks up on you. By the time it has arrived it will have momentum, and at that point it will be even more difficult to cost effectively minimise its impact."

Retirees are unlikely to need a radical overhaul of their investment portfolios unless they are poorly diversified to begin with. But this, according to Lang, is the norm. "In general New Zealanders have approached retirement with the same DIY attitude that as a nation we are famous for. Unfortunately for many that meant putting all their savings into the finance company sector, instead of only a portion of their assets."

Today, as a direct backlash against losses incurred in finance companies, property and shares, New Zealanders are overweight cash. "Cash is a strategy that will lead to short term success, followed by long term disaster. The vast majority of New Zealanders never enjoy the interest rate they see advertised in bank windows. The sign might say 4.5% per annum but by the time the Government has finished taxing your gains, investors on a 30 per cent tax rate have grown their capital by approximately 3 per cent. That is not enough to keep up with food price inflation. The higher the rate of inflation, the worse this equation gets," Lang says. For example, if inflation were to increase to 10 per cent, interest rates might also rise to 10 per cent, but on an after tax basis investors would be falling 3 per cent behind each year, or approximately 35 per cent over 10 years.

Lang advocates investors overhaul their financial plans with the help of a professional financial adviser sooner rather than later. Some of the better ways to inflation-proof a financial plan include:

1. Shorten up your bond portfolios by avoiding overexposure to long term corporate bonds. Even cash is better than locking money up for many years at the low interest rates that prevail during downturns in the market. Many corporate bonds being sold today have 5 or 7 years before maturity. A corporate bond paying 7.5% per annum is on an after tax basis, only just keeping pace with food price inflation. Locking money up for seven years at that rate without the ability to enjoy an increase in returns each year as interest rates rise is not a smart strategy. Instead either use shorter maturity bonds – second hand issues with only one or two years to run – or employ a hedging strategy which can convert fixed interest rate bonds into variable interest rate bonds which can benefit from future rises in interest rates. "Investors who hold securities with shorter maturities have the opportunity to reinvest at higher rates more quickly".

2. Consider purchasing inflation-protected bonds. Inflation protected bonds guard against inflation because in addition to paying a fixed rate of interest,

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the principal (or amount originally invested), increases with inflation. Interest payments also rise with inflation. Not many New Zealanders realise that these bonds are currently offered by the New Zealand Government because unlike corporate bonds there are not big investment banking fees attached with their promotion. Allocations within a financial plan should vary according to the benefactor's circumstances but an average client using NZ Funds Management's Goal-Based Financial Planning Process has a 20% exposure to a globally diversified portfolio of inflation protected bonds.

3. Contrary to popular opinion the share market is not particularly useful as a tool to protect against inflation, unless you know where to look. "Half the shares in the market are negatively impacted by inflation, some significantly so. New Zealanders in retirement should consider only purchasing high and stable dividend yielding shares such as water, power and gas utilities or infrastructure asset such as ports and airports. Most monopoly assets have the right to increase the price they charge by some measure of inflation each year. When this is combined with a policy of distributing the profits through regular dividend payments with imputation credits attached it makes for a very attractive addition to an inflation-protection orientated financial plan.

Two asset classes Lang is more sanguine about are Commodities and Property. Commodities, taken in aggregate will undoubtedly rise with inflation but few investment managers, let alone retired New Zealanders, are skilled enough to cope with their excessive volatility, which Lang points out is often in excess of twice that of the share market.

"Furthermore, there is no easy way to gain exposure to commodities. Most funds which offer investments in commodities also require you to lock up your capital for a period of time if things don't work out. That's nuts if you understand the impact of inflation on your cash. Yes, you might get your cash back in 5 or 10 years but by then it will only be able to purchase half of what it used to buy," says Lang who likens such products to finance companies which took advantage of New Zealanders desire for capital stability, which with the benefit of hindsight turned out to be an illusionary.

Unlisted property should also be well down the list of assets to consider. The property market is highly illiquid. It has still not adjusted from the bubble type level it reached in the boom times. Lang expects to see further property price declines, even in the face of rising food and household energy inflation as occurred in 2009 and 2010. "Access to debt and interest rates greatly influence property prices so the first thing that is going to happen when inflation picks up is that interest rates are going to rise and unless there is a corresponding boom in real economic activity, real property prices will fall". Because of elevated property, price levels New Zealand is starting from property is unlikely to be the saviour it was during New Zealand's inflationary bout in the 80's and should be well down the list of inflation protecting assets", Lang says.

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