

Investing Insights

BALANCING RISK WITH RETURN: THE IMPORTANCE OF GOOD FINANCIAL ADVICE

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One would think that assessing the competence of your financial adviser and investment manager would be easy. After all, the end result (your return) is transparent and easy to compare against the alternatives. Unfortunately, the same cannot be said for the corollary of return. That is, risk.

Most clients would be very pleased with a 50% gain over a short period of time. However few would be pleased if they learnt that the gain came from betting on black at a casino. While this is an extreme example it highlights that the risk taken in order to try and fulfil an investment objective is at least as important as the return achieved.

As a consequence, undue emphasis is often placed on investment return rather than a more reasoned, objective focus on investment performance – which encompasses both return and risk.

SHORT AND LONG-TERM RISK

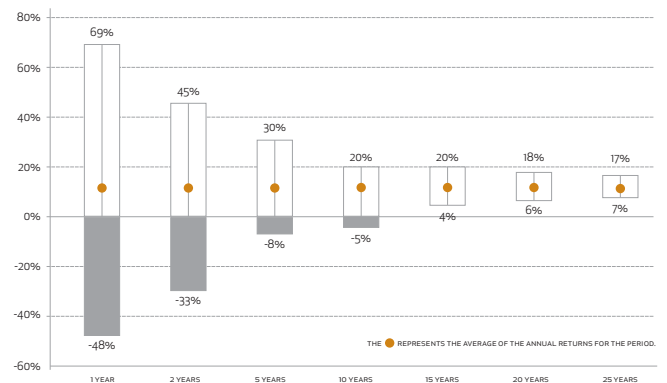
Risk is easy to define – it is a loss of capital. When considering how capital may be lost it is often useful to break risk into two types: volatility risk (which can also be thought of as short-term risk), and purchasing power risk (which can also be thought of as long-term risk). It is important to understand the characteristics of each.

Volatility risk is a popular topic in finance. It is easily quantifiable by taking the standard deviation or its square, the variance of returns, over a year.

By way of example, United States shares have returned 11% on average since 1952, however they are volatile. Two thirds of the time clients should expect the annual return to be between - 5% and + 26%, and one third of the time the annual return to be above or below this range.

The volatility or wide range of possible returns from shares over short periods of time can be unnerving compared to the reliable return achievable from investing in bank term deposits. But does reliable equate to “safe”?

SHARE VOLATILITY RISK REDUCES WITH TIME



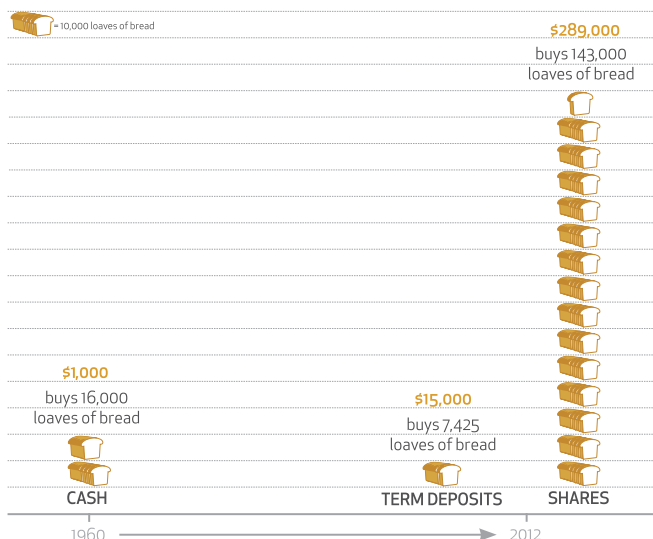
SOURCE: SIFMA, NZ FUNDS MANAGEMENT CALCULATIONS.

Recall that we said risk is easy to define: it is the risk of losing money. After all the whole point of saving during a working career is to be able to spend that money later in retirement. In fact most clients wish to do more than save – they wish to invest. That is, they wish to set aside a certain amount of money today (say \$1,000) in the expectation of receiving more money back in the future (say \$1,800). Unfortunately, over periods of longer than one year the assets which have the lowest short-term risks – that is their value does not fluctuate much over any one year period – are most likely to suffer from purchasing power risk.

Over the last 52 years a continuous investment in term deposits would have generated a return of 7.5% annually.

That sounds satisfactory. But for a tax paying investor on an average tax rate of, for example, 25%, the return drops to 5.6%. Unfortunately over the same timeframe inflation in New Zealand averaged 6.2%. After 52 years of investing in an asset with little or no “volatility risk” this client would have turned \$1,000 into \$15,000 but would only be able to purchase goods worth \$700 in 1960 equivalent values. This defies the whole objective of saving which is to be compensated for forgoing consumption today in order to consume more in the future - not less! In contrast, the same investment in shares would have been far more “risky” (volatile) over the short-term but would have grown to \$289,000 (assuming the same notional tax rate) over the same 52 year period.

PURCHASING POWER RISK INCREASES WITH TIME



SOURCE: MERRILL LYNCH, NZ FUNDS MANAGEMENT CALCULATIONS.

As Shakespeare once noted, “ay, there’s the rub”. Assets which tend to have low volatility (short-term risk) tend to carry a lot of purchasing power risk over the longer term and assets with the best history of growing purchasing power over the long-run are most volatile over shorter periods.

But there is a pathway through this conundrum. A well constructed financial strategy and competently managed investment portfolio should address both types of risk if implemented with discipline.

For example, during the period 1990 to 2000 when the global share market rose strongly virtually all global share portfolios rose in value. The inverse occurred during the more recent global financial crisis. Over long periods of time the underlying market movement is far more powerful than investment manager skill.

Consequently, the most important investment decision New Zealanders will probably make after purchasing their home will be the balance between the asset types (cash, income, inflation and growth assets) in which they invest at each stage of their life.

The allocation between asset types, together with the amount they contribute regularly to their portfolio will be the primary determinants of how much wealth is accumulated during their working life. Similarly, for those in retirement, asset allocation and the rate of spending will be the primary determinants of how long their capital will last in retirement.

Helping clients make objective and disciplined choices – in particular ensuring an appropriate mix of assets at each stage of the client’s investment life – is where a financial adviser can add considerable value.

Good advisers will focus on achieving a dynamic (ie. changing over time) balance between the risk of short-term price volatility and the longer term risk of not achieving the desired level of purchasing power growth.

NZ FUNDS WEALTH TECHNOLOGIES: RISK SIMULATION

NZ Funds Wealth Technologies has developed a software system for “stress-testing” a client’s risk profile and proposed asset allocation. The client’s proposed investment portfolio is entered into the software. The programme then uses historic returns to walk clients through four extreme investment outcomes including the 1987 share market crash and the 2009 global financial crisis. In each situation clients are able to see the impact on each component of their investment portfolio (cash, income, inflation and growth) from the respective financial event.

It may not be complete to consider only negative market scenarios and to exclude periods when investment portfolios tended to perform unusually well. Nevertheless, it is often insightful to start building your financial strategy by considering “what is the minimum amount of capital I could not do without?”, rather than by asking “what level of return would I like to target?”

If you have not considered the balance of your investment portfolio recently or would like to stress-test your portfolio, your financial adviser will be happy to apply the new Wealth Technologies software to your situation.

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