Bramwell Brown Ltd

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The Energy Sector – Are We Over-Exposed?

I'm currently in the process of reviewing client portfolios and a familiar theme has been the exposure to the New Zealand energy sector. Before the sale of the state assets many clients already held a combination of Contact Energy, Trustpower and Vector. Further exposure was evident through most clients holding Infratil, who own 51% of Trustpower. The first company to be offered in the Government assets sales programme was Mighty River Power. We encouraged investors to participate, assuming the Government would pitch it at a price that would give investors a good experience. The logic behind this was that the Government couldn't afford to have the Mighty River share price languishing at the time they were bringing the other companies to the market. How wrong we were – Mighty River was trading at $2.20 when Meridian listed in late-October 2013. This was 30 cents (12%) less than its listing price of $2.50.

The decision on whether or not to invest in Meridian was made easier by the attractive terms being offered. These terms included an instalment receipt basis of payment where only $1 per share was required upfront, with the remaining 50 cents payable in May 2015. The dividend yield was extremely attractive and subsequently it wasn't a difficult decision to invest. By the time Genesis came to the market I think there was a fair amount of investor fatigue around the asset sales programme. Mighty River Power was trading at $2.15 after hitting a low of $1.95. Meridian was trading above its listing price after spending a month trading under $1.00. There was still a fair amount of political noise around the whole programme. Nobody seemed particularly interested in Genesis, and this is probably why it was pitched at such a good price. A fifteen to one bonus share sweetener and a prospective gross dividend yield in excess of 10% proved too good to pass up.

So a good number of investors have now ended up owning most (in some cases all) of the New Zealand listed energy companies. Vector can be considered somewhat separately because it is not a generator of electricity (although it does hold a 22% stake in NZ Windfarms Ltd). It's an electricity, gas, and telecommunications distributor, and therefore is still subject to the regulation that the big generators are exposed to.

How many is too many? I think what is more important is your exposure to the sector as a whole, rather than the number of companies you hold. Holding all of the generators is probably unnecessary – I would suggest three is ample. The generators have a varying mix of assets including hydro, wind, diesel and geothermal, and will perform differently in varying weather conditions. So holding all of them is not a problem in itself, but I would caution investors not to become over-exposed to the industry as a whole. They will all be subject to certain conditions (for example Government regulation).

The same argument can be used with the listed property trusts. Many investors hold five or six of the property trusts. This is not a problem in that they hold different assets (retail, commercial, industrial, office) so perform differently. But if, for example, the Government changed the tax rules on property trusts they would all be subject to that change regardless of what sector they invested in.

Investment Fundamentals

I apologise for regurgitating old material, however reviews of client portfolios tend to bring up recurring themes each year. Here are some of the fundamental principles investors should be considering.

<u>Diversification</u>

Investors should look to diversify across sectors of the financial markets meaning they should spread their funds across cash, Government bonds, term deposits, bonds, property and shares. Many investors thought they were diversified by owning five or six different finance companies; however they were actually exposed to one sector. If you own shares you can further diversify by spreading your risk across different industries. For example instead of owning only property shares you can ensure you also hold retail, utilities, infrastructure and healthcare shares. Depending on the size of your portfolio you can also diversify into other countries to gain access to industries not represented in New Zealand. This is one aspect of diversification I think many investors don’t take seriously enough. Overseas investments are your insurance policy against a significant shock to the New Zealand economy. There is a counter-argument that suggests you can diversify your investments into mediocrity. Instead of diversifying, some may argue they have benefitted greatly from backing one or two winners, rather than spreading their funds across a number of different companies. For example if you had put $100,000 of retirement savings into Apple ten years ago it would have grown to over $4 million today. But what if you had chosen GPG or Telecom?

<u>Risk and Return</u>

I think most people would recognise the relationship between risk and return. Basically if we take more risk with our money we should expect to be compensated with higher returns. However I think what investors often fail to understand is the relationship between risk and loss. Unfortunately sometimes higher risk investments lead to loss, and rarely does an investor's aversion to loss match their aversion to risk. It's not until an investor loses money that they realise they have a lower aversion to risk than they thought. Always remember that return "of" capital is more important than return "on" capital. How much risk to take is an extremely difficult thing to determine and is influenced by your stage in life, your income, your goals, and your capacity to make up any losses you may incur.

Timing

Timing markets is fraught with difficulty and if I thought I could trade my way to riches I wouldn't be doing this job for a living. History has proven very few people are capable of predicting market movements and benefitting from them to any consistent degree. "Time in" the markets is possibly more important than trying to time the peaks and troughs. Timing also becomes a factor when you have a specific use for your funds. You wouldn't invest in the sharemarket if you knew you needed the funds for a deposit on a house in twelve months time. Ensure your fixed interest investments are maturing regularly over a five to ten year period. This takes some of the volatility out of fluctuating interest rates and avoids being caught with large sums of money to be invested at the bottom of the interest rate cycle.

Liquidity

The ability to cash up all or part of your investments in a timely manner is an important fundamental of investment. Emergencies sometimes arise, and you may need to access funds immediately. All investments have various liquidity characteristics. Cash is the most liquid, whereas property held directly would be considered an illiquid asset. Consider the implications if most of your wealth was tied up in a single commercial property, and you suddenly needed access to funds for a family emergency. Commercial property (particularly at the bottom of the cycle) can take months rather than weeks to sell. You may be able to raise a loan against that property depending on your financial position, and in that case liquidity is less of a concern. If instead you owned shares in property trusts listed on the stock exchange, you could have access to your funds in three days.

Emotion

As difficult as it may be, investors need to take the emotion out of investment decisions. Too often I hear people say, "I couldn't possibly sell at that price, I paid far more than that." You must ignore what are referred to as sunk costs. Regardless of what has happened in the past you need to ask the question, "What is the best use for this money from today?" What has happened in the past is largely irrelevant. Beware also of getting caught up in the hype of an investment craze. Gold is a good example. Make sure you understand what you are investing in and have a good grasp of what drives that particular investment.

Mighty River Power Bond

A number of clients have questioned whether holding a company's bond is a good idea if you already hold their shares. Is it increasing your exposure to that company and the sector? Yes it is, however the risk is quite different. I don't think you should discount adding the Mighty River Power bond to your portfolio just because you own their shares. The bond stands ahead of shareholders and in the case of Mighty River Power there is some comfort in the sheer volume of dividends paid to shareholders that would have to be halted before bond-holders had their interest payments suspended. The minimum interest rate for the first five years has been set at 6.80% (it could be slightly higher). This interest rate is made up of the five-year swap rate plus a margin of 2.25%. The actual rate will be set on July 11th. So on that day they will take whatever the five year swap rate is; add 2.25% and that will be the rate for the first five years. After five years the interest rate will be reset at whatever the five year swap rate is on that date, plus 2.25%, plus 0.25%. The company has the right to offer new terms at the five year anniversary, which you can accept or decline. If they don't get enough people accepting the new terms however, they don't have to pay you back – the bond rolls over for a further five years on the terms described above. This process can continue until 2044; however it is highly likely the bond will be repaid in 2024.

Kiwi Income Property Trust Bond Offer

The Kiwi Income Property Trust is considering making an offer of up to $100 million of fixed-rate, senior, secured bonds with the ability to accept up to $25 million of oversubscriptions. The bond offer will open in early July and is expected to have a seven-year maturity. Indications of interest are being sought now, but will not involve an obligation or commitment of any kind.

CONTACT THE OFFICE TO REGISTER YOUR INTEREST IN THIS BOND OFFER

IPO's

The sharemarket is currently experiencing a flood of new listings. Investors are spoilt for choice, however I would urge caution before committing funds to companies we know little about. Technology companies Gentrack and Serko listed this month with a number of others likely to list throughout the year. Scales Corporation, part of the late Alan Hubbard's business portfolio will list this month. Hirepool was due to list also, but has been withdrawn due to a lack of support. I fear investors may be lured into taking on the tech stocks without knowing much about the business, hoping for another Xero experience. I would also question the reasons for listing – is the company trying to raise more money to expand a growing business, or is a private equity owner looking to sell out at the peak of the market?