BRAMWELL BROWN LTD

INVESTMENT ADVISERS – BROKERS

Director: Brett Dymond – AFA, BBS, GradDipBusStud (Personal Financial Planning)

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Australia

As I mentioned last month I met Alex Hay from Ballieu Holst when I was in Melbourne in January. He gave a good insight into the factors affecting their markets, and it seems Australia is facing very similar issues to New Zealand. Low interest rates and a high dollar are a focus, as they have been here. Low interest rates overseas have seen a flood of money (largely from fund managers) flow into Australia looking for better returns. This has driven their share market, with yield stocks particularly sought after. They too have grappled with the need to lower interest rates in order to stimulate the economy, and the effect this has on the exchange rate. Their dollar reached parity with the US in 2010, and reached $1.06 in April 2013. A high dollar hurts exporters; however there is a corresponding argument that it can benefit an economy by making the cost of goods brought into the country cheaper.

It appears the restructuring we have been through since the global financial crisis is occurring in Australia also, only later. They went into recession much later than other countries and weren't required to implement the economic changes until later. This was largely due to the demand for their resources, mainly from China. The strong growth in resources may have masked deficiencies in the rest of the economy, and there was often talk in the media of Australia's two-paced economy. Once the resources boom cooled as China began to contract, the issues throughout the rest of the economy had to be addressed (cuts in Government spending, and lowering interest rates to stimulate growth).

In general, Australian companies, like their New Zealand counterparts are now in better shape than they were before the global financial crisis. Debt levels are more realistic and investors are more focussed on companies that can provide sustainable earnings. They are also trading at lower multiples (P/E ratios) than their New Zealand counterparts. This, combined with our historically high dollar makes investing in Australia relatively attractive at present. Of course we can't predict where the dollar will go in the future – there are so many internal and global forces at play. However, as I have said often, my main reason for investing overseas is to provide insurance against a large shock to our own economy. If such a shock occurs your overseas investments become more valuable in New Zealand dollar terms. If you would like to discuss opportunities available in relation to offshore investments don't hesitate to contact the office.

Risk versus Reward

I've spoken before about the level of return we are achieving for the risks we are taking. I think the current environment is extremely challenging in this regard, and I'm finding it harder to provide investors with returns that compensate them adequately for the risks involved. There are a number of factors at play, not the least of which is the low-interest rate cycle we are experiencing at present. Low interest rates have made investors reluctant to invest in bank term deposits, there being an assumption that rates are going to climb. Unfortunately some have been sitting on the sidelines waiting for a number of years and have missed out on possible increased returns. The low interest rates have also affected the returns on bonds and shares. Investors have moved into these other asset classes looking for higher returns, which has driven the price up and the yields down. My concern is that investors look to these other asset classes focussing on the increased return alone – at times ignoring the risk. Here is a summary of where I see these asset classes at present.

<u>Cash</u>

Bank call accounts are paying between 2% and 3% - a fair return in my view for the very low risk together with the fact you can access your funds immediately.

<u>Government Stock</u>

Our only risk-free investment (although investors in Greece might disagree). Kiwibonds are currently offering between 2.00% and 3.75%. Government Stock available on the secondary market is yielding between 3.20% (1 year) and 4.56% (9 years). It's difficult to compare this asset class with others due to the fact there is little (if any) risk involved. I feel there are few investors who are so risk averse that they would choose Government Stock ahead of bank deposits in the current environment.

<u>Bank Deposits</u>

The banks are offering rates from 3.00% to 5.80%. These rates are adequate but hardly startling. As I mentioned, investors are reluctant to invest for the longer terms because there is an assumption that rates are due to increase. I feel investors often overlook bank deposits in favour of higher-yielding securities. To me this is where investors should anchor their portfolio – this is the "no-risk" section of your investments that you can rely on. Maturities should be spread to even out the volatility in interest rates.

<u>Bonds</u>

Currently the secondary market for bonds is overvalued in my view. For example you can buy Z Energy maturing in August 2018 at a yield of 5.84%. After paying 1% brokerage to purchase the bond your yield to maturity would be approximately 5.60%. Is this a good enough premium over bank deposits for the extra risk? I accept bank deposits don't offer the liquidity (ability to sell) that bonds do. However most of the investors I deal with have diversified portfolios of shares, bonds and bank deposits and don't require every one of their investments to be liquid. The primary market (new issues) for bonds offers better value due to the fact no brokerage is paid by the investor when buying. Returns, however, are only marginally better than bank deposits and the question must be asked – are the returns compensating me adequately for the extra risk?

<u>New Zealand Shares</u>

The New Zealand sharemarket is trading at a historically high multiple (P/E ratio) of around 15 times earnings. Yields are very low for the growth companies like Ryman Healthcare, Metlifecare, Auckland Airport and Mainfreight, and higher for the traditional income stocks like the property trusts and the power companies. On a pure yield basis there appears to still be value in the New Zealand share market, however you would have to be prepared to ride out any short-term volatility in prices. Again the comparison needs to be made with the bank term deposit rates – is a 7% yield on a share adequate compensation over and above a 5-year bank term deposit?

<u>International Shares</u>

This is where most of the analysts I speak to claim the best gains are available at present. Our high dollar coupled with an improving global environment make overseas shares relatively more attractive. The risks are greater of course because you have the exchange rate to consider also.

Bond Issues

<u>Sky Network Television</u>

Sky TV is offering up to $100 million of unsecured, unsubordinated, fixed-rate bonds.

- Maturity date – March 31st 2021
- Interest rate – 6.25%
- Minimum application - $5,000
- Interest paid quarterly – June, September, December and March

<u>Auckland City Council</u>

Auckland Council is considering an offer of fixed-rate, secured bonds to the public and is seeking preliminary indications of interest. The bonds are expected to have a term of 10 years and will form part of Auckland Council's overall borrowing programme, which includes refinancing maturing debt and funding investment in projects across the region. It is expected that full details of the bond issue will be released and the offer will open on 14th March 2014.

Contact Energy

Contact Energy is offering up to $250 million of unsecured, unsubordinated, fixed-rate bonds.

- Maturity date – May 15th 2019
- Interest rate – 5.80% – 6.00%
- Minimum application - $5,000
- Interest paid quarterly – May, August, November and February

Contact Energy currently has $534 million of bonds due for repayment in May this year. Existing holders of these bonds will be given priority when applying for the new bonds. Considering Contact is only seeking up to $250 million in the new issue it seems unlikely new investors will be able to participate. This will depend of course on the rate of interest offered by Contact. They are inviting investors to tender a rate they would be prepared to accept between 5.80% and 6.00%. I would have thought 6.00% was a minimum considering the rates being offered on five-year bank term deposits at present. However, I predict the rate will be set at 5.80% considering the size of the offer. Those who tender above 5.80% run the risk of missing out altogether if other investors are prepared to accept less. My advice is to tender a rate that you think reflects a fair return for the risk involved – don't be swayed by the fear of missing out.

Contact the office as soon as possible if these bond offers are of interest to you

Genesis Energy

It's difficult to become enthusiastic about the final state asset to be sold – Genesis Energy. The asset sales process has been far from successful for a number of reasons and I predict there will be less demand for Genesis than there was for the previous power companies. Perhaps that means the asking price will be more favourable? What do we know about Genesis?

- New Zealand's largest retailer of electricity, natural gas and LPG
- Generates around 18% of New Zealand's electricity
- Owns New Zealand's largest thermal power station at Huntly
- Owns hydro electric power stations at Tongariro, Tekapo and Lake Waikaremoana
- Owns the Hau Nui wind farm in South Wairarapa
- Owns 31% of the Kupe oil and gas field

More details on the offer will be released soon – please contact the office if you would like to participate.