Bramwell Brown Ltd

Investment Advisers – Brokers

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Local Government Funding Agency

I commented in the December newsletter about the formation of the Local Government Funding Agency. In September the Government passed the Local Government Borrowing Bill. The legislation allowed for the formation of a "bond bank," the Local Government Funding Agency. It allows local authorities (city and district councils) to borrow money at lower interest rates than they can at present. The funding agency now issues local Government bonds to investors and then on-lends those funds to the participating local authorities. I got a bit excited when I heard interest rates around the six percent mark being mentioned, however it turned out to be a false alarm. In fact for retail investors it appears to be a bit of a fizzer. The bonds are issued under a tender process, similar to Government Bonds. So far they have issued two bonds, one maturing in 2015 and the other in 2017. They set the coupon rates at 6.00% and invited bidders to tender based on a yield they would be happy to buy at. The successful tenders were at yields of 3.67% and 4.61% respectively. Large institutions buy these bonds at tender in million dollar denominations and then offer them to retail investors through the secondary market. A retail investor would have to be extremely risk averse to buy a bond yielding 3.67% considering they have to pay 1% brokerage to get it.

Secondary Market Bonds (Coupon versus Yield)

For those struggling to understand the difference between coupon and yield mentioned above I'll revisit my June 2009 piece on the intricacies of the secondary bond market. Exaggeration is often the best method to explain a concept so here goes. First of all a quick look at the terms that are important when looking at a bond in the secondary market.

- Coupon – the interest rate received for the term of the bond. The coupon is set at the time of issue and does not change (there are securities on the market whose coupon is reset at various intervals, but let's not muddy the waters at this stage).
- Price – how much you pay for the bond. For example if you buy 1,000 bonds at issue the price you pay would be $1,000. If you buy 1,000 bonds on the secondary market half way through their term, the price you pay will be determined by supply and demand. This is where "yield" comes in.

- Yield – the return the new buyer will receive, from the time they buy the bond in the secondary market, until maturity.

Example

A one year bond is issued today with a coupon of 10%. I invest $100,000 and at maturity I will receive $110,000. The coupon is 10% and my yield will be 10%. The price I have paid for the bond is $100,000. A week after I bought the bond I desperately need my money back, so I decide to sell it to someone else. Unfortunately in the preceding week the company who issued the bond has been sued by a supplier and there is a chance they may go bankrupt. Who is going to give me $100,000 for my bond now? I find someone who likes risk and is prepared to buy my bond so long as they achieve a return (yield) of 50%. The only way they can yield 50% on a bond that is going to pay them back $110,000 in one year is to pay me $73,333 for it. I've lost about $27,000 in one week and the new owner of the bond stands to make a 50% return on their money (or lose the lot if the company defaults). The important thing to remember is that different yields only arise if the bond is resold after it is issued. If you are not forced to sell, and you hold your bond until maturity, you will yield whatever the initial coupon rate was.

Fundamentals

A number of new investors have signed up to our newsletter recently so I thought it would be worthwhile revisiting some of the fundamental philosophies on investment.

Diversification

Time and again I read of investors losing all of their money to a failed venture. Last week it was the Lombard trial that brought out the inevitable story of an elderly investor losing his life savings. This should never happen if you follow the most basic of investment concepts – diversification. To an adviser diversification is a bit like knowing the alphabet – it's so basic you take it for granted. Unfortunately there are many people out there who don't or can't grasp the implications of investing all of their money in one thing.

Investors should look to diversify across sectors of the financial markets meaning they should spread their funds across cash, term deposits, debentures, 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. 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 in Mainfreight ten years ago it would have grown to nearly $1 million today. But what if you had chosen GPG or Telecom?

Risk Versus Return

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. 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 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. I can still recall one of the first pieces of advice I offered to a client not long after I had bought this business. A young man sought my advice on investing $300,000 (his entire net worth) in the share market. He wanted to buy property within one year to eighteen months and wanted his funds available if a good opportunity became available. My advice was that he invest his money in bank deposits with maturity dates that matched his timeframe for the use of those funds. My rationale was that liquidity was his main objective (having the money at hand when the time was right), and the sharemarket was not the place to invest short-term funds. He went to the bank to deposit his money; however was intercepted by a friendly "relationship manager" who convinced him to invest the money in their share portfolio instead. This was in July 2008 – just as the wheels were beginning to fall off the global economy. Hindsight's a wonderful thing, and you could debate that investing in shares in 2008 wasn't such a wise decision, however the real issue is that the investor's time-frame didn't suit an investment in shares.

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 need 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.

Telecom

Telecom has announced an on-market buyback of its shares as it looks to return surplus capital to shareholders in the most efficient manner possible. What does this mean for investors? In general companies buying their own shares is positive for existing shareholders. Theory suggests the share price should rise as the company buys back and cancels a proportion of their shares. This is because their earnings are now spread across fewer shareholders, so provided the company can maintain its earnings each shareholder should be entitled to a higher dividend in the future. Whether or not you participate in the buyback is up to individual investors. You will not individually be offered the opportunity to sell your shares – rather Telecom will buy them (as any other buyer would) through the NZX over the course of this year.

I'm not going to attempt to do the maths on this but the theory I hope is sound. Telecom is looking at buying back roughly ten percent of their shares. If you do nothing you will retain the same number of shares you have held in the past. The share price should (all other things remaining equal) increase, and you should expect to receive a higher dividend in the future. Another way to look at it would be to sell ten percent of your shares. You should (all other things remaining equal) continue to enjoy similar dividends as you have received in the past, with the bonus of having received some cash as well.

Of course, all things very rarely remain equal!

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