BRAMWELL BROWN LTD

INVESTMENT ADVISERS – BROKERS

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Investment Fundamentals

Twice a year I speak at a money management class taught locally by Jeanette Hall. It's a good chance for me to reflect on the basics of investing, and I would suggest we could all gain something from a refresher course occasionally.

Diversification

Time and again I read of investors losing all of their money to a failed venture. Recently it was a story of a Wellington couple who were persuaded to invest $1.3 million into a start-up business that "couldn't fail." It failed. The sad part of this story is that the couple were trying to recoup $1.5 million they had lost in the finance company collapse. 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 (and advisers) 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, 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?

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. 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. 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 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.

Z Energy IPO

As expected, Z Energy has issued an investment statement and prospectus for an offer of ordinary shares in the company. Z Energy is currently owned by Infratil and the New Zealand Superannuation Fund through Z Energy Holdings Limited. The offer is being made to allow Infratil and the NZ Super Fund to realise a portion of their investment in Z Energy, and to further diversify their portfolio. After the completion of the offer Infratil and the NZ Super Fund will have a shareholding in Z Energy of between 40% and 50%.

In 2010 Infratil and the New Zealand Superannuation Fund bought Shell's New Zealand business and renamed it Greenstone Energy. They embarked on an extensive marketing campaign and rebranded the business "Z Energy" in 2011. They have pipelines, terminals and bulk storage facilities throughout the country, a 17.1% stake in the New Zealand Refining Company, a 25% share in Fly Buys, over 200 service stations, and about 90 truck-stops. They supply fuel to retail customers, and large commercial customers like airlines and trucking companies.

I'm usually a little cynical when a company such as this is floated not long after it has been bought and rebranded. You could argue that Infratil and the NZ Super Fund have extracted the growth they were after and are now selling out at a handsome profit. However in this case they are retaining up to 50% of their investment, which gives me some comfort in that they still view it as a sound investment. Yes, they have grown the business considerably in the last two years; however investors should not expect similar growth in the coming years. What you can expect, if the company achieves its targets, is a relatively stable investment offering good yields.

One thing you should be aware of is that the shares are being offered in a price-range, and the final price will not be known until after applications have been received. This is similar to other recent floats including Mighty River Power, Fonterra, Trade Me and Synlait. Brokers and institutions bid for the shares at certain prices, and that demand sets the final price. Applications will be by dollar amount, rather than a number of shares. It's by no means ideal for investors who would prefer certainty; and my recommendation would be to satisfy yourself that the investment stacks up from your point of view at the top of the price range. If the price is set lower than that, so much the better. Here are some statistics from the offer document:

Number of shares on offer:	200 million to 240 million
Indicative price range:	\$3.25 to \$3.75
P/E Ratio:	12.3 to 14.2
Implied dividend yield:	8.10% to 9.40%

Allocations are only available through brokers, as there will be no public pool. The offer opens on Friday, August 2nd and closes on Thursday, August 15th.

PLEASE CONTACT THE OFFICE AS SOON AS POSSIBLE IF THIS OFFER IS OF INTEREST TO YOU

Rights Issues

Argosy and Vital Healthcare Property Trusts have recently sought to raise money via rights issues. How do rights work? A right is type of option that allows a shareholder to purchase extra shares in a company. Rights usually have a short time-frame, and are also usually renounceable (the holder can sell the right to someone else). The offer is always at a discounted price because of the dilutionary effect the extra shares has on the price. During the rights trading period (usually two or three weeks) the right should trade at the difference between the current share price and the price at which the new shares are being offered.

The important thing for investors is to ensure they take up one of the alternatives. Either take up the new shares at the discounted price, or sell the rights to someone else. Doing nothing means you lose the value of the rights assigned to you. On any given day the difference (financially) between paying for the new shares or selling the rights is negligible. Taking up the new shares will be beneficial in the long-term, provided the company performs well in the future. Call the office if you need any guidance.

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