BRAMWELL BROWN LTD
INVESTMENT ADVISERS – BROKERS

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Interest Rates

Just when we thought there was some light at the end of the tunnel for fixed-interest investors, rates have fallen. The major banks have lowered their longer-term rates in response to the Reserve Bank's commentary indicating interest rates will stay low for longer than expected. Inflation is proving hard to find so the Reserve Bank will be holding the Official Cash Rate at 3.50% for the foreseeable future. The global economy continues to falter, leading to extremely low interest rates overseas. Our secondary bond market holds little value for retail investors with yields lower than bank term deposits now common. The rate offered recently by Trustpower (see below) on its seven-year bond is an indication of just how difficult it is to source high yields.

Spare a thought for German investors, however. Retail and business customers of the German bank Deutsche Skatbank, with over €500,000 on deposit earn a negative interest rate of 0.25%. In other words they have to pay 0.25% per annum to the bank for looking after their money. Admittedly this only applies to investors with large sums, however other customers are only offered 0.20% for a twelve month term deposit.

Trustpower

The Trustpower bond that is due to mature this month has been offered on new terms of 5.63% for the next seven years. I would be very interested to know who is buying this bond. What signals are being sent to the market when we can achieve a higher return on an A+ rated bank deposit than we can on an unrated corporate bond? I've spoken previously about the narrowing gap between the returns on various asset classes. As interest rates have dropped investors have sought higher returns from the other asset classes (bonds and shares), driving the prices of these assets up, and the yields down. Returns across the asset classes are now in a much tighter range than they have been historically, and I fear investors may be ignoring the risks they are taking in the pursuit of return. The rate offered on the Trustpower bond defies logic in my view, and I would be interested to know how many "financial planners" include it in clients' portfolios as part of a pre-determined asset allocation. If this is happening those investors deserve better. I doubt "liquidity" is a good enough excuse.

China

I recently had the opportunity to meet with some fund managers based in Australia who are having success investing in Asia. They dispelled some of the myths investors have of Asia, and painted quite a compelling picture for investing in China. Historically we have formed a bias against investing in China due to the perception of, among other things, corruption, human rights' abuses, and the lack of a free market. While these issues haven't gone away, the financial, political and social reforms currently underway in China will go some way to encouraging international investment. Furthermore, it's probably only a matter of time before China becomes the largest economy in the world – and the question is "can we afford not to have some investment exposure to China"?

Here are a few points on China worth considering

- China is the largest country in the world by population, with almost 1.40 billion people – 19% of the world's population
- India is second with 17.5% of the world's people. To put this in perspective the US is third with only 4.43% of the world's population
- Over the last 30 years China has achieved an annualised average GDP growth rate of close to 10%

China's closed economy has been, and continues to be the main barrier to foreign investment. Current reforms will go some way to alleviating that, and over time their economy will become more open. The Chinese share market has historically been difficult to access for a foreign investor. This table shows the different share classes traded out of China and Hong Kong.

	A-Share	**H-Share**	**Red Chips**
Company Profile	Incorporated & based in Mainland China	Incorporated & based in Mainland China	Based in Mainland China, but incorporated internationally
Stock Exchange	Shanghai Shenzhen	Hong Kong	Hong Kong
Availability	Chinese residents Qualifying foreign institutional investors	No resident restrictions	No resident restrictions
Currency	Yuan	HKD	HKD

A qualifying foreign institutional investor is a global investor, allowed on a selective basis, to invest in Yuan-denominated A-shares in China's mainland stock exchange. Institutions such as UBS, Citigroup and Goldman Sachs have licenses to participate in this market. There is also a B-share market, which was set up to allow foreign investors access to some companies on the Shanghai and Shenzhen exchanges, however it is now out of favour due to the opening up of the A-share and H-share markets.

Shanghai-Hong Kong Stock Connect

In April this year the Chinese securities regulatory authorities announced approval for the development of a pilot programme to establish mutual share market access between Mainland China and Hong Kong. What this indicates is a further opening up of China's capital markets to a broad range of international investors. Overseas investors will be able to trade China's A-shares through the Hong Kong Stock Exchange. The combined A-Share and H-Share market will be the second largest equity market in the world, second only to the New York Stock Exchange.

Valuations

I've previously discussed P/E ratios as a means of comparing the values of shares. The P/E ratio is the company's share price divided by its earnings per share. It is a ratio used to compare companies. The higher the P/E ratio the more you are paying for each dollar of earnings. All other things remaining equal a company trading on a lower P/E ratio represents better buying. The long-term average P/E ratio for New Zealand and Australian shares is around 14, with companies currently trading at around 15 or 16. Investors are prepared to pay more for a dollar of earnings in the current environment partly because returns elsewhere are so low. The P/E ratio of shares on the Chinese market is currently under 10.

MSCI Indices

Various investment indices are maintained around the world to provide benchmarks against which investment performance can be measured. They are also used by fund managers to replicate holdings in certain markets or sectors. The MSCI Emerging Markets index is one such index that measures the performance of a selection of equities in global emerging markets such as Brazil, India, Chile, Russia and Korea. Presently China A-Shares are not included in the MSCI Emerging Markets Index, due largely to the constraints on investment imposed by Chinese authorities. It is believed, however, that as China relaxes its rules on foreign investment the A-Shares will eventually be included in the index. When this happens its likely there will be an influx of allocations to China by global investors and fund managers as it is currently under-represented relative to the size of its economy. The theory is that when the A-Shares are included in the MSCI index there will be significant demand from fund managers that construct their portfolios to match the index.

I generally have an aversion to the managed funds industry due to the fees investors pay, however there are some very good managers out there adding value and providing good returns. In some circumstances we simply don't have the ability (or expertise) to invest directly in markets, and managed funds provide a better vehicle for accessing those markets. Ultimately the return an investor receives after management fees is what is important, not just the amount taken in fees. For those interested in reading more on the opportunities in China please call the office. I have some very good printed material available.

It goes without saying that this type of investment comes with significant risk. Not only are we dealing with an emerging market that is subject to Government control and corruption, we are also dealing with the risk of exchange rate changes. It is an exposure that any investor would need to take a long-term view on. Needless to say you should seek personalised financial advice before making any commitment. Feel free to call the office if you are interested in exploring the opportunities further.

Rabobank

Rabobank recently announced the removal of its parent guarantee on deposits. Since 1998 Rabobank Nederland has guaranteed funds deposited in New Zealand. The guarantee was put in place to establish Rabobank as a credible financial alternative in New Zealand. Rabobank claims the growth it has experienced in New Zealand means it now has the size and strength to do without the parent guarantee. The guarantee will end in April 2015. Rabobank remains one of our strongest banks and I don't believe investors need to be concerned in any way. Here are their current interest rates.

Term	Rate (annual interest)
1 year	4.95%
2 years	5.10%
3 years	5.35%
4 years	5.65%
5 years	5.85%

Kiwi Income Property Trust

Investors in the Kiwi Income Property Trust mandatory convertible notes will soon be issued shares in the company. The notes were issued in December 2009 and have paid a fixed rate of return of 8.95% since then. They have a relatively complex conversion mechanism; however you are guaranteed to (at least) receive units to the value of $1.02 for every $1.00 you invested. Based on the current share price of $1.20 you should receive 850 shares in the company for every $1,000 you invested in the notes. Phone the office if you are unsure of your entitlement.

Precinct Properties

Precinct Properties have just announced their intention to offer up to $50 million (with the ability to accept $25 million of oversubscriptions) of fixed-rate senior bonds. The bonds will rank equally with other secured creditors and bank lenders. The terms look very similar to the Trustpower bond (under 6%), but are yet to be confirmed. Phone the office if this is of interest to you.

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