accordia

the advantage

Autumn 2012

Putting it Simply

"Return"

It's the raison d'être of investing - the return you make. If you weren't going to achieve a return, you might as well put the money under the mattress. So how do you actually measure return?

There are two basic sources of return: income and capital gain. Some investments produce a return from both, others only from one.

Income Only Return

One of the most popular single-source return investments is a bank term deposit. You invest a lump sum for a fixed period of time. At the end of the time period, the bank returns the same lump sum to you. You make no capital gain, receiving only an income return at the rate agreed when you placed your deposit.

Totally Gross

It's important to be aware that bank term deposit rates are always quoted at gross rates, i.e. the rate of interest return before tax. The net or after-tax return will depend on your individual tax situation. It's also important to consider how much income you will actually make before you make your decision.

Compounding the Issue

Another important consideration with term deposits is whether the interest is calculated on a simple or compounding basis. Simple interest, as the name suggests, is calculated on the most simple basis. If the interest rate is 10%, you will receive income exactly equal to 10% of your original investment. If the interest rate is 10% compounding, you will earn a little more than 10% depending on how the compounding works. If the interest compounds monthly, for example, one month's income (at 10% per annum) is added at the end of the month and the next lot of interest is calculated on the original amount plus the first lot of interest and so on. The end result will be better with compounding interest.

Income and Capital Gain Return

Some investments have capital gain as well – a rise in the value of the original amount you paid for the investment that's different from income being added. Be aware that if there's the potential for capital gain, there's also the potential for capital loss. Property and share investments are examples where returns come from income and capital gain/loss. Property's income element is the rental income paid by tenants and, for shares, it's the dividends. The capital gain is the difference between the price you achieve when you sell compared to what you paid at purchase. Costs should be factored into any calculation of capital gain/loss.

Comparing Apples with Apples

If you want to compare investment returns, make sure it's on an 'apples for apples' basis.

Identify whether the figures are stated before or after tax and before or after costs.

At Accordia, we calculate returns on an after-tax, after costs basis using a method called Internal Rate of Return. Your return is affected by the timing of when you bought your investments, what money you put in or took out subsequently and also your tax rate.

refreshingly honest investment advice

Staying Power

Investing can be challenging at times. We're all risk averse to some extent, and feel more comfortable when our investments are rising. The truth of the matter though is that diversified portfolios produce variable returns. If you're not willing to accept variable returns, then your other option is term deposits with predictable returns.

Term deposits and interest-bearing call accounts can be a good investment for some money, but reasonably-sized funds managed over the medium to long-term (5 years and over), require diversification across a variety of asset classes. Why? Because it provides both opportunity for a greater return, and can offset the effects of inflation. If your investment time horizon is medium to long term, then diversification should definitly be considered.

However, diversification can only be effective if you remain invested long enough to actually reap the benefits.
Returns from diversified portfolios aren't earned in a smooth, linear fashion but in sometimes volatile patterns of ups and downs. Although this is normal, it's sometimes difficult for investors to hold their nerve and focus on the long-term.

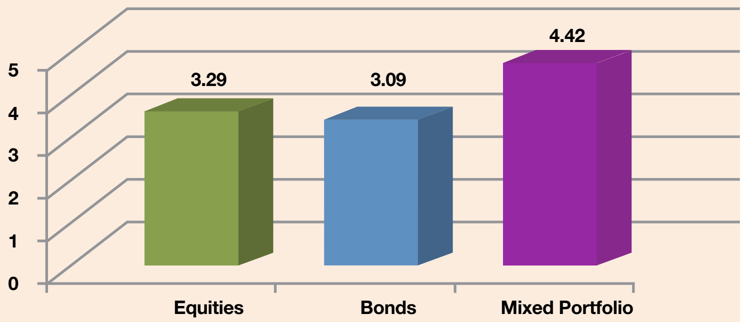
Pulling the plug when prices are down is one of the worst things you can do, as is waiting for markets to have risen to buy in. Research shows that investors who invest with short (less than 5 years) time horizons, who continually buy and sell, effectively rob themselves of the return achieved by those with more commitment and patience.

Reasons for this behaviour range from relying on advice from inexperienced family members and friends, reacting to unfavourable news without reasonable examination of all the issues, and taking undue risk in one area but avoiding rational risk in others.

To truly benefit from market returns you need to avoid these traps and stay the course.

As the research firm Dalbar has found, investors achieve significantly lower returns than the market due to their inability to hang in there.

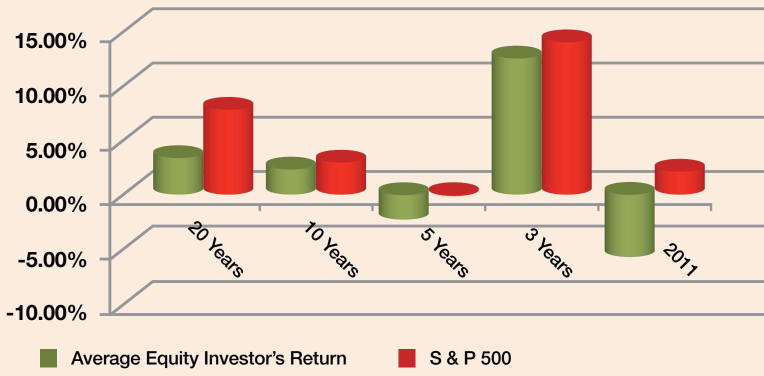
Average Investment Fund Retention (20 yr analysis)



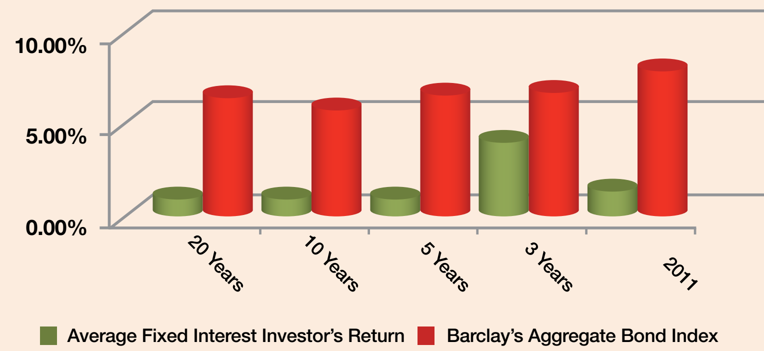
This year's report shows that, over the last 20 years, fixed interest investors have remained invested for a mere 3.1 years on average, and equity investors just 3.3 years. Those with mixed portfolios have shown a little more staying power but their investment holding period is still too low at 4.4 years.

The penalty for continually buying and selling is significant. Equity investors have earned 4.3% per annum less than the market and fixed interest investors have taken a whopping 5.6% cut in returns compared to the market as a whole. Mixed portfolio investors have also significantly under performed.

Average Equity Investor's Return versus Benchmark



Average Fixed Interest Investor's Return versus Benchmark



(If you would like a copy of the latest Dalbar research paper please contact us.)

It can be difficult to hold your nerve but working with a good adviser will help you to stay on track and get through the ups and downs. Accordia's portfolios are robustly constructed to generate long-term returns and, if your time horizon indicates the need for diversification, we ensure the right kind of portfolio is built and maintained for you.

If you are not already an Accordia investor, please get in touch to discuss how we might help you maximise your investment returns.

A Perfect Storm

From the Investment Manager

Little did we know that an economic storm that had its origins 20 years ago would culminate now in substantial changes to what has typically been regarded as a “solid” investment. That’s exactly what has happened to Government bonds and high grade corporate debt (fixed interest investments).

These investments have traditionally been regarded as safe havens for investors. Default rates in recent history have been extremely low and they have delivered generally steady and reliable returns, especially in the last few years. Prices for these bonds are driven by anticipated inflation, which itself is driven by economic growth. So, when all looks doom and gloom on the economic front, investors typically flock to the bond markets. By contrast, when economic growth prospects pick up, investors usually sell their bonds, attracted by the stronger potential of equity returns.

The storm started brewing at the height of the Global Financial Crisis when Governments were bailing out wayward banks. At that time, the notion that Governments’ own balance sheets would become as suspect as those of the banks they were bailing out was lost in the paralysing fear of potential financial system collapse.

Three years later, we’ve had economies ravaged by recession, further bailouts and pump-priming to help stave off Governments’ balance sheets looking shaky. Government debt had blown out to deeply-concerning levels, and most worryingly, in developed economies.

Country	Government Debt to GDP Ratio
Japan	200% plus
Greece	140%
Italy	120%
USA	100%
Spain	70%

Both the Greek and broader European debt crises have been the subject of much discussion and debate, with virtually all European countries on one side of the ledger or the other.

Some 20 years prior, central banks around the world, including our own Reserve Bank of New Zealand, took part in a concerted effort to get to grips with inflation. Unfortunately, following this, the seeds of the storm were then sown by the large developed economies driving interest rates lower, and allowing exponential credit growth in loosely regulated environments.

The scenario was exacerbated by cheaper goods and services from China causing disinflation. In addition, a false sense of security also developed around prices and valuations for leveraged assets including property.

The result was a bond rally that lasted for 20 years, a ten year bond yield on US Treasuries of below 2%, and the rest, of course, is history.

From an investment management perspective, some key drivers came together in late 2011:

- There were more heavily indebted developed economies than before
- We had a substantial lift in the volatility of bonds as the risk of a sovereign debt default was realised
- There were structural changes to the fundamental drivers of this sector driven by default risk and the uncertainty of servicing interest payments
- Central banks made concerted global efforts to prop up the banking system by providing facilities for European banks to access liquidity
- There was a massive expansion of central bank balance sheets as they “printed money” to provide liquidity to the financial system
- A breakdown occurred in the traditional bond-pricing signals as a result of the substantial central bank intervention

As part of Accordia’s normal monitoring and review process, we have been carefully watching these developments and we then fed our conclusions into an Asset Allocation Review – a review of the mix of assets that’s appropriate for portfolios going forward. The result was a strong recommendation to address the risks that had arisen in International Fixed Interest and take those risks right “off the table”.

This decision was driven from a risk management perspective because the factors listed above had fundamentally changed the drivers of bond markets. It was not about picking “turning points” or making “tactical” asset allocation changes, but followed our normal and on-going process of monitoring and reviewing the fundamental drivers of assets in portfolios.

Rather than trying to ride out this perfect storm, we chose to position clients’ portfolios in a more clement and predictable environment. You can rest assured that we will still be keeping a wary eye on the weather.

Accordia advisers will be discussing these changes with investors over the coming period.

We're Listening

Thank you for filling out the survey in the last issue of Advantage. If you haven't shared your thoughts with us yet, there's still time, and we'd love to hear from you. It's a quick and simple process with just 6 easy questions and is available by clicking here.

Although some of your responses so far were as we expected, others were more surprising. In terms of frequency, most of you are happy to receive Advantage every three months, so we'll continue to produce our seasonal editions.

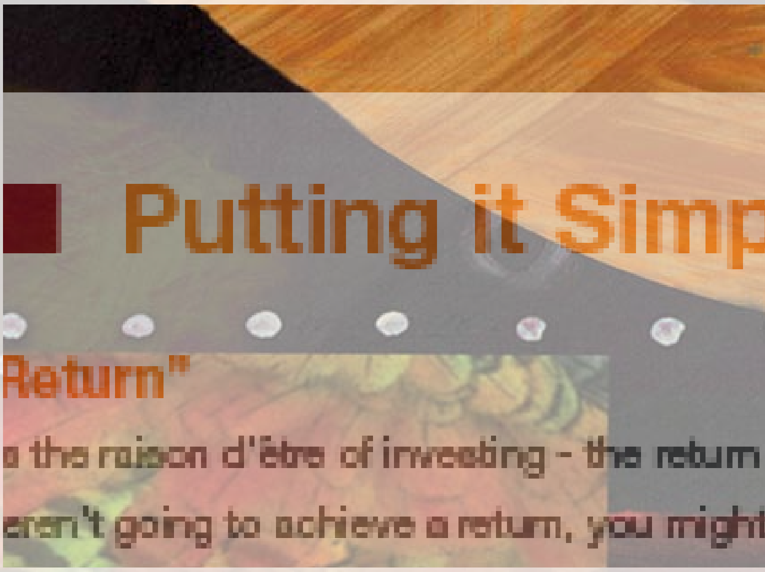
You most enjoy our "Putting it Simply" feature and articles about economic events. The same could not be said for articles on tax issues however, which were clearly very unpopular.

Although we can't avoid our annual checks on tax rates, and still need to provide information about it, we will try to avoid producing articles that labour tax issues.

Some of you have already ventured into the world of social media, with users of Facebook, YouTube and LinkedIn amongst Advantage readers. PCs and laptops are in common use, and one of you is a tablet user. (We've taken this to mean leveraging modern technology rather than ingesting medicinal products.) Quite a few of you still prefer more traditional means of communication and so we plan to continue to cater for all of your format preferences.

It was particularly interesting to hear of your suggestions for articles that you'd like to see in Advantage. You're clearly interested in New Zealand matters, and also understanding how we fit into the wider global economy. Specific subject requests included how local issues affect investors, the impending state-owned enterprise sales and the fluctuating New Zealand dollar. Thank you so much for these wonderful ideas which we'll use to inspire future articles.

Thank you also for your constructive feedback on how we could improve Advantage. Despite multi-level checks, there has been the occasional embarrassment when spelling errors have crept through. For these we apologise and assure you that we will try harder in future.



Accordia Christchurch	**Phone (03) 348 1689**
Accordia Hamilton	**Phone (07) 855 2888**
Email	**service@accordia.co.nz**

accordia

www.accordia.co.nz