accordia

the advantage

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Portfolio Risk Budgeting - An Essential Tool for 21st Century Portfolio Management

The basic concept of budgeting is familiar to most of us when we manage our personal household income and expenditure.

The concept of risk budgeting when investing is just as important, but involves a strategy for determining how much risk to assume with long term investments.

Risk questionnaires assist with this process. As part of the initial and ongoing planning work with us, all of our clients have completed these. They are designed to assess your tolerance for risk, and then match you to a mix of assets which reflect your responses. This would be fine if the initial portfolio maintains a constant risk level over time. The challenge for us at Accordia is that we know that the risk levels associated with almost every asset type can and do vary extensively over extended time periods. The result is that the initial portfolio will experience significant changes in risk exposures over the years, as changes in the relationship between asset classes occur, (known as correlations) changes in market risks, and changes in sector specific risks.

Because we are aware of these dynamics, and the need for you to keep within a given risk range, (the risk budget), a static portfolio will not achieve this. For the purposes of any of our clients, what is critical to understand is that the risk level associated with any given portfolio changes over time, and that these changes have to be tracked and managed effectively. This is why the process of regularly rebalancingour portfolios in line with the risk budget set for it is essential. The process of rebalancing is one of the more effective ways to stay on track with a long term portfolio. Not only does it help

keep it correctly aligned with your goals, it also provides an opportunity to lock in gains from a strongly performing asset class, and redeploying the proceeds to other assets that are relatively inexpensive.

Unfortunately, the majority of investors have a tendency to do the reverse of risk budgeting. When risk levels remain low for a long period of time, many investors become inclined to become more and more aggressive with their investing strategies. (This is indeed one of the reasons that asset bubbles grow.)

For example, if an investor had participated in the boom in technology shares in the late 1990's and received substantial gains for six months, then it was highly likely that a more aggressive exposure to the same shares over the following six months would have occurred. The longer that it has been since an adverse market event, the more people discount the risk that they are taking. It's known in Behavioural Finance as a "recency bias". (We have also seen such behaviour manifesting itself in the New Zealand property market in recent years.) Portfolio risk budgeting counteracts recency bias by establishing objective estimates for total portfolio risk and keeping portfolios within acceptable risk boundaries. This work is an integral component of ongoing portfolio risk management at Accordia. A properly diversified portfolio is key to managing volatility and risk. This means that a portfolio will have a combination of investments from a range of asset classes such as cash, fixed interest and shares, along with other speciality investments with different underlying investments which also serve to provide additional risk management strategies. It is worth remembering that financial markets do not always move in concert with one another, and individual asset classes perform differently in any given year. At any time, one asset class may be leading the market, while others lag.

This process greatly enhances the likelihood of you achieving your long term goals and objectives over long timeframes. The importance of this cannot be underestimated especially when life expectancy is now very much longer than previous generations. As your expected time in retirement grows, there is even greater need to carefully manage financial resources over periods of thirty years or more.

Preparing for Retirement

When we work with clients to prepare for retirement, the focus on the financial aspect of this major change in lifestyle is only one component. Of equal importance is working through how this change will impact on your life. Retirement is a huge life event, and can in many cases leave you feeling that you have lost your identity. For many of us, the thought of retirement is nirvana. The idea of not working long hours, not getting up early in the morning, and not working in the evening is very appealing.

The reality is that after being active and being engaged within a trade or profession, many of us don't plan what we are going to do with our spare time. There are thousands of people who have retired from their primary occupation. (However, that doesn't mean that there is a need to retire from life!) For many of us, it presents an exciting opportunity to do many things that were not possible due to regular working commitments. There is a massive resource of skills and knowledge acquired over a lifetime of working that can be harnessed for the benefit of family, friends or community that should not be discounted.

Here are a few key areas to address that can significantly enhance your quality of life after a long and active career.

A. Plan what you are going to do with your time

This may sound obvious, but when you have been working very hard, and usually involving long hours, there is quite often little time for other interests or hobbies. Start thinking about new interests or a community activity that you would like to pursue. Remember, this is now a fantastic opportunity to enjoy the benefits of having retirement capital available to enable you to do lots of interesting things.

B. Think about your social life

In many situations, you can find that your social circle gets smaller when you stop working. This is an ideal time to join organisations such as Probus or U3a. These organisations run programmes for retired or semi-retired people where there are educational speakers and social programmes to keep minds active, and for ongoing social interaction with others.

This time can be a great opportunity to rekindle old friendships or generate new ones. This is also a great time to take advantage of the many amenities in and around the community in which you live. This stage of your life can also be a great time to plan extended holidays both in New Zealand and offshore.

C. Embrace technology

Many of us will already be very familiar with the myriad of benefits that technology delivers. Keep up to date with your IT skills, and enjoy the huge lifestyle benefits that technology already delivers to you. Use it to keep in touch with family and friends both in New Zealand and abroad. Stay engaged with life.

Staying the Distance

There are many commentators who have written at length about the importance of staying the distance with a long term investment portfolio. As our clients have a long term investment horizon of 10 to 40 years plus, we at Accordia manage portfolios with this in mind.

There are countless examples of why veering off course from a carefully thought out plan can change a temporary loss of confidence into a realised loss on an investment portfolio.

People who have maintained perspective and stay mindful of their investment time horizon have a much better chance of achieving their investment goals and objectives than people who react to short term market fluctuations.

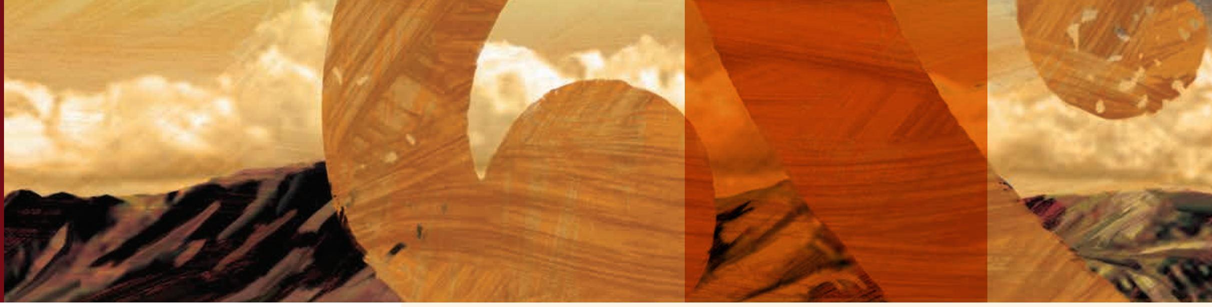
There are even more countless examples of why staying invested and not attempting to enter and exit the markets is by far the more rewarding strategy over the long term. Years of strong market performance can outweigh periods of decline, resulting in long term returns that more than compensate patient investors.

The key is to maintain discipline. We are surrounded by a lot of market "noise" from market commentators and the media that has little or no relevance to long term investors. The consequences however of taking notice out of context of market noise can have a significant impact on the likelihood of not achieving long term financial goals. By maintaining a disciplined approach and perspective during periods of market volatility, a patient investor will most often be rewarded when markets perform well.

As a market decline increases in duration, there is a natural tendency to want to move into "safer" investments in the hope of avoiding further paper losses. However, this action usually results in needlessly locking in losses on sound investments that given time, should recover. Getting out while the market is falling turns paper losses into real losses. Secondly, because picking the actual bottom of the market is near impossible, there also the very high likelihood of suffering a double whammy of missing out on the best of the rebound as well. Of key importance is overcoming this emotional reaction, is to refrain from trying to time the market.

Another unfortunate aspect of investor behaviour is the practice of "yield or return chasing". Jumping from one type of investment to another is not only expensive, but very risky, as in many cases this action is undertaken on the back of past return history. There is no guarantee at all that past performance will be repeated, or sustainable going forward.

Maintaining a long term outlook and keeping emotions in check during significant market movements can take a strong stomach. But with advice and guidance from your Accordia adviser, this will avoid the same behavioural traps that have plagued so many other investors for many years. The rewards will be significant.



What is Inflation? How is it Managed?

Inflation is the rising price of goods and services over time. It is an economic term that means that you have to spend more to buy goods and services, from filling your car with fuel, to buying groceries at the supermarket. The effect of this is to increase your cost of living.

Inflation reduces the purchasing power of each unit of currency. As prices rise, your money buys less. That is why inflation reduces your standard of living over time.

Reserve banks around the world use monetary policy to manage inflation, and it's opposite, Deflation. In New Zealand, the Reserve Bank's target is between 1% to 3% per annum, with a midpoint of 2%. If inflation is above the target rate, the bank raises interest rates to slow the velocity of money and economic growth. If inflation is below the rate, the bank will use expansionary policy to lower interest rates to stimulate economic growth. This has been the case in New Zealand in recent years, with record low interest rates.

Mild inflation makes consumers expect prices to rise, therefore it is better to buy now rather than wait. This increases demand in the short term. As a result, retailers sell more, and manufacturers produce more. Businesses are more likely to employ more staff, all of which boosts economic growth. It also reduces the risk of deflation, which is when prices fall.

There is now evidence that some central banks are moving into a tightening phase, most notably the US Federal Reserve. It is likely that the next move for the Reserve Bank of New Zealand will be the same as economic growth and inflation moves into the bank's target range.

This is where a long term portfolio with growth assets will protect the purchasing power of invested capital over time, allowing for an adjustment in drawdown to compensate for inflation.

Accordia welcomes Alan Austin

The Directors of Accordia Asset Management Limited are delighted to welcome Alan Austin to the Board. Alan was appointed on the 13th of March, and brings significant experience in key areas of the financial services industry in a career commencing in 1985.

Over this time, Alan has been involved in a range of areas including personal investment advice, investment management business development, investment consulting and insurance and investment research. Having worked in New Zealand, Australia and the U.K, Alan brings a broad set of experience and industry knowledge to his association with Accordia. He has a passion for good governance, a client focused culture and building value for all stakeholders.

Alan comes from a rural South Island background, and grew up in the Nelson region. He now lives in Auckland, where outside of the work environment, he has a number of interests including food and wine, motorsport, travel, riding and cinema.

My Accordia

We are delighted to advise that our new client portal is now up and running. We are currently in the process of inviting our clients on to the website in order that they can access portfolio valuations and history, as well as current economic commentary. We will be bringing you up to date and topical content so that you can keep up with issues as they evolve. The website is user friendly, and is designed for ease of use. My Accordia will be even easier to stay in touch with us wherever you are, and at any time. If you have not yet been invited on to the client portal, please contact your Accordia adviser, who will be only too happy to assist you.

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