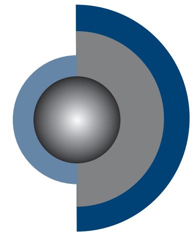
A SELECT VIEW



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The last time we saw a global economic recession was back in 1992. While there have been substantial share market and credit market declines since then none have resulted in a global recession. This relatively stable period for global economic growth has seen tremendous wealth creation as asset prices have risen (particularly real-estate), driven to an increasing extent by leveraged investor positions in the low cost debt environment since 2000.

The focus on sustaining returns (and fees for fund managers and investment bankers) has come at the expense of risk management. We are now seeing the unwinding of these leveraged positions, driven by the collapse of the 'sub-prime' or impaired (higher risk) mortgage market in the US. A large portion of these loans should not have been written at all yet they made up 40% of all US mortgage originations in 2006. Funding for these loans mostly came from mum and dad investors around the world who invested directly in securitized products (that packaged up these mortgages), or indirectly through managed funds that owned these products.

Much has been written about the impact of this melt down in credit markets and no doubt we have not heard the last of it. In this edition of A SELECT View we take a look at risk management and what it means for good portfolio construction. There is no doubt a lack of knowledge and transparency has led to a poor appreciation by investors of the risk associated with high yielding fixed interest or structured offers. This can be seen in NZ with the near cavalier approach mums and dads (and some of their advisers) have been taking putting large chunks of their retirement funds into non-investment grade securities including finance company debentures.

While we have not used these products for our clients (despite some pressure to do so) there is nothing wrong with such securities in themselves as they play an important role in funding growth in the economy. The real problem has been the relatively poor return offered (as little as a 1-2% p.a. benefit regardless of asset quality) and perhaps more importantly, the very poor portfolio construction decisions made by investors.

Government moves to regulate finance companies may help with transparency but it is not going to solve these fundamental investment issues for investors. Just as investors panicking and putting all their cash into the bank is not necessarily the right long term solution either.

At SELECT we focus on risk management both at the portfolio asset allocation level and also at the individual security and product level. Our experience has been that you can construct a portfolio which will meet client objectives without the need for investing in junk credit. We hope you enjoy this edition and would appreciate your feedback or comments on any of the material.

Regards - Wayne Ross & Mike Newton

SELECT ASSET MANAGEMENT

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PORTFOLIO RISK MANAGEMENT

Over the last few years it seems that the management of investment risk has itself been at risk. The collapse of several finance companies in NZ and the speculative credit (high risk) market meltdown in the US has investors running scared. We are getting very high levels of enquiry from people with junk credit (i.e. below investment grade) or structured products that contain junk credit in their portfolios. Their concerns are justified.

At SELECT our first focus is risk management . . .

At SELECT our first focus is risk management. We encourage investors to firstly establish their strategic or longer-term risk constraints for all their financial assets on a combined basis.

These risk constraints are normally expressed as probability and a loss in any year on the total portfolio. For example this could be a maximum 10% portfolio loss in any 1 year and the chance of a loss 1 in every 5 years on average. This chance of loss includes asset valuation or price volatility, potential loss of income (defaults) and permanent loss of capital. Ultimately the risk is an investor not being able to achieve their objectives.

Whilst there are wide variety and definition of the types of risk investors can face we are primarily concerned with 2 levels of risk management:

1) The first is asset allocation. The weightings investors have in each asset class are critical as each (shares, bonds, cash, property, alternative assets and commodities) have quite different long term risk and return characteristics. You also want to hold assets which are not highly correlated, that is they don't all move up or down in value at the same time.

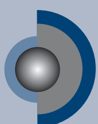
2) The second is securities selection and management – what securities should be bought in each asset class; how to access them cost and tax efficiently; and whether active management can deliver a more efficient result than passively 'buying the total market' or index.

1) Asset Allocation

Our observation is that DIY investors tend to jump straight into securities selection issues before thinking about their asset allocation. Rather than focusing on whether they should own shares at all and if so in what proportion, the debate tends to be on whether one share or one security is better than another and if now is the right time to buy.

The main risk and return determinant of any portfolio is asset allocation . . .

The main risk and return determinant of any portfolio is asset allocation. SELECT takes a strategic or 5+ year view on asset class returns for our clients. We have expected average returns for each asset class based on a combination of historical returns, a 'building blocks' risk premium methodology and forecast consensus views.



We presently expect the following longer term results from each asset class on average.

	Total Average Gross Rtn p.a.	Income Component	Growth Component	Risk level Standard Deviation p.a.
NZ Cash	5.1%	5.1%		+/- 1.6%
NZ Bonds	6.7%	6.7%		+/- 9.6%
Global Bonds	6.7%	6.7%		+/-5.8%
Australasian Shares	11.7%	4.7%	7%	+/- 23.1%
Global Shares	11.5%	1.5%	10%	+/- 20.3%
Listed Property	9%	3%	6%	+/-16.3%
Alternative Assets	8.3%	0%	8.3%	+/- 8.9%

As you would expect the higher the return from the asset class the higher the expected volatility or risk each year. For example while we expect a total gross return of 11.5% p.a. on average for Global Shares there is a 68% chance the return could be anywhere from -9% to +32% in any year. Using long term return forecasts allows us to incorporate historical experience so we don't lose sight of the key fundamentals during times of market bubbles.

What is also important is how each of these assets reacts in different market conditions. An efficient diversified portfolio helps to smooth overall volatility. Diversification at an asset allocation level does not mean you are necessarily better off holding 5 finance company debentures than 1, as many mum and dad investors can attest to at present.

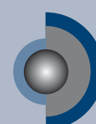
An efficient diversified portfolio helps smooth overall volatility . . .

Asset allocation needs to be carefully considered when preparing any investment portfolio strategy. It is important that this includes all financial assets including if appropriate business activities, direct property assets or property development, farming interests and private equity. We spend significant time with clients understanding the risk and return characteristics of those assets and activities.

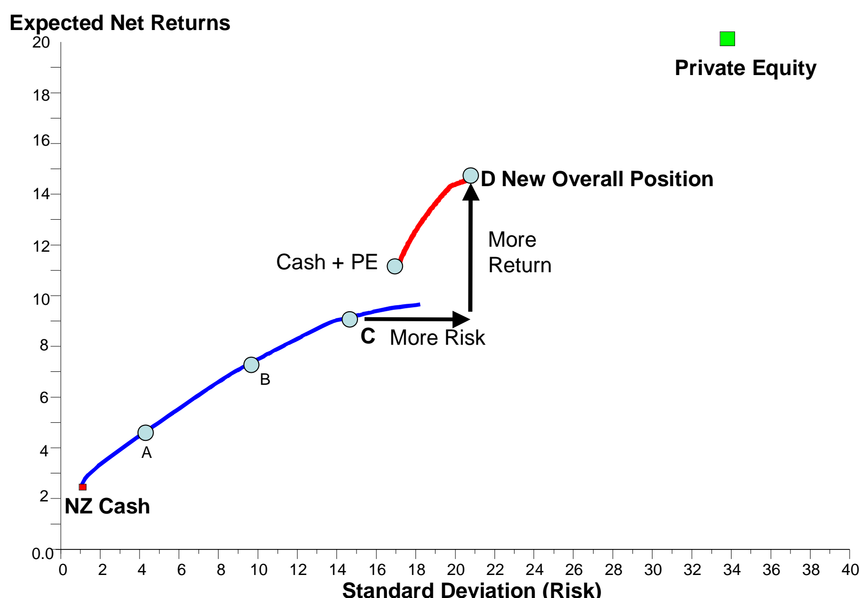
Once understood, we can then look at how their passive or indirect assets such as listed shares, cash and fixed interest might best be combined into a portfolio to complement the direct assets and achieve the overall risk and return objectives.

Most advisers ignore client's direct investment activities and how to combine these with other assets. We think this is a serious mistake and can lead to investors assuming far more risk than they intend.

Most advisers ignore clients direct investment activities . . .



For example: Consider an investor that has a large private equity (PE) investment that represents 50% of their overall net financial asset wealth. If this client has a relatively high propensity for risk (given the large PE interest it is a definite possibility) then they might select a portfolio at position C on the blue efficient frontier below. Portfolio C is expected to achieve a 9% p.a. net return with +/- 15% p.a. standard deviation. This means they should expect the portfolio to make a loss on average every 3 years and the client is comfortable with this relatively high level of risk.



However, when we add in the PE asset the available investment frontier shifts upward and becomes the red line. The new overall position D represents the combined portfolio and achieves a higher return but is significantly more risky.

In fact a better solution might be for the client to hold only cash and bonds until all or part of their PE exposure is sold down.

The asset allocation decision will dominate investor risk and return and should not be ignored.

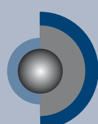
Most DIY investors typically end up with an eclectic collection of shares . . .

2) Securities Risk

The next key area of risk and return management is the securities selection within each asset class. The higher level decisions include:

1) Which securities to buy/sell?
2) How many securities to own and what proportional ownership should be had of each security?
3) How to hold these securities in the most efficient way?

Sifting through thousands of investment options is a daunting task and most DIY investors typically end up with an eclectic collection of shares and fixed interest investments that have been bought over time as; funds were available, as share brokers or other advisers recommended or as their own research has suggested. We often find little evidence of any science being applied to the selection (and de-selection) of these securities.



Understanding the current absolute and relative value of a security is paramount. As is the nature of the security - that is the way it is expected to deliver its return and the risk of that return not happening (including a loss of capital). This all requires substantial work and a constant research and screening process. The rules for these screens are the first defence against risk. Given the recent turmoil in credit markets in particular we have taken a look at fixed interest securities and related products.

Fixed Interest:

NZ Investors have access to a wide range of fixed interest assets both here and offshore. These assets generally fall into 2 types:

1) Vanilla fixed interest investments provide the investor/lender with a direct relationship with the borrower. They include such instruments as Government, Semi-Government and Corporate (including finance companies) Bonds, Notes, Debentures and Mortgages.

2) Structured fixed interest investments which seek to modify the characteristics of normal credit so that they behave differently. This might present itself in the form of capital guarantees, internal gearing or borrowings to enhance returns, currency hedging, interest rate reset provisions or simply access to different types of credit or to provide layered exposures to increasingly higher risk (and yield) credit. These products are generally manufactured by investment banks and funds managers and are most often created using synthetics or derivatives.

Investors have increasingly lost sight of the risk in both types of fixed interest assets and they have simply not been receiving the level of return that they should be for the risk they were taking. Typically, the issuer or manufacturer of the securities has been making either large margins (in the case of finance companies anywhere from 7% to 20%+) or both margins and fees in the case of structured products.

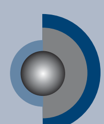
Investors have increasingly lost sight of the risk . . .

Investors have the task of interpreting the Investment Statements of finance companies and structured products to determine the risk they are taking. While the financial data for finance companies is relatively straightforward to understand the underlying risk of most structured products is extremely difficult given their complexity and use of ‘over the counter’ derivatives and counter party insurance and re-insurance arrangements.

Unless an investor can understand the risk they are undertaking with an investment then they have no chance of determining what should be an appropriate return for that asset. While a 10.5% forecast yield of an offshore structured product using CDOs (collateralised debt obligations) sounds good, what if the investor should really be earning 15% for the risk they are taking? Or, if a finance company is paying a debenture yield of 10.5% and then lending the same funds out to borrowers at 20% p.a. shouldn’t the investor be receiving more return for the risk they are taking?

The simple fact is investors have not been getting paid for the risk they have been taking.

Investors have not been getting paid for the risk they have been taking . . .



A rating screen is the start of the investment process not the end . . .

A simple initial screening and risk management tool investors can use for fixed interest securities are their independent ratings. Although we stress a rating screen is the start of the investment process not the end. Issuers of debt will normally have their offer rated by a rating agency who research the offer and rate it accordingly. We would recommend investors only consider the ratings of international agencies such as Standard & Poors, Fitch Ratings or Moodys Investor Service. Standard & Poors have just launched an excellent website which provides information on their methodology and we have included a summary of their broad rating definitions below.

Investment Grade

Long term Ratings	Probabilty of default over 1yr	Definitions
AAA	0% - 0.01%	Highest credit quality. 'AAA' ratings denote the lowest expectation of credit risk. Extremely strong capacity to meet financial commitments.
AA	0.01% - 0.02%	Very high credit quality. 'AA' ratings denote expectations of very low credit risk. They indicate very strong capacity for payment of financial commitments.
A	0.05% - 0.10%	High credit quality. 'A' ratings denote expectations of low credit risk. More susceptible to changing circumstances but capacity for payment of financial commitments is considered strong.
BBB	0.2% - 0.4%	Good credit quality. 'BBB' ratings indicate that there are currently expectations of low credit risk. The capacity for payment of financial commitments is considered adequate. This is the lowest investment grade category.

Speculative Grade

Long term Ratings	Probabilty of default over 1yr	Definitions
BB	0.6% - 1.6%	Speculative. 'BB' ratings indicate that there is a possibility of credit risk developing, particularly as the result of adverse economic change over time. Major uncertainties or exposure to adverse conditions
B	3% - 11%	Highly speculative. For issuers and performing obligations, 'B' ratings indicate that significant credit risk is present, but a limited margin of safety remains.
CCC, CC, C	25% - 30%	For issuers and performing obligations, default is a real possibility. Vulnerable or highly vulnerable to non-payment.
D	100%	Issue in payment default.

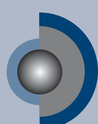
So an investment with a BBB rating for example has an average 0.3% probability or three-in-one-thousand likelihood that an investor will not receive repayment on a 1year investment on time and in full.

Interestingly, according to comments made by S&P to Good Returns in late 2005, NZ finance companies are made up of a preponderance of BB and B rated companies (based on public information). There are only a handful of investment grade finance companies (Marac, UDC and South Canterbury) and the differentiation will become clearer with the mandatory requirement to seek a credible rating.

The first purpose of holding fixed interest assets is to provide portfolio protection . . . not high returns

The first purpose of holding fixed interest assets in any portfolio should be to provide portfolio protection first and then income – but not to provide high returns. At SELECT we do not use fixed interest investments unless they are investment grade (at least BBB-). If an issue has not been rated then we do not use it.

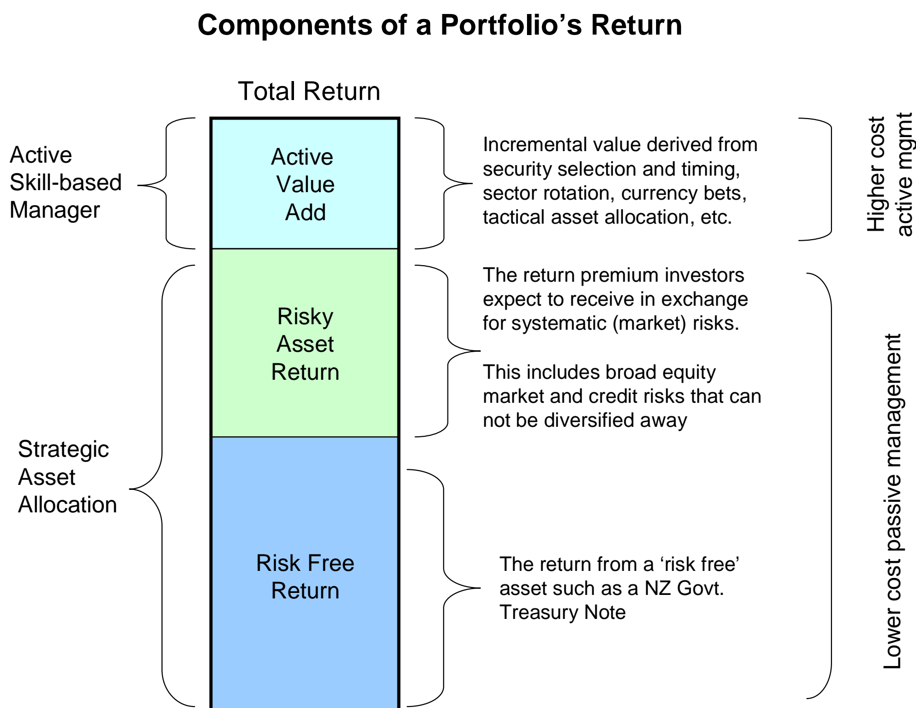
Our view is that you can achieve a better result by seeking higher returns from other asset classes such as shares and property. This is what good portfolio construction is all about and what allows investors to achieve their objectives and still sleep at nights.



Components of a Portfolio Return

It is useful to think about an investment portfolio return in respect of the components that make up that return and how those components can be efficiently accessed. In the diagram below we have broken down the total return and risk of a portfolio into 3 components.

Components of a Portfolio's Return



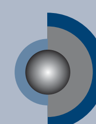
1) The Risk Free Return. This is the return that all investors can access by placing their funds in a virtually 100% safe investment like NZ Government treasury notes. Investors would expect over time to achieve this return at the minimum.

2) Risky Asset Return. By moving some money from Risk Free Return assets and into other riskier asset classes (or taking market risk), investors can gain additional returns and risk. The decision about how much to allocate to the risk free component and to the riskier asset classes is a strategic asset allocation decision which account for up to 90% of the total return of a portfolio.

3) Active Value Add, often referred to as 'Alpha' and reflects the additional return a portfolio can achieve through active investment management. This activity can subtract as well as add value each year. Over time it can add up to add up to 10-20% of the total return.

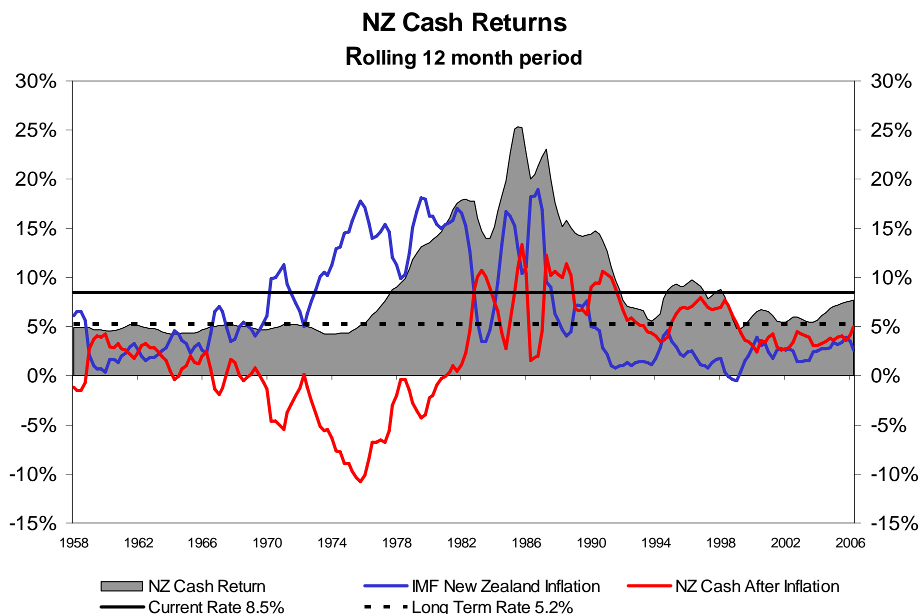
Taking additional risk through strategic asset allocation (SAA) has the greatest impact on the total return of a portfolio. At SELECT we spend a lot of time getting this SAA decision right and it is why we build individually optimized portfolios for each client which includes all investment assets.

It is possible to access the Risk Free and Risky Asset components of return at relatively low cost. The Active Value return (or 'Alpha') component is higher cost, more nebulous and hard to consistently achieve. Despite this, we believe it is important to pursue this return component as it can add significant value to portfolio returns over longer periods of investment.



Cash Returns – Why be in anything else?

The official cash rate is now at its highest level in a decade as the Reserve Bank seeks to dampen inflationary pressures – primarily consumer demand and house inflation. Bank term deposits for 90 days can now be had for 8.5% p.a. (large deposits) which net of tax at 33% represents a seemingly attractive return of 5.7% p.a. So given the low level of risk why invest in anything else?



There are several reasons why sitting in cash may not be appropriate:

1) Inflation levels are between 3% and 4% at present. This means real net cash yields are actually closer to 2% p.a. which although reasonably high by historical standards may still not be conducive to achieving long term return objectives.
2) Shares and property deliver a return at a risk premium to cash (see components of a portfolio return diagram). For forecasting purposes we expect a 5-6% premium for shares over cash rates and 3-4% for property. So despite current high cash rates we would still expect growth assets to perform better over the long term
3) Cash returns have a short time horizon. While cash rates are high at present we have only a limited idea of what they might be in 3-5 years time. Five years ago cash rates were running at 5% p.a. gross.
4) Critically as cash rates decline (as the economy slows) other asset options are constantly revalued by the market to reflect the premium gap. It is not possible to wait until cash rates fall then invest into other assets – you will simply be paying a higher price for those assets at that time.

If you are sitting in high levels of cash you are doing so for one of three reasons.

a) You are trying to time markets as you think other asset classes are fundamentally overbought and you are therefore looking for a trading opportunity - you are looking to add “Alpha’.
b) You have a known short term capital or expense requirement for the cash and cannot afford to take any risk with it, or
c) You only require a long term net rate of return on your capital after inflation and tax of around 1% p.a.

Otherwise there is value in constructing a well diversified and efficient portfolio.

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