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As cash rates continue to fall we are fielding an increasing number of calls from investors concerned about generating sufficient income and preserving capital. Over recent years it has been a relatively easy and rewarding activity for risk adverse investors to invest solely in term deposits. Now as governments struggle to resurrect the global economy it is those same prudent savers who will come under the most pressure as interest rates plummet and yields become insufficient to meet objectives.

In NZ, the situation has been made worse by the collapse of the finance company debenture market and the move back to a positive (normal) yield curve where longer term rates are higher than short term rates.

At NEWTON ROSS we consider and manage client portfolios for total return rather than focus purely on income yield. Focusing on income yield only is driving many investors back into assets where the risk is much higher than the return being offered. Investors should take the recent collapse of government guaranteed Mascot Finance as a timely reminder that it is the quality of the underlying investments which ultimately matters most.

Fixed interest securities should be held for risk reduction reasons and it can be prudent to consume capital within the context of a long term investment strategy. Income assets play a critical role in the majority of client portfolios but not at the expense of prudent risk management and only as part of a clearly defined and properly modelled wealth forecast.

In this paper we have reviewed several key issues facing investors chasing income.

Regards

Wayne Ross & Mike Newton

MARCH 2009



*Investors
reallocate
towards cash*

Cash Deposits

Reserve Bank figures suggest \$566m of new cash deposits were invested in finance companies in the December quarter and an additional \$2.3b was deposited in retail banks. The reallocation towards cash when rates are falling is questionable but understandable as investors looked to avoid the extreme share market volatility. It is likely that the bulk of these funds were transferred post the sharp market sell-offs in September and October and following the introduction of the Crown Deposit Guarantee schemes.

Crown Deposit Guarantee Schemes

On 12 October 2008 the Government introduced a crown backed guarantee for retail debt securities. These include deposits, term deposits, current accounts, bonds, bank bills and debentures. Under pressure due to schemes being introduced in other countries, the Government was forced to move to “engender confidence while continuing the efficient functioning of NZ financial markets.”

Since this time we have seen several amendments and a wholesale version has subsequently been introduced. The key elements of the retail scheme are:

- institutions need to apply for a guarantee and the cover can extend to the debt securities held with NZ Registered Banks, Non-Bank Deposit Takers (NBDT) and branches of overseas banks but only in relation to holdings by NZ residents and citizens
- it excludes investment by other financial institutions, related parties to principal debtor and NBDT currently in breach of their trust deed or in moratorium
- it includes amounts in guaranteed securities which are held via wrap or bare trustee relationships (such as Aegis)
- it does not cover super schemes, unit trusts or shares but may include some cash PIE's. Subordinated corporate debt is also not covered unless issued by a building society or credit union
- there is a cap on cover of \$1m per depositor per institution. This includes principal and interest
- fees are being charged by the Government up to 300bp or 3%, essentially the lower the credit rating the higher the fee
- institutions may be required to provide additional information and the guarantee may be withdrawn under some circumstances
- retail deposits of family trusts and businesses with participating institutions to the scheme will generally be guaranteed.

*The scheme . . .
has created yet
more distortions
for investors*

At one level the scheme has provided much needed stability and security of the banking system. It has also created yet more distortions in the local market for investors and in our view provides yet another opportunity for investors to get poorly paid for taking on too much risk.

The main investment issues are:

- what happens when the guarantee runs out in October 2010? Will investors be left once again in poor underlying investments? What happens if a guarantee is withdrawn? Presumably funds will be locked up until the Government tries all possible avenues to recover funds
- there is confusion and uncertainty for investors around what and who is actually covered by the guarantee which has led to pricing anomalies
- funds out-flow pressure for non-guaranteed vehicles such as mortgage trusts has led to redemption freezes as investors switch to guaranteed investments
- share markets have sold off sharply and there is a greater temptation for investors to lock in losses and move to guaranteed deposits at just the wrong time
- a broader concern for the economy is that funds will flow to guaranteed issues primarily offered by the banks. This effectively forces companies to seek funding almost entirely from the banks who are a) seeking to strengthen their own balance sheet and maximise margins and b) less inclined to take on risk.

We have yet to see the full impact of the Government guarantee. It could be argued that all guaranteed debt should fall in price (i.e. interest rates come down) to a level below Government bonds as investors are effectively asked to pay all or part of the guarantee fee.

Looking forward we can only summarise what will happen in the run up to October 12 2010 when the guarantee period ends. How will the borrowers who may be lending on medium to long term investment projects cope with repaying deposits demanded back by concerned investors? This mismatching of investment assets against short term investor repayment liabilities is exactly the problem that many troubled finance companies faced. It seems like investors have tried to mitigate this risk by only investing for 18 months the beat the guarantee deadline. Regardless of the term, if the borrowing company doesn't have any new cash coming in then how is it going to repay either before or after the deadline? It appears investors are betting on an extension of the guarantee which seems like an incredibly risky thing to do for the additional return offered by finance companies.

We are recommending clients discount the benefit of the guarantees and focus on the prospects of the underlying investment assets.

What happens when the guarantee runs out?

Mismatching of investment assets against short term investor liabilities

Investors are betting on an extension of the guarantee



Cash PIE's – Are they finance company debentures in drag?

Investors not compensated for risks involved

Regular readers will be aware that we have never invested client monies in finance company debentures. This was mainly due to the large number of companies with weak business models and/or poor management. Even the offers from very well run finance companies have, in our opinion, not fairly compensated investors for the risk involved.

Essentially finance companies lured NZ retail investors into a false sense of security by offering fixed term investments at fixed interest rates set just above the banks. Because the rates were fixed, investors believed they were less volatile and therefore less risky than say share investing. This is despite there being no transparency or direct link to the underlying assets being purchased, no guaranteed return of capital or payment of interest and no clarity of the margin being taken by the finance company.

The collapse of poorly managed finance companies has led to billions of dollars being lost by investors who can ill afford it. In the search for more security investors have flooded back to bank deposits and (on the back of some aggressive advertising of the tax benefits) into cash Portfolio Investment Entities or PIE's.

So are cash PIE's just finance company debentures in drag? On the face of it cash PIE's appear to offer the same deal to investors as a term deposit only the government has seen fit to tart things up by offering a tax advantage for higher income earners who are direct investors. However one crucial difference is that PIE's are not held on the balance sheet of the issuer and are therefore limited to the assets of the fund itself.

This may not be an issue depending on the quality of the issuer and the quality of their lending. But it is unfortunate reality that not all cash PIE's are equal and a closer inspection suggests that for some, underneath the glossy make-up not a lot has changed for the finance company model. It is also worthwhile considering the following:

- **Low risk?** With no transparency of the underlying assets the effective level of risk cannot be ascertained. Cash PIE's are not guaranteed by the issuers and don't sit on their balance sheet. The Government guarantee scheme offers cover if the underlying PIE assets meet certain criteria but the complex inter and intra-funding issues mean it is not always clear

Not all cash PIEs are equal

- **No fees?** There is no such thing as a free lunch. Even if there is no explicit management or administration fee the product providers are making their margin in the effective lower yield being offered to investors. It remains to be seen whether these margins are to extent of the up to 10% previously being gouged by some finance companies
- **Liquidity?** At first glance it appears as though investors are free to move funds into or out of a PIE as required. However, just like we have seen with many managed funds, if cash flows suddenly turn negative and the underlying assets are not liquid then the manager may have no alternative but to freeze funds in the “best interests of investors”
- **Lower tax rate?** Much is made of the 9% tax differential on income between 39% marginal tax rate and 30% PIE rate. In reality this advantage is much less for investors with funds in a family trust structure where the difference is only 3% on income before additional costs. It is worth noting there are significant benefits in using a PIE to manage total assessable income up to \$60,000 at 19.5% although that too has limitations.

Our advice therefore remains the same as with finance company investments:

- Focus on the process not the product and understand exactly what you are investing in. Is it a plain vanilla cash fund or is it something else? What assets does it hold and can it hold?
- Ensure you are adequately compensated by return for the true risk of the investment
- Understand the financial position of the provider and their capacity to manage the investment.

But most importantly get the strategy right to begin with and put in place a well diversified portfolio that has both growth and income securities in the right combination for your required risk and return requirements.

There is no such thing as a free lunch

Focus on the process . . . understand what you are investing in

Get the strategy right to begin with



Investment grade issues welcome for liquidity and diversification

Global bonds to enhance client risk and return

Other Options

There are a range of other income producing options currently being promoted

Corporate Bonds

As the banks tighten lending criteria increasingly companies are looking to the financial markets to directly raise their required funds. Hence we have seen an increase in the number of corporate bond issues brought to market. Demand has been high from retail advisers and investors for those issuers with a known brand such as Fonterra, Tower, Contact Energy and Auckland City Council. Issues have typically been longer dated maturities to assist with their existing debt profile and allow for higher headline rates to the investor. Where they are of investment grade quality these issues are welcomed for liquidity and diversification benefits as the local market has long been thinly traded and dominated by bank issuance.

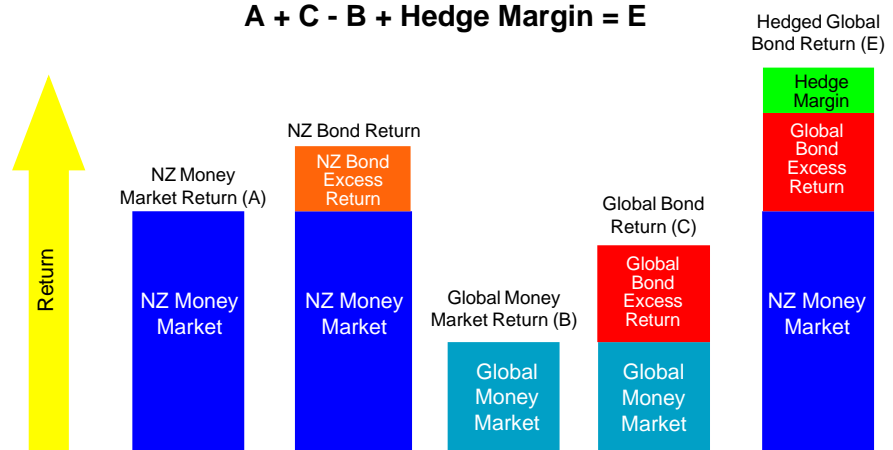
The oversubscription of some issues once again suggests investors and their advisers have sought yield at the expense of appropriate risk management and proper portfolio construction. To ensure bond portfolios are not adversely affected by liquidity or interest rate risk they need to be actively managed for duration and credit risk. There is little too suggest this has been taken into account by investors and no doubt the potential for capital losses will also come as a shock to many when interest rates inevitably rise or corporates get re-rated.

Global Bonds

Much like the local share market, the local bond market is limited in size, diversification and yield opportunities. We have regularly looked for an opportunity to access global bonds to enhance our client risk and return exposures. Unfortunately until very recently the lack of local investor demand (due to the focus on finance company debentures) has meant it has been uneconomic for fund managers to offer cost effective product.

The Global Bond Hedging Equation

$$A + C - B + \text{Hedge Margin} = E$$



The fund managers fees effectively wiped out any benefit relative to investing in a direct NZ bond portfolio and the requirement to hedge the return back to the NZ dollar (to pick up the currency hedge gains) meant there are few direct options available offshore.

So it has been pleasing to see a renewed focus from local managers on this asset class. Manager costs remain but this impost has potentially been mitigated by a recent IRD ruling to allow one fund manager to offer a PIE product which will be taxed under the FDR rules. That is, taxed at the investors PIR rate on a maximum 5% yield. This is potentially quite attractive if you assume the active fund management involved can add value and the returns are likely to be higher than 5% p.a. (a reasonable assumption given we forecast long term returns from this asset class of 6.7% p.a. before costs).

To illustrate this point we have compared investing directly in a NZ bond portfolio with investing via a NZ based fund under the accrual regime and also a NZ based PIE fund under the FDR regime. We have assumed both NZ and global bonds will return 6.7% p.a. gross, with fund manager fees of 1.20% p.a. and a family trust investor with a Prescribed Investor Rate (PIR) of 30%.

*Global Bond
PIE taxed
under FDR
attractive*

	NZ Bonds Direct	Global Bond Fund	Global Bond PIE / FDR
Gross Return	6.7%	6.7%	6.7%
Assessable income	6.7%	6.7%	5.0%
Non-assessable income	0.0%	0.0%	1.7%
Tax rate	33%	30%	30%
Management Fees	0.0%	1.2%	1.2%
Net return	4.49% ¹	3.85% ²	4.36% ³

Calculations
 1) $6.7\% \times (1 - 0.33) = 4.49\%$
 2) $6.7\% - 1.2\% \times (1 - 0.30) = 3.85\%$
 3) $5.0\% - 1.2\% \times (1 - 0.30) = 2.66\% + 1.70\% = 4.36\%$

What would make these offers even more effective is if the vehicle was domiciled offshore in which case there would be the opportunity to look at returns on a total FIF portfolio basis and the opportunity to pay less tax if overall portfolio returns including global shares were less than 5%.

We will continue to review the opportunities in this space.



Property Syndicates

Low interest rates, investors searching for yield and developers with property to shift before the banks foreclose create the perfect environment for property syndicators to once again enter the market. The premise seems reasonable, club together with many other like-minded small investors to purchase a property you couldn't afford yourself. Pay someone else to manage it, sit back and reap the rewards.

But property syndication has some specific drawbacks as well.

- Single asset risk - investors are typically exposed to a single commercial or industrial building. How easy is it for the property to be reconfigured and at what cost. On what basis has the building been valued for transfer into the syndicate
- Tenancy risk - investors are reliant on the ability of tenants to withstand difficult market conditions. Even with several tenants they often operate in similar market sectors
- Liquidity risk - there is no easy out for investors should conditions sour. An orderly exit requires the property to be sold or the investor to find a buyer for their share
- Leverage - in order to maximise returns there is typically substantial leverage in the financing structure. This increases the risk of breaching banking covenant's and shuffles investors further back in the queue in the event of default
- Manager motivation - the manager is motivated to maximise their return not necessarily the investors.

All is well while the tenant continues to pay the rent. Problems arise if the tenant defects, the lease matures or interest rates rise. This is when the lack of liquidity and diversification of property syndicates is exposed. Next thing you know distributions are being cut or stopped altogether and the only way to exit is to sell your exposure at a loss if you can find a buyer.

How quickly investors forget the lessons of recent history. A quick online search reveals the headline, "People in syndicated property funds are getting a timely wake up call". The article refers to investors facing significant property syndicate losses similar to the early 1990's, the date of the article is August 1999!

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