

MELVILLE JESSUP WEAVER

Investment Newsletter October 2011

Will investors need to reduce the returns they expect in the future?

Introduction

The end of September marks the half-way point in the financial year for many funds and it has been a very tough six months with share markets producing negative returns from May onwards. These results when considered in the light of weaker long term returns from shares lead to questions as to a fund's exposure level to shares; particularly when income assets have done so well over both the short and long term horizons. Have investors in growth assets received the returns commensurate with the risks they've assumed when investing in shares?

A related question is, "Where are charitable trusts going to get the income they need to meet the level of donations they wish to grant in the future?"

Recent returns

How has an average fund performed over the most recent six month period?

Table 1 illustrates the gross returns to 30 September 2011 for three hypothetical funds with varying levels of exposure to growth assets.

So as expected the lower the exposure to growth assets the better the return.

The results from bonds have continued to be positive over the period thanks to the major falls in interest rates globally. The asset allocations are shown on the table to the right.

Table 1	Income	Balanced	Growth
NZ Shares	2.5%	6.3%	10.0%
Australian Shares (hedged)	2.5%	6.3%	10.0%
Global Shares (50% hedged)	15.0%	37.5%	60.0%
Growth Assets	20.0%	50.0%	80.0%
NZ Bonds (Government)	17.5%	15.0%	5.0%
Global Bonds (Aggregate)	35.0%	30.0%	10.0%
NZ Cash	27.5%	5.0%	5.0%
Income Assets	80.0%	50.0%	20.0%
Return, 6 months to 30/9/11	0.7%	-4.4%	-10.2%

Looking back 15 years

What do the results look like if we look back at the longer period of 1996 to 2011? During this 15 year time period we have witnessed:

- Two periods where share markets have risen strongly only to then fall substantially.
- The rates on 10 year US Treasuries which were yielding 6.7% at the end of September 1996 have fallen as far as 1.7%.
- Since 2007 the US Federal Funds rate has been held low.
- Strong share market returns in the emerging markets.

To provide some reference points we have compared some indexes then and now in Table 2.

Table 2	30 Sep 1996	30 Sep 2011
NZX 50 ¹	1,495	3,684
ASX 200	9,134	30,239
S&P 500	687	1,131
NZ Official Cash Rate ²	10.05%	2.50%
NZ Govt Stock - 10 year	8.04%	4.46%
US Federal Funds Rate	5.25%	0% - 0.25%
US Treasury - 10 year	6.72%	1.92%
NZD / USD	0.699	0.764
NZD / AUD	0.884	0.787

¹ The NZX 50 did not exist in 1996. We have hypothecated its level by using its predecessor, the NZSE 40.

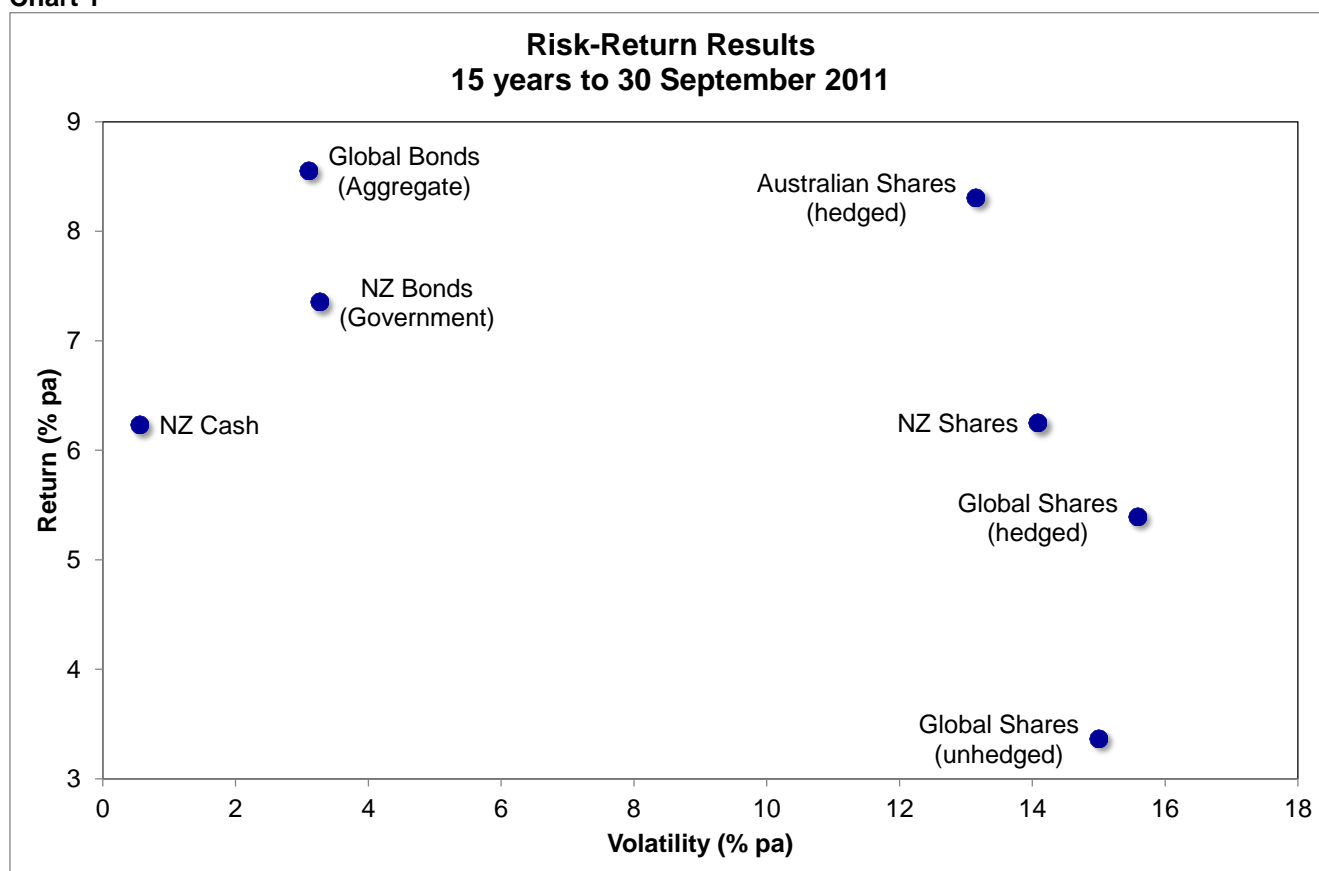
² The Official Cash Rate was introduced in 1999. We have shown the level of the overnight interbank cash rate at 30/9/96.

Individual sector returns

The table and chart below show the results for the individual asset classes over the 15 year period.

Table 3	30-Sep-01 % pa	5 years to 30-Sep-06 % pa	30-Sep-11 % pa	15 years to 30-Sep-11 % pa
NZ Shares	2.9	16.4	0.1	6.2
Australian Shares (hedged)	10.5	15.8	-0.7	8.3
Global Shares (unhedged)	16.5	0.1	-5.3	3.4
Global Shares (hedged)	8.6	11.7	-3.5	5.4
NZ Bonds (Government)	8.3	6.3	7.5	7.4
Global Bonds (Aggregate)	8.5	8.5	8.6	8.6
NZ Cash	6.9	6.3	5.5	6.2

Chart 1



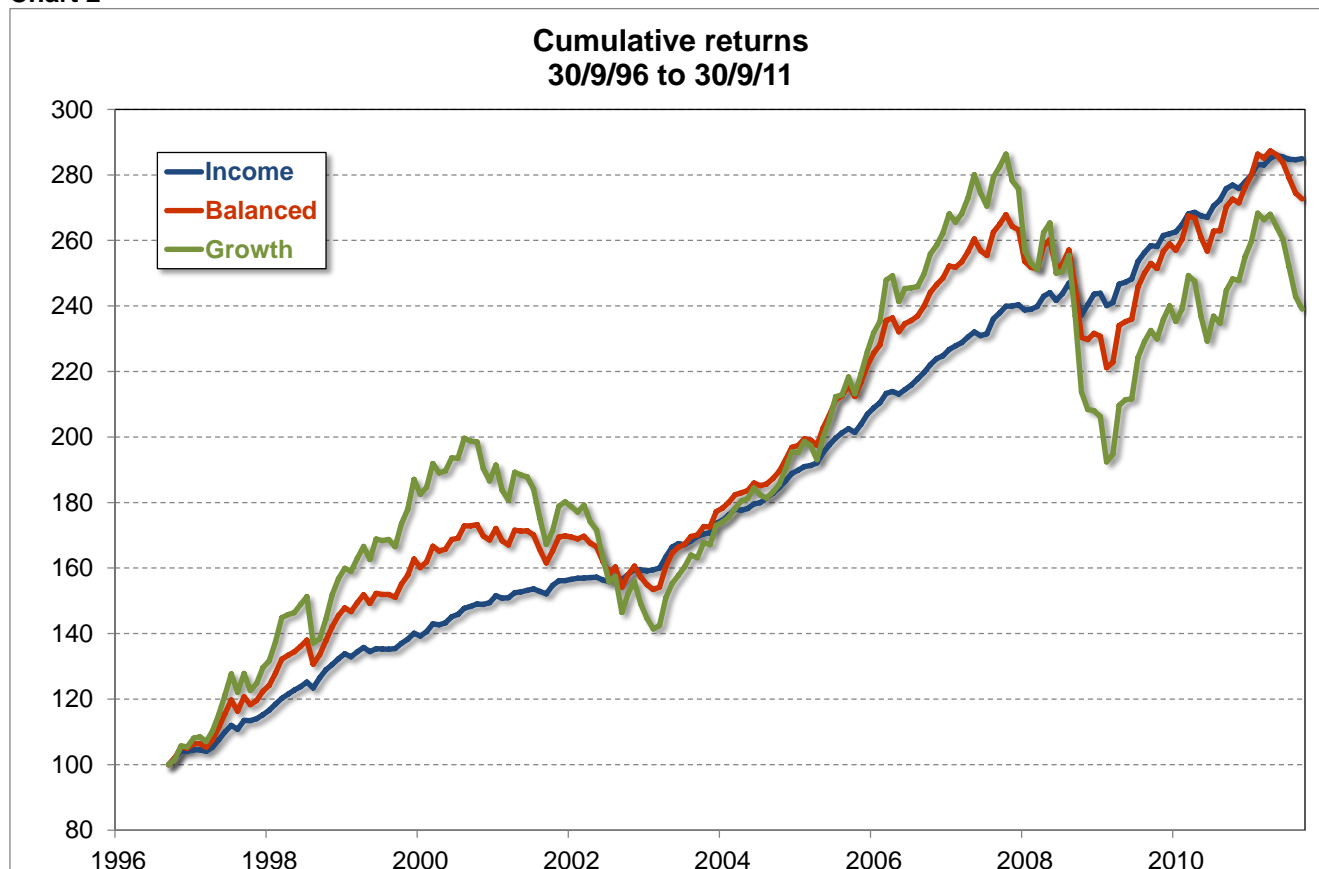
Commenting on the results:

- Volatility is similar for the growth assets, significantly higher than that for income assets.
- But the holders of growth assets have not received any additional returns.
- A comparison of the NZ bonds and shares shows a premium of 1.2% pa for bonds over shares.
- Global bonds have outperformed NZ bonds as one would expect. But NZ shares have outperformed global shares over the period, although unhedged global shares have been hurt by the rising NZ dollar.

Cumulative return

Chart 2 illustrates the cumulative returns over the period for the three portfolios.

Chart 2



Commenting on the results:

- The three portfolios have very different volatilities with the growth portfolio very volatile.
- The best return for the whole period is the income portfolio.
- There were occasions during the 15 year period when the growth portfolio was the top performing.

Share markets have been very volatile and over the period considered the rolling 12 month returns on the global shares (50% hedged) varied from -33% to +54%. Are we then just looking at the markets at a down spot for growth assets?

A question this raises is what returns would the shares need to achieve over the next two years for the growth portfolio to achieve the same cumulative result as the income portfolio. The rate is 14.6% per annum. (We assume that the income assets earn 5% per annum for the period.) Is this achievable?

Separating out the returns from growth and income assets

The income and growth assets have very different characteristics. The income assets are there to provide steady annual returns with some certainty of preserving the capital invested. In contrast the growth assets are expected over time to produce the greater returns. Put simply the investors in growth assets need the additional return if they are going to take the additional risks involved.

The three charts on the following pages illustrate the contribution made by the income and growth assets over the period to the total return of each portfolio.

Chart 3

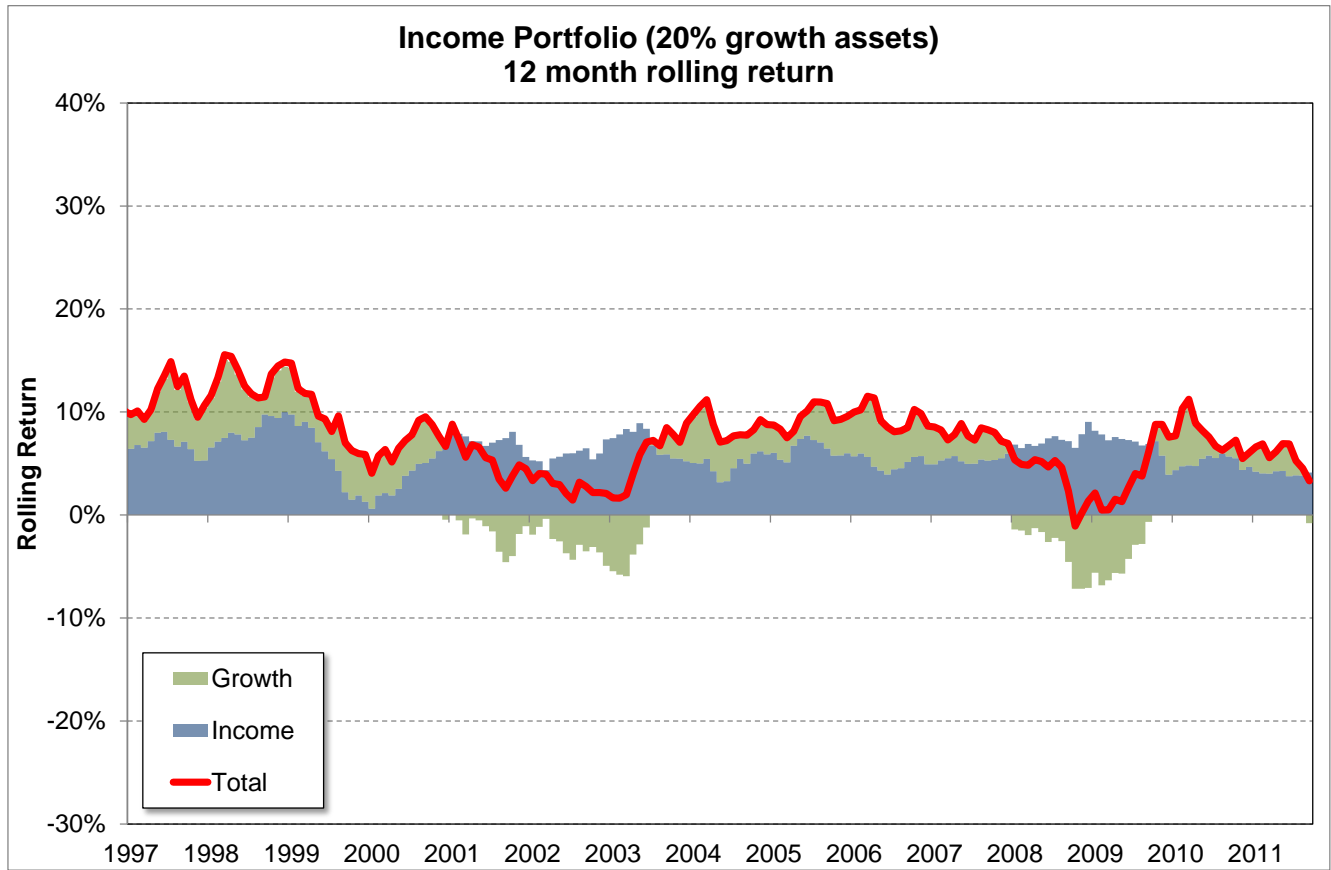


Chart 4

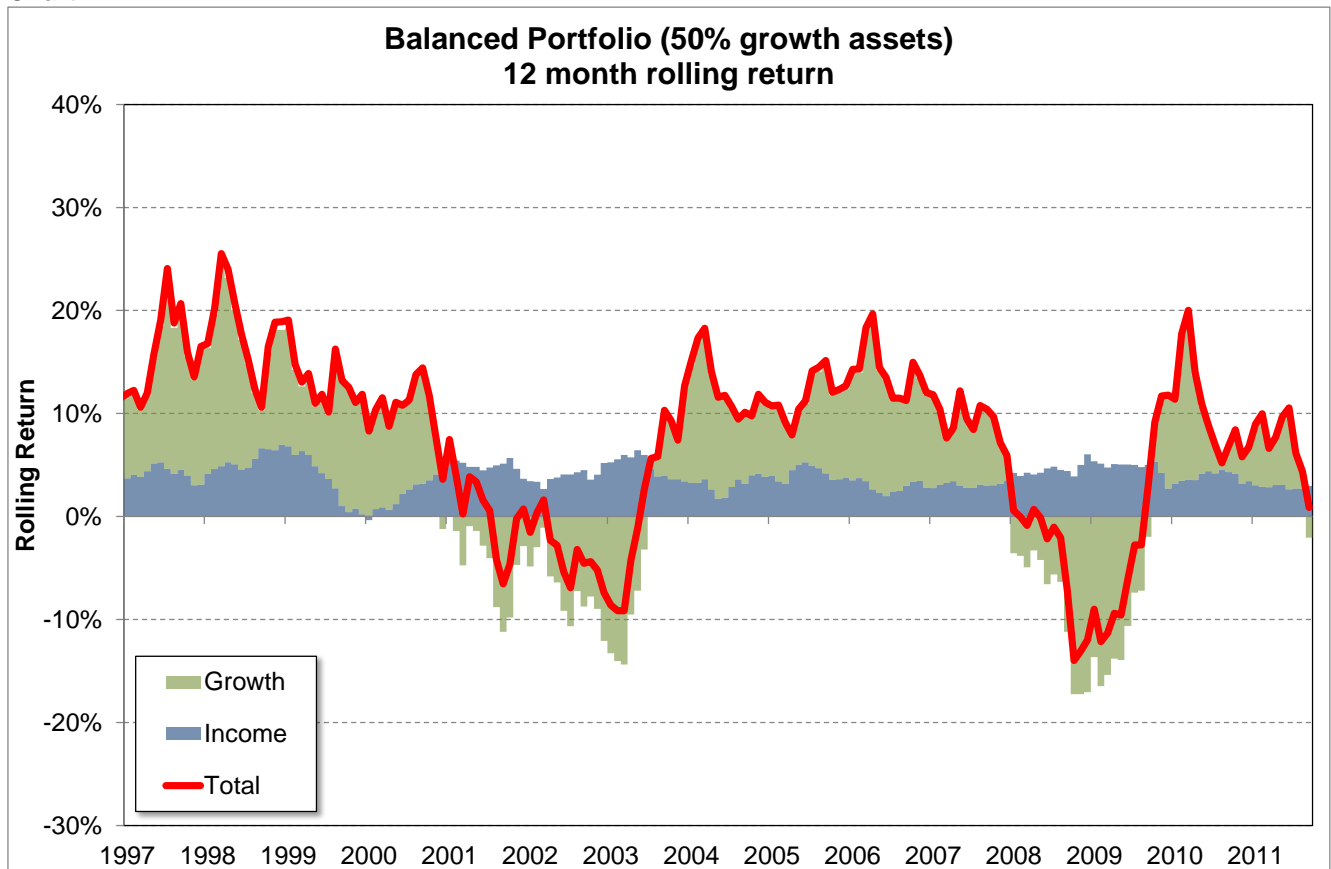
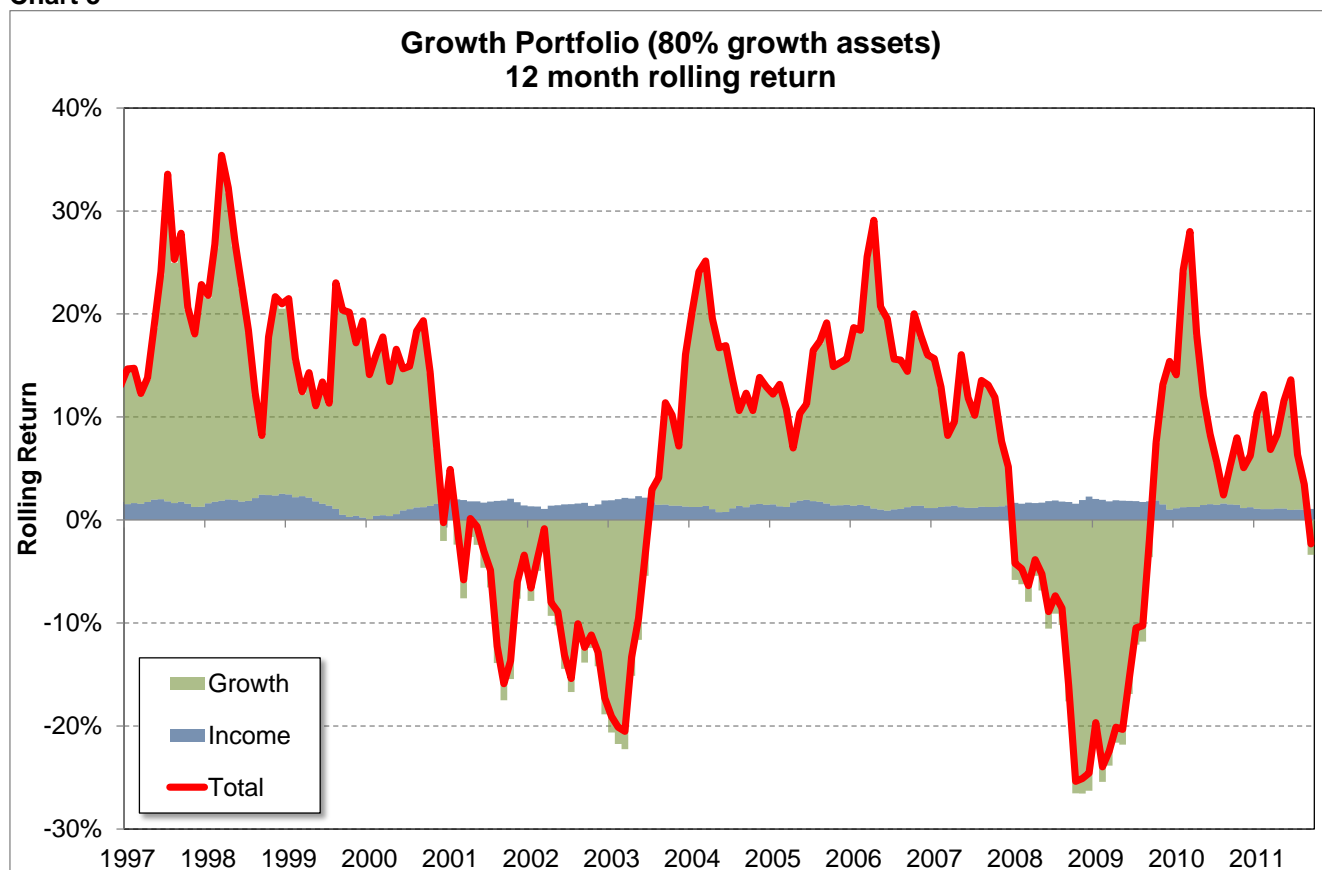


Chart 5



Conservative portfolio

The blue area is fairly steady over the period with the exception of 2000 when interest rates rose and the fall in the capital value of the bonds reduced the total return from income assets. But, except for late 2008, the overall return on the portfolio has always been positive. The return on the shares component of the portfolio in contrast has been very variable but the limited exposure to this sector has limited the overall impact on the total return.

Growth portfolio

The overall return is dominated by the return on the growth assets with the income assets providing just a small cushion to reduce the losses in 2003 and the 2008/09 period.

Balanced portfolio

The results are naturally a combination of the lows and highs of the other two portfolios.

Achieving good steady returns for a charitable trust in the future

The consensus view is that with interest rates so low and the outlook for share markets limited it is going to be extremely tough for charitable trusts to produce good steady returns from which to make their grants in the next few years.

The problem is illustrated by the chart for the balanced portfolio which illustrates the importance to these funds of the returns they have received from their income assets. Looking forward we can reasonably expect the level to be lower which is going to require the growth assets to make a more sustained contribution in the future.

A question which arises here is whether to increase the exposure to growth assets to achieve this. Perhaps this depends on the current exposure level and the extent to which the trust can take on more variability in the annual returns.

Conclusions

We see the conclusions as:

- The strategic asset allocation dominates the overall return for a fund.
- The last 15 years have been tough on investors with a high exposure to growth assets. They have not been rewarded for the additional volatility that they have experienced.
- Income assets have behaved broadly as one would expect of providing a good income level with general capital preservation assisted by a general downward movement in interest rates.
- The current tough market conditions with concerns over future growth levels mean it is a good time to review a fund's strategic asset allocation. The issues are:
 - What is the role of each asset held?
 - Where is the fund spending its risk budget? Are there some assets held which are now considered too risky?
 - What is the best exposure level to share markets? Should the current level be increased?
 - Are there any other sources of return which are significantly uncorrelated with the returns on listed securities? For example real assets such as commodities, forestry and infrastructure.
 - While the alternatives can look attractive what are the risks underlying them?

Perhaps the only clear conclusion to reach from the analysis is that investors will need to lower the investment returns they expect in the future and manage to this new normal accordingly.

About Melville Jessup Weaver

Melville Jessup Weaver is a New Zealand firm of consulting actuaries. The areas in which we provide advice include superannuation, employee benefits, life insurance, general insurance, health insurance, asset consulting, accident insurance and information technology. The firm, established in 1992, has offices in Auckland and Wellington.

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For further information please contact:

Bernard Reid 09 300 7163
bernard.reid@mjlw.co.nz

Mark Weaver 09 300 7156
mark.weaver@mjlw.co.nz

Ian Midgley 04 499 0277
ian.midgley@mjlw.co.nz

Ben Trollip 09 300 7154
ben.trollip@mjlw.co.nz

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