Newsletter
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Investment Market Review

In spite of both Greek and Chinese markets facing some uncertain times, investment returns for the March to June quarter were generally strong, particularly for portfolios with larger allocations to growth assets.

While this may sound surprising since many international share market returns were flat or negative, well diversified portfolios benefitted from a sizable weakening in the New Zealand dollar over the quarter.

This is another timely reminder why investors here can be a little more relaxed about the various dramas playing out overseas. When uncertainty hits global markets, a common reaction is for a 'flight to safety' mind set to develop. This can, for example, manifest in an increased demand for perceived 'safe' assets such as US Treasury securities at the expense of perceived 'risky' assets such as Greek equities.

One of the common outcomes of such a mentality is for the US dollar to strengthen (as a result of an increased demand for US dollar denominated securities) and for smaller currencies, such as the New Zealand dollar, to weaken. However, when the New Zealand dollar weakens, we are in the fortunate position of having in-built investment shock-absorbers in our portfolios in the form of unhedged foreign currency assets (because the NZ dollar value of these assets *increases* when our exchange rate falls).

For this reason, unhedged foreign allocations can provide a real helping hand to the performance of portfolios when international investment markets come under pressure, as has been the case in the recent quarter. With the New Zealand dollar having weakened over the last three months by -8.9% against the US dollar and -9.8% against the Australian dollar, this has delivered a significant benefit to local investors holding some exposure to unhedged foreign assets.

Over the last few weeks global media have focused considerable attention on the events unfolding in Greece. Even as we write, this situation appears to have some way to go to reach a clear conclusion. This ongoing uncertainty is weighing heavily on the citizens of Greece and, to a lesser extent, global markets.

For most of us in New Zealand, the natural question is, how will this affect my portfolio? In the short term, global share markets have reacted by becoming more volatile. We are seeing bigger daily market swings on many markets, in both positive and negative directions. This is a typical market reaction to uncertainty. Fear of the unknown will often see speculators or very short term investors exit the markets. Unfortunately for those investors, long term evidence suggests that these sort of behavioural or emotion-driven decisions most commonly lead to sub optimal investment performance.

On the other side of these trades are usually institutions or long term strategic investors who are better able to tolerate a higher amount of daily market volatility. Over time, these investors will generally have opportunities to add to their portfolios at attractive prices, and taking advantage of these opportunities is usually very rewarding.

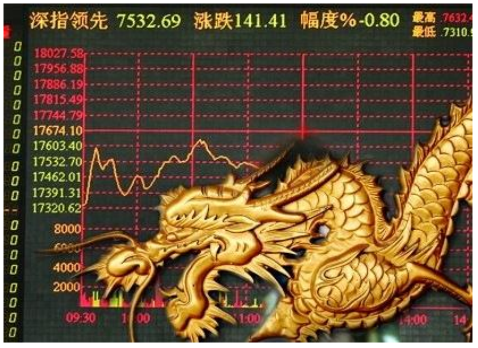
Bond markets, which are much less volatile than share markets, have also exhibited a little more volatility than normal in recent weeks. However, in the main, these assets continue to do exactly what they are meant to do – that is, to provide a much more defensive and consistent asset class return. Bond markets will also generally react to news differently to share markets (i.e. when share prices go down, good quality bond prices will generally go up). It is precisely these attributes which make bonds such a powerful addition to any diversified portfolio.

So the Greek issues have made most markets more volatile, but should we be worried about this? Well, at risk of upsetting any readers with strong connections to Greece, we don't think so. We will face a lengthening period of uncertainty about what a potential Greek exit from the Euro might mean for Europe and the global economy, but the direct market repercussions have so far been relatively minor. This makes sense when we consider the Greek share market in a global context.

The Greek share market has a total market capitalisation of around USD 29 billion. Although that sounds impressive, our own New Zealand share market (which we are constantly told by foreigners is largely a footnote on the world stage) is almost 2.5 times bigger! The share market of our major trading partner (China) is 150 times bigger than Greece. The US share market is 1,000 times bigger.

If we put this into a portfolio context, an investor with $1 million in one of our recommended model portfolios would have less than $200 directly exposed to the Greek share market. So our direct exposure to Greece's is next to nothing.

The more relevant uncertainty is how will other markets perform as a result of Greece's issues? The answer to that question is unknown, and unknowable given the developments yet to come. However the risks of contagion have reduced significantly since the first indication of the Greek debt crisis emerged in 2010.



Although not receiving quite the same amount of column inches, New Zealanders should probably take greater interest in what is happening in China than in Greece. China is now our largest trading partner, taking more than 20% of our exports, and economic growth there continues to slow. This has implications for commodity prices (such as milk and dairy products) and is also one of the reasons our New Zealand dollar has weakened in recent months. So, what happens to China, is increasingly important to New Zealand.

In the last month the Chinese share market has fallen by more than 30% and the Chinese government has initiated a series of policy initiatives to try and avert a larger correction, such as initiating interest rate cuts, using pension funds to prop up the market and announcing plans to investigate short sellers.

On the surface this looks like a market getting rid of some obvious speculative excesses. From the beginning of June 2014 to its June 8th high this year, the Chinese market soared by an unsustainable 151% on the back of margin traders and momentum based investors. The current correction, while uncomfortable for latecomers to this market, *should* end up with a sensible market equilibrium eventually being attained.

As always, if investment markets either individually or collectively go 'on sale' it is long term investors who buy rather than sell at a discount, who inevitably reap the best long term rewards.

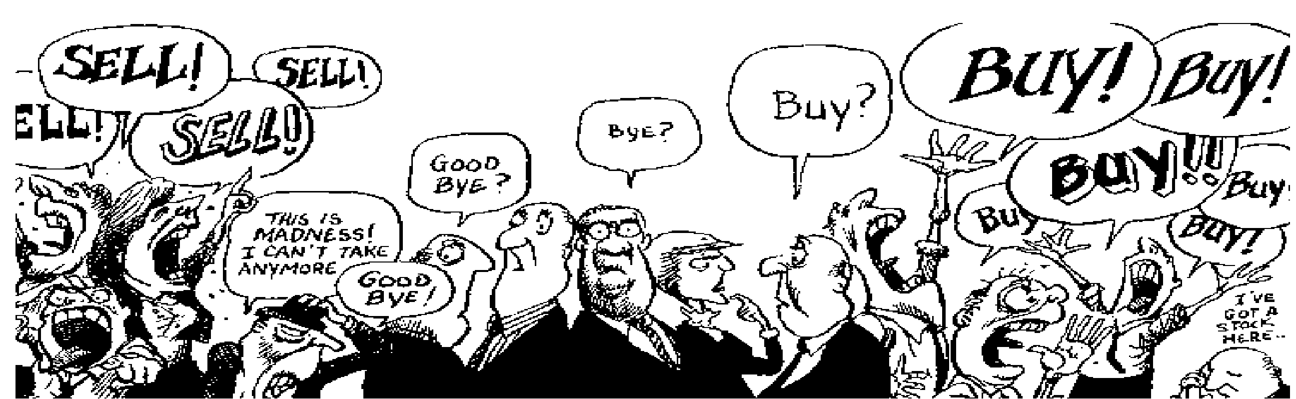
As indicated earlier, the impact of our weaker dollar provided the strongest contribution to returns this quarter as markets overall were decidedly mixed. Equity markets tended to struggle on the back of the well-publicised turbulence in both Greece and China, and bond markets also delivered some patchy results. Even property, for so long a leading sector in portfolios, struggled to maintain momentum as the US Federal Reserve indicated they could begin the process of increasing US interest rates as early as September this year.

While we cannot control the news, the evidence (yet again) from the recent quarter is that the news alone doesn't always tell us a great deal about investment outcomes. Our focus, as always, remains on the important disciplines that we can control.

These are to:

- Maintain prudent country and security diversification, so that investors are not directly exposed to a single small and unstable market, such as Greece.
- Maintain a sensible balance between assets that deliver different returns in the same market conditions - such as shares versus bonds; hedged versus unhedged assets.
- Hold thousands of small exposures rather than concentrating investments into just a handful of large exposures, to minimise overall risk.
- Ensure that only high quality bonds are owned, rather than gambling on those with lower credit quality.
- Ensure that all assets are highly liquid so they can always be converted to cash easily and at a fair price if the need for funds ever arises.

If we do all of these things well, then history continues to remind us that the best possible outcomes for investors are generally achieved.



Key Market Movements for the Quarter

-1.83%

NZ Shares

The NZX 50 declined over the quarter. What began as modest profit-taking in April accelerated a little by the end of the quarter as investors weighed up the relatively 'expensive' local company valuations against concerns that offshore political and economic issues could lead to weaker share prices globally. Bucking the broadly negative trend was Auckland International Airport, up 9.6% over the quarter.

Source: NZX 50 Index

+1.66%

NZ Fixed Interest

After earlier indicating an easing bias as a result of low inflation and softening exports, the Reserve Bank confirmed a cut in the Official Cash Rate to 3.25% on 11th June and then to 3.00% on 23rd July. With a general reduction in corporate bond yields throughout the quarter, this proved to be beneficial for domestic bond returns.

Source: ANZ Corp A Index

+0.23%

NZ Property

The domestic listed property sector was largely flat for the quarter. With the immediate interest rate outlook in New Zealand now looking more subdued (ie, the prospect of further rate cuts now expected), investors have had few concerns about maintaining existing investment exposures to the sector.

Source: New Zealand Property Index

+4.44%

Australian Shares

In sympathy with global share market jitters around much of the world, the Australian share market had a poor quarter (in Australian dollar terms) with the ASX 100 down -6.7% and the ASX Small Ordinaries down -4.0%. For New Zealand investors with an unhedged exposure to these markets, the result was far more rewarding with the ASX 200 up 4.44% in New Zealand dollar terms.

Source: S&P ASX 200 Accumulation Index

+0.07% (hedged)

10.87%

(unhedge

International Shares

After starting the quarter strongly, most major global share markets moved into negative territory by quarter's end as tensions mounted in both Greece and China. The main exceptions were Asian and emerging markets where performance over the quarter was, on average, stronger. Once again the biggest performance differentiator for investors was whether the underlying investments were hedged or unhedged. The weaker New Zealand dollar meant unhedged returns were 10.8% higher than hedged returns.

Source: MSCI World ex-Australia Index

+0.73%

International Fixed Interest

Global bond markets experienced increased volatility as a more positive outlook from the Federal Reserve was offset by increasing concerns about Greece's potential impact on the Eurozone. With global credit spreads generally widening over the quarter, longer dated and lower quality securities tended to struggle, while high quality and short duration securities delivered another small gain.

Source: Citigroup World Government Bond Index 1 – 5 Years (hedged to NZD)

+1.04%

International Property

Global listed property suffered from reduced investor support over the quarter as indications that the US Federal Reserve could commence their 'interest rate normalisation' process as early as September, weighed on the sector. Returns to New Zealand based investors in unhedged international property assets remained positive due to the favourable impact of a much weaker New Zealand dollar.

Source: UBS Global Real Estate Investors Index

All returns are expressed in NZD. We're assuming Australian shares and international property are invested on an unhedged basis, and therefore returns from these sectors are susceptible to movement in the value of the NZD.

Trusts in the Spotlight

Trusts have many uses, including creditor protection, protection against relationship property claims from partners or spouses under the Property (Relationships) Act 1976, estate planning and even tax minimisation in certain instances. Alongside other developments, recent court judgments have set new precedents that suggest trusts may be becoming less effective against these types of claims. In this article, we take a look at a few of the issues.

Residential Care Subsidy

According to the New Zealand Herald, 21% of those over 85 are in residential aged care. With science allowing us to live longer and healthier lives, the proportion of retirees in care is likely to increase.

Whilst it's clear many later in life may need this care, what has become less clear of late is who will pay for it. Historically, those who have been unable to meet the costs of their own care have had the costs met by the Ministry of Social Development (MSD), in the form of the Residential Care Subsidy. The test of a person's ability to pay is assessed on the basis of assets held in their own name. If you have assets above a certain level - currently $218,598, including a house and car - you are responsible for meeting the costs of your own care.

Assets properly gifted to trusts were previously not included in this asset test, however, the MSD has been increasingly aggressive in ensuring that trusts are not used as a way to divest assets, and thus, gain subsidy eligibility.

The maximum you can divest is $6,000 per annum for five years prior to application, and $27,000 per annum per couple before that (not $27,000 per person per annum as was previously understood).

The MSD requires that applicants provide full information with regard to all the assets that have transferred into a trust and whether you were the settlor, trustee or beneficiary of a trust or estate. In addition, the MSD will look at the assets that a couple has transferred to a trust rather than just the share of the assets in the trust that came from the one making the application. The MSD can look back as far as it wants in order to determine if you are at the threshold for qualifying as a result of asset divestment.

This developing policy now substantially reduces the potential efficacy of trusts for accessing the Residential Care Subsidy.

Relationship Property

A recent Court of Appeal case concerning Mark and Melanie Clayton, who separated almost a decade ago after 17 years of marriage, appears to be rewriting the law on trusts for relationship property purposes.

Mark Clayton has significant sawmilling interests in the central North Island, worth approximately $28 million. The business and other assets are owned by a series of companies and trusts. Melanie Clayton believed she was entitled to half of the value of the business and trust assets. The Court of Appeal decision this year resulted in Melanie being largely successful in 'busting' the trust. In particular, the case found that Mark Clayton's power to add and remove discretionary beneficiaries to and from the trust (the power of appointment) fell within the definition of "property" in the Property (Relationships) Act, and was "relationship property" under that Act when the Claytons separated. The Court determined that the value of this property right held by Mark Clayton was equal to the net value of the assets of the trust at the separation date. Mark was required to pay Melanie an amount equal to half of that value.

Mark's lawyer was quoted in the New Zealand Herald as saying, "It certainly significantly reduces the apparent comfort people would have in putting all their property into trusts and thinking that was safe… There has been a long-held view that a trust protects them from creditors or from claims from their spouse and this decision means that will really need to be looked at very carefully because the courts have found it is not a shield necessarily."

Clayton to be appealed

We should note that Mr and Mrs Clayton both appealed (on different grounds) to the Supreme Court, and the Supreme Court has granted appeal on some grounds including the matters discussed in this article. The Clayton case clearly illustrates how complex the interface between trust law and relationship property law is and how quickly it is evolving.

Disclosure to Beneficiaries

The Clayton case brought another issue to light with regard to disclosure. The court found that, if information regarding a trust was not disclosed, the court was entitled to reach adverse findings against the trustees under the presumption that they refused to reveal it because it did not help them. The implication for trustees is that the courts are moving towards trust transparency. This may extend to sharing information with beneficiaries and seeking their input.

Potential new trust law

Our last discussion point - and an item that we are closely monitoring - is the reform of New Zealand trust law that is currently underway.

The Justice Minister, Amy Adams, has advised that a new Trust Act is one of the three main areas she is focusing on in this term of Government. When enacted, the new act is likely to include several important provisions regarding the way in which trust assets are invested. In our view, almost all the proposed changes are positive.

Our view is that the six main areas of interest are:

1. Trustees are likely to be required to invest for total return without specific regard to capital gain or income.

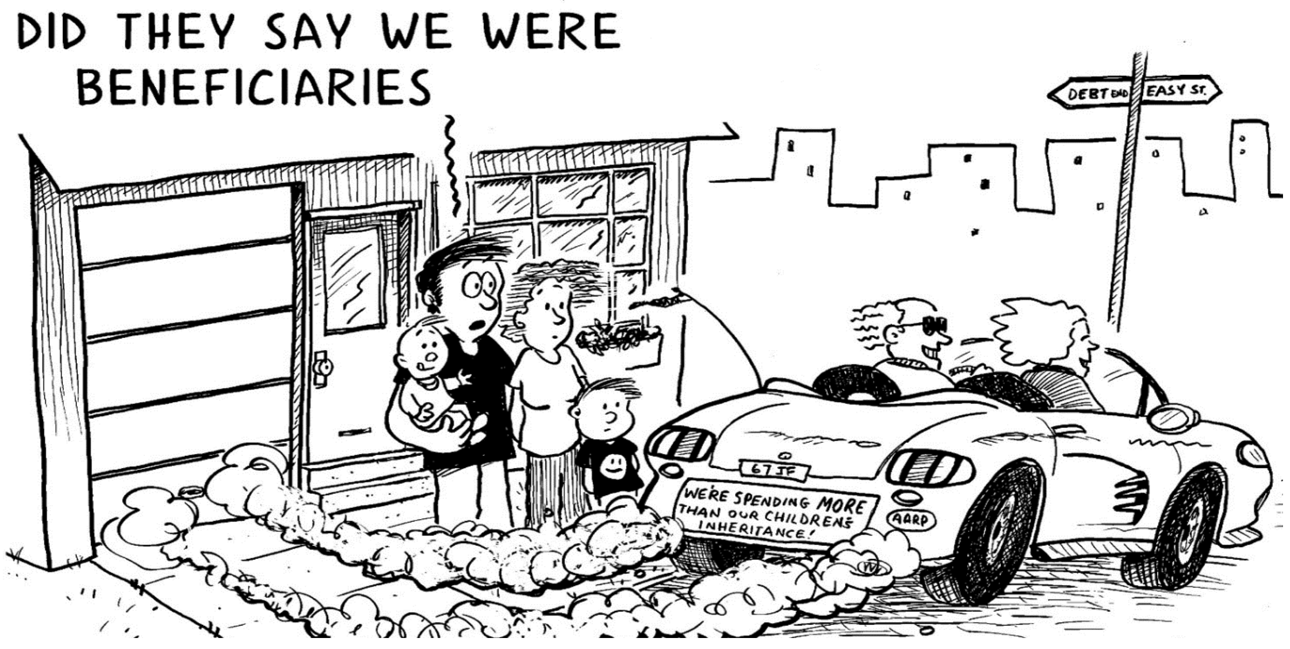
2. Trustees are likely to be authorised to appoint investment managers and give them authority over investment decisions.

3. Trustees are likely to be required to act in good faith, exercise the reasonable care, diligence and skill of a prudent person when appointing an investment manager, and must review the manager's performance regularly.

4. Trustees are likely to be required to create a written investment policy statement which describes how the functions are exercised by the investment manager, and the general investment objectives. Investment managers will be required to agree to comply with the policy statement.

5. Trustees are likely to be personally liable for default of their investment manager if they've failed to act honestly and in good faith, or failed to exercise the reasonable care, diligence and skill of a prudent person when appointing an investment manager or monitoring their performance.

6. When appointing an investment manager, the two key issues trustees are likely to be required to consider are whether the manager has the appropriate skills and experience, and whether employing the manager is cost effective.



One area of particular interest is found in section R17 (2) of the Law Commission review, where trustees have the responsibility to exercise reasonable care, diligence and skill when appointing an investment manager.

We believe that means there needs to be a process - even a simple one - that a trustee can point to, to show that they have fulfilled this requirement. That process needs to be documented and reviewed on an ongoing basis. We are already working in the background to provide such a process to the trustees we work with, based on external checks of our investment due diligence process.

As this article suggests, trusts are currently very much in the spotlight. We believe those of you who have trusts should have discussions with your trustees regarding the matters outlined in this article. It might also be time to arrange for trust lawyer to review your trust deed to ensure that the trust still meets its intended purpose, is providing the best possible protection against claims and is managed in a way that is consistent with the proposed new trust legislation.

Key Indicators and Rates			
OCR (official cash rate)	3.00%	UDC Finance Deposit – 1 year	3.90%
90 day Bank Bill	3.06%	Mutual Credit Finance Deposit – 18 mths	6.00%
Enhanced Cash Portfolio	3.25%	Heartland Bank Deposit – 1 year	3.95%
Income Securities Portfolio – Call	3.75%	Income Focus 18 Portfolio *(estimated)*	4.70%
Income Securities Portfolio – 3 & 6 mths	4.00%	Income Focus 28 Portfolio *(estimated)*	5.30%
Income Securities Portfolio – 12 mths	4.00%	Income Focus 50 Portfolio (estimated)	6.60%
Income Securities Portfolio – 24 mths	4.25%	Corporate Bond Portfolio (estimated)	3.90%

FOREIGN SUPER – To Transfer or Not?

If you have worked or lived overseas, it is likely that you will have investments in foreign superannuation and pension schemes. These investments are caught between different tax treatments in different countries. As a result, the longer you wait, the greater the chance that returns on these investments may be double-taxed.

While you can transfer these overseas investment schemes to New Zealand, how and where these are transferred to depends on where your funds are held. For example:

- **Australian Super** – can only be transferred to KiwiSaver.
- **UK Pensions** – can only be transferred to QROPS approved NZ superannuation schemes only (not KiwiSaver now).
- **US Pensions** – withdrawals are possible under an amnesty prior to full implementation of the US Government's new FATCA tax rules.

The Rede team has advised many clients on the options for transferring foreign superannuation to New Zealand. Time is of the essence and advice is key – call us today to discuss your options.

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