

# If it looks too good, don't believe it

In NZ just about anything goes when it comes to promising financial returns

**I**F YOU go to a financial planner, banker or stockbroker to invest the proceeds of a house sale, divorce or Lotto win you will most likely be told you are in luck.

The aforementioned adviser can likely find bargains in the local stock markets, identify the world's best fund managers and combine the various asset classes together in a portfolio for you in such a way that return is maximised and risk is minimised.

Unfortunately just that sort of fairy tale is taught to aspiring financial planners and stockbrokers. But although low standard deviations and high Sharpe measures are nice, the key variable for Mum and Dad with \$200,000 saved is invariably how much they will be able to spend each year in retirement while keeping their capital intact. That fact is often lost on practitioners as the industry standard spreadsheets amortise the capital over time, theoretically running down your savings to zero on the day you die.

In the end the test of a good model is the extent to which it approximates reality and most humans I deal with don't work that way. They want to keep their capital reasonably intact for children, charities and/or just out of habit, and live off the income.

So while efficient frontiers, emerging markets and absolute return investing dominate many financial plans, very few actually set out details of the "free cashflow" the portfolio will produce. For retired investors cashflow is important because it will determine how much they can spend in retirement. It is thus vital the adviser has a realistic view of the sort of returns he or she can achieve from a portfolio of bonds, property and equities. The bad news is many advisers obfuscate the issue and use unrealistic numbers, because:

\* Annual fees are high and cash yields are low so financial advisers' computer models combine capital gains and cash income into total return. That produces the required numbers but has the problem that while coupon payments from bonds and



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dividends from shares are reasonably stable, capital gains can be elusive. For example, the past 10 years' actual results from international share portfolios have been a particular problem for the spreadsheets that forecast 10 per cent returns when reality was around -2 per cent a year.

\* Many advisers' experience is anchored in the 1990s bull market when returns from shares and bonds were much higher than normal.

\* Financial advisers know the higher the return they show the more attractive their plan will look.

\* They also know no one is going to pay them to get the same return as they could earn in the bank.

That means that, all other things being equal, your average financial plan is likely to contain some pretty aggressive assumptions regarding future returns. At the moment in New Zealand just about anything goes.

Some fund managers trumpet the past year's double-digit returns, omitting to say the year before it was a double-digit loss.

So what sort of total return should you expect from your diversified retirement portfolio? That issue was considered in Britain by the leading regulatory body there, the FSA. In a discussion paper, it looked at



YOU'RE DREAMING: If retirees think an adviser's promised return sounds like a fairy tale, it probably is.

FREE CASH FLOW FROM A BALANCED PORTFOLIO		
Description	Weighting	Pre-tax, pre-fee yield (% a year)
Bonds (local, low risk)	40%	6.5%
Property (50% NZ and 50% international)	10%	7.0%
NZ Shares	12.5%	6.0%
Australian Shares	12.5%	4.0%
International Shares	25%	2.5%
Weighted Average Cash Yield	100%	5.2%

Source: Private Asset Management/HERALD GRAPHIC

the quality of the projections used to sell financial products in Britain. It decided the system needed changing.

In particular, its paper highlighted consumers were being given a poor indication of the volatility of returns. But compared with New Zealand, the British system is highly regulated. Financial advisers and fund managers are told by the FSA what rates of return are acceptable to "prevent firms from competing for business on the basis of unrealistically high projections of future returns".

No such safety net exists in Godzone. Indeed, a fund manager can get away with advertising that says he or she is aiming for returns of 50 per cent a week. That that sort

of marketing actually seems to work locally is another, rather sad story.

But back to the central question. Mum and Dad buy a portfolio of bonds, property and shares - how much can they spend without diminishing the capital; that is, what is it going to earn?

The FSA paper refers to a document it commissioned from international accounting firm PricewaterhouseCoopers, in June 2004. The FSA's numbers are bonds, 4.5 per cent, and shares, 7.5 per cent.

Managed fund salesmen please note that these figures are nominal; that is, they include inflation of 2.5 per cent a year and are also before fees and tax.

The PricewaterhouseCoopers' report adds, for clarity, that the real after-inflation

expected return for a 50/50 bond/equity portfolio is 3.5 per cent a year pre-fees and pre-tax.

These forecast returns are similar to those calculated by the British Society of Actuaries of 5 per cent for bonds and 7 per cent for equities.

In New Zealand interest rates are a bit higher than Britain, as are dividends. But local planners favour lots of international shares and bonds in client portfolios and New Zealand interest rates may well converge down toward the average in the long term.

But let's be optimistic and assume that by virtue of living in New Zealand we get an extra 1.5 per cent return on a balanced portfolio beyond the FSA's 6 per cent - that is, 7.5 per cent a year.

So how do the numbers used in the real world by the New Zealand financial planning industry compare with those sobering figures?

It is probably fair to say the FSA executives would have a fit if they saw some of the numbers being used locally. Anecdotal evidence suggests that not only are the numbers used in financial plans typically much higher than the FSA's figures, they are also much more variable.

I recently saw a plan that had some truly ridiculous assumptions. The advisers forecast 10 per cent a year from an absolute return fund. These sorts of funds promise the returns of equities with the risk of bonds, often overlaid with a high management fee and a performance fee. As the Securities Commission has said before, "If it looks too good to be true, it probably is."

Absolute return funds have a long history of over-promising and under-delivering so those investors are likely to be lucky to get a 5 per cent return after fees, rather than 10 per cent. The plan also forecast a 9 per cent return from international shares after fees of about 3 per cent a year in a portfolio held by a Mastertrust. The FSA reckons 7.5 per cent before fees.

In Britain that adviser would be breaking the law with those outrageous forecasts. If we simply take the 7.5 per cent

a year return for a balanced portfolio and deduct fees of 3 per cent a year, being a 1.5 per cent management expense ratio, liquidity costs including brokerage and bid/offer spreads totalling 0.5 per cent a year, plus the typical 1 per cent monitoring fee payable to a financial planner, we get 4.5 per cent a year - less than what the bank offers. The numbers above refer to total return but, as mentioned earlier, many retirees like the idea of spending the free cashflow and letting the capital grow.

What level of free cashflow can we expect today from a balanced portfolio, after fees but before tax? The table sets out the numbers for a portfolio invested 40 per cent in New Zealand bonds, 10 per cent property and 50 per cent in shares, with the latter split 25 per cent New Zealand, 25 per cent Australian and 50 per cent international.

The yields shown are what you can get today from a properly balanced portfolio in each area. You could do a bit better by taking more risk - for example, getting 8 per cent in the bond sector from South Canterbury Finance or 8-9 per cent from a portfolio of high-yield New Zealand shares.

But the difference is the portfolio above is sensibly diversified and invests in bonds with little or no default risk, rather than junk.

It also has a broadly diversified share portfolio rather than a "pick 10 high-yield stocks and hope for the best strategy". Junk bonds and stock picking have consistently let investors down in the past 10 years and should be rejected by any sensible investor.

So the pre-fee, pre-tax yield from a "sleep well at night" portfolio is 5.2 per cent. Knock off 3 per cent a year for annual fees and the cash yield is just 2.2 per cent a year. Note who gets what in terms of cashflow: 3 per cent a year for fees, 2.2 per cent a year for the investor. Costs have to come down.

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