



Brent Sheather's RESEARCH

Private Asset Management Ltd

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TRUST OBJECTIVES: REALISTIC OR NOT? – Part 2

Two weeks ago, in the first part of this story, we looked at the long-term historic returns, back to 1925, for NZ and US bonds and shares and noted that NZ stocks had returned 9.3% pa over the period versus 10.0% for US stocks. In the bond sector local bonds returned 6.1% vs 4.8% for US bonds. That is not the full story however because inflation in NZ has been higher than that of the US (4.2% pa vs 2.9% pa) consequently the NZ dollar has fallen against the US currency by about 1% pa. Today we will, using that database, look at whether the typical family trust and charitable trust objectives of spending all the cash income and maintaining the real value of the assets is achievable. Obviously this depends on the asset allocation profile of individual portfolios so we will also model various combinations of bonds and shares and see how that impacts the "maintaining the real value of the portfolio" objective.

The bond data comprises two series for each of 10 year US and NZ government bonds – the first records total return i.e. income and capital gains with the second series recording just capital gains i.e. excluding income and reinvested income. The data is summarised in the table below and confirms the,

Bond returns and inflation 1925 – 2023 (% pa, NZ\$, US\$)		
	NZ	US
Total Return	6.1%	4.8%
Return excluding Income	0.3%	0.5%
Inflation	4.2%	2.9%
Real Return excluding Income	-3.7%	-2.4%

Source: Private Asset Management, Ibbotson, SBBI Yearbook

admittedly obvious, fact that if all of the income from a bond portfolio is spent the capital value stays reasonably constant in nominal terms but falls precipitously after inflation is taken into account.

The only caveat is that for most of the period for which we have data inflation has been reasonably elevated, averaging 4.2% per year in NZ and 2.9% pa in the US, whereas a mildly deflationary environment, which apparently has been more common in the very long term, would be more supportive of the real value of bond portfolios.

Similarly the equity data comprises two series for each of NZ and US shares. The first series is based on total returns i.e. income and capital gains, with the second series detailing just capital gains i.e. excluding income and reinvested income.

The data is summarised in the table below and shows that the real return from NZ equities, excluding income, has averaged 0.6% pa over the period. On the same basis US stocks returned 3.2% real.

Equity returns and inflation 1925 – 2023 (% pa, NZ\$, US\$)		
	NZ	US
Total Return	9.3%	10.0%
Return excluding Income	4.8%	6.2%
Inflation	4.2%	2.9%
Real Return excluding Income	0.6%	3.2%

Source: Private Asset Management, Ibbotson, SBBI Yearbook

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So what does all this mean in the context of typical trust objectives? Obviously a portfolio invested just in bonds won't achieve the "maintaining the capital value in real terms objective" so, based on this long term data some allocation to equities, both local and offshore is worth considering. The quid pro quo will be lower income, at least initially, over the typical retiree investment horizon. The table below summarises the impact of various combinations of NZ bonds and shares and US equities on real portfolio values over the typical average 25 year retiree's "investment

Real returns excluding income for various asset allocations			
Option	Asset Allocation	Real return excluding income (%pa)	Real value of \$1m portfolio after 25 years
A	NZ bonds 100%	-3.7%	\$ 390,000
B	NZ bonds 40%, NZ equities 60%	-0.7%	\$ 840,000
C	NZ bonds 40%, NZ equities 15%, US equities 45%	0.1%	\$1,025,000
D	NZ bonds 25%, NZ equities 25%, US equities 50%	1.5%	\$1,450,000

horizon". Note that these results assume regular rebalancing to the original asset allocation, exclude exchange rate effects and are based on historical data. Whilst the numbers constitute a very long term history the future could be quite different. Risks include the fact that the past has been dominated by inflation and if deflation were to take hold the relative performance of high quality bonds would likely be very much improved. Having said that history is pretty much all we have to go on as regards an insight into the future. The results suggest that an all-bond portfolio (Option A) where the income is spent will

decline in value in real terms by about 60% over 25 years. A portfolio made up of 40% NZ Government bonds and 60% NZ shares (Option B) would give an improved result limiting the reduction in value to about 16%.

Of the various asset allocations in the table Option C arguably most accurately represents the typical balanced portfolio held by an NZ pension fund and this asset allocation has historically maintained the real value of the capital where all the income is spent. Whilst it will likely maintain the real value of the portfolio the achievement of this objective comes at the cost of much lower annual income. After accounting for the impact of the FIF capital tax and annual fees the income from the 45% of the portfolio in overseas stocks is likely to be, at best, close to zero. Taking the yield on the lowest cost option, a global equity ETF, if we then deduct fund management advisory, platform and transaction costs of say 1% pa and FIF tax the post-tax, post-fee yield will be nominal. A back-of-the-envelope calculation of the after-tax after-fee cash income produced by Option C, taking the zero contribution from international shares into account, suggests that a \$1m portfolio would produce just \$15,000 of income per year i.e. a cash yield of 1.5%.

So the reality is that, due to the combined impact of fees, tax and low cash dividends on international shares, most retired individuals wishing to achieve a reasonable level of income will need to supplement the after tax, after fee cashflows produced by their portfolio with regular withdrawals of capital. As we noted in Part 3 of Quantifying The Long-Term Impact Of Asset Management Fees on Retiree Income and Inheritances where withdrawals from the portfolio are made at a rate in excess of the actual income produced and the fee and tax costs are effectively funded from capital, the effect of fees has a much greater impact on residual value.

[Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.](#)