SUPERLIFE
a Member of the NZX Group

THINKING ABOUT INVESTING

MAY 2015

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This guide helps you work out how to invest your current and future savings to achieve your financial goals. It covers the types of assets you might buy and when and how you should buy them. It also discusses related investment issues. The guide is set out as follows:

Comments in this guide are of a general nature only and constitute "class advice". They do not take into account your specific circumstances.

If you require personalised financial advice, you should seek advice from an appropriately experienced Authorised Financial Adviser.

1. INVESTING OPTIONS - OVERVIEW

If you have money to invest, one option is to put it in a bank on deposit. This is a form of "cash" investment. Before tax, this is likely to return somewhere between 2% and 9% depending on the interest rates from time-to-time. Over the next 20 to 30 years, the average is likely to be 4.0% to 5.0% a year[1] before tax.

Cash is a "safe" option

The attraction of such an investment comes from:

- the convenience of making the investment.
- the certainty of the return in the immediate future.
- the security of your capital. Unless the bank goes under or gets into serious financial difficulties, you will get your money back.
- the flexibility of the investment.
- the fact that administration and management fees are not directly incurred.
- the current low level of inflation.
- the general comfort and perceived understanding of the investment.

At the lower end of the expected normal returns and after tax at 28% (the maximum PIE tax rate) and after inflation, say 2.0%, bank deposits give an expected net real return of 0.88% a year (on average).

	4.00%	(gross return)
tax @ 28%	-1.12%	
	2.88%	(net return)
inflation	-2.00%	
	0.88%	(net real return)

Even if inflation is higher (say, 2.5% p.a.), you will still normally get a positive average return, after-tax and after-inflation. That is, if you invest your money in cash then, together with the return, it is expected to buy more goods in a year's time than it can today.

Bonds provide a higher return but require a longer timeframe

Bank deposits are easy and can be flexible. However, bank deposits may not be the best investment if your intended period of investment is 5 to 10 years, or if you need a higher level of income. Also, if your investment horizon is 5 to 10 years, there is no guarantee that inflation will stay low or a financially sound bank will stay sound. With cash investments there is little margin to protect an investor against unexpected inflation particularly where it arises from a change in government policy.

[1] MCA NZ Limited projection

As an alternative, by leaving some of your money in cash (for a "rainy day" and your expected expenditure over the next few years), and investing the balance in, say, fixed interest or bonds, the expected average return increases. Good quality - but reasonably safe – corporate bonds are expected to return 6% to 7%[2] p.a. over the next 20 to 30 years.

But while the average return is higher, to get the higher return, your money is invested for the duration of the bond. If you were to need it sooner, you may incur a loss when you try to sell it before the end of the term. That's why some of your money should be kept in bank deposits for your short-term expenditure. Still, if you are investing for 5 to 10 years, bonds should be better on average, but not in every year, than just money in the bank. You could also buy a bond with a higher yield, but it will not be as secure. In addition, not all bonds paying 6% to 7% are secure. You still need to be careful and possibly retain some in government bonds.`

Of course, if you are investing for 10 to 15 years or even longer (e.g. for your retirement), you may be better off to have some of your money in shares (and property). Longer term (20 to 30 years), shares are expected to provide on "average" a return of 7.5% to 9.0% a year before tax.

Shares can be good if you are investing for at least 10 years

The problem with shares is that while they may return an average 7.5% to 9.0% gross a year, they won't in every year. In some years, the return may be as low as -20%, say, or as high as 45%, or possibly lower and higher. If you may need your money to spend in a year's time, you would probably not want to risk getting the minus 20% return. However, if you don't need your money for at least 15 to 20 years, investing in shares should provide you with a better average return than cash or bonds, but will give you some highs and lows along the way over shorter periods.

In practice most investors have some short-term, medium term and long-term needs. This is one reason why a combination of cash, bonds and shares, often gives the best result and/or some property.

Overall

Investing in bank deposits is the short-term "safe" and flexible option, and for many people this is the right option. However, by accepting a little less flexibility, and being willing to tie up your money for longer, (as you may get a loss if you sell them in the short-term), you should be able increase your average returns by investing in bonds and/or property and/or shares.

The amount of money you allocate to cash, bonds, property and shares is called your "investment strategy". This is one of the most important investment decisions you will make. Having established your investment strategy, it should change over time, as your circumstances change.

Your investment strategy is an important decision you make

[2] Assumes investment grade corporate bonds. Government stock is more likely to return 4.5% to 5.25% p.a. on average.

2. IMPORTANT INVESTMENT DECISIONS

Your investment goals and the importance of each goal, along with your willingness to take on risk, should drive how you invest your savings.

Purpose

One reason that many people save, is to generate a future income stream to meet their future expenditure needs. This might be to provide an income to live on in retirement, or to have a lump sum to help buy a house or to go on a holiday. The reason forms part of your overall financial goals. It is therefore best to understand your financial goals in terms of their timing, amount and importance.

Between the time that you save the money (capital) and the time that you ultimately spend it (purpose), it needs to be invested. When investing capital, it is important to remember that the purpose is to help achieve your financial goals. To achieve this purpose, you should set consistent investment goals. These will involve levels of liquidity, required returns (income, inflation protection and overall growth) and a level of certainty.

When you then invest to achieve your investment goals, there are three important decisions which you need to make that influence the return you will receive:

- what your "investment strategy" will be?
- how will you implement the strategy?
- how will you modify the investment strategy over time?

Whether or not you receive the right return depends on whether your "investment strategy" is right for your goals.

What is an investment strategy?

An investment strategy is the allocation of your money between the different types of assets. That is, how much is invested in cash (e.g., bank deposits); in bond or fixed income assets (e.g., government stock, corporate bonds); in property (e.g., commercial buildings, residential rentals), and in shares (local and overseas shares, listed and private).

Investments in cash provide more short-term certain returns, but no growth. Investments in bonds provide medium term certain returns, variable short-term returns, but no growth unless you save part of the return. Investments in property and shares provide some income and some long-term growth, but can have very variable returns, particularly over the short and medium term.

The investment strategy therefore determines the emphasis that is placed on your immediate income and certainty needs, relative to obtaining potential growth to provide higher long-term income.

The income from the investments comes from the return received, which is made up of actual income (e.g. interest, dividends on shares, and rent on property), and the growth in the value of the investments (i.e. the increase or reduction). At times expenditure may also be met by spending some of the capital.

For a given market environment, your investment strategy generally explains 80% to 90% of the gross return you receive. How you implement your strategy accounts for the remaining 10% to 20% of your gross return. But, because of deductions by way of tax and fees, how the strategy is implemented, will often reduce the gross return by half and therefore is equally important, in achieving a successful outcome.

Successful investment outcomes are more likely to occur when the pattern of returns (i.e. the income from the investments) equals the pattern of intended expenditure.

How do I implement my investment strategy?

When it comes to implementing an investment strategy there are many options. You can either do-it-yourself, or invest in one or more investment products, or you can delegate decisions to a third party (e.g. investment adviser, investment manager etc). You can also employ someone (an adviser) to help you choose investments or choose a manager. In practice, for most people, a combination of doing it themselves and employing a manager is the right approach.

However, whatever the approach, a good way to implement a strategy is one that reflects three principles:

- **maximise diversification** - spread your investments and not become dependent on the judgement of just one manager or the performance of one investment, unless you are prepared to spend a lot of time researching it, to understand the risk and then in monitoring it.
- **maximise tax efficiency** - adopting a long-term buy and hold approach and look to reduce or defer tax. The motivation should be to be tax efficient.
- **minimise fees** and costs - again adopting a long-term passive approach, that avoids short-term trading is normally best.

Getting the investment strategy right in the first place is important, but implementing it well (i.e. focusing on minimising tax and fees) is equally important. There is no point in getting a high gross return if the tax and fees then reduces it to a low net return. At the end of the day, it is the net return that you end up with.

A long-term low cost approach is often best

3. THE INVESTMENT PROCESS

The investment process can be considered to be a 7 step process.

A. **Purpose**. Make sure that you have a clear understanding of the purpose for your investments, in terms of your goals and why you are investing. You may have several short-term goals in the context of your long-term plan. Different investments are suited to different goals. Therefore, you should first consider each goal separately and then look for synergies between goals.

B. **Return**. Decide on what returns you require, in terms of your immediate income and long-term income and growth, to achieve your goals. The income and the growth components make up the total return.

C. **Time-frame**. Decide on what time-frame you are investing for, to achieve, or make progress towards achieving, your goals. Your time-frame is a combination of the period until you will spend your capital (e.g. to retirement) and the maximum period you are willing to wait before you see success in your investment results. This will give you confidence that you are on track to achieving your goals.

D. **Risk.** Decide on which investment risks and how much risk you are willing to take. Also, decide on which risks and potential adverse outcomes need to be managed and can be managed.

E. **Investment strategy.** Decide on what investment strategy is best to balance your return requirements and your risk requirements, over your time-frame.

F. **Investments.** Decide on what assets (or products) you will buy (or managers you will appoint) to implement your strategy.

G. **Review.** Repeat steps A to F, as required, to reflect changes to your goals and circumstances, together with your experience.

In following the seven-step investment process, you will often require help and advice. It is often a good idea to discuss financial goals with someone who can assist you to be objective and realistic. Likewise, when it comes to identifying the appropriate assets for your strategy, you may require someone with that specific expertise.

However remember, the more you pay in fees to obtain advice, the less return you end up with. The advice obtained therefore, should focus on improving the probability that you achieve your financial goals.

4. UNDERSTANDING RETURNS

To understand the likely returns that the different types of investments are likely to produce, see the section "what returns can I expect? In most cases, it is the net-of-tax and after inflation return which is important and you should focus on. Also important are the components of the return, in terms of income and market movement.

Net returns are important.

Net returns are important

In terms of building wealth, the returns that are important, are the "net" investment returns. The net returns are the returns that you end up with (i.e. the additional money you receive) after the payment of tax and the deduction of all fees. There is no point in earning a high "gross" return, if high tax and high fees come off it, leaving you a low net return. The net return is what you get to spend. This leads to the equation of value. The equation value is:

gross return less **fees** less **tax** = **net return**

Successfully investing requires not only a focus on the gross return (i.e. the investment strategy), but also a focus on ensuring that the fees paid are justified (i.e. add value) and tax is minimised. The investment strategy plus what happens in the market, less the costs of implementation and tax, give the net return.

Over the short-term, focussing on the actual level of the net return is important. Over the long-term, focussing on the level of the net-real-return is what counts. The net-real-return is the return you receive after adjusting for the changes in the cost-of-living over time. If you are investing for the long-term, protecting the spending power of your wealth is what is important.

Net-real-returns

The net-real-return is the return you receive after allowing for inflation. This means you will be able to buy more in the future than you could today. This makes it worthwhile saving.

net return less **inflation** = **net-real-return**

If the prices of goods are going up at 2.0% p.a., then something that costs $1,000 today, will cost $1,020 in one year's time. If you have $1,000 and want to buy the product, but not for a year, you need to make sure, that your $1,000 grows by at least inflation, so you can still afford to buy it. For example if you earn a gross return of 7.5%, and the tax rate was 28%, your-net-real return is:

	%	**$**	
Gross return	7.5%	75	(i.e. 0.075 x $1,000)
less tax (28% say)	2.1%	21	
	5.4%	54	
Less fees (1.3% say)	1.3%	13	
Net return	4.1%	41	← *This is important*
Less inflation (2.5% say)	2.0%	20	
Net-real-return	2.1%	21	← *This is what counts long-term*

As can be seen while $75 is earned before tax and fees, when tax and fees have been deducted, you only have $41 left. And, of the $41 left, $20 is required to protect the original $1,000 against the impact of inflation, leaving only a real return of $21.

It is the net-real-return that is important in the long term, as this decides whether your savings go ahead or backwards, i.e. will buy you more or less goods in the future.

The example also highlights the importance of low-fees. If the total fees were 0.5% and not 1.3%, the net-real-return would be 2.9% and not 2.1%. The additional 0.8% a year makes a big difference over the long-term.

What returns can I expect?

The return you will get will be mainly influenced by your investment strategy, i.e. the mix of cash, bonds and shares and the market returns these assets produce.

The expected long-term (over at least 20 years) "average" returns, before fees, of the different sorts of assets are:

	Cash	Bonds[3]	Shares[4]
Gross "average" return	4.50%	6.25%	8.00%
Tax at 28% (say)	1.26%	1.75%	1.40%
	3.24%	4.50%	6.60%
Inflation (say)	2.00%	2.00%	2.00%
Net "real" return (before fees)	1.24%	2.50%	4.60%

Source: MCA NZ Limited, Actuaries & Consultants, April 2015

Note: Investment management and advisory fees (if any) need to come off the net "real" returns shown. Remember, these are long-term average return expectations and not current returns. Also, the returns in individual years will be different.

It should be noted that the expected returns are generalisations. Within shares, for example, there would be a range of returns reflecting developed markets, emerging markets, large companies, small companies, start-up companies etc.

5. UNDERSTANDING 'RISK'

When it comes to investing, there are a number of risks that an investor faces. Some risks are real and, if not managed, can have an adverse long-term consequence on the ability to achieve your goals, and some are simply perceived and driven by emotion or human bias.

There are the obvious risks, such as the company you invest in goes bankrupt, so that you permanently lose your money. However, this doesn't happen often and the consequences can be minimised by diversification and not chasing the promise of very "high" returns.

Diversification is a good way to manage many risks.

[3] Assumes investment grade corporate credit.

[4] Assumes global shares, and tax under the FDR regime

Often investment advisers and investment managers talk about risks such as interest rate risk, market risk and currency risk etc. Each of these can lead to returns being less than expected and also at times, low or negative. However, they are all reasonably manageable and are the components of the more important risks.

Having time and patience solves many risks.

The more important risks are that you don't earn sufficient returns to achieve your goals, or the nature of the returns (i.e. mix of income and capital movement) is wrong for your purpose. This often occurs because an investor is too conservative or too greedy, or gives up to much of their returns in tax and fees. There are also event risks that will have an unexpected negative impact on the value of your assets. For example, in New Zealand, foot and mouth disease.

The basic principles of managing risk:

1. **There is normally no return without risk**
    - the return is only half of the investment equation. Investments earning higher average long-term returns usually carry higher short-term risks. The rewards go to investors who take and manage risks and do not look to avoid risk altogether. Risk is the other side of the potential of the investment. What is important is that the risks taken on are appropriate for the investment, your goals and the goals' time-frames.

2. **Risks must be understood and returns transparent**
    - if risks are not understood they can't be managed. If the sources of returns are not transparent, the risks are "higher", because of the unknown. Investing first requires knowledge of investments and potential understanding of outcomes, and then the application of common sense.

3. **Experience and judgement count**
    - risks can't be managed solely by a mathematical model. A model, at best, is a tool that forms the basis of sound judgement.

4. **Understand what can go wrong**
    - all assumptions should be questioned. The consequences of different scenarios should be discussed be on a regular basis. In most cases, the adverse scenarios will not happen, but deciding in advance what you will do if they do happen is important, as when they happen it is often too late.

5. **Diversification**
    - multiple investments, within one asset class, reduces risk without altering the expected return. Diversification reduces the level of uncertainty that the return outcome is materially different (above or below) the average expected.

6. **Consistency and discipline**
    - a rigorous and consistent approach will manage risk better than a constantly changing process. It also provides a better framework for understanding the outcome. It is also

important to understand where the competitive advantages are and where decisions are made on the basis of a guess.

6. UNDERSTANDING TAX

As a general principle, tax should not drive investment decisions. However, efficient tax management can make a significant difference to the investment return outcome.

Tax is complex and often changes. A booklet of this nature cannot provide the necessary details of the legislation. The comments below provide a general overview and an investor should always make sure that they understand how tax will affect the returns of their investments and seek appropriate advice.

PIE

An investment vehicle such as a unit trust or managed fund can apply to be a portfolio investment entity (PIE). A vehicle with PIE status, attributes its total investment income to the individual investors. The taxable income for a PIE vehicle is the same as a non-PIE vehicle, for all investments except NZ shares and certain Australian shares. These shares are taxed on dividends only. However, while what constitutes taxable income may be similar, the tax rates can vary.

PIR

If an investor invests via a vehicle with PIE status, the tax is payable on the income attributed to an investor, at the investor's prescribed investor rate (PIR). A PIR can be 10.5%, 17.5% or 28%. The 17.5% rate generally applies to investors whose taxable income was below $48,000 in at least one of the last two years and their taxable income and PIE income in that year was below $70,000. Overseas tax residents generally have a 28% PIR regardless of their income level. Some PIEs also qualify for zero tax for overseas investors.

The maximum PIR rate is currently 28%. This is 5% below the maximum personal rate of 33%.

FDR

The fair dividend rate (FDR) is the tax regime that applies to overseas "equity" investments. This will include shares, some property and some bond products. It also applies to many Australian investments that do not fall under the Australasian tax regime for shares.

Under the FDR regime, investors are defined to have taxable income equal to 5% of the value of their overseas investments (often on 1 April each year). Tax is payable on this deemed income, whether or not the investor receives that income. At a 28% tax rate, the tax on the deemed income is 1.4% (i.e. 28% x 5%). An investor's return therefore is the total market return (whether positive or negative) less 1.4%.

A “de minimus” exception applies for direct investments by an individual, if their overseas assets are below a total of $50,000. This does not apply to local products that invest overseas. Also, some investments are based on average value throughout the year and not the 1 April value.
New investments are not subject to FDR tax in the year they are made unless they are bought and sold in the same year, or bought under a unitised or equivalent structure.

If you have questions on tax, it is a good idea to talk to a tax expert.

7. THE DIFFERENT TYPES OF ASSETS

From an investment point of view, most investments fall into one of four general types of assets:

Cash Bonds	Often referred to as “income” assets.
Property Shares	Often referred to as “growth” assets, but provide income by way of rent and dividends.

There are only 4 different type of assets.

Each type has its own characteristics in terms of expected returns, what drives the return and the level of certainty of the returns over the short-term.

Taking time to understand the expected returns of each of the different types of assets is important, as it is only then that you can make sure that your investment strategy (i.e. your combination of the different types of assets) is the right strategy for you. For more information see the section “determining an investment strategy”.

Cash

The most common form of cash investments are bank deposits. However, “cash” typically includes any fixed interest investment where the capital will be repaid within a year. The return from cash is the interest paid.

Bonds

A bond is often referred to as a “fixed interest” investment. It is in effect a loan to the issuer. The return is the interest received together with the change in value, i.e. the profit or loss you would make if you sold it to another investor. If you hold a bond to maturity, the profits and losses cancel out and you are left with an average return equal to the interest received.

Property

Property investments are land and buildings. As the owner of the property, you receive the rent paid less expenses. If the property increases (or reduces) in value, you will also receive the change in the value of that property. There are several types of property. The most common types are residential (houses), commercial property and land. Commercial property may be offices, industrial complexes, warehouses or retail outlets. Land includes farmland, though the farming of the land is more akin to running a business.

With property, it is important to recognise that investments are typically larger than other assets and are often less marketable (ability to be sold quickly).

Shares

Share investments (also often referred to as “equity” investments or “stock”) represent a share of the ownership of a business. The owners of the shares (the “shareholders” receive the residual of the businesses’ earnings after the payments of all costs. As such, shares return to the investor the profits of a company. In some cases the profits are returned as a dividend and in others by way of retaining the profit in the business to expand and therefore grow the share price. Shares also increase or reduce in value, as other investors are willing to pay more or less for the share than the value of the company’s future profits.

Commodities

Some people also consider commodities (e.g. gold, precious metals, oil etc) as investments. While such assets can be used to make money by buying and selling them, they tend to be a risk management tool and a preserver of wealth in certain environments, as opposed to an investment. In this booklet, we have not included them as an investment, but note that some shares an investor buys will indirectly depend on the price of commodities.

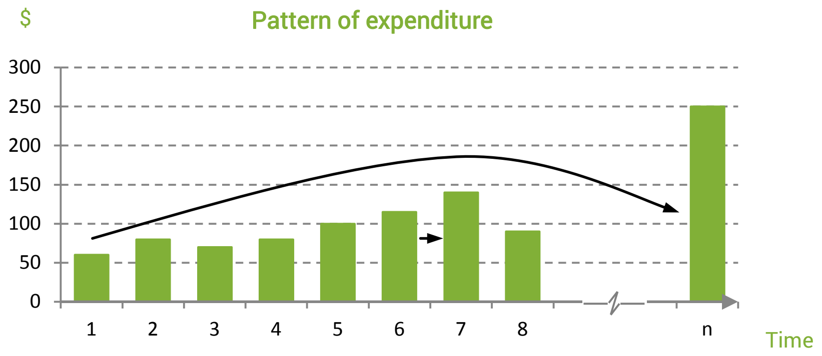
8. DETERMINING AN INVESTMENT STRATEGY

An investment strategy is the mix of cash, bonds, property and shares that your capital is allocated to.

The purpose of an investment strategy is to align the pattern of the returns (income, growth and timing) from the different investments, with the pattern of your future expenditure, in the context of the importance of the expenditure and the certainty of the return required. To the extent that they are not aligned, there is a risk that when you come to spend the money, there will be not sufficient money available and you will need to realise some of your assets and spend more of your capital than was planned.

The starting point for determining the appropriate investment strategy is to look at the expenditure pattern that will be funded by the investment returns and assets. To do this you should prepare a budget of expected expenditure and understand how that may change in future years, either through changes to the nature of your expenditure or through inflation.

For most people the expenditure pattern will be a series of payments over time, payments that generally increase to keep up with inflation. The pattern will not be smooth as in some years larger items (a new car, an overseas holiday etc.) will occur, and in other years a lower level of expenditure may be incurred. Also, unless you sell your house and spend your last dollar before you die, there will be a large payment at the end as assets transfer from your generation to the next.



The expenditure can also be broken down into required expenditure (day to day basic living costs) which is very important and discretionary expenditure. With required expenditure, a higher level of certainty is necessary as unless the returns achieved are equal or more than what are required, you will have to spend some of your capital.

In terms of your expenditure, part may be met from other sources, for example, your income while you work, or New Zealand Superannuation when you retire. What is important is understanding the expenditure which will be met from your investment earnings and from spending the capital itself.

As a general rule, expenditure that will occur in the immediate future (next 3 years) should be provided by way of cash investments. Expenditure that will be met in the next 3 to 10-12 years should be invested in bonds and expenditure beyond 10-12 years, in shares and property. This minimises the risks of having to sell an asset, when the value of the asset has fallen.

We call this the bucket approach i.e. having a bucket for liquidity (cash), a bucket for medium-term income (bonds) and a bucket for longer term growth (shares/property).

9. THE BUCKET APPROACH

When it comes to investing, SuperLife favours the "bucket" approach.

Rather than have a single portfolio where all assets are invested together and the focus is on single overall return, we believe it is better to think in terms of three buckets, for the three distinct needs each investor has (liquidity, income, inflation protection). Capital should be allocated to each bucket.

The bucket approach lets you target a specific need/goal and so choose the types of investments that are right for that need. This in turn increases the chance that your total needs/goals are met.

This bucket approach is particularly beneficial in retirement. This does not stop anyone investing the assets as one portfolio, for efficiency reasons, but if they do, there are still advantages in thinking about the single portfolio as being the sum of the three buckets.

Investor needs

The three buckets provide for the needs of:

Liquidity: You should have a bucket for the assets that provide for your immediate expenditure and your "rainy-day" fund. This bucket will normally be invested in cash assets, as immediate access, short-term certainty and safety are important.

Income: In your income bucket should be your investments designed to balance the need for certainty with the need for a higher income returns. The focus will be on income generating assets, particularly bonds.

Inflation protection: As part of your expenditure will occur well into the future, protection against inflation is important. This bucket should focus on long-term, real returns and be less concerned about the short-term temporary return. Shares and property may be the focus.

As you get older

One driver of the theoretical investment strategy is the period to go until you will spend the money. Under the bucket approach, as you get older your theoretical investment strategy should change. More is needed in cash and bonds and less in shares and property. This is because the number of years of your remaining retirement that are more than 10 years away, become fewer. Shares are normally suitable only for expenditure that will occur well into the future, when inflation is the biggest risk, or where the assets available are significantly more than is required to be spent.

10. SUGGESTED INVESTMENT STRATEGIES

While there is no single investment strategy that is right for all investors, it is possible to develop a series of sample strategies for generic circumstances. These can form a basis for an investor determining their appropriate strategy.

The development of the sample strategies reflects the principles discussed on pages 28 to 32.

Age	20	30	40	50	60	65 (retirement)
Years to retirement	45	35	25	15	5	0
Asset class						
Cash	0	0	0	0	12.5	20
Bonds	4	20	20	25	30.0	30
Property/shares	96	80	80	75	57.5	50

Age	65 (retirement)	70	75	80	85	90
Asset class						
Cash	20	20	25	33	40	50
Bonds	30	40	50	57	55	50
Property/shares	50	40	25	10	5	0

Source: MCA NZ Limited, Actuaries & Consultants, April 2015

In all cases, before adopting a specific strategy, it is important to understand what the expected returns are in terms of income and capital movement, and what the range of the potential returns are around the expected, from one year to the next.

Also, in most cases, investors may want to hold a little more cash in case their circumstances change and their time horizon becomes shorter.

The previous strategies reflect investment strategies for savings made for retirement. In many cases, particularly at the younger ages, savings will be for other goals (e.g. a deposit for a home) and less short-term volatility and therefore a lower exposure to property and shares will be appropriate.

11. INVESTMENT OPTIONS

When it comes to implementing your investment strategy, there are a range of investment options. You can buy assets direct, e.g, shares in company ABC, or you can buy the same asset via a product or pooled investment vehicle, often referred to as a "managed investment funds" ("managed funds"). When buying direct, you can do so in your own name or via a third party service, often referred to as a "wrap" account.

There is no simple answer of whether direct investments or a pooled investment vehicle is better. Each has different cost and tax implications. Also, managed funds may have greater diversification and access to investments not otherwise available to individuals.

The most common managed funds include:

- Unit trusts
- Superannuation schemes
- KiwiSaver schemes
- Group investment funds
- Special purpose vehicles
- Partnerships

Also, each managed fund may be a PIE (portfolio investment entity) or a non-PIE, and therefore have a different tax treatment (see page 15 – understanding tax).

Which is best?

No product is always best. When evaluating the different options the key requirement is the ability to tailor your investment strategy to your needs and the fees you will pay.

In addition, the things you need to think about are:

- Ability to withdraw money
- Costs (entry, management and exit)
- Discretion given to management
- Diversification
- Flexibility
- Liquidity
- Security
- Size
- Tax
- Transparency.

Low costs are very important over the long-term

Overall, if it has the right level of flexibility for your needs and a level of security you are comfortable with, competitive fees become the more important criteria over the long-term.

12. INVESTMENT GOALS

One of the best ways to achieve good financial health is to convert your financial aspirations into specific investment goals. The goals might relate to required levels of return and/or the achievement of a particular level of assets (wealth), over a particular timeframe. Goals may also include clearing debt and in some cases will be for a particular purpose, such as saving for a car, education or for retirement.

Deciding exactly what you want to achieve and when you want to achieve it, lets you plan how to get there and lets you monitor your progress along the way.

Your goals will generally fall into one of three time horizons: short, medium and longer term.

- **Short-term goals** might have a time horizon of up to 3 years. These could include immediate expenses, saving for a car or a boat, or buying a new fridge.
- **Medium term goals** generally have a time-frame of 3 to 10 years. They may involve a larger amount of money (e.g., to buy a business or a holiday home, or relate to specific events like a child's university education).
- **Longer term goals** are generally 10 or more years away. Retirement security is one example of such a goal.

You should also decide on the importance of the goal, as this will influence how much and what type of risks you can take along the way. We might all want to be rich, but we may not be prepared to make the short-term sacrifices that this requires, in terms of saving levels and therefore giving up current expenditure.

A goal without action is only a dream

Financial health

In addition to setting investment goals to achieve good financial health, you should also set non-investment, but related, financial goals. For example, reviewing your Will, establishing a power of attorney, or learning more about how the investment markets work.

Having set your goals, you then need to act by deciding how much to invest and, equally important, how to invest it.

Understanding your goals and working out a plan of how to achieve them, means you are often half way there. The other half is having the discipline to take action and to stick to your plan. The best goals are written down and reviewed often, and for the longer term goals, to be broken down into shorter term "progress" goals. Some people refer to this as making your goals "smart" - Specific, Measurable, Actionable, Realistic and with a Timeframe.

Goals also have to be "relevant" as if they are not relevant to you; they are not likely to receive the time and focus needed, to achieve them and manage the risk.

Goals therefore have to be "smarter" i.e. also essential and relevant.

Smarter goals	
s	specific
m	measurable
a	actionable
r	realisable
t	time frame
e	essential
r	relevant

13. INVESTMENT PRINCIPLES

There are a number of key investment principles to keep in mind when making investment decisions.

Diversification

Diversification has, for a long time, been one of the key principles of achieving successful investment outcomes. Diversification focuses on controlling the exposure to a single investment, and thereby limiting the negative consequences if something goes wrong. Diversification means buying several investments and not just one.

Do not put all your eggs in one basket.

You don't buy car insurance because you know you're going to be involved in a car accident. You buy it because of the risk that you might be in an accident, and the financial consequences if you don't have it. Diversification is like insurance. It may mean that some of the investments you buy won't have good returns. But you don't diversify because you know or think that an investment you hold is going to go down. You do it because you don't know, because markets and investments are unpredictable.

As a rule, the less time you have to monitor and manage your investments, the more diversification you need to avoid being dependent on luck.

Thinking about diversification involves thinking about multiple companies, multiple industries and multiple countries.

Flexibility

In many cases you will be investing for long periods of time and one thing is certain and that is "change". Your circumstances needs and the investment opportunities will change. Because of change, it is a good idea to ensure that your investments are flexible so that they can be altered within a reasonable period of time and without penalty, to meet the changed circumstances.

Do not put yourself in a position where you may have to sell an investment

Liquidity

Always hold some money in cash

One of the key investment principles to achieve success is to ensure that you are never forced to sell an investment. Being forced to sell may mean you get less for your investment than it is worth. To avoid this you should always hold sufficient cash to meet your immediate and unexpected expenditure. This puts you in the position where you do not have to sell a bond, a property or a share in a rush. By holding sufficient cash, you can sell your other assets in good time, i.e., when you can get a good price.

Liquidity is different to marketability. Marketability is a measure of how quickly you can sell an investment. Liquidity is a measure of the ability to buy and sell an investment immediately in the market, without affecting its price.

Fees

Minimising or ensuring that you pay only appropriate fees is a key strategy to getting successful return outcomes. Of course financial advisers and investment managers don't necessarily want you to minimise fees as it means less money for them. This does not mean that you should pay no fees. Paying fees that reflects the work done and advice given is appropriate.

Understanding the fees you will pay is often difficult as many products don't explain them consistently, and don't disclose them accurately. It is always a good idea to get the adviser/manager to explain the fees you will pay including commissions, upfront fees, management fees, trustee fees, exit fees, internal fees etc.. Ideally, fees should be explained in terms of dollar amounts and over the likely period of the investment. Remember the lower the fees, the higher the return to you, all else being equal.

Timing – stick to the plan

There is a saying about investing – *"it's time, not timing that is important"*. You cannot get a good 10-year average return if you have not invested for 10 years. As an investor therefore, you need to have a clear understanding of what you are trying to achieve, and have patience while you achieve it.

History has shown that the values of sharemarkets generally go up, but along the way they go both up and down. Historically, falls in share markets are generally followed by rises and, market fluctuations tend to be cyclical. However, each cycle is not the same as the previous and in each case, it's almost impossible to say when the top or the bottom of the cycle has been reached, or how long the cycle will last. Even the experts find it difficult to accurately guess market movements before they happen.

Investments very rarely all move in the same direction. The investment markets are dynamic and there are many things that can have an impact on the value of an investment at any point in time. Global economic and political conditions, inflation and one-off events (such as oil shocks) all influence the current value of an investment, along with local events and conditions. At the same time investor confidence has a significant influence and can dominate over the short-term.

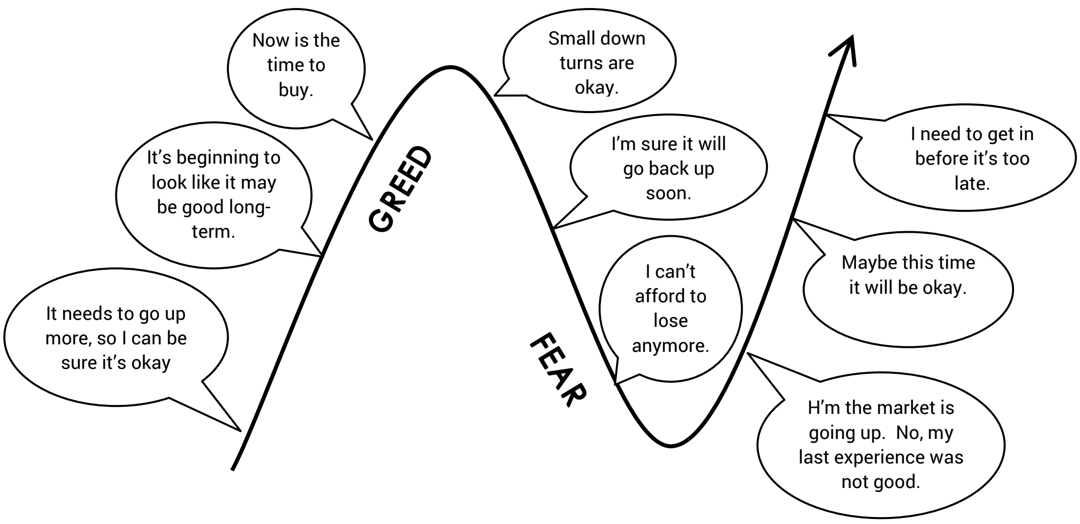
Because the investment markets are dynamic, often by the time economies have slowed down, share markets may be positioning themselves for a recovery with share prices rising and vice versa.

Waiting to invest until it is clear that an economy is growing can therefore result in missing a market upturn.

Patience – successful savers take a long-term view

Over a longer period, the evidence is that carefully chosen investments will progressively increase in value. It therefore pays to be patient, and understand the benefits time, not timing, will bring.
At times when the market fluctuations lead to returns that are low or negative, it pays not to automatically sell an investment. Instead, put the negative short-term return in the context of the normal pattern of returns that arise from market ups and downs.

"it's time not timing that is important"



Human bias

When investing, it is important that decisions are made with an awareness of our common human bias. As humans, we tend to have two common traits; we like to make relative decisions and we are loss averse.

Rather than making decisions based on what others are doing, or what is common practice, we should look to make decisions based on what is best to achieve our goals. Absolute or relevant returns, and not relative returns, are normally best. Likewise, when looking at the risk of an investment, we should focus on the chance and magnitude of a permanent loss, as opposed to the potential for a short-term but temporary market downturn.

Fads

From time to time a particular investment will go up because it is a “popular” investment and not because it will give the best long-term return. There are many examples of this. For example, in the later 1990’s it was the technology stocks. What happens to be “the best thing since sliced bread” today will normally go stale tomorrow - it is only a question of when and not if. Investors should avoid “fads” unless they have the time and skill to work out when the fashion will change.

Past performance

As a rule the level of past performance is not a good guide or reliable predictor to the level of future performance. The exception is where the good returns are explained by low fees as opposed to human judgement. Unfortunately, money does not flow to future quality; it flows to past performance. It should not be this way, but it is.

If a manager or investor has had the “best” return in the last 5 years, in the next 5 years, they are just as likely to have a bad return as they are to have another good return. In fact, very rarely does one manager or one investment always or consistently have the best return.

Fashions come and go

Simplicity

It is normally important to keep investment arrangements simple and to understand exactly what you are investing in, what will influence the return you will achieve and what can change. When you understand the full range of what to expect, surprises and disappointments are less likely.

14. OTHER ISSUES

Property

In the general discussion on strategy, investments in property were deliberately left out. It was done so for several reasons:

- most people have a high exposure to property through owning their house.
- the risks associated with property, because of its nature, the typical size of the investment and low diversification, do not make it an ideal investment. It is not flexible and is not liquid and it is hard to get diversification (i.e. buy several properties).
- unless you spend time to understand the property market, you normally do not get a good return.
- property is often not a good asset to buy via a managed fund or product, which is how most people end up buying such investments.

While we do not see direct property as a natural asset for most people's investment strategies, we acknowledge that for the few who know what they are doing, excellent returns can be made. If you are one of the few, property may be an ideal investment. Also, many people are happy to "gear up" (i.e. borrow) to buy a property, but not other investments. This can sometimes gives property an advantage.

Global versus local

There is no simple answer to the question of how much of a portfolio should be invested globally versus locally. Global investments often provide additional diversification and potential, and also investment opportunities not available in the local market. However, local investments often have an information advantage and convenience advantages, and so make it easier to manage risk and implement an investment strategy.

Investing globally also introduces a currency risk. This can be both positive and negative. While it introduces a different source of volatility, it also provides protection against the risk that the New Zealand economy underperforms.

Rule of 72

The rule of 72 is an easy way to estimate how many years it will take for an investment to double in value at a given return. Simply divide 72 by the return. It can also be used to find out how inflation will affect the purchasing power of your investment income in retirement.

For example, if you wanted to estimate how long it will take for value of an investment to double if it earned 6% after-tax each year, you divide 72 by 6 to get 12. The investment will double in value approximately every 12 years (6 x 12 = 72).

On the other hand, if the rate of inflation was 3% a year, the effective purchasing power of your income would be halved in 24 years, i.e. (72 divided by 3).

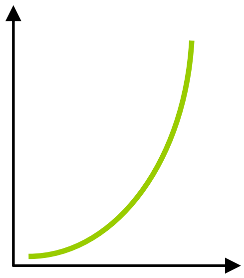
Dollar cost averaging

Dollar cost averaging is a "technique" to reduce the risk that you make a major investment at the wrong time, i.e. when the market is up and about to fall. It smoothes the purchase of investments over a period of time. Instead of making an investment as a single lump sum, the investor buys several smaller amounts over a longer period of time.

Trying to pick the market's highs and lows in order to maximise gains is very difficult to do. Therefore, through dollar cost averaging, as the price of the investment rises, fewer investments are bought, and as prices fall, more investments are bought. Overall it results in more investments being bought on average and reduces the risk that the total investment is made at the wrong time.

It is important to recognise however, that while dollar cost averaging is good when you are investing, it has the opposite effect when you are selling assets to spend.

Compound interest



Many people claim that compound interest is “magical” and lets you earn greater returns. In practice, it’s all about not spending your interest and therefore earning interest on it, as well as continuing to earn interest on your capital. This is not magic.

Compound interest is the process of earning interest on interest. For example:
Assume that you make a $10,000 investment and that your investment earns 5% interest per annum after tax and fees.

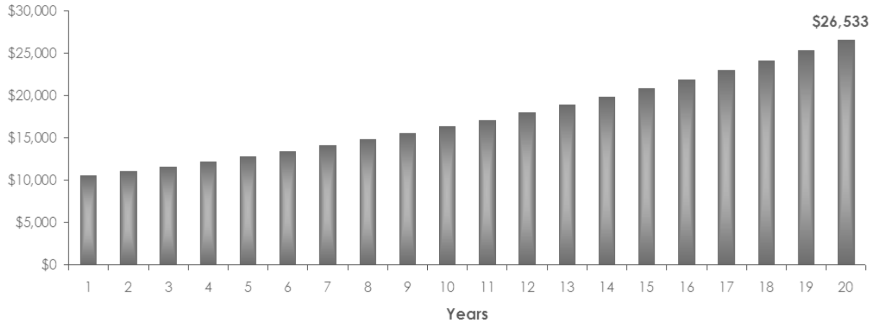
After one year your investment will be worth $10,500 (i.e. $10,000 plus 5% x $10,000). In short, you have made $500 interest in year one.

At the end of the second year your investment will be worth $11,025, that is you have made $525 interest in year two. The $525 interest in the second year is made of:

	$10,000 x	5%	=$500	(interest on your original investment)
+	$500 x	5%	= $25	(interest on the interest from year 1)
			$525	

The above is an example of compounding interest. What is important is that the longer you invest your money, the greater the effect compound interest has, e.g. if you invested $10,000 for 20 years and continue to receive interest at 5% p.a., after 20 years you will have $26,533.

Graphically your initial $10,000 will grow (compound) as follows:



15. INVESTMENT TERMINOLOGY

Terms used in this guide and generally within the investment industry include:

90 day bank bill rate: The interest rate that banks pay on a three month deposit for wholesale money.

Asset class: A broadly defined category of financial assets e.g. cash, overseas fixed interest, NZ fixed interest, overseas shares and NZ shares etc..

Asset allocation or investment strategy: The split of money across the different asset classes.

Basis point: A "basis point" is one hundredth of 1%, i.e., 0.0001.

Consumer price index (CPI): Designed to compare the relative "cost of living" over time and used as a measure of inflation. The index measures, at various times, the prices of a group of selected goods and services typically bought by ordinary New Zealand households.

Currency hedging: Currency hedging lets investors remove or reduce the impact on the return from an overseas investment, from currency movement. If an investor hedges the currency risk, they do not benefit from a fall in New Zealand dollar and are protected against the impact of a rise in the New Zealand dollar. Currency hedging is normally implemented by buying forward currency hedging contracts.

FDR (Fair dividend regime): Under tax laws, for many overseas investments, the taxable income is a deemed dividend equal to 5% of the value of the asset. See page 17 for more details on FDR tax.

GDP (Gross Domestic Product): The total monetary value of all goods and services produced in a country in a given year. It is normally calculated in real terms, i.e. excluding the increase due to inflation.

Government stock: A fixed interest investment or bond, offered for a specified term by a government.

Gross return: The return received before tax is paid and expenses are deducted. Once these are taken into your account, you end up with the net rate of return.

Growth investments: Include higher short-term "risk" investments such as New Zealand and overseas shares. The focus is on generating growth over the long-term, but they will also generate some income through dividends over the short-term.

Income investments: Include lower short-term "risk" investments such as cash (e.g. bank deposits) and NZ and overseas fixed interest or bond investments. The focus is on generating income not growth.

Inflation: The rate at which the general level of prices for goods and services is increasing. Typically measured by the CPI.

Index: An index is a measure of the performance of an investment e.g. the NZSX50 index for New Zealand shares. It represents the general movement in the value of those investments.

Managed fund: A term to describe all pooled vehicles and managed investment funds. For example, unit trusts, superannuation schemes and KiwiSaver schemes.

Net rate of return: As for return, but adjusted for expenses (such as investment expenses), tax and fees.

Official cash rate (OCR): The base overnight interest rate at which the RBNZ lends or pays to registered commercial banks. This is the tool that the RBNZ uses to manage inflation.

PIE: Portfolio investment entity. A managed fund may have PIE status for tax purposes.

PIR: Prescribed investor rate. This is the tax rate applicable under a PIE

RBNZ: Reserve Bank of New Zealand.

Risk (for investment): A measure of the chance or likelihood of a negative event occurring. In relation to investments, it commonly refers to the variability of returns over the short-term, around the long-term average, particularly the variability below the average.

Return: The amount of money received annually from an investment including movement in capital values. It is usually expressed as a percentage.

Real rate of return: The difference between the return earned, and the rate of inflation.

Security: Generally, an asset pledged to ensure repayment of a debt or loan and forfeited if the debt or loan is not repaid. In financial markets, the term "security" also refers to the right to an asset which is tradable such as a share, bond, etc.

Volatility: A word used to describe the unpredictability of the return and the potential for an investment to fluctuate (go up and down in value) over time.

Yields: The interest rate at which a fixed interest security (bond) is issued by governments and companies and can be purchased in the secondary market.

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