

The China story has been well debated since our August comment. Andrew's caution was warranted, with a 20% plus decline in their stocks in August.

In the US, September has the dubious historical record as the worst month in the year for stocks, with the Dow Jones Index on average since 1928 losing 1.30%; many commentators are introducing caution into their expectations.

Peter Lynn brings back the debate that I first encountered when I returned to New Zealand in 1998. Is active management worth the higher fees than passive investment? This is a more straight forward debate now that the tax incentive has been removed for New Zealand passive investors.



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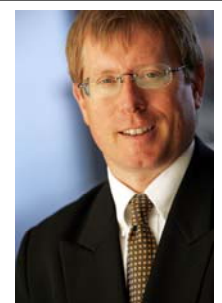
Accepted Facts and Reality

In 1936, no doubt while rueing some of his own investment losses, the famous economist John Maynard Keynes noted that the business of financial forecasters was not to correctly predict what was going to happen to the real economy at any given time but to predict what the consensus would believe was going to happen at that moment. Ultimately, the consensus will predict correctly what will happen but for surprisingly long periods of time it is quite possible that the perception of reality can differ from the true situation (often with the help of a credit boom or bust) and thereby cause a sustained movement in share and other asset prices away from what might seem to be their fundamental position. As Keynes noted, financial forecasters should at least attempt to incorporate this behaviour into their models.

As an investment strategy, we suspect that this approach still has much to commend it. For example, six months ago – and perhaps even only a month ago – it clearly paid to believe in the China growth story because the consensus believed in the story regardless of the rather mixed – but generally negative – landscape portrayed by the reliable parts of the Chinese economic data. Quite simply, there was sufficient faith and credit growth in China to support the story of China's supposed 'structural recovery' despite the evidence to the contrary. However, when China's authorities hinted that they might curtail the rise in credit late last month, the consensus expectation

Consensus or reality? Contemplating the Keynes' theory.

shifted dramatically and some Chinese share prices tumbled by 40% in a matter of days. Of course, little had changed in China's underlying economy between July and August – in both months it was a credit dependent economy with little consumer demand in high inventories - but changes in investor expectations caused dramatic reversal in fortunes for those invested in the concept. Of course, in theory, it is possible that expectations vis-a-vis China may once



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more swing into more positive territory again in due course, and so provide a new rally in the share market, but ultimately we believe that the 'truth will out' and that the structural flaws in China's growth story will continue to constrain long term investor

returns, at least until they are resolved. However, it is not only in the case of China that we should be aware of a critical divergence between accepted fact and reality.

According to popular wisdom, US companies are facing a credit crisis that is forcing them to raise money from wherever they can (including by liquidating their inventories of goods) and to economise on their expenditure. In reality, this is

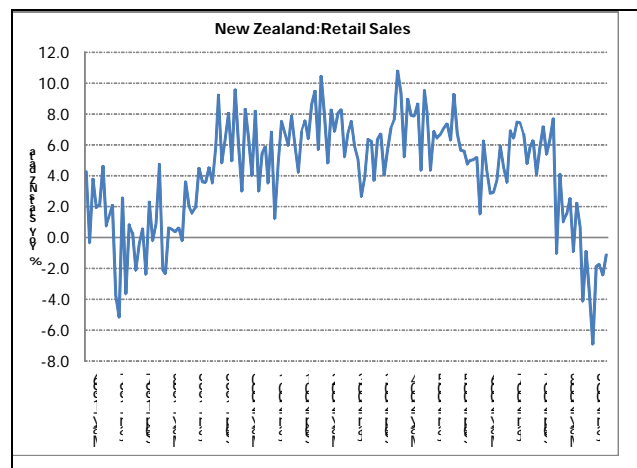
certainly true for small companies who are indeed struggling and being obliged to shed labour as well as their stocks but large companies - the household names – are at the same time enjoying unparalleled access to the corporate bond markets. Despite the credit crisis, US large companies have managed to issue record quantities of corporate bonds so far this year, so much so that they have been able to afford to continue to ‘buy back’ their own outstanding shares, a policy which we can assume will have helped their share prices. Far from being cash constrained, these large companies have evidently had ‘cash to spare’ and hence have been able to indulge in what the Japanese used to call ‘Zaitech’ or financial engineering, albeit at the cost of a further rise in the level of debt on their balance sheets. Intriguingly, since much of the fall in share markets in 2007 and 2008 was attributed to US companies and individuals having borrowed too much, it would seem a little strange that share markets should now be welcoming a new borrowing binge by US large cap companies but nevertheless they are and we can assume that this will continue for some time – at least until fears of a US credit tightening re-emerge at some point in the future. At the very least, we expect investor attitudes regarding US corporate financial health to prove very sensitive to any tightening rumours from the Federal Reserve, although these noises may still be some months away.

However, perhaps the greatest apparent divide between accepted economic fact and reality revolves around the current state of consumer demand in the global economy. At present, there is a relatively strong belief in financial markets that, because equity and other risk asset prices are recovering, a global recovery must soon be forthcoming. In fact, we have noticed over the years that rising asset prices do often tend to create a self reinforcing expectation within financial markets of an imminent recovery, although this may not always be the case. Indeed, if we conduct a survey of current consumer trends within the major economies we find that, aside from a surprising partial recovery in Italy, the only significant consumer spending growth that we could find was what we might describe as ‘previous-momentum-led-growth’ in countries that were still wringing out the last parts of the previous cycle, most notably Australia, India and Brazil.

When will the consumer signal a recovery and where?

During the latter stages of 2008 and even the early part of this year, there clearly was a very dramatic reduction in global consumer spending in many countries and primarily in what we might describe as

the ‘deficit countries’ (i.e. those in which consumers were spending more than they earned – the US, UK and Spain being obvious examples). We firmly believe that the falls in consumer spending in these countries were the result of an enforced rise in the savings rates – when the global credit crisis caused the supply of credit to dry up, these consumers simply had to spend less (and therefore to arithmetically save more) because they could not finance their cash flow deficits. Interestingly – and perhaps crucially from a forecasting point of view - disposable income growth in many of these countries was quite rapid at the time but this could only partially offset the damage done by the credit crisis. Stage one of the consumer retrenchment was therefore credit crisis / savings rate driven.

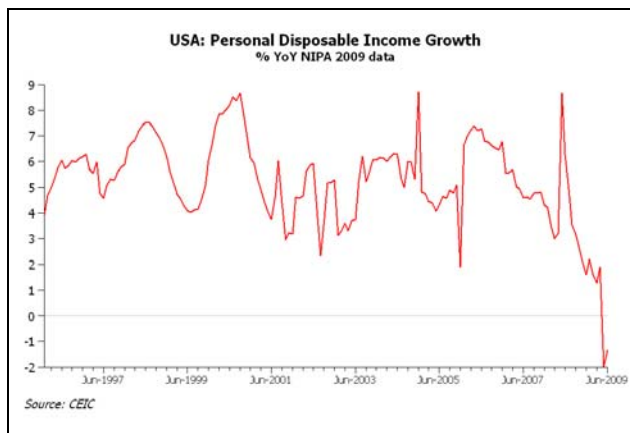


Now, however, the credit crisis is easing in places and there is some – albeit reduced – credit supply available to households that has allowed consumer spending to stabilise vis-a-vis household disposable incomes. This suggests that stage one of the consumer crisis has passed, as indeed many have recently noted. Unfortunately, we wonder if stage two is now about to unfold.

As we note above, the weakness in consumer spending during stage one occurred against a background of positive household income growth, partly because government fiscal measures were effective in mobilising funds to the household sector (particularly the Bush & Obama tax rebates and the Brown VAT reduction in the UK) and partly because in most countries outside the US the employment situation was relatively slow to react to the slowdown in global growth. However, as we look into the second half of 2009 and on into 2010, we are left with the inescapable fact that the employment situation is now becoming much weaker in Europe and Japan, and that it is still soft in the USA.

Moreover, we must also be aware that the period of government fiscal largesse is clearly coming to an end – the ‘cash for clunkers’ and similar schemes in many respects mark the last ‘direct injections’ into the consumers’ cash flow situation; any remaining benefits from fiscal policy will have to come through

the roundabout income effects of the various public works projects that are still in the pipeline. Therefore, it seems to us that over the next six months we will see a marked degree of weakness in consumer disposable incomes (in fact, this has already begun in the US and is beginning in the UK).



The weakness in household disposable incomes implies that in order for consumer spending to now rise in the way that the consensus apparently expects (following the rise in asset markets), savings rates will have to drop precipitously and certainly back to 2006-7 boom-like levels. Of course, rising asset prices and a probable stabilisation in US house prices do indeed suggest the potential for some degree of a rise in consumption trends / decline in saving from current incomes but we would argue that with consumer confidence still absolutely weak, job uncertainty still rife and credit still relatively hard to come by (it is difficult for society to save less without some form of credit boom), a sharp drop in the savings rate that is sufficient to lift consumer spending is unlikely. In practice, we do expect US and other savings rates to now drop passively as incomes come under pressure but we do not expect them to rise proactively by enough to force consumer spending to rise in absolute terms as incomes fall.

Therefore, far from expecting a consumer recovery in 2010, we expect that stage two of the consumer slowdown process (i.e. that caused by weak incomes) may unfold from late 2009Q4 onwards, something which might even challenge the optimism currently prevalent within today's liquidity-driven financial markets. For investors, the trick will be in attempting to decipher when the consensus will switch from its current faith in a consumer recovery to acknowledging that all is indeed not well in the household sector and we suspect that the Thanksgiving / Christmas sales numbers may be instrumental in this regard, as indeed could a seasonal rise in bond market yields and hence mortgage rates in the latter part of the fourth quarter. As China proved, taking the consensus view on trust can produce spectacular short term gains but to protect one's capital, it does pay to look the 'gift horse' in the mouth occasionally and a good time for this examination may soon be upon us. In the long

term, we do have considerable faith in the highly flexible US economy's ability to recover but we fear that at the current time, financial markets may have got a little ahead of themselves in predicting the recovery and this divergence between expectation and reality could prove temporarily destabilizing if the right (or wrong?) catalyst intervenes as the year draws to an end.

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Active vs Passive: The Debate Is Back

During the latter half of the 1990s, in particular, there raged in the New Zealand investment management community a vigorous debate over active and passive investment. Although the hoary old chestnuts of “the average active manager does not beat a passive manager” were brought out repeatedly, the debate basically came down to one issue: tax.

In fact, my phrase “vigorous debate” is a slight exaggeration, because a situation was created that made it almost impossible to debate against passive investment. You see, for those who do not remember or were not in the industry at the time, on 11 June 1996, the New Zealand Stock Exchange launched their listed TeNZ fund, covering the top 10 stocks in the New Zealand market (now known as an “exchange-traded fund” called SmartTENZ). Because the fund invested in these top 10 stocks passively (and hence was forced to buy and sell stocks whenever the index weights changed), the fund applied for and acquired from the IRD a binding ruling that saw it excluded from being taxed on capital gains. Remember, at that time, investment funds paid tax on all capital gains as well as income.

Once the IRD had set this precedent with TeNZ, all other passive New Zealand equity funds followed suit and gained similar binding rulings. Now this created a hurdle for active managers to surpass, just so their investors would receive the same net return level as the passive fund investors. Over the period from 1 July 1996 to 30 September 2007 (when the PIE regime removed taxation of active capital gains), the NZX 10 Gross Index rose 8.5% p.a. However, the average gross dividend yield was 6.5% p.a. over this period, so only 2.0% p.a. was capital gains. Therefore, if an active and a passive investor generated exactly the same returns after fees, the passive fund had an advantage of 33% on the 2.0% p.a. capital gain, or 0.66% p.a. This 0.66% p.a. was the hurdle that an active New Zealand equity manager had to surpass after active fees before it could be at the same level as a passive New Zealand equity fund. In fact, over that period from 1 July 1996 to 30 September 2007, the average active manager in NZ returned 15.0% p.a., comfortably achieving that outperformance hurdle. In fact, all those who survived to the current day earned over 13.6% p.a. over that period.

The playing field, though, became far less level when the IRD granted a similar binding ruling to AMP's

WiNZ fund, which was a passive global equity fund. AMP's rationale was, quite rightly, that the fund was transacted in exactly the same way as the New Zealand passive equity funds so should be treated the same on a taxation basis.

The main difference between New Zealand and global equities is that dividend yields are significantly lower in global equities than domestic equities. That difference was probably at an extreme in the late 1990s. Over that same period, 1 July 1996 to 31 March 2007 (when the FDR regime removed the taxation of capital gains), the MSCI World Index with net dividends reinvested (so not including withholding taxes that are unable to be reclaimed) returned 7.8% p.a. in local currency terms (local

currency means US stocks in US dollars, UK stocks in sterling, etc). Of this, a staggering 6.2% p.a. was in capital gains, leaving only 1.6% p.a. in net dividends. To now grant that 6.2% p.a. a tax-free exception created a hurdle of $33\% \times 6.2\%$ or 2.0% p.a. for active managers. This was also after the fee differential between active managers and passive funds.

In New Zealand actuarial surveys, unhedged NZD returns tend to be used to quote manager performance in global equities. On that basis, the MSCI World index was 7.4% p.a. over that period. The average active global equity manager in New Zealand returned 9.4% p.a. – pretty good (2% p.a. better than index, which is a common outperformance target), but not quite at the level required to offset the tax hurdle after the higher fees that active managers charge. Fortunately, the dichotomy that had been wrought between active and passive managers was removed with the taxation changes in 2007.

In the past few months, though, demand for passive funds is on the rise again. This is a global phenomenon and this time, in New Zealand at least, it has nothing to do with tax.

The horror of 2008's investment markets and disappointment from a small number of active global equity managers (mainly those few who purchased financials when they became “cheap” and watched



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Are passive funds the best way to increase returns in a volatile environment?

them fall even further) has caused many investors, particularly trustees of superannuation funds and charities to decide that the “safe” thing to do is to move to a passive manager for global equities. Investing in a passive manager (which usually costs less) mitigates the risk of active manager underperformance.

Well, passive investing does mitigate that risk, but it also carries with it a large opportunity cost – the chance of active management gains. One rationale given recently is that investment markets for the next few years are likely to be on the rise. The thesis continues that active management gains aren’t as “important” in up markets (as both passive and active investors share in the gains and, anyway, what’s a couple of points extra in a double-digit rise?) That thesis, though, will be completely blown out of the water if the market suffers a fall in the final quarter of this year and weakness throughout 2010, possibilities that are slowly gaining some traction as people wonder about the world after the stimulus packages have been worked through.

Active investing is at its best in weaker markets. A good active manager (only good ones should be appointed) should be able to wade through the heavy waters of falling or weak markets and avoid the stocks that fall the most (as indeed many active managers did during the past 18 months). In this regard, active managers are actually a much safer option than passive managers.

Passive managers are completely at the mercy of the indexes they follow. Indexes are dominated by the performance of their largest stocks, which determine the rise or fall of the passive funds that invest in them. As an extreme example, imagine you are in passive global equity fund in the 1980s. As the decade progresses, Japanese stocks take up a larger and larger proportion of your fund. By the end of 1989, they comprise 40% of the index and hence of your portfolio. By the end of 1990, those Japanese stocks are nearly half of the value they were at the start of that year. The poor passive investor must simply watch the fund value fall in line with the index. An investor with a good active manager should have been able to avoid the large performance drop by underweighting Japanese equities as their valuations became more and more stretched. Because passive funds rise and fall in line with the index, they are actually more volatile than actively managed portfolios. If your idea of risk is volatility, then an active portfolio is less risky (and thus possibly more safe) than a passive fund.

The actual theoretical basis for passive investing is not particularly strong either. Passive investing has its roots in Harry Markowitz’s Modern Portfolio Theory, which uses as a basis the Capital Asset Pricing Model. This model states that all investors need is a combination of a risk-free asset and an efficient portfolio, with the weights of that combination being determined by the level of risk the investor is willing to take on.

Over the years, most have assumed that the “efficient portfolio” is the index, linking it in with the “efficient market hypothesis” that all securities reflect all known information and, ultimately, render active management as luck or “randomness”.

Don’t be fooled. The weak form of the efficient market hypothesis actually says that a stock’s price is composed of the probabilities of all future events – the actual outcomes may be different. Stronger forms of the efficient market hypothesis are routinely discredited by market behaviour itself (especially during bubbles and their bursting). Further, Markowitz himself has said that he never stated that the “efficient portfolio” of Modern Portfolio Theory was meant to be the “efficient market” (an index). The portfolio itself had to be efficient, which means there is not another portfolio of a similar risk level that will offer a higher return.

So, investing in an index is not necessarily the most efficient way of achieving global equity (or any other asset class) exposure. If markets do not strongly track upwards, it can be significantly more volatile than active management and often lower returning. As for that old chestnut that the average active manager does not perform as well as an index fund, it is possibly true. But then you don’t want an average active manager anyway, do you?

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1 September 2009