ASIA PACIFIC INVESTMENT FORUM

20 November 2008

# Risk and Investment Strategy
## Past lessons and future developments

Heathcliff Neels, Auckland

# Introduction
## Movember

- Cancer Society
- Mental Health Foundation
- https://www.movember.com/nz/donate/donate-details.php?action=sponsorlink&rego=**1936451**&country=nz

# Introduction
## Agenda

- Risk profile changes in general
- Strategic response to risk profile changes
- Two Case studies
  - 2007/8 tax changes and
  - how balanced funds responded
- FDR taxed global bonds

# Risk profile changes

Risk profile changes are not limited to tax paying investors

Examples:

- Adding risk to a sector:
  - using debt to gear a portfolio
  - adding credit risk or duration risk to an income portfolio
  - adding development activities to a property or infrastructure portfolio
- Choosing between a “debt” or “equity” stake in a venture
  - changing ownership structure of direct investments
  - NZ tax changes to share investment

- Two rules for success in life

- 1. Don’t reveal all you know

- 2. ………………..

- (refer to rule number 1)

# Strategic Response to Risk Profile Increases

Single critical decision

- Keep strategy and change objectives or
- Keep objectives and change strategy?

- Keeping Strategy means changing the investment objectives to allow for more risk (and return)
- Changing strategy (i.e. less growth assets) means having a clear understanding of the objectives of the Scheme as long term expected returns are being forgone.

**Case Study**

2007/8 Tax Changes

# 2007 / 2008 Tax Changes

Overview from investment viewpoint

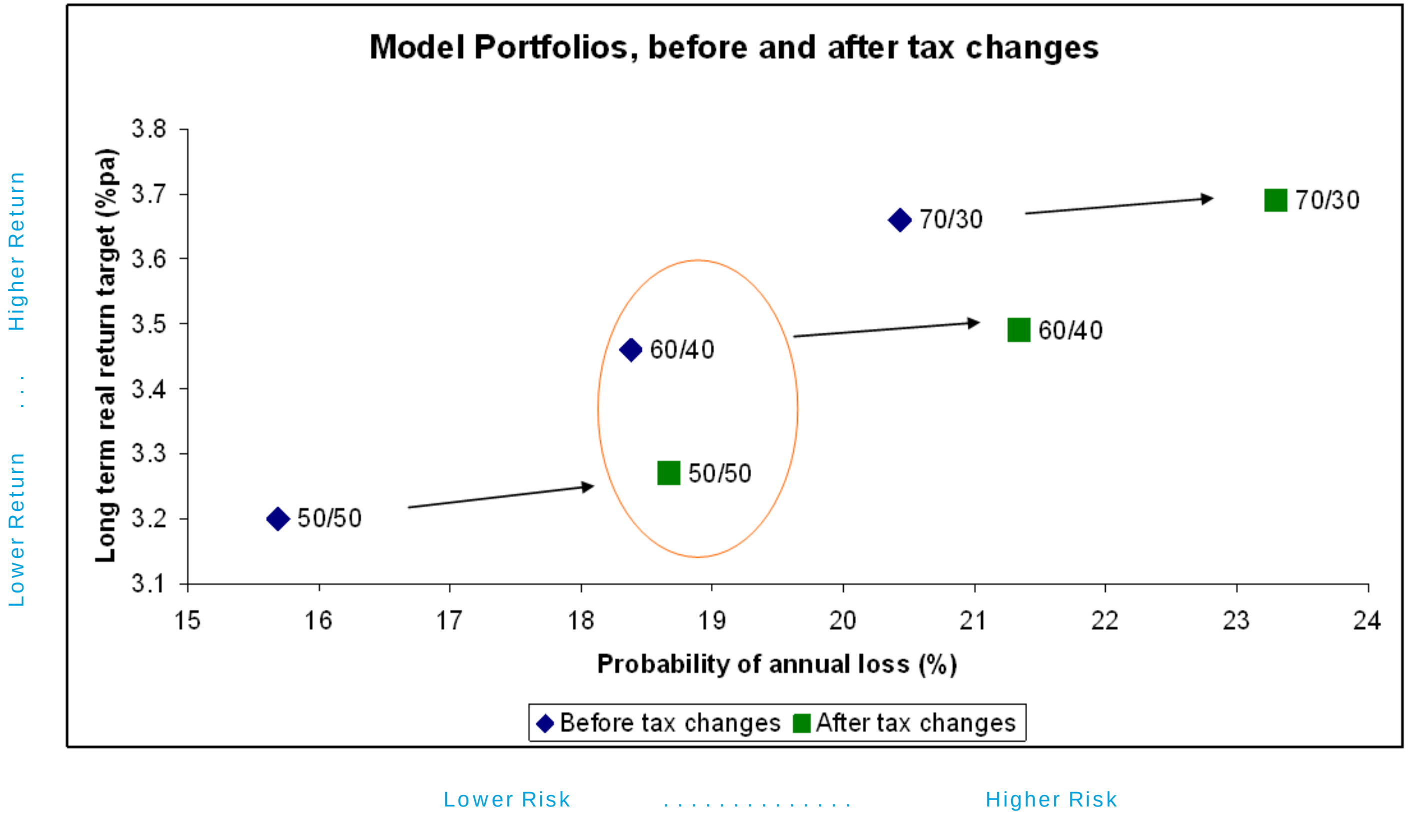
- Tax = Assessable Income * Tax Rate
- Assessable income changes:
  - Fair Dividend Rate (FDR) of 5% on global shares
  - Dividend only tax on NZ and some Australian shares via Portfolio Investment Entities (PIE)
- Tax rate changes:
  - Selection of tax rate via PIE flow through
  - Reduction of the top tax rate from 33% to 30%

# 2007 / 2008 Tax Changes
Impact

- Assessable income : Major Impact On Risk
- Tax rate : Minor Impact
- Incentives for active equities management : Major
- Regional biases : Unchanged
- Incentives to find loopholes: Minimal*

# 2007 / 2008 Tax Changes

## Risk – Return impacts on strategy




- For these strategies a 10% reduction in growth assets maintains risk levels
- The impact varies by starting point, so the range is a 0% to 20% reduction

## **Case Study**

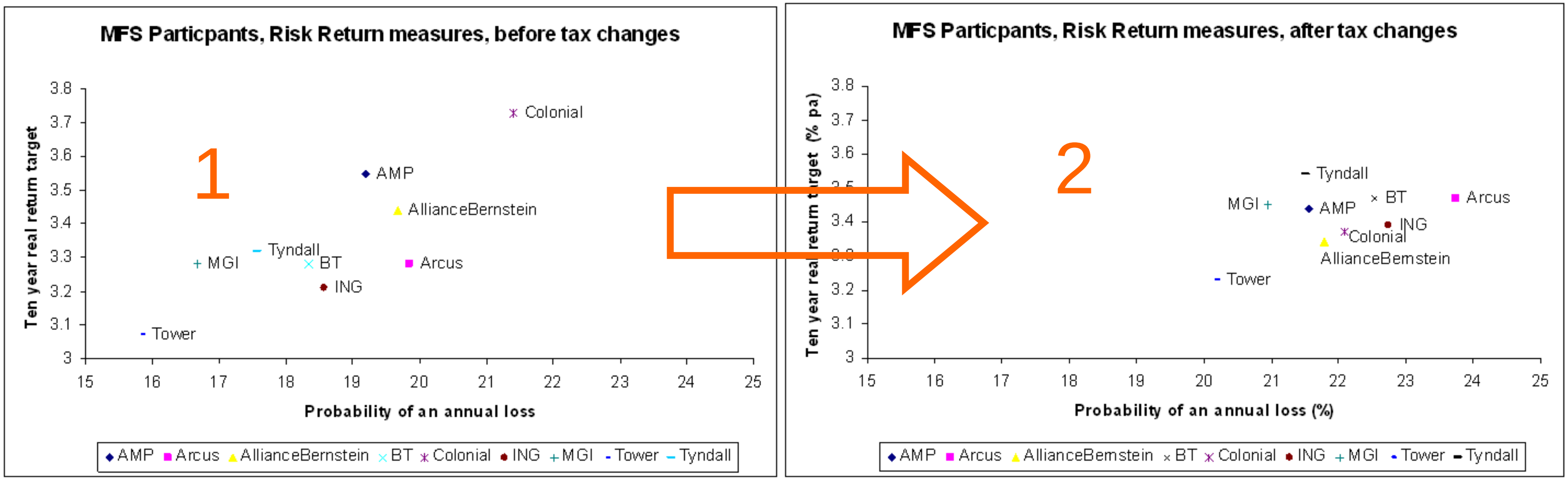
## Balanced Fund response

# Case Study: NZ Balanced Funds
## Strategic impact

- Balanced fund providers are important to review as they are the immediate future for KiwiSavers, once members move out of default options.
- For many to maintain their risk objectives across the tax changes they should have moved to 50% growth assets from the 60% to 70% growth strategies used prior to the tax changes.

# Case Study: NZ Balanced Funds

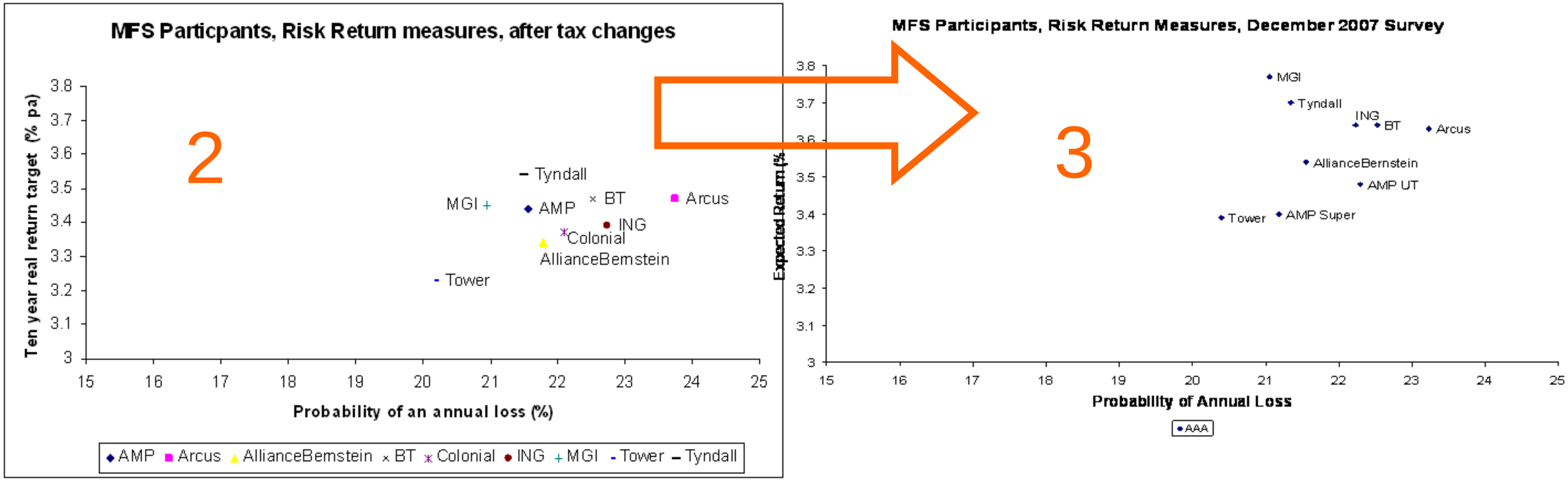
Decisions made: impact of tax changes




- Increased risk post tax
- Bunched Beta returns post tax

# Case Study: NZ Balanced Funds

Decisions made: response is to maintain strategy




- Strategy maintained, risk levels increased by Balanced Funds
- Sector adjustments to improve return prospects

# Case Study: NZ Balanced Funds

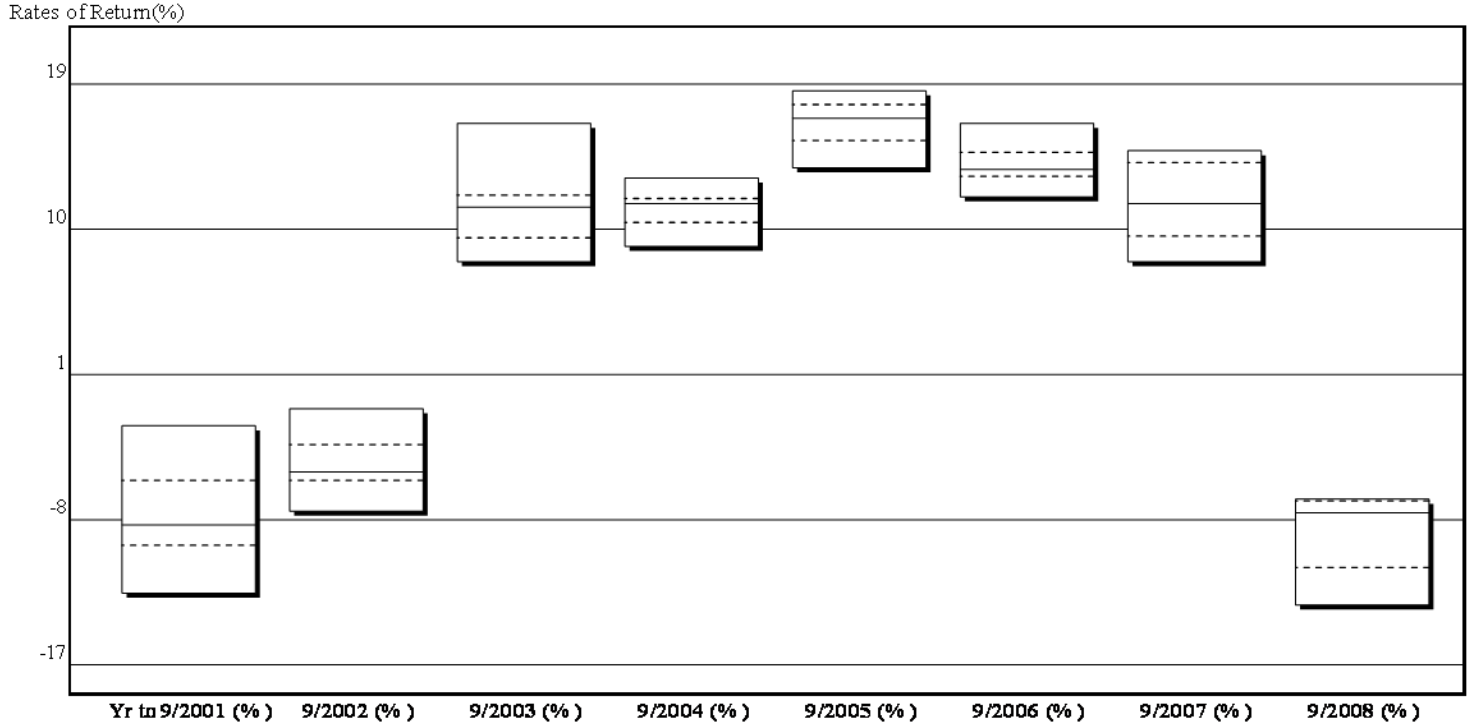
## Short term consequences of maintaining strategy

- 2008 after tax returns are poorer than this

**Mercer Managed Fund Index**

**Comparison with the Mercer NZ Managed Fund Survey Universe**

**Performance before tax and before fees for the last 8 years ended September 2008**




| | Yr to 9/2001 | 9/2002 | 9/2003 | 9/2004 | 9/2005 | 9/2006 | 9/2007 | 9/2008 |
|---|---|---|---|---|---|---|---|---|
| 95th Percentile | -2.3 | -1.2 | 16.5 | 13.1 | 18.5 | 16.5 | 14.8 | -6.8 |
| Upper Quartile | -5.6 | -3.4 | 12.0 | 11.9 | 17.7 | 14.7 | 14.1 | -6.9 |
| Median | -8.4 | -5.1 | 11.3 | 11.5 | 16.8 | 13.6 | 11.5 | -7.7 |
| Lower Quartile | -9.6 | -5.7 | 9.5 | 10.4 | 15.5 | 13.2 | 9.5 | -11.0 |
| 5th Percentile | -12.6 | -7.6 | 7.9 | 8.9 | 13.7 | 11.9 | 7.9 | -13.4 |
| Number of Funds | 14 | 13 | 12 | 12 | 12 | 10 | 9 | 6 |

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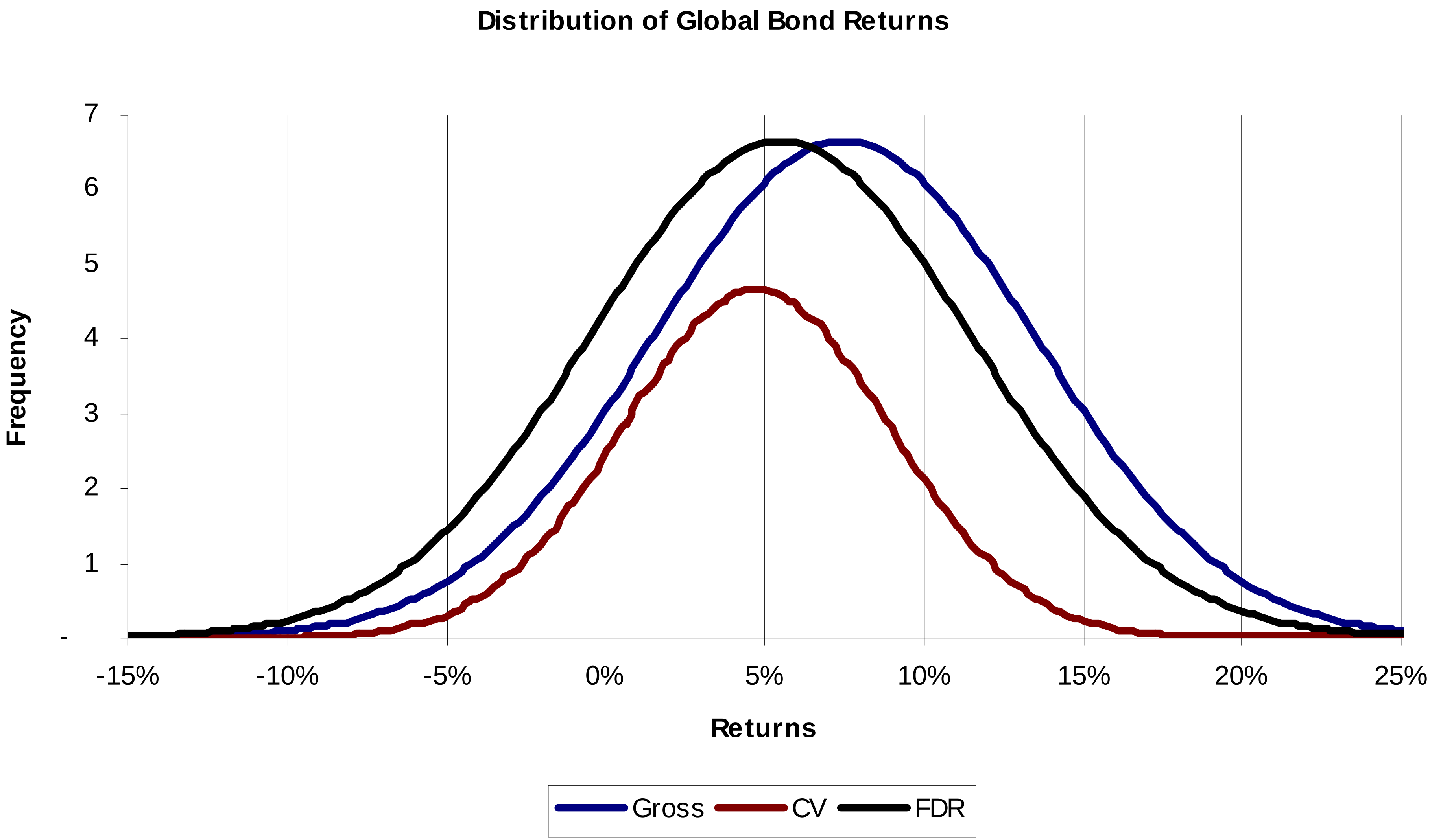
# FDR Taxed Global Bonds

# Partially unhedged FDR taxed Global Bonds

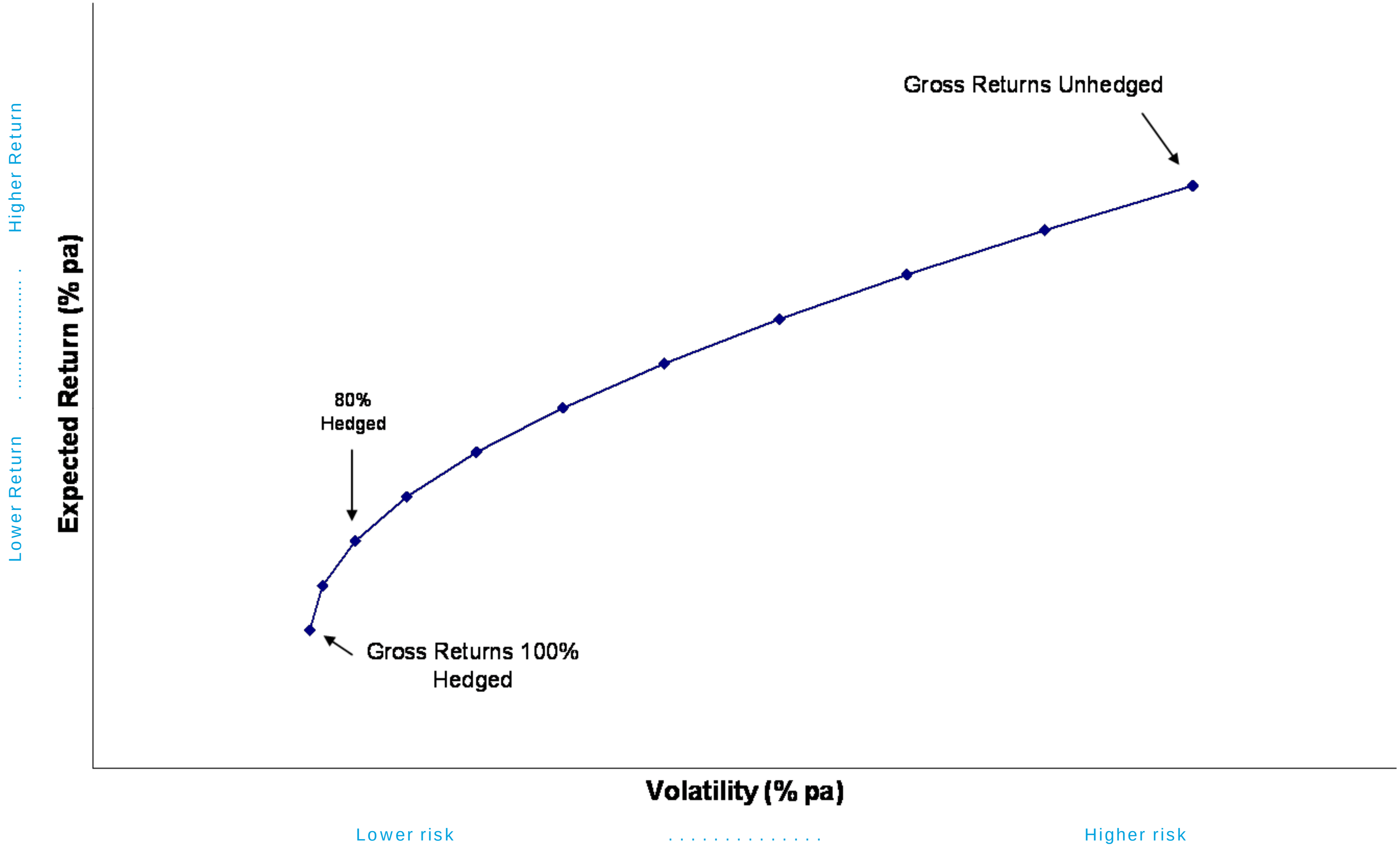
## Overview

- Comparative Value (CV) tax – “equity” stake
- FDR tax – “debt” stake
- Each have very different risk -return profiles after tax

# Theoretical Distribution of Returns
Before and after taxes (30% PIE)

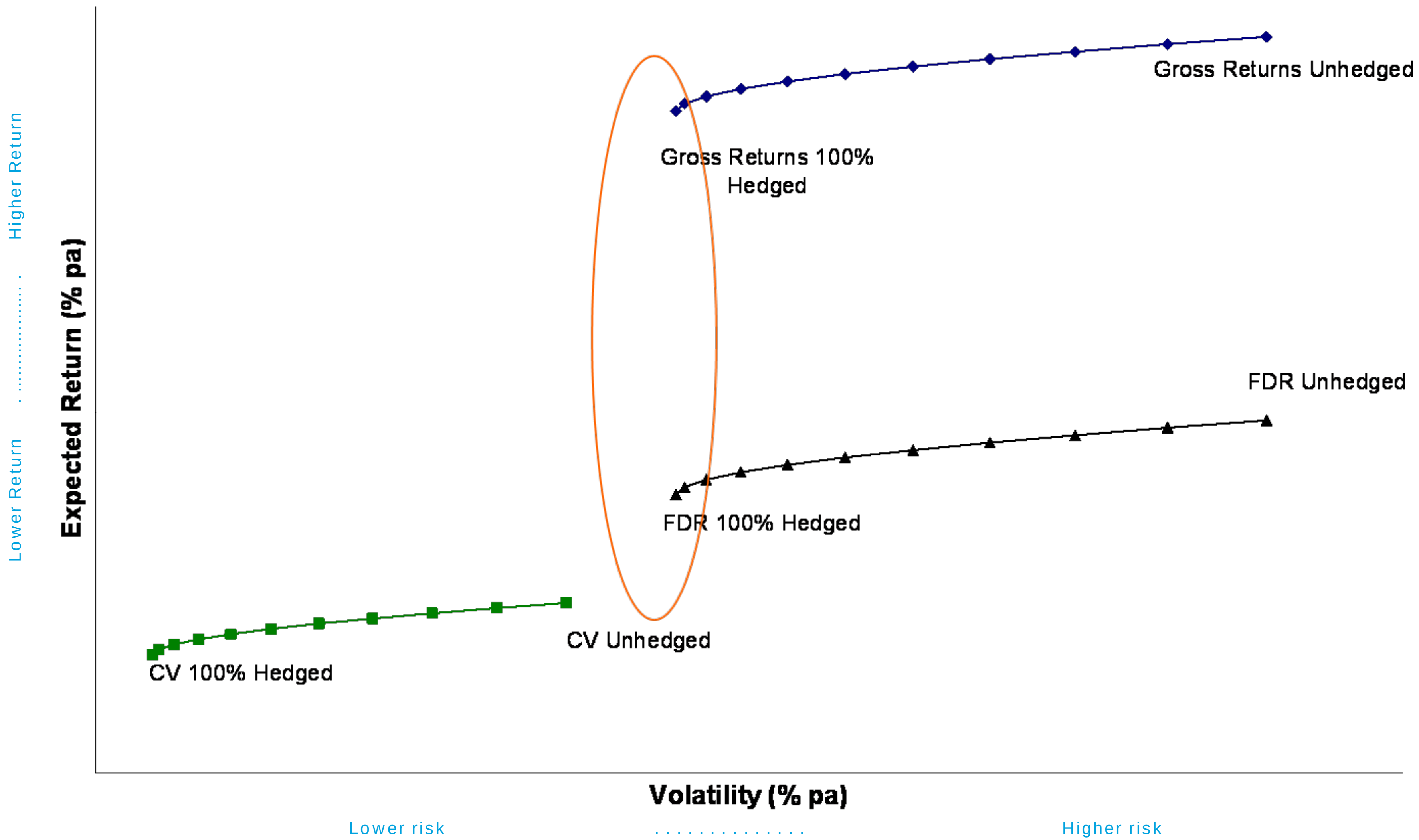


# Global Bonds – Currency risks
## Mean – Variance for gross, by hedging level



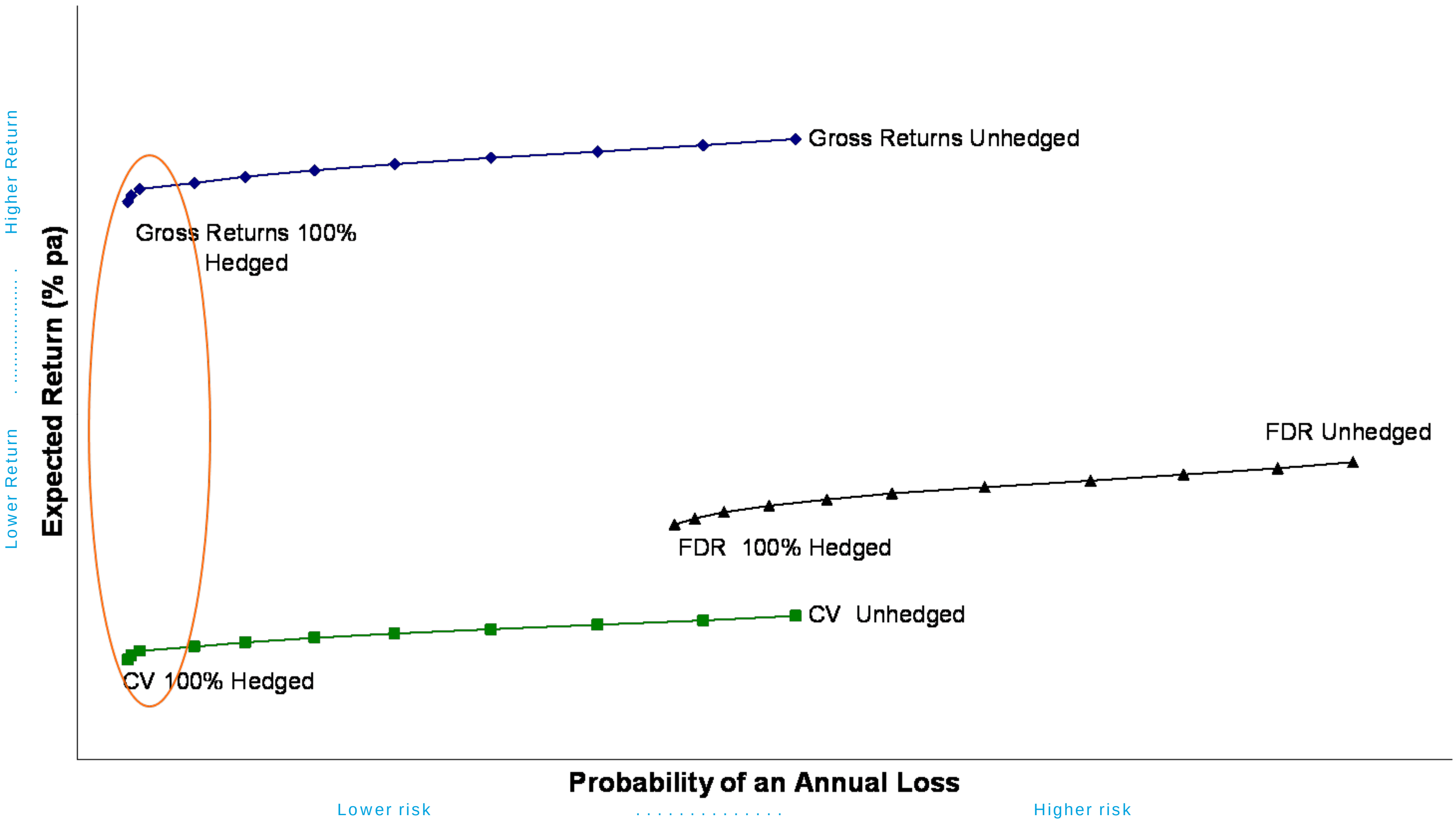
# Global Bonds – Currency risks

## Mean – Variance for gross, FDR and CV taxed, by hedging level



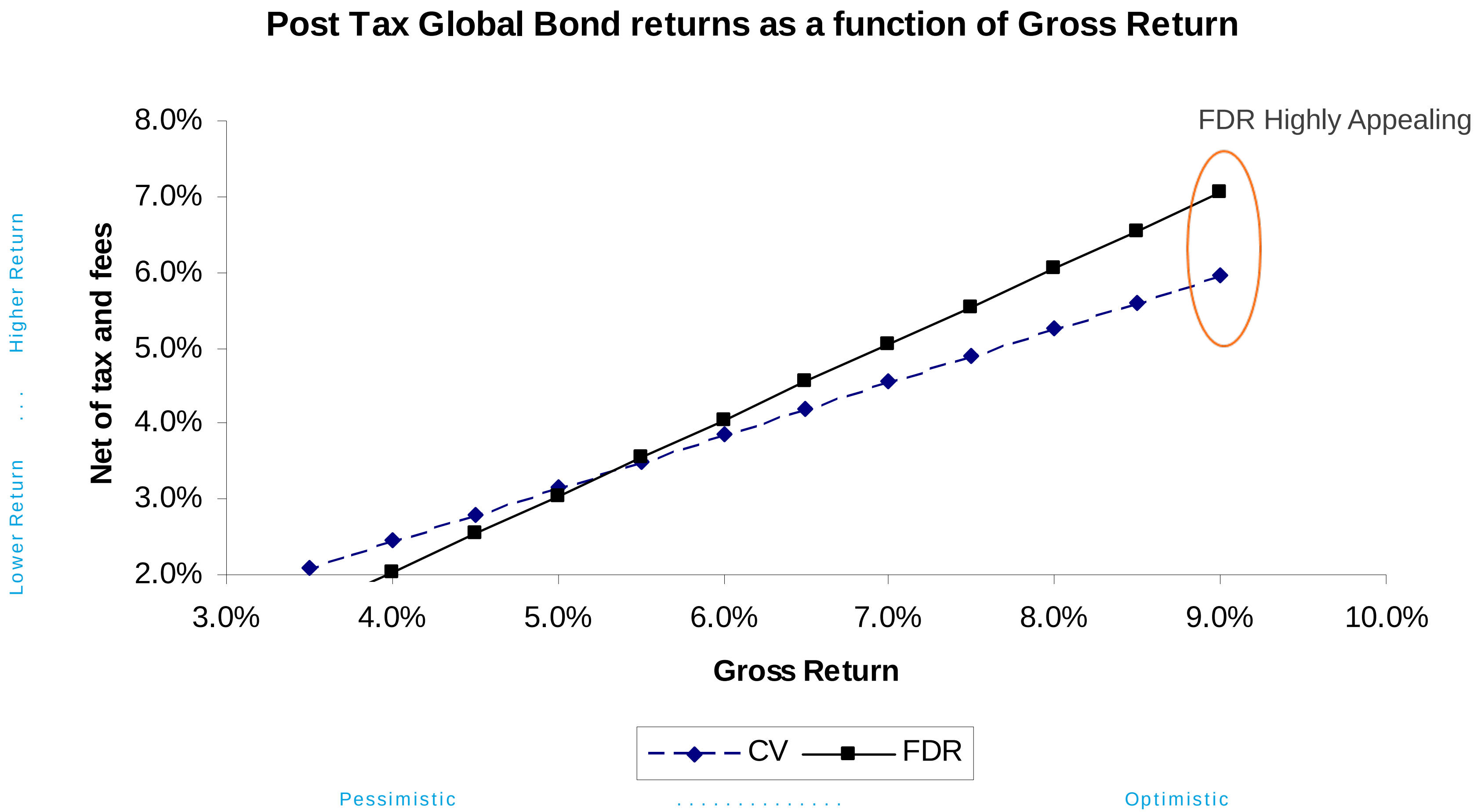
# Global Bonds – Currency risks

## Loss Probability for gross, FDR and CV taxed, by hedging level



# Partially unhedged FDR taxed Global Bonds

## Optimism favours FDR




The higher the expected pre- tax return the better the FDR after tax return

# FDR taxed Global Bonds

## Implications to the overall strategy for FDR bonds

If risk limits are maintained what strategy changes are required?

- Income portfolio
  - Reduction in bonds for cash
- Total strategy
  - Reduction in equities

# FDR taxed Global Bonds

## Implications to the overall strategy for FDR bonds

If global bond allocation is maintained how much risk is added?

- Income portfolio
  - Income assets are no longer low risk
- Total strategy
  - Effective increase in growth assets

# Close

- Common thread for all fiduciaries when faced with risk profile changes:
  - Maintain strategy vs. maintaining objectives.
- Presumption that the investment risk objectives should be constant over time, however risk appetite can vary from time to time as can the riskiness of underlying obligations.
- Consequences for either option to long term risk – return characteristics.
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