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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®o=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.

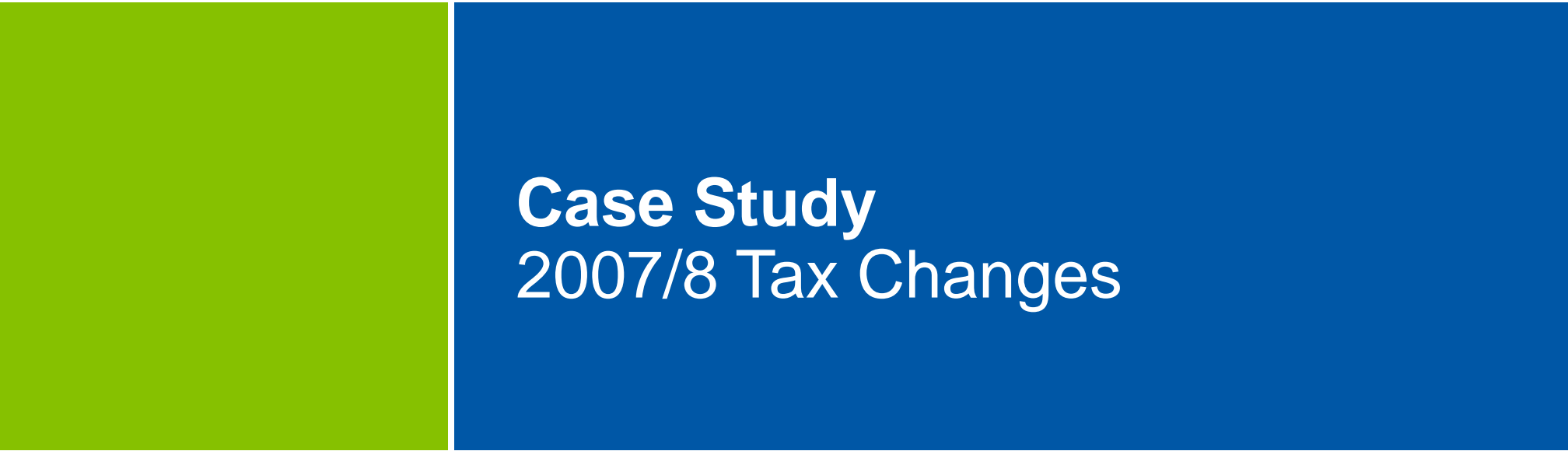
■ (refer to rule number 1)



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

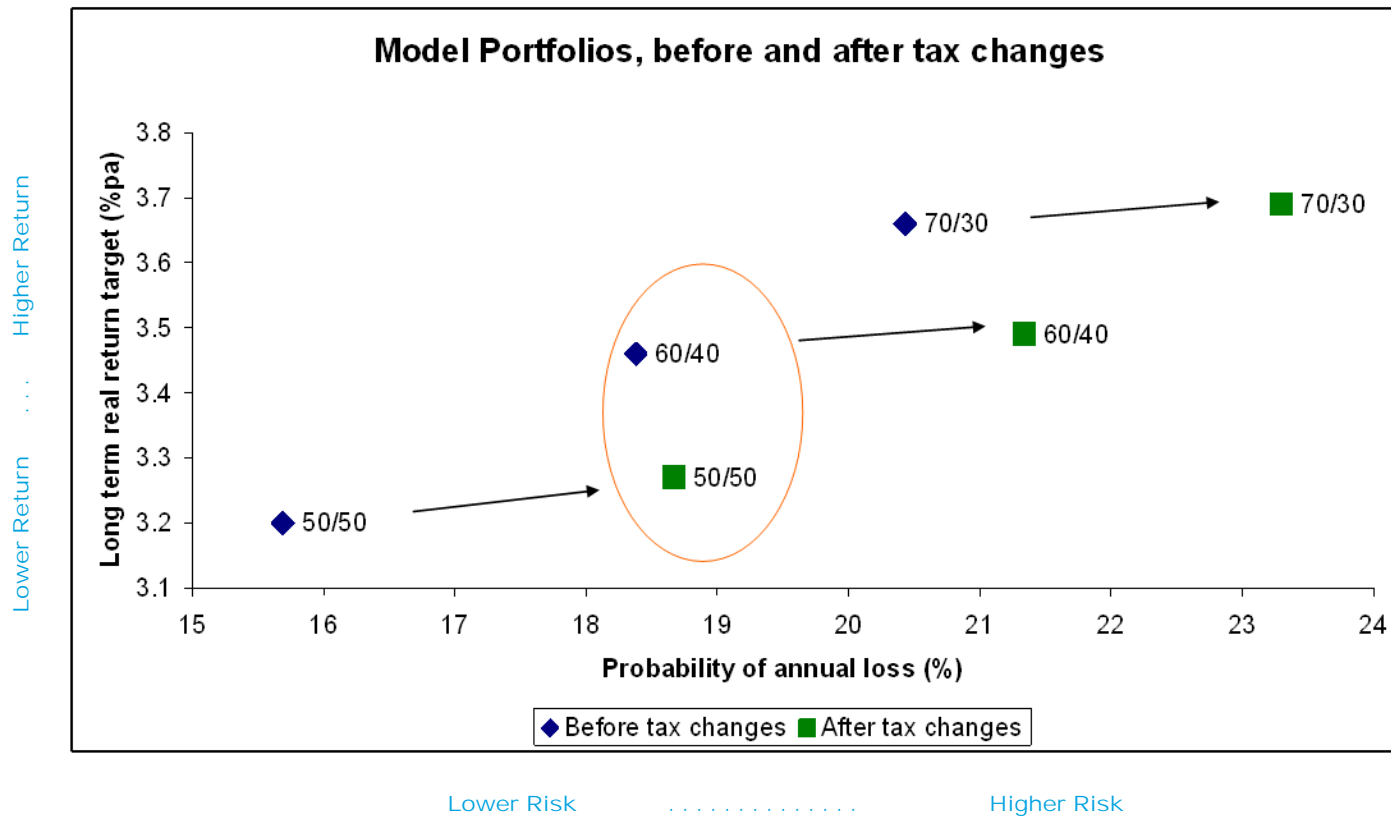
Impact

- 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

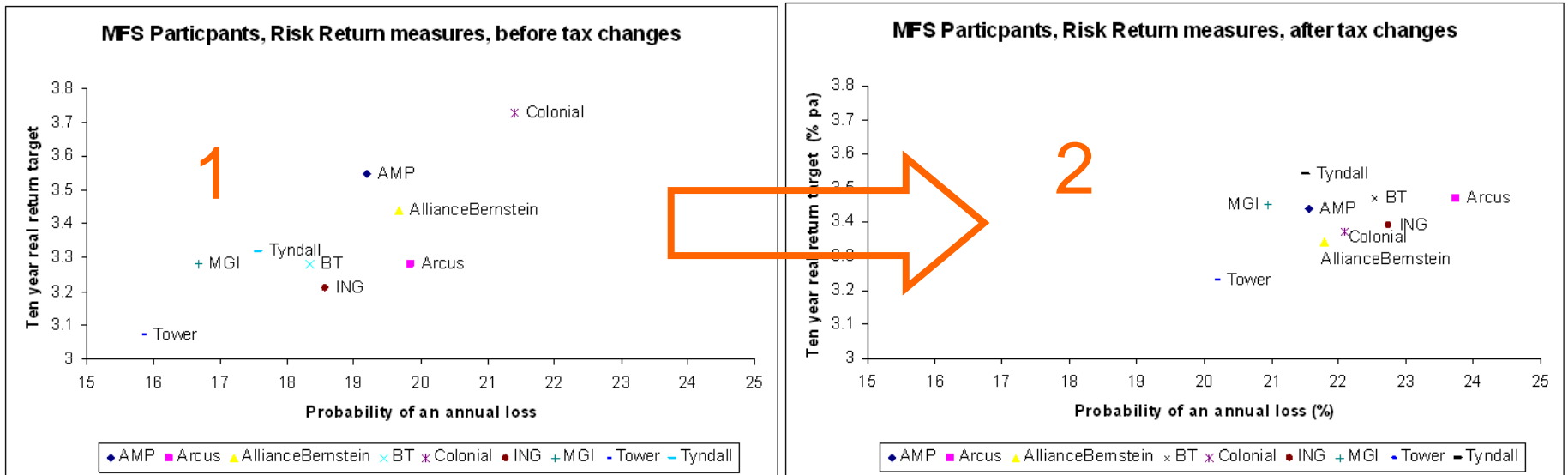
Strategic impact

- 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

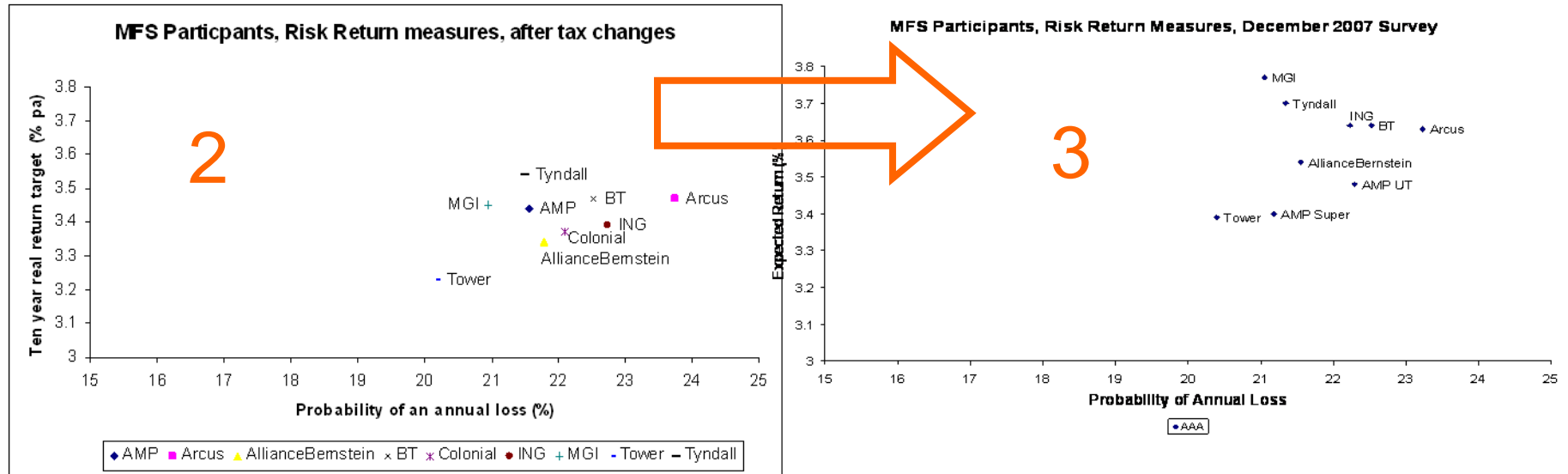


- Increased risk post tax
- Bunched Beta returns post tax



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

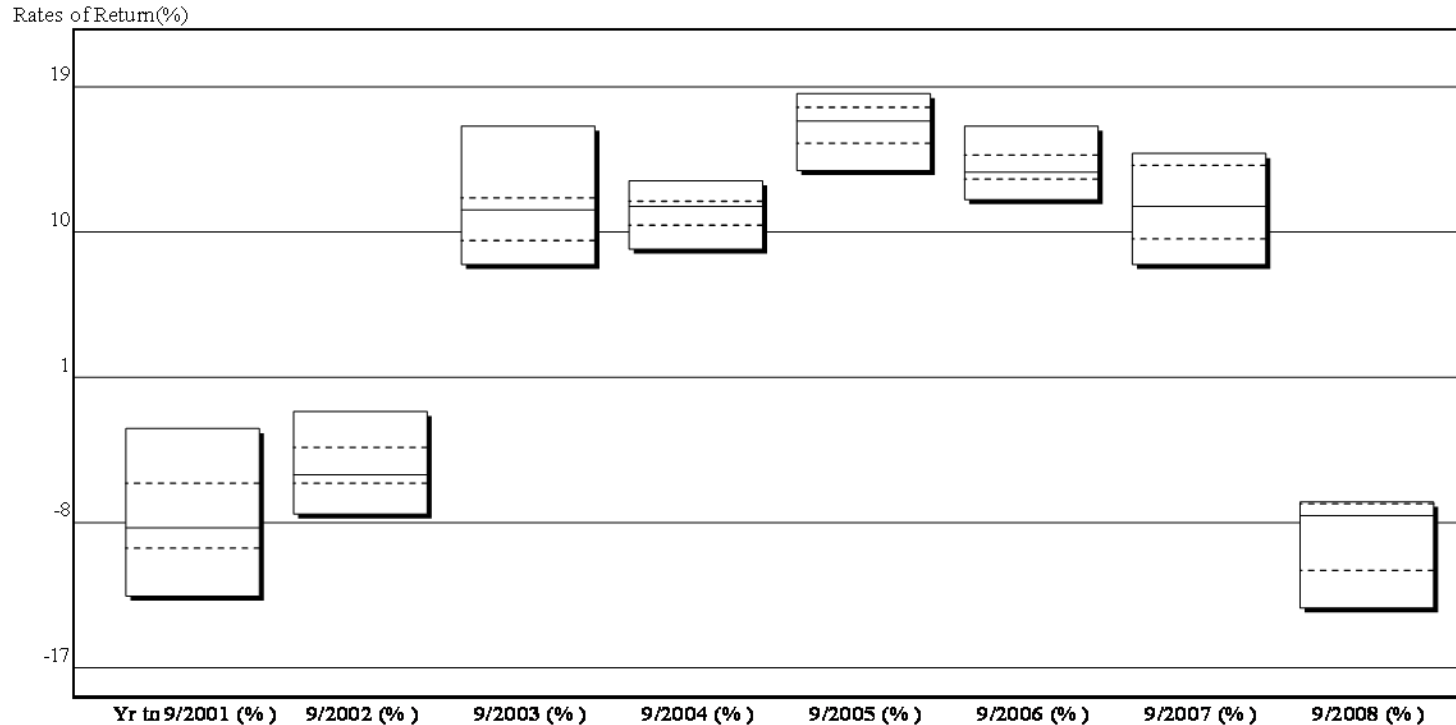


Case Study: NZ Balanced Funds

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



FDR Taxed Global Bonds



Partially unhedged FDR taxed Global Bonds

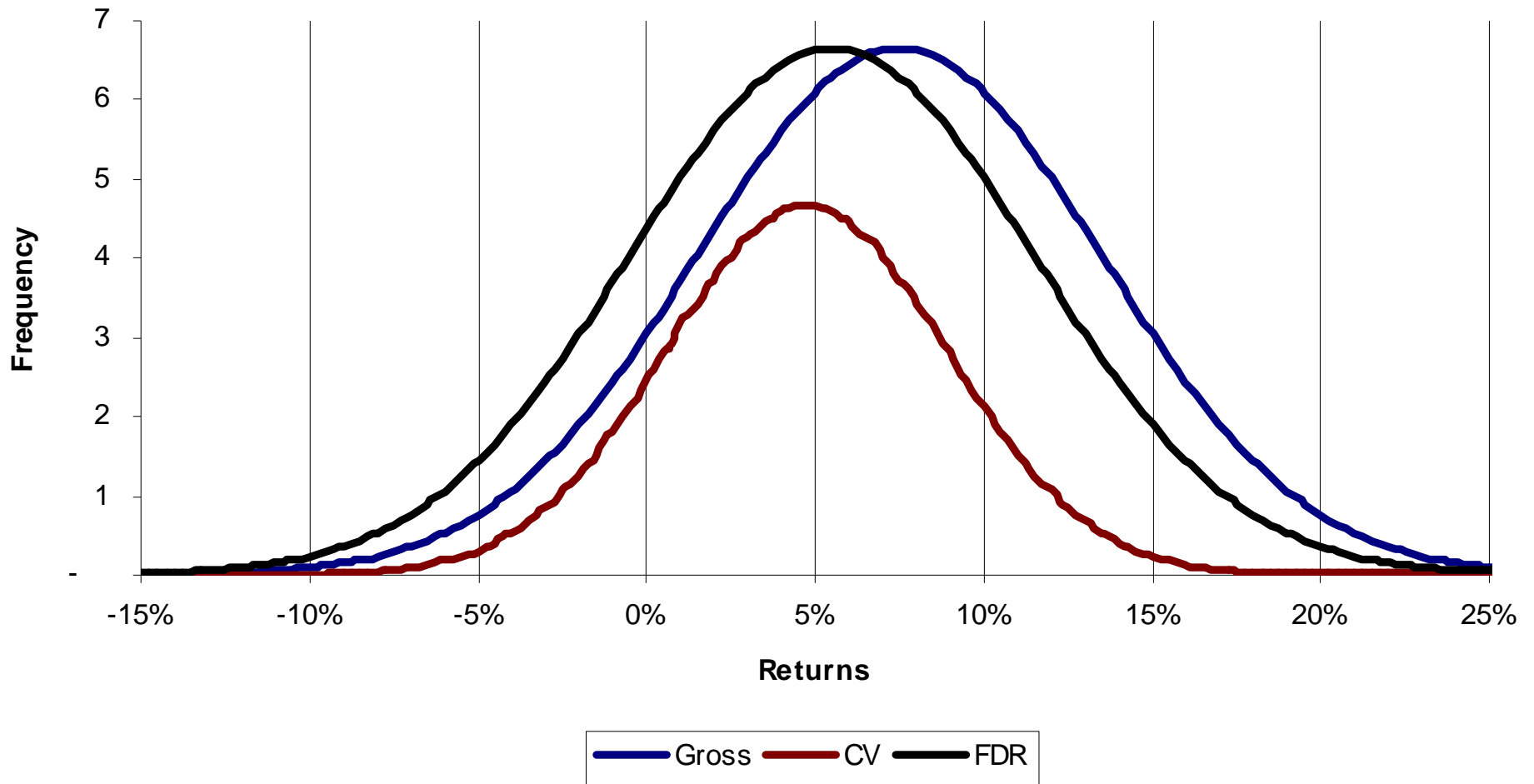
Overview

- 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)

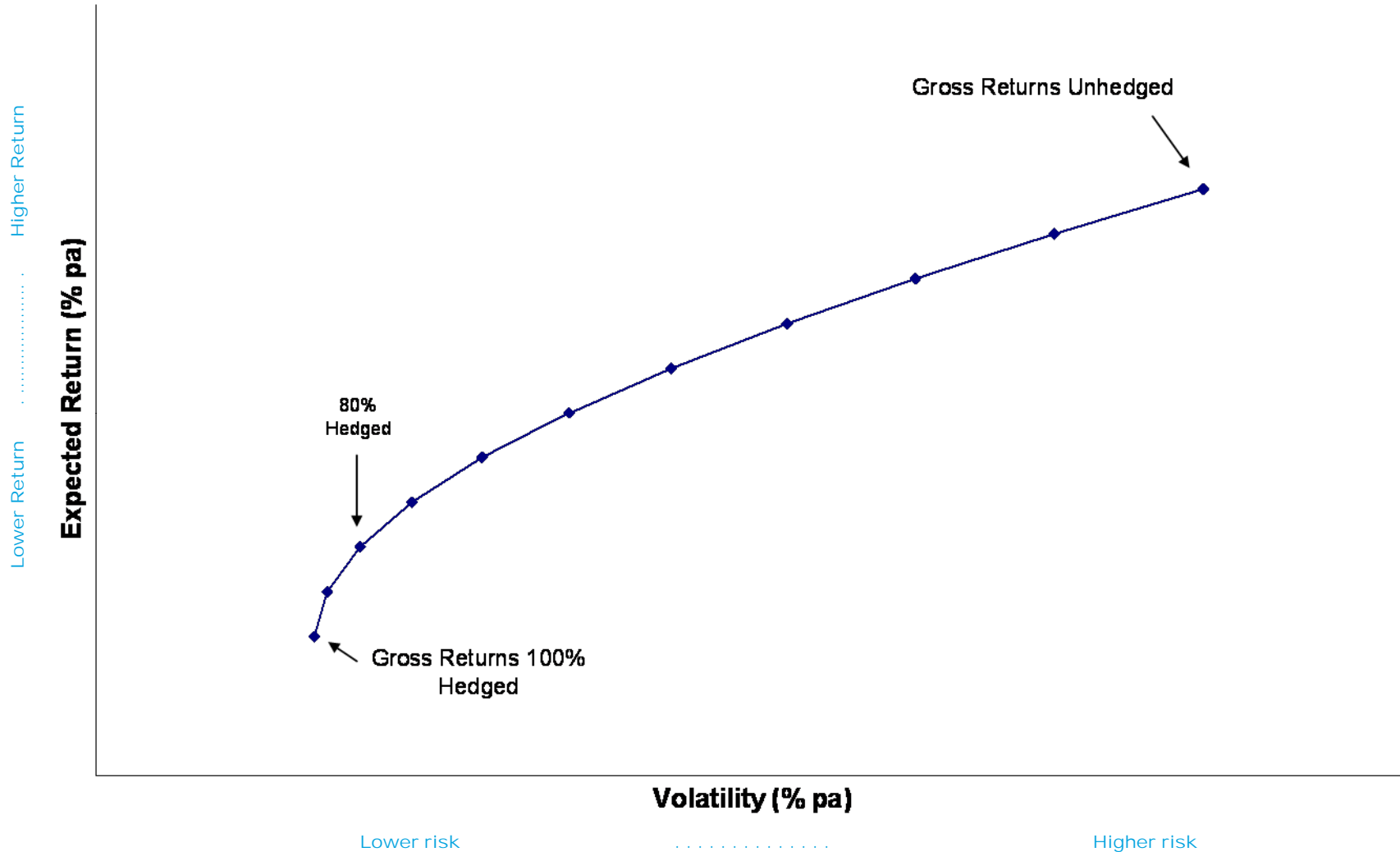
Distribution of Global Bond Returns





Global Bonds – Currency risks

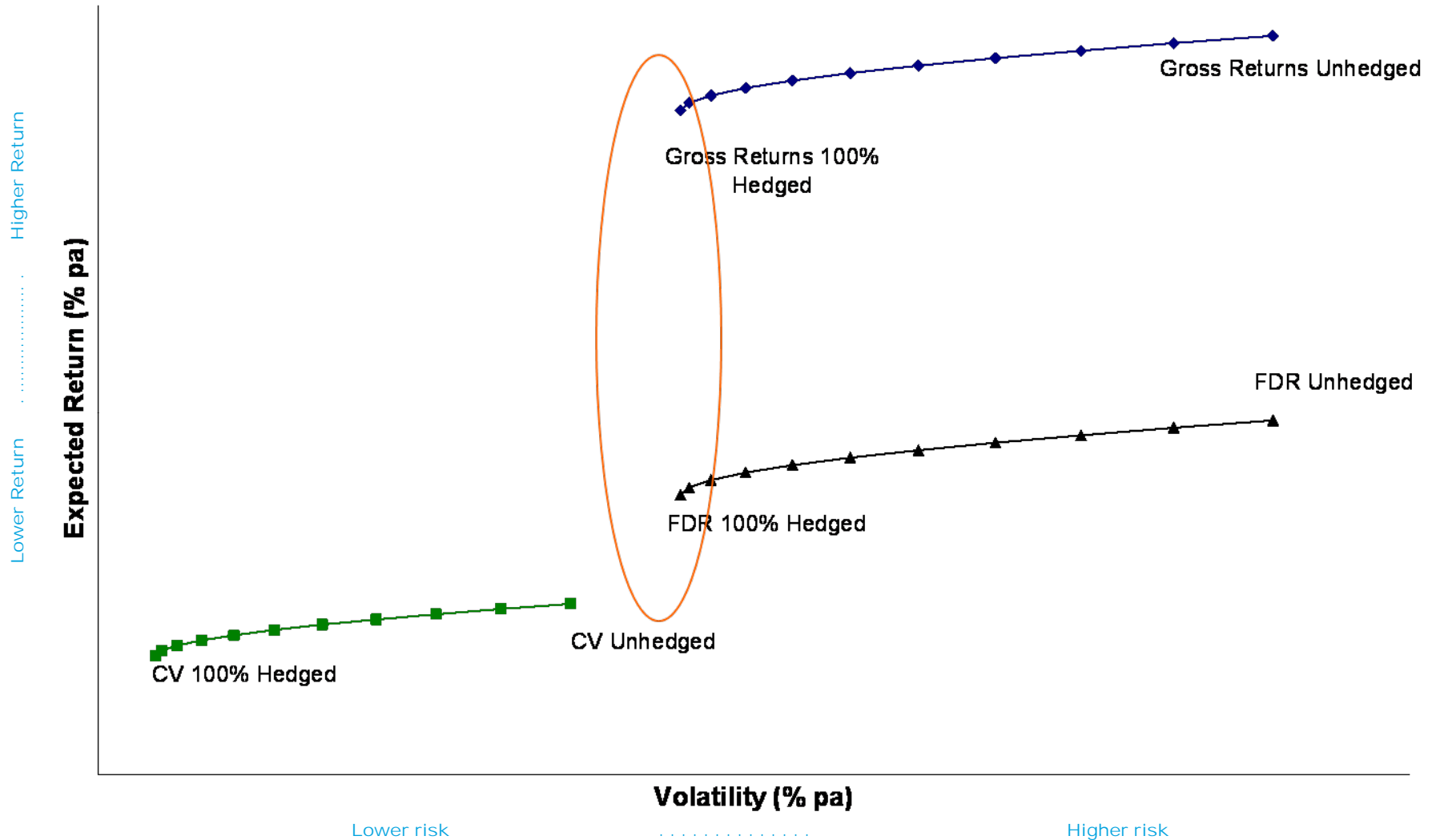
Mean – Variance for gross, by hedging level





Global Bonds – Currency risks

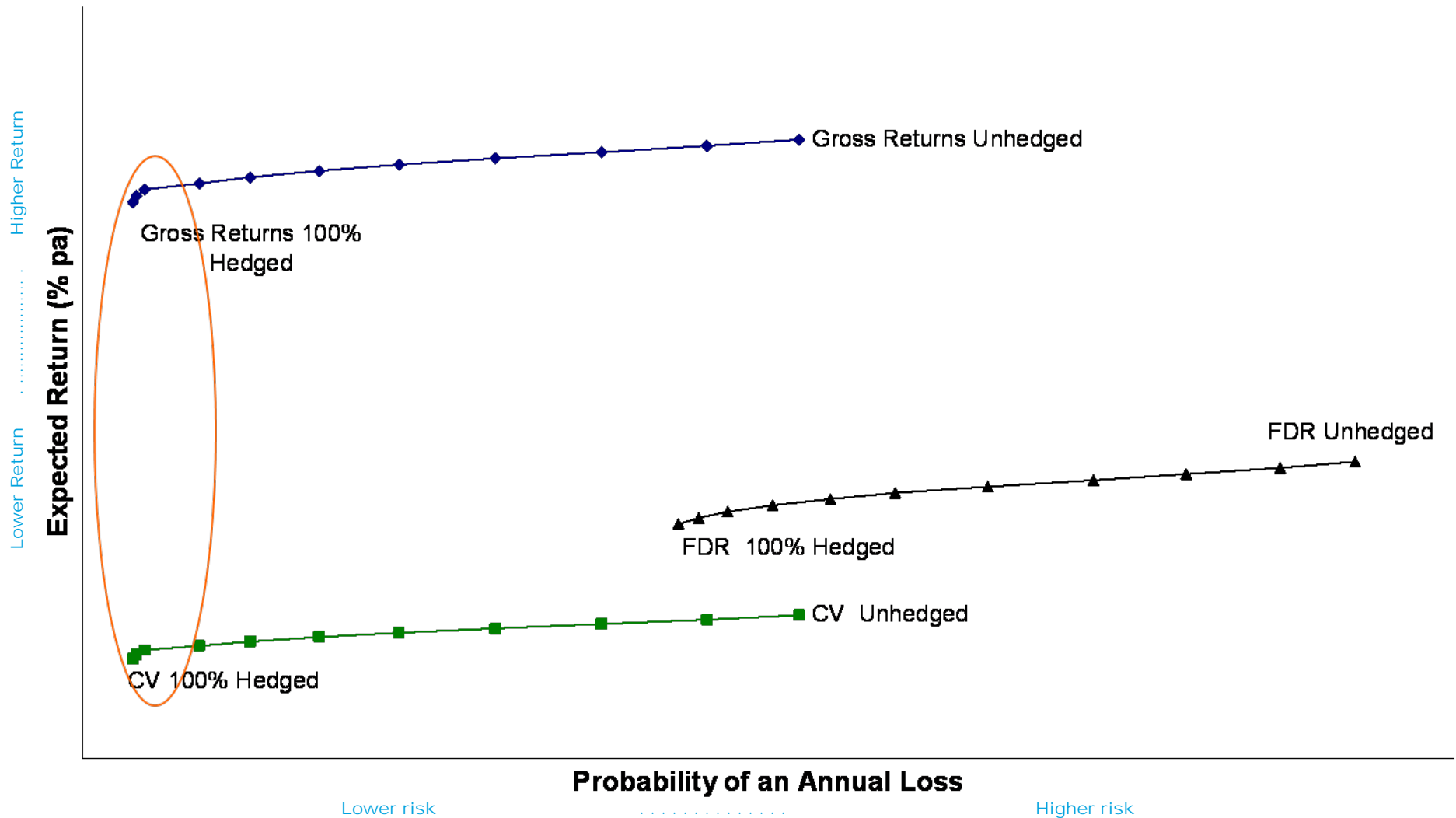
Mean – Variance for gross, FDR and CV taxed, by hedging level





Global Bonds – Currency risks

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

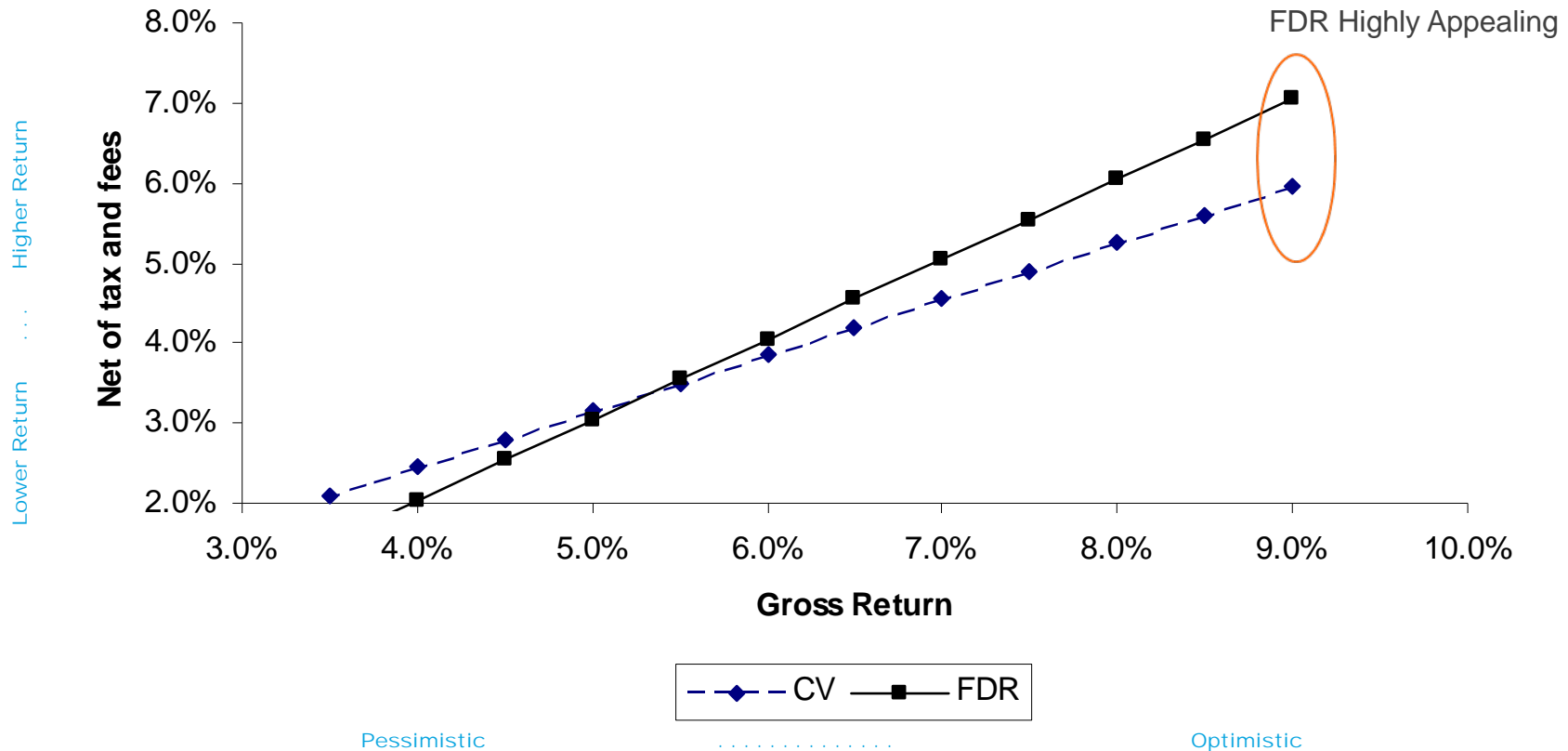




Partially unhedged FDR taxed Global Bonds

Optimism favours FDR

Post Tax Global Bond returns as a function of Gross Return



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.
- <https://www.movember.com/nz/donate/donate-details.php?action=sponsorlink®o=1936451&country=nz>

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