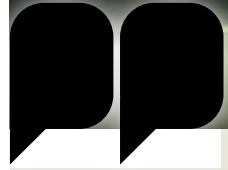


DIY AND POOR ADVICE SET LANDSCAPE FOR FINANCE COMPANY LOSSES



OPINION

Why do we hear so many sorry stories where a lifetime of savings is caught in one or another finance company failure? It would seem that several things are happening here: a DIY attitude, poor advice driven by commissions, and a general lack of financial literacy.

New Zealanders' penchant for DIY is in our DNA, and more dominant in earlier generations. This attitude still influences the investment decisions of many investors in the 55yr+ age group. The media calls them Mum and Dad investors.

At the most simplistic level, debenture holders in finance companies are savers rather than investors. Clipping a coupon from a newspaper or responding to a prime time television ad does not even begin to provide the building blocks for developing an investment portfolio. Those who do this on a DIY basis are usually oblivious to the inherent risk in the products they invest, not even reading the fine print or failing to understand it.

Anecdotes abound of investors having a spread of several finance companies with a similar underlying risk exposure. It is troubling how many of these were following the advice of – and had put their faith in – a so called financial adviser. High front loaded commissions and trail fees are typically paid to these advisers, and until the Securities Commission tightened the rules on 29 February this year the commissions were usually either undisclosed or inadequately disclosed.

Conflict of interest is embedded in using commissions as a form of remuneration – the financial interests of the commissioned adviser are aligned to the institution that pays them rather than the investor. Worse, the highest commissions are often paid as an incentive to sell the worst quality investments. Contrast this with a 'fee only' independent adviser, who is paid only by the client and has no vested interest to recommend one investment over another.

Why do people think that if the salesperson is getting a commission, rather than them needing to pay a fee for the service, that the advice isn't costing them anything? Of course it is, by way of a lower return from the investment than would otherwise apply for the level of risk accepted!

The 55yr + age group of investors have been through a number of cycles that has no doubt psychologically framed the way they see markets. The '87 crash, which was more pronounced in New Zealand than major overseas markets deterred a generation from re-entering

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the stock market. Some who eventually did re-enter, after years of being on the sidelines watching the US stock market boom through the '90s, invested in global shares just in time to suffer the 'tech bubble' burst in 2001 and have since had years of an appreciating New Zealand dollar, which has inhibited further prudent offshore diversification.

These events have left a distorted view of risk – where shares are perceived as risky and fixed interest as safe irrespective of the credit worthiness of the issuer or their underlying application of funds. Now that eighteen finance companies are in receivership or subject to moratoria those views will no doubt be re-framed. The Reserve Bank in its May 2008 Financial Stability Report notes that the direct loss to creditors will range between \$625m at the most optimistic to \$1,060 million (between 40% and 70% of total exposure).

Failure to secure quality independent advice has cost many who can ill afford it dearly. Invariably too much emotion is present in investment decisions – greed entices market entry at the top of a bull run and in fear the same investors bail out following a market downturn. Most people need to be saved from their own reactionary tendencies.

Credit risk can be likened to a submerged reef. Your boat has a high probability of safe passage while the tide is in, but the risk of foundering increases dramatically when the tide goes out. The change in the tide of economic circumstance affecting finance companies lending to the property development and consumer finance markets is evident. This, coupled with the loss of debenture holder confidence in the overall finance company sector wrought by the initial failure of the most vulnerable finance companies, and consequent dwindling of new

fund inflows, has left an increasing number of depositors exposed.

The long term rewards for disciplined and prudent investment are very healthy. However, the investment experience of many people over the years has been quite different. The essential mantras for wise investment have been well established over decades of academic research in the field of finance. Essentially: (1) Asset allocation (where you broadly spread your funds) determines returns not picking individual winners or timing the market; (2) Risk and return are related, make sure you can quantify the risk exposure and that you get paid for the risk you take; (3) Diversify, diversify, diversify – by asset class, geographic region and security numbers; and (4) Fees, tax and other costs matter - identify all the layers of costs deducted from your returns in both good and bad years.

Many finance company investors broke all of these key tenets of portfolio theory and prudent money management.

To put all this together in an efficient and meaningful manner in today's sophisticated investment marketplace is not a DIY job. But be discerning about the quality of the advice you seek and be prepared to pay appropriate professional fees – the cleanest way to achieve this transparently is via a 'fee only' adviser, rather than a commission driven salesperson. A good adviser will be able to explain why an investment structure is appropriate for you and transparently demonstrate how it is implemented. Take the opportunity to learn and be an educated investor, not someone reliant on the personality of your adviser or some back room process that is too complex to explain.