

## Capital Markets and the Case for Rational Patriotism

There has been much talk recently about the strength of New Zealand's domestic economy and its resilience in the face of a major global economic downturn. Our economy is growing steadily; business confidence is up and, for the first time in many years, New Zealanders are feeling decidedly pleased about their place in the world and their ability to succeed.

Yet despite this air of positive anticipation, New Zealanders seem to be ignoring the fact that to sustain such growth, and move back up the OECD ladder (current rank 22), we need significant and sustained capital investment in our domestic markets. International research has proven a strong link between capital domestic market strength and national growth. Quite simply, the stronger your domestic market, the better your overall economy. The links are obvious. When capital markets expand, capital is available for local companies to invest. As these local companies make investments, they create more jobs and more growth. Conversely, if there is no investment in new projects, there will be no growth. For there to be investment in new projects, there has to be a supply of domestic capital, and this needs a set of investment strategies by local investors that supply capital to the local market.

By international standards, New Zealand has a low savings rate. This puts even more emphasis on the need for capital market investment. Yet, ironically for the past decade our investment strategies have not come close to international best practice in this area. More than any other OECD country, New Zealand public and private money has been systemically invested offshore, ignoring the capital needs of our home market. This has resulted in not only horrendous returns on our investments, leaving New Zealanders much poorer, but has left local companies starved of capital compared to their foreign counterparts. These strategies have directly contributed to our low slide in the rankings, and unless New Zealand addresses this, it risks sliding further.

At present New Zealand fund managers own a mere 15% of our domestic market (compared to the Australian market where domestic fund managers own greater than 40% of the market). Worse still, money invested on behalf of all New Zealanders (e.g., the Government Superannuation Fund (GSF) and local Community Trust monies) is massively invested offshore. Apart from New Zealand, Holland is the only OECD country with greater than 20% invested offshore. Most other OECD countries mandate a certain minimum level of investment in their own market. In fact, some countries believe so deeply in the benefits of domestic investment, that they mandate similar criteria for private money. Canada, for example, caps private pension fund investment at 30% offshore – 70% of money must be invested locally.

Our aversion to domestic investment seems all the more odd when you compare NZSE returns over the last 10 years with their global counterparts. NZSE40 Gross has returned to shareholders 10.2% over this period - more than the FTSE, MSCI, Nikkei and the German DAX. It has also been one of the least volatile public markets, which means that, not only are the returns from investing domestically higher, but the variation, and hence the risk, is lower.

Australia provides a classic example of the power of domestic investment. Australia began investing significantly in its local markets with the introduction of its forced savings regime in 1992 and, as a result, its economy has grown at almost 4% per annum over the last 10 years (compared to its previous 10 year average of 3.0%<sup>\*</sup>). Cumulatively, this 1% per year differential has resulted in

greater than \$210 billion of wealth creation every year. Indeed, their Treasurer, Peter Costello, has said that the Australian economy grew on the back of a capital market expansion. This is true of nearly all sustained expansions in history. Thus, it is highly unlikely that a sustained period of higher growth in New Zealand will be achieved unless there is a sustained market expansion to underpin it. Were this to occur, and NZ to match Australia's performance it would result in an extra \$15 billion annually for the New Zealand economy.

So, how did a proud country like New Zealand that typically backs itself, end up backing everyone else's economy? While there are a few contributing causes, in my opinion one of the main reasons lies in the nature of the advice given to the gatekeepers of our nation's trust funds and crown entities.

A number of these entities are advised by US-based investment companies, headed by actuaries whose focus is to continually rebalance their portfolios against strict and aggressive offshore criteria. This occurs despite the dismal performance of global markets over the past 3 years and in total disregard of New Zealand's own strong performance. I understand that one such company (the Frank Russell Company) advised the Government Superannuation Fund to invest more than 50% of all money in offshore markets (compared to an estimated 5% in the New Zealand sharemarket). Thankfully, at the time of writing, this advice has only been partially implemented, but on current prices has still cost New Zealand taxpayers more than \$280m in unrealised losses over the last 12 months. (I also believe the GSF may be reassessing its investment strategy).

I also understand that in most instances, these fund managers mandate the greatest proportion of funds be invested in global rather than local securities for all the community trust and other groups they advise. The results speak for themselves.

The negative impact on the New Zealand economy is very significant and it's a story that more New Zealanders need to take notice of. With so little of our money going into New Zealand, there's little chance that New Zealand capital will end up helping New Zealand companies to generate productive job-producing investment, and grow. If New Zealand is to achieve sustainable growth, I believe that as a country, we must break this vicious circle.

What this means is that New Zealand needs a radical rethink of our investment strategies. Instead of the approach being "what does Investment Advice 101 say," or "why should I bother investing in NZ?", my view is that the question should be "how much can I invest in New Zealand without sacrificing returns or making my investment more risky, before I put it offshore?" If this framework were used, instead of the model described above, we would have up to 3 times the amount invested in New Zealand companies. Moreover, this would have resulted in significantly improved returns to investors, who have been systematically disadvantaged by putting far too much money offshore.

To address the legitimate need for diversification, it is my view that diversification is an art, not a science, and while there are certain guidelines, there is no such thing as a model that spits out the right answer. Instead, the right answer is actually a range, and the range itself is quite dependent on the inputs used. For example, if you use 100 year returns on the US market versus the last 10 years, you get quite a different answer. My best estimate is that a large (i.e., \$1 billion plus) fund, can be fully diversified with only 30% of total assets offshore. To address the issue of whether the

New Zealand markets can actually absorb this much money, we believe, for example, that up to 30-40% of the Cullen Fund could be invested in the New Zealand market without affecting returns. Moreover, given the Government stated dual goals of strengthening the capital markets and maximising returns, this would be appropriate.

The good thing about this issue is that it is not some academic debate that you can't do anything about. In my opinion the steps are clear. Funds and trusts that have employed the advice of an advisor who suggests that the majority of money be put offshore should very strongly challenge that advice. If there are only 3-5 NZ fund managers that make these advisors "cut" you should ask why. You should also challenge why some of the off shore funds that have performed horribly, are on the list. Those advisors should be made to explain what the downside scenarios are in the context of the benefits - the most obvious being the tax advantages - that might be gained by investing off shore. They also need to explain why, when offshore investment is more costly to execute (typically another 0.5%) and has higher custody and legal fees as well as exchange rate risk, they are ignoring the New Zealand market.

New Zealand needs that money to grow and, given our market's performance over the last decade, it's time to reconsider the levels of domestic investment in our country and our companies. We have some fantastic local companies performing brilliantly against a depressing international landscape and they need our support. This is about looking after our own destiny as a country.

*\* Reserve Bank of Australia - <http://www.rba.gov.au/Statistics/Bulletin/G09hist.xls>*