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# Taking Stock

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Winter 2011

# WELCOME



**“Congratulations to our investment teams who contributed to AMP Capital’s third and consecutive win as Morningstar Fund Manager of the Year – New Zealand.”**

→ Welcome to the Winter issue of Taking Stock 2011. The past six months have continued to be a volatile and uncertain ride for investors. Since the last edition, we have had more extreme global events, including the earthquake and nuclear reactor problems in Japan, the political turmoil in the Middle East and the European sovereign debt crisis that reared its ugly head again with renewed intensity. But it’s not all doom and gloom, the current soft patch has been driven by temporary factors, for the most part.

Locally, New Zealand economic activity is showing signs of strengthening and is expected to pick up over the second half of this year – just in time for the Rugby World Cup and the start of Spring.

*“The winner is the chef who takes the same ingredients as everyone else and produces the best results.”* Edward de Bono’s quote could be quite a fitting metaphor for the funds management industry. If asset classes are the ingredients, and fund managers are the chefs – then asset allocation is the recipe for producing the best results. But how important is asset allocation in determining the performance of a particular portfolio relative to its peer group? What is the difference between the various types of asset allocation and how are they implemented by the fund manager? Our lead article, “Allocation, Allocation, Allocation”, looks at different approaches to asset allocation, and the facts and fallacies in the investment industry surrounding this investment strategy.

It delights me to again extend congratulations to our investment teams who contributed to AMP Capital’s third and consecutive win as Morningstar Fund Manager of the Year – New Zealand. This is what the judges had to say: *“This is the third consecutive year AMP Capital has taken out the top award. The manager was also a finalist in the fixed interest, domestic equities, and international equities award categories, and has ably demonstrated how consistency in performance is the key to long-term results. Head of Equities Guy Elliffe and Head of Fixed Income Grant Hassell have shown that a tried and tested process executed by talented and stable investment teams will continue to produce top-notch results for investors.”*

» Graham Law  
MANAGING DIRECTOR

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# NEWS

## AMP CAPITAL APPOINTS CHIEF INVESTMENT OFFICER AND CHIEF ECONOMIST

AMP Capital Investors continues to build capability within its funds management business in New Zealand with the appointment of Peter Verhaart to the newly created role of Chief Investment Officer, and Bevan Graham to the role of Chief Economist, New Zealand. Peter will report to David Kiddie, Head of the Multi Asset Group (based in Sydney) and Bevan reports to Peter. Peter Verhaart and Bevan Graham's appointments reflect the deep talent pool created by the merger of AMP and AXA (earlier this year). They both have integral roles in AMP Capital's current funds management business, and will work with the Fixed Income and Equities teams, as well as the wider AMP Capital Multi Asset Group to expand the strength of capability across AMP Capital for our New Zealand clients.



## MANAGER CHANGES

Lazard Asset Management has been added to the Emerging Market Share Fund's manager line-up reflecting the Fund's refinement of strategy. Lazard Asset Management is a quantitative manager with a defensive focus, seeking quality, undervalued names with superior growth potential.



Two new managers – Enhanced Investment Technologies (EIT) and AQR Capital Management – have been added to the Enhanced Index International Share Fund (which forms part of the AMP Capital Global Shares Fund via the Future Directions International Shares Fund). EIT employs a differentiated stochastic process that combines stocks which exhibit some relative volatility, but are lowly correlated, in a more efficient configuration than the benchmark. AQR Capital is a quantitative manager that combines top-down and bottom-up processes, with some valuation and momentum features.

AMP Capital's Core Global Shares Fund and Core Hedged Global Shares Fund both invest into the Future Directions Core International Share Fund, and there has been a change to the underlying manager mix within that Fund. The Technical Opportunities strategy, managed by Wellington Management, has been replaced with a shareholder yield-driven strategy managed by Epoch Investment Partners, a NASDAQ Global Select Market listed specialist equities boutique.

## PERFORMANCE MEASUREMENT DURATION CHANGES

For a number of our funds we are changing the duration over which performance is measured reflecting a longer term outlook being taken by the managers of the funds. The gross return duration has been changed from a rolling 12 month basis to a rolling three year basis for the AMP Capital Global Shares Fund, Core Hedged Global Shares Fund and Hedged Global Fixed Interest Fund. The gross return duration has been changed from a rolling three year basis to a rolling five year basis for the Responsible Investment Leaders Global Shares Fund.

## INDEX CHANGE

The Extended Markets Global Shares Fund has replaced the Citigroup Extended Markets Index with the S&P Developed Small Caps Index.

## FEE CHANGES

An increase in brokerage fees has meant that we have had to make changes to entry and exit fees of some of the AMP Capital Funds. Within the diversified range of the AMP Capital Investment Funds these changes apply to the Conservative, Balanced and Growth Funds. In the single sector funds, these changes apply to the NZ Shares, Strategic NZ Shares, NZ Equity Opportunity and Listed Property Securities Funds. In the case of the diversified funds this has meant a decrease in the entry and exit fees. A complete list of exit and entry fees for all the funds are published under Prices and Performance at [ampcapital.co.nz](http://ampcapital.co.nz)



In the property market, they say the key to success is location – pick the right location and you are sure to benefit from capital appreciation in the medium to long term. In the capital markets, the key to success seems to be **ALLOCATION, ALLOCATION, ALLOCATION.**

Or is it?

#### THE FALLACY

One of the biggest fallacies in the investment industry seems to be that “Asset allocation determines 93.6% of the difference in returns between portfolios”. Many investment industry professionals quote this figure and this belief stems from the misinterpretation of the results of one of the most highly debated studies in investment history, namely the “Determinants of Portfolio Performance” conducted by Gary Brinson, Randolph Hood and Gilbert Beebower in 1986 (“BHB”). This view has been put forward by a number of critics of the BHB study, including Roger Ibbotson, investment professional and a professor in practice at the Yale School of Management, who is one of the most preeminent authors on asset allocation.

Despite his criticism of the BHB study and conclusion however, his own studies also deduce that asset allocation is definitely a key driver of the difference in performance between funds, it just does not account for 93.6% of the return.

Reading through a lot of the research, it appears we can continue with the premise that a key driver of performance is asset allocation, yet it seems we should not underestimate the importance of active portfolio management simply as a result of the BHB study.

#### ASSET ALLOCATION IN SIMPLE TERMS

Asset allocation is an investment strategy that aims to optimise portfolio returns, while managing financial risk. In essence it is the distribution of capital across different asset classes including shares, bonds and cash, based on the expected returns for each of those asset classes. Holding a variety of assets that are non-correlated lowers portfolio risk because not all securities, industries or markets move at the same time. It is simply a case of not putting all your eggs in one basket.

In his book “Understanding Asset Allocation”, Scott Frush compared the benefits of asset allocation to the protective equipment, like helmets, knee pads and shoulder pads, used in ice hockey. Without this protective gear, the player would probably be able to skate faster, pass the puck more easily and almost certainly shoot more goals. However the risks would make that a worthless exercise since one hit into the boards by an opponent would leave him injured and possibly out of the game for a long time. It is clearly not worth the risk.

Asset allocation is to investors what the protective gear is to ice hockey players in that it protects their portfolios from volatile markets and enhances long term risk-adjusted returns.

So how important is asset allocation in determining the performance of a particular portfolio relative to its peer group? Strategic asset allocation (SAA) is the traditional form of asset allocation which refers to the long term or benchmark allocation of capital to each asset class in an investment portfolio. Most of the research relates to SAA.

#### WHAT THE RESEARCH SAYS

The methodology BHB (1986) used replaced the actively managed investments in 91 pension plans with market indexes over the period 1974-1983. The objective was to see how much of a particular fund’s increases and decreases were explained by its SAA. They concluded that SAA accounts for 93.6% of the average fund’s return *variance* over time. Many people have misinterpreted this statement omitting the word variance and claim that 93.6% of investment returns come from SAA, which is incorrect.

There have been many critics of the BHB study. Roger Ibbotson and Paul Kaplan (2000) sum up the issue explaining that the BHB (1986) result does not apply to the actual return level, but only to the variation in return within one particular fund.

It answers the question 'How much of the variability of returns across time within a particular fund is explained by SAA?'

The BHB study does not answer the more pertinent question which is 'How much of the difference between the performance of two funds in a peer group is explained by their differences in asset allocation?' That question is significantly more relevant to us as investors in a portfolio. If the fund we have invested in underperforms compared to other similar funds, we want an explanation.

Ibbotson and his team conducted two studies of their own, the first in 2000 and the second in 2010. The results of their studies are a lot more practical and applicable to investors. The purpose of the studies was to answer the question 'Is the difference in returns between funds the result of strategic asset allocation or active portfolio management?'

Ibbotson, Xiong, Idzorek and Chen (2010) explain that a portfolio's total return consists of three components:

- 1) The return from the overall market movement.
- 2) The asset allocation return of the specific fund in excess of the market return.
- 3) The return or alpha from active portfolio management, which comprises timing, stock selection and fees.

Roger Ibbotson and Paul Kaplan (2000) examined 10 years of monthly returns in 94 US balanced mutual funds and five years of quarterly returns in 58 pension funds<sup>1</sup>. They excluded the return from the overall market (1) and compared the asset allocation return (2) to the return from active portfolio management (3).

They concluded that 40% of the difference in return between funds was explained by asset allocation and 60% of the difference in return between the funds was explained by other factors such as asset class timing, style within asset class, security selection and fees. In the mutual funds 35% of the difference in returns was attributable to asset allocation.

Ten years later Ibbotson, Xiong, Idzorek and Chen (2010) conducted further research in which they also removed the effect of the market movements and with that excluded as a component of return, they concluded that asset allocation and active management are equally important in determining portfolio return differences within a peer group.

Ibbotson (2010) explains the difference saying that Ibbotson and Kaplan (2000) and HEI (1991) excluded the return from the overall market (1) and compared the asset allocation return (2) to the active portfolio management return (3). By comparison, BHB (1986) simply combined the return from the overall market with the asset allocation return (1 and 2) and compared them with the active portfolio return (3). That is where the confusion in the market arose.

Whether BHB and Ibbotson and his team agree or not, the message from the research remains very clear. Either way you look at it, asset allocation remains a key driver of performance.

So what is the difference between the various types of asset allocation and how are they implemented by portfolio managers in a fund?

#### STRATEGIC ASSET ALLOCATION (SAA)

As investors, we are usually aware of the more traditional form of asset

allocation known as strategic asset allocation. Strategic asset allocation refers to the long term or benchmark allocation of capital to each asset class in a portfolio, based on expected rates of return for each asset class. SAA is primarily concerned with the long term return and risk objectives of the investor. Balanced funds use SAA to allocate capital across stocks, bonds and cash offering investors a good mix of assets.

The SAA approach assumes that there is a constant long term return differential between each asset class which implies there is a constant risk premium between bonds and cash or between shares and bonds. Fundamentally, this approach implies that markets are always efficient and that the real return expectation from any particular level of share prices or bond yields is always the same. As a result, the SAA can be set on a once-only basis and there is nothing to be gained by varying it. This concept supports the theory of 'time in the market' rather than 'market timing'.

#### TACTICAL ASSET ALLOCATION (TAA)

Although useful for a balanced portfolio, SAA is a fairly rigid strategy over the long term. Recent history in the capital markets clearly proves that markets are not efficient and the expected real return for each asset class is not always the same. As a result, fund managers often find it necessary to engage in short term, tactical deviations from the mix in order to benefit from certain investment opportunities. This flexibility adds a component of market timing to the portfolio, which is often used when short term economic conditions are more favorable for one asset class than for others. This strategy is called tactical asset allocation. Once the short term opportunity has run its course, the portfolio is rebalanced to the original long term SAA.

#### DYNAMIC ASSET ALLOCATION (DAA)

In simple terms, dynamic asset allocation is a strategy that changes in response to changing market conditions. This approach assumes that markets are not efficient and as a result the starting point valuation or price at which capital is invested in any asset

*"Whether BHB and Ibbotson and his team agree or not, the message from the research remains very clear. Either way you look at it, asset allocation remains a key driver of performance".*



JAMIE ROACH / SHUTTERSTOCK.COM

*"Asset allocation is to investors what the protective gear is to ice hockey players" – Scott Frush.*

class will dramatically affect the return achieved over relevant time horizons, both on a relative and an absolute basis. It assumes that investors cannot wait 20 years to get a long term target rate of return and that the asset allocation should be set based on a much shorter time horizon using currently available valuations as a starting point.

According to proponents of DAA, SAA strategies have failed investors in recent years with portfolios experiencing increased volatility. This volatility is driven by strategies that only take into account the long term returns for each asset class, while failing to consider current market forces.

DAA is a very active portfolio management strategy and unlike SAA and TAA strategies, DAA does not include any fixed ratio between investments.

Portfolio managers using DAA constantly look for more profitable asset classes with respect to current

market direction and performance. They diversify their investments on different financial instruments like shares, derivatives, mutual funds, index funds, fixed income securities and money market funds. They change the asset allocation frequently, buying instruments which are rising, and selling instruments which are losing.

When DAA is implemented effectively, investors should experience a smoother, more consistent pattern of returns over the long term and are less likely to suffer large losses during unexpected or extreme financial market shocks.

#### ALLOCATION, ALLOCATION, ALLOCATION

Whichever way we look at it, effective asset allocation is one of the keys to success in capital markets since the research shows that it accounts for between 35% and 50% of the difference in return between portfolios. Returning

to our analogies, it is simply not worth the risk of going into the ice hockey game without protective gear. In the property market, location is the key to success, but it is certainly not the Holy Grail of property investment. If you bought a leaky home it wouldn't matter that it was on the cliff top overlooking the sea in the best area, you could still stand to lose a lot of money. In the same way, asset allocation is a key driver of performance, yet it remains vitally important to select experienced portfolio managers with a good track record of active portfolio management.

<sup>1</sup> Roger Ibbotson and Paul Kaplan (2000) carried out a cross-sectional regression of compound annual total returns for the entire period on compound annual asset allocation policy returns.

***"Risk is good. Not properly managing your risk is a dangerous leap."***

Evel Knievel, Motorcyclist/Stuntman

## MANAGING YOUR RISK

Many individual investors are obsessed with finding 'superstar' stock picks, completely ignoring the balancing act needed for long term wealth generation. It is possible to pick a winning horse on the odd occasion, but can anyone do it every day? Probably not, which is why gambling is a loser's game.

Investment success is all about managing risk and that's why Strategic Asset Allocation (SAA) is the key to achieving financial goals. Everyone would like to turn a \$100 investment into \$10,000, but when deciding on asset allocation, it is important to be realistic about the return expectations. Investors that are too greedy for a high return are likely to take too much risk chasing it and end up with nothing.

Generally, younger investors can be more aggressive and let the magic of compounding work for them, while older investors need to take a more conservative approach especially as they near retirement.

A time-honoured investment adage is that the investor's asset allocation should mirror their age. Simply subtract the investor's age from 100 and invest that percentage of their savings into stocks. Investors who are 40 years old, should invest 60% of their portfolios in shares and the remaining 40% in bonds and cash.

Although this rule of thumb provides a rough guideline and can be useful in determining the asset allocation of an investor's retirement savings, it is also important to take into account the investor's individual situation, their own tolerance for risk and their short and long term goals.

If the investor's goal is to own a retirement house on the beach in 15 years' time, short term fluctuations in the stock market are not a concern. Tilting the asset allocation towards growth assets that are more risky, but should generate higher returns over the long term, is more likely to achieve that goal. In this case, the portfolio needs to have a higher weighting in stocks, real estate, commodities, listed property trusts and private equity.

If the investor's daughter is going to university in five years and the portfolio needs to generate funding for this short term goal, it would be prudent to tilt the asset allocation away from high risk/high return assets, towards lower risk assets, like fixed income investments. This asset class is well suited to meeting short term goals and offers far less probability of the investor losing any of their capital.

Together with a financial adviser, investors need to determine their overall SAA. It is important to remember that SAA stands for strategic asset allocation, not static asset allocation and it needs to be reviewed regularly. Life is constantly changing and so will each individual investor's goals. To ensure their investments are well positioned, investors should review their SAA annually, taking into account any significant changes to their financial position and their aspirations.

***"The average long term experience in investing is never surprising, but the short term experience is always surprising. We now know to focus not on rate of return, but on the informed management of risk."***

Charles Ellis, Investment Policy, 1985

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# Safe and stable ...

## Now that's a good investment option

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Given the volatility in global markets over the past few years, it is good to know there are stable, safe investments out there that can generate good long term returns and offer diversification in an investment portfolio. Compared to traditional asset classes like shares and bonds, global listed infrastructure is a relatively new asset class so many investors don't know much about the benefits it offers.

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Infrastructure funds were launched in Australia in the 1990s, when a debt-laden government turned to capital markets to fund the development of public works. At the same time, the national pension insurance funds became compulsory in Australia and these pension funds liked the stable long term returns that the infrastructure funds could deliver. As a result, the pioneers in infrastructure investing were the Australian financial institutions. The research varies, but it seems that the first infrastructure fund in the world was launched in 1993 by US based, Conduit Capital Partners, while leading UK infrastructure investment group Innisfree, set up the first European infrastructure fund in 1996.

Less than two decades later, global infrastructure is a significant, highly liquid market with the market capitalisation estimated to be worth more than US\$2.4 trillion as at 31 December 2010, according to Australian based, RARE Infrastructure.

Globally, governments are reducing their investment in public infrastructure assets, which has created this relatively new asset class for investors. In the last few years many new specialist infrastructure funds have been launched, providing investors with a range of opportunities to invest in the public assets that governments have sold. These infrastructure funds allow individual investors to own a part of a portfolio of infrastructure assets they wouldn't usually have access to.

Infrastructure basically covers four sectors. Transport (including toll roads, airports, ports and rail), utilities (including electricity, gas and water), social (including healthcare, education and aged care) and communications assets (including mobile phone towers, cable networks and broadcast networks). Returns from listed infrastructure funds generate returns in a similar way to listed property funds, through a combination of capital growth and income.

***“Market commentators are expecting a rapid infrastructure build-out in the developing markets. The Asian Development Bank estimates that over the next 10 years, developing Asian countries will require \$20-30 trillion in infrastructure spending.”***



#### SAFE AND STABLE

Global listed infrastructure is inherently a safe and stable investment because the underlying companies provide essential services like gas, electricity, water, roads and airports to communities. Countries need these services to operate and prosper over the long term and society can't survive without them.

Infrastructure assets are protected from inflation because the price a consumer pays to use these assets is usually linked to inflation. With its inflation-protection and essential service attributes, global infrastructure has a low correlation to other equities.

Given the defensive nature of global infrastructure, investors are increasingly viewing this asset class as a critical element of their investment strategy. Banks, pension funds and private investors are looking to infrastructure as a new, long term, inflation-linked asset class that offers a combination of hard assets and solid long term earning streams.

#### BENEFITS

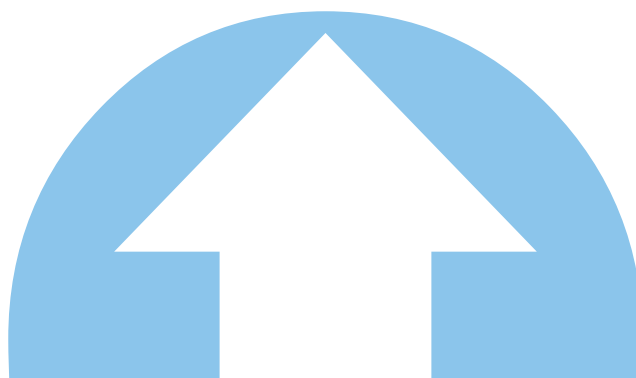
Global infrastructure assets are usually very resilient to economic conditions and demand is largely predictable because they provide essential services. As a result, investors have more certainty of underlying cash flows, earnings and dividends. Many global infrastructure assets, such as utilities, have legal or economic market monopolies meaning their returns are not subject to competitive market forces.

Global infrastructure assets, especially the more mature ones, generally offer comparatively higher yields, in the form of dividends, because of the predictability of long term cash flows and earnings.

The main benefits of investing in global listed infrastructure are:

- Longevity and stable returns
- low volatility
- low maintenance and fixed operating costs
- low correlation to other asset classes including global equities
- protection from inflation
- diversification across geographic regions, sectors and securities
- access to a growing asset class, and
- liquidity.

Global infrastructure funds offer investors a range of infrastructure assets managed by professional portfolio managers. The low correlation of these assets with more traditional asset classes gives investors the opportunity to reduce the overall risk of the portfolio by allocating a portion of the capital to these assets.





*“Infrastructure assets are protected from inflation because the price a consumer pays to use these assets is usually linked to inflation. With its inflation-protection and essential service attributes, global infrastructure has a low correlation to other equities.”*

#### RISKS

Generally, the risk characteristics of infrastructure assets fall in between those of bonds and shares. According to Standard & Poor's, the main risks in listed infrastructure are a shortage of project management talent, proper financial management of highly leveraged projects and foreign currency risk.

Many infrastructure businesses are subject to governmental oversight and regulation, with the result that there are often caps on earnings and rate increases that must be approved by the relevant government agencies before they can be implemented.

The sharp growth expected in infrastructure development has led to a shortage of qualified project management talent and experienced firms. Infrastructure projects are often highly leveraged, so interest rates and debt refinancing need to be managed properly. In addition, the debt and revenues might be in different currencies exposing investors to foreign exchange risks.

#### THE FUTURE

The emphasis on infrastructure spending in the various stimulus programmes being applied by governments around the world is likely to further promote growth in the sector, where many of these projects will be undertaken in partnership with the private sector. Market commentators are expecting a rapid infrastructure build-out in the developing markets. The Asian Development Bank estimates that over the next 10 years, developing Asian countries will require \$20-30 trillion in infrastructure spending. This gives a good indication of the scope of future projects.

Despite severe economic and financial pressures, research shows that infrastructure investment is still a sound long term investment option as it provides investors the opportunity to invest in lower risk, asset-backed ventures that also meet increasing global infrastructure investment needs. By all accounts, it doesn't seem as if the reasons to invest in global listed infrastructure are going to change any time soon.

#### AMP CAPITAL'S CAPABILITY

AMP Capital is one of the longest standing and most experienced infrastructure investment managers with more than 20 years of experience. We first invested in direct infrastructure in 1988 when AMP participated in the financing of the Sydney Harbour Tunnel. AMP Capital is an experienced and active investor in Asian infrastructure with particular expertise in India and China. We also have European expertise with various assets located throughout the UK and continental Europe.

One of our key competitive strengths is our ability to source opportunities through our established networks and relationships with governments, infrastructure project operators, corporates and financial institutions.



**If you would like to talk to us about infrastructure investing, please call your relationship manager or 0800 400 499.**

# Booms, Busts and Investor Psychology

In the last issue of Taking Stock we looked at how volatile times, including specific disruptive events, can contribute to a nervous national psyche. This nervousness can be shared by investors as well as consumers, producers and manufacturers. A nervous consumer will probably make conservative decisions – in terms of spending and saving. A nervous investor will be similarly affected but may also make illogical investment decisions taking a short term view. Conversely, in this update, Dr Shane Oliver looks at the other side of the fence - how investment markets are driven by more than just fundamentals and that investor psychology plays a huge role and helps explain why asset prices go through periodic booms and busts.

## INTRODUCTION

Up until the 1980s the dominant theory was that financial markets were efficient. In other words, all relevant information was reflected in asset prices and in a rational manner. While some think it was the Global Financial Crisis that caused faith in the so-called Efficient Markets Hypothesis (EMH) to begin unravelling, this actually occurred in the 1980s. In fact it was probably the October 1987 crash that drove the nail in the coffin of the EMH. It was virtually impossible to explain why US shares fell over 30% and Australian shares fell 50% in a two month period, as there was very little in the way of new information to justify such a massive downward move.

It's also hard to explain (on the basis of fundamentals only) the 80% slump in the tech heavy Nasdaq index between 2000 and 2002. Sure, there was an economic downturn and decline in IT demand at the time – but this is normal

and should have been allowed for in setting share prices.

Study after study has shown that share market volatility is way too high to be explained by investment fundamentals alone. Something else is obviously at play, and that is investor psychology.

## INVESTOR PSYCHOLOGY

Several aspects of investor psychology interact in helping drive bull and bear phases in investment markets, including individual lapses of logic and crowd psychology.

## INDIVIDUALS ARE NOT RATIONAL

Numerous studies by psychologists have shown that people are not rational and tend to suffer from various lapses of logic. The most significant examples are as follows:

- **Extrapolating the present into the future** – people tend to downplay uncertainty and assume recent trends, whether good or bad, will continue.
- **Giving more weight to recent spectacular or personal experiences in assessing the probability of events occurring.** This results in an emotional involvement with an investment strategy – if an investor has experienced a winning investment lately he or she is likely to expect that it will remain so. Once a bubble gets underway, investors' emotional commitment to it continuing steadily rises, and this helps to perpetuate it.
- **Overconfidence** – people tend to be overconfident in their own investment abilities. This is particularly the case for men.
- **Too slow in adjusting expectations** – people tend to be overly conservative in adjusting their expectations to new information and do so slowly over



time. This partly explains why bubbles and crashes in share markets normally unfold over long periods.

- **Selective use of information** - people tend to ignore information that conflicts with current views. In other words they make their own reality. This again helps to perpetuate a bubble once it gets underway.
- **Wishful thinking** – people tend to require less information to predict a desirable event than an undesirable one. This may partly explain why asset price bubbles normally precede crashes.
- **Myopic loss aversion** – people tend to dislike losing money more than they like gaining it. Various experiments have found that a potential gain must be twice the potential loss before an investor will consider accepting the risk. An aversion to any loss, particularly in the short term, probably explains why shares traditionally are

able to provide a relatively high return (or risk premium) relative to “safer” assets like cash or government bonds.

#### THE MADNESS OF CROWDS

As if individual irrationality is not enough, it tends to get magnified and reinforced by “crowd psychology”.

Investment markets have long been considered as providing examples of crowd psychology at work. Collective behaviour in investment markets requires the presence of several things:

- **A means where behaviour can be contagious.** More than ever, investors are drawing their information from the same sources. Mass media (including the financial media) in print and electronic form are a perfect example of this. This behaviour, in turn, results in an ever increasing correlation of views amongst investors, and this reinforces any trends.
- **Pressure for conformity.** Interaction with friends, monthly performance charts, industry standards and benchmarking, all help result in a “herd mentality” among investors.
- **A precipitating event or displacement that gives rise to a general belief that motivates investor behaviour.** The IT revolution of the late 1990s or the growth in China and emerging markets are classic examples of this on the positive side. The demise of Lehman Brothers and related events setting off investor panic is an example of such a displacement on the negative side.
- **A general belief which grows and spreads** – for example, share prices can only go up or alternatively the irrational belief of homeowners and rental property investors that property values would continue to rise ad infinitum.



DR SHANE OLIVER

**BUBBLES AND BUSTS**

The combination of lapses of logic by individuals in making investment decisions and the magnification of such lapses by crowd psychology (or herd mentality) goes a long way to explaining speculative surges in asset prices. Surges develop (usually after some good news) and feed on themselves (as individuals project recent price gains into the future, exercise “wishful thinking” and receive positive feedback via the media). Of course this also explains how the whole process goes into reverse once buying is exhausted, often triggered by contrary news to that which drove the surge in the first place.

The chart below, which was developed many years ago by Russell Investments, shows pretty well how investor psychology appears to develop through a market cycle. When times are good, investors move from optimism to excitement, and eventually euphoria, as an asset’s price – be it shares, housing, gold or whatever – moves higher and higher. So by the time the market tops out investors are maximum bullish and fully invested, often with no one left to buy. This ultimately sets the scene for a bit of bad news to sooner or later push prices lower. As selling intensifies and prices fall further, investor emotion goes from anxiety to depression, and eventually capitulation and

despondency. By the time the market bottoms out investors are maximum bearish and out of the market.

This then sets the scene for the market to bottom as it only requires a bit of good news (or less bad news as is often the case) to bring back buying, and then the cycle repeats. This pattern has been repeated time and time again over the years. In the late 1990s, investor psychology became euphoric on enthusiasm for tech stocks. Broad media enthusiasm for shares was highlighted by bestselling books such as Dow 36,000 and Dow 100,000.

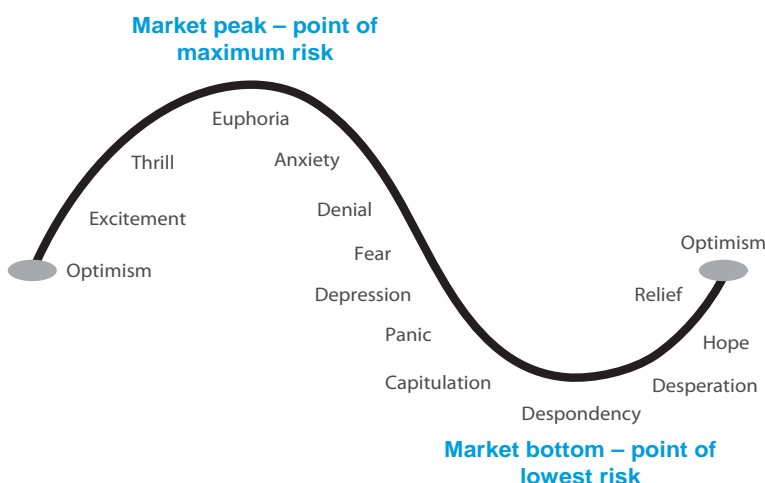
Cracks in the tech boom appeared in March 2000, leading to initial anxiety which eventually gave way to capitulation and despondency in late 2002 and early 2003.

By 2007 the spotlight of investor euphoria had reappeared but was focused on credit, the US housing market and commodities. At the depths of the Global Financial Crisis in early 2009 this again turned to capitulation and despondency with respect to most growth oriented investments, which in turn helped set the scene for the recovery in investment markets over the last two years as the GFC subsided and economic data started to improve.

There are several points to note from all this. Firstly, confidence and investor psychology do not act in a vacuum. The move from despondency at the bottom of a cycle to euphoria at the top is usually ultimately underpinned by fundamental developments, for example strong economic growth and easy monetary conditions.

Second, at market extremes confidence is best read in a contrarian fashion – major bull markets do not start when investors are feeling euphoric and major bear markets do not start when they are feeling depressed. The reason is that by the time investor confidence has reached these extremes, all those who wish to buy (or sell) have done so meaning it only requires a small amount of bad news (or good news) to

**Investor emotion through the market cycle** Source: Russell Investments



tip investors back the other way. So extreme low points in investor confidence are often associated with market bottoms, and vice versa for extreme highs. For this reason many strategists monitor investor sentiment as a guide to when market extremes may have been reached. Currently, short term measures of investor sentiment are around average levels, suggesting no strong reading either way. However, longer term measures suggest that investors are still pretty cautious towards shares, which from a contrarian perspective suggests more upside for shares over time.

#### WHAT DOES THIS MEAN FOR INVESTORS?

There are a number of implications for investors.

1. The first thing investors need to do is recognise that investment markets are not only driven by fundamentals, but also by the often irrational and erratic behaviour of an unstable crowd of other investors. Investors also need to recognise that not only are investment markets highly unstable, they can also be highly seductive. The key here is to be aware of past market booms and busts, so that when they arise in the future one does not overreact (piling into unstable bubbles near the top or selling everything during busts and locking in a loss at the bottom).
2. Investors need to recognise their own emotional capabilities. In other words, investors must be aware of how they are influenced by lapses in their own logic and crowd influences. For example, an investor should ask, "Am I highly affected by recent developments (whether positive or negative)? Am I too confident in my own expectations? Can I bear a paper loss?"

3. Investors ought to choose an investment strategy which can withstand inevitable crises while remaining consistent with their financial objectives and risk tolerance.
4. Investors should essentially stick to this broad strategy even when surging share prices otherwise tempt them to consider a more aggressive approach, or when plunging values might suck them into a highly defensive approach.
5. Finally, if an investor is tempted to trade they should do so on a contrarian basis. Buy when the crowd is bearish, sell when it is bullish. Extremes of bullishness often signal market tops, and extremes of bearishness often signal market bottoms. But investors need to recognise contrarian investing is not foolproof – just because the crowd looks irrationally bullish (or bearish) doesn't mean it can't get more so.

#### THE BOTTOM LINE

The bottom line is investment markets are driven by more than just fundamentals. Investor psychology plays a huge role and helps explain why asset prices go through periodic booms and busts. The key point for investors is to be aware of the role of investor psychology and the influence that psychological illusions can have on both the market and themselves.

Finally, some may be thinking if investment markets are not efficient and prone to swings from irrational pessimism to irrational exuberance, how can we rely on them to best allocate scarce resources throughout the economy? The answer is simple - for all their faults, free capital markets are far better at this task than centralised government bureaucracies.

*"The key point for investors to be aware of is the role of investor psychology and the influence of psychological illusions. The best defence is to be aware of past market cycles (so nothing comes as a surprise) and to avoid being sucked into booms and spat out during busts. If an investor is looking to trade they should do so on a contrarian basis. This means accumulating when the crowd is panicking, lightening off when it is euphoric."*

# Market report

There was no shortage of event risk and macro concerns over the first half of this year. The political turmoil in the Middle East led to soaring oil prices while the Japanese earthquake and reactor problems added to growth concerns. As if the worry list was not long enough, Europe's sovereign debt crisis intensified markedly as the year progressed. The risk of a Greek sovereign default rose substantially, which in turn raised worries about contagion across to countries such as Portugal and Ireland.

While these extreme events kept investors on edge and led to elevated market volatility, global economic data also weakened significantly, lowering growth prospects for 2011. US economic activity data in particular disappointed over the June quarter, raising concerns over the sustainability of the recovery. Moreover, China appeared to have entered the sour spot of its economic cycle. Growth and property price momentum slowed, but still high inflation has maintained pressure for monetary tightening which in turn proposed the risk of a hard landing. These all came at a time when shares have had strong gains since August last year and a correction was overdue.

In New Zealand, the news of the earthquake in Christchurch devastated the nation with significant loss of life and massive damage. Signs that the economy was beginning to recover into 2011 were more than offset by the quake as it caused a substantial disruption to business activity. Not surprisingly business confidence and consumer confidence deteriorated sharply immediately following the

disaster. And the Reserve Bank of New Zealand delivered an emergency rate cut of 50 basis points (bps) in March. However, over the June quarter, the New Zealand economic outlook improved notably, with local economic data showing underlying economic resilience along with rising inflation expectations. Business confidence staged a V-shaped recovery while the housing market also showed signs of recovery, led by Auckland. Residential construction activity remained subdued however, as the ongoing aftershocks in the Canterbury region have deferred the rebuild led construction recovery by another quarter.

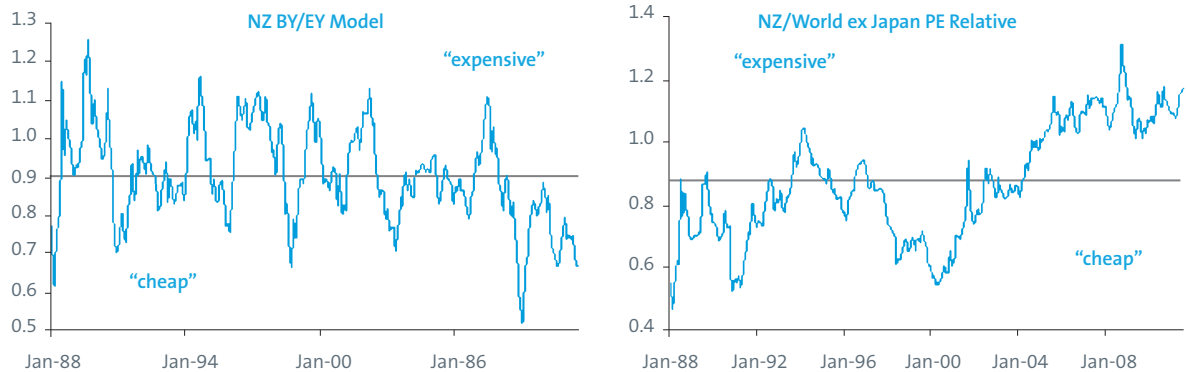
In response to a weaker global economic pulse and the deepening Greek debt crisis, risk appetite deteriorated and, despite solid performance over the March quarter, global equity markets and commodity prices lost ground over the June quarter. The MSCI World Index, the leading measure of global share market performance, still ended the first half of this year up 3.2% in local currency terms. The NZX50 Index rose 4.2% over the six months. Bonds, as safe-haven

assets, in contrast performed better, benefitting from the elevated risk aversion. New Zealand bonds performed particularly strongly with yields falling sharply over the period. The 10 year New Zealand bond yield fell 81 bps. The New Zealand dollar fell sharply following the earthquake but rallied strongly over the June quarter on the back of the strengthening economic outlook. The New Zealand dollar ended the first half of this year up 3.4% on a MSCI-weighted basis and up 2.3% on a trade weighted basis.

## OUTLOOK

Clearly global growth has lost momentum over recent months. It has been noted that the soft patch in the global economy was largely driven by temporary factors, such as Japanese supply chain disruptions, the surge in oil prices and bad weather in the US. However, with economic data continuing to remain weak, the global economy is now looking softer than we previously assumed. The downside risks for global growth have increased materially in recent weeks. Monetary policy will remain accommodative in

THE NEW ZEALAND EQUITY MARKET REMAINS GOOD VALUE RELATIVE TO BONDS BUT EXPENSIVE RELATIVE TO GLOBAL COUNTERPARTS



many economies for some time to come, to offset the global trend toward fiscal consolidation.

New Zealand's growth momentum should pick up notably over the second half of this year. Reconstruction in Canterbury is expected to boost the level of economic activity significantly over the coming years and the backdrop of strong export commodity prices and the favourable terms of trade will continue to be supportive of growth.

Downside risks to this optimism are further external shocks stemming from the European sovereign debt crisis, global economic slowdown and cautious household sector on the back of elevated household debt. Fiscal consolidation also will weigh on activity over the coming years.

While attractive valuations and easy global money are positive for shares, the worry list remains significant and so further volatility and weakness is likely for global shares in the months ahead.

Softer economic data has helped sovereign bonds in key countries perform well over the last few months as yields have fallen. Considering the

prospect that the global recovery regains momentum later this year and bond yields are already at such low levels, global bonds offer poor returns from a long term perspective. New Zealand bond yields should start to move higher fairly rapidly in anticipation of the eventual resumption in the tightening cycle.

The New Zealand dollar is likely to be broadly range bound over the coming year or so. In the near term, the strong commodity prices and improving local economic data should be supportive of the New Zealand dollar. However, the long term valuation measure suggests the New Zealand dollar is becoming increasingly overvalued.

The demanding valuation makes the currency vulnerable to external shocks and any near term pull-backs.



# AMP Capital Investment Funds

AMP Capital Investors in New Zealand manages around \$12 billion<sup>2</sup> for our clients . This update provides you with the latest information on how the AMP Capital Investment Funds suite of products are tracking. Please refer to the Investment Statement for the complete list of funds and the specific investment strategies and objectives of each fund. These funds were established as Portfolio Investment Entities from 1 October 2007 to provide investors with the tax benefits under the Government's PIE regime. Our fund performance figures are shown before tax, before fees and assumes that income is reinvested.

## AMP Capital NZ Cash Fund



ASSET ALLOCATION (FUND SIZE: \$1,723.1 MILLION)

Term Deposits: » 60.4%  
 Promissory Notes: » 17.6%  
 Floating Rate Notes: » 12.7%  
 Corporate Securities: » 1.8%  
 Local Authority Stocks: » 7.5%

FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	4.24	3.10
2 years	4.12	2.94
3 years	5.07	4.00
5 years	6.45	5.76

## AMP Capital NZ Fixed Interest Fund



ASSET ALLOCATION (FUND SIZE: \$979.2 MILLION)

Government: » 48.8%  
 Corporate Debt: » 34.4%  
 SOE's: » 1.5%  
 Local Authority: » 15.2%  
 Cash/Short Term: » 0.1%

FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	7.23	6.76
2 years	8.32	7.47
3 years	10.75	8.24
5 years	8.70	7.08

## AMP Capital NZ Shares Fund



ASSET ALLOCATION (FUND SIZE: \$307.2 MILLION)

New Zealand Shares: » 66.5%  
 Australian Shares: » 33.2%  
 Cash: » 0.3%

FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	18.34	17.51
2 years	12.44	12.42
3 years	5.68	3.95
5 years	3.14	0.75

## AMP Capital Strategic NZ Shares Fund



ASSET ALLOCATION (FUND SIZE: \$529.5 MILLION)

New Zealand Shares: » 92.6%  
 Australian Shares: » 6.1%  
 Cash: » 1.3%

FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	15.15	16.14
2 years	11.87	13.25
3 years	5.47	4.45
5 years	2.55	0.30

## AMP Capital Equity Opportunity Fund



ASSET ALLOCATION (FUND SIZE: \$7.4 MILLION)

New Zealand Shares: » 75.0%  
 Australian Shares: » 24.1%  
 Cash: » 0.9%

FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	21.47	5.36
2 years	17.80	5.02
3 years	12.94	6.10
5 years	-	-

<sup>2</sup> As at 30 June 2011

### AMP Capital NZ Property Fund



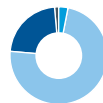
#### ASSET ALLOCATION (FUND SIZE: \$225.1 MILLION)

Direct Property » 99.6%  
Listed Property: » 0.0%  
Cash/Other: » 0.4%

#### FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	-0.30	na
2 years	-11.54	na
3 years	-14.65	na
5 years	-0.65	na

### AMP Capital NZ Enhanced Yield Fund



#### ASSET ALLOCATION (FUND SIZE: \$38.5 MILLION)

Government » 0.0%      Local Authority: » 22.3%  
SOE's: » 3.3%      Cash/Other: » 1.3%  
Corporate Debt » 73.1%

#### FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	5.68	3.10
2 years	7.54	2.94
3 years	6.71	4.00
5 years	-	-

### AMP Capital Hedged Global Fixed Interest Fund



#### ASSET ALLOCATION (FUND SIZE: \$128.5 MILLION)

Treasuries » 49.8%      Securitized: » 19.9%  
Government-Related: » 7.4%      Other: » 1.7%  
Corporate » 17.5%      Effective Cash: » 3.7%

#### FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	6.79	4.95
2 years	13.33	7.62
3 years	10.55	8.79
5 years	8.24	8.67

### AMP Capital Global Shares Fund



#### REGIONAL ALLOCATION (FUND SIZE: \$160.6 MILLION)

North America: » 44.2%      UK: » 10.2%  
Japan: » 5.6%      Asia Pacific: » 3.3%  
Continental Europe: » 19.7%      Other: » 17.0%

#### FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	20.23	19.45
2 years	15.9	14.83
3 years	-0.16	0.14
5 years	-0.01	-0.04

### AMP Capital Core Global Shares Fund



#### REGIONAL ALLOCATION (FUND SIZE: \$334.7 MILLION)

North America: » 44.3%      Asia Pacific: » 6.9%  
Japan: » 4.6%      Cash: » 4.6%  
Continental Europe: » 25.0%      Other: » 2.3%  
UK: » 12.3%

#### FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	9.38	8.67
2 years	7.03	6.21
3 years	-3.99	-2.23
5 years	-	-

### AMP Capital Extended Markets Global Shares Fund



#### REGIONAL ALLOCATION (FUND SIZE: \$89.1 MILLION)

Japan: » 5.1%      UK: » 3.1%  
Emerging markets: » 30.3%      Asia Pacific: » 4.2%  
Continental Europe: » 12.8%      Cash: » 4.0%  
North America: » 36.9%      Other: » 3.6%

#### FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	12.44	11.58
2 years	10.88	12.70
3 years	1.35	2.26
5 years	-	-

### AMP Capital Responsible Investment Leaders Global Shares Fund



#### MANAGER ALLOCATION (FUND SIZE: \$12.9 MILLION)

Henderson Global Investors: » 30%  
Global Currents Investment Management: » 30%  
Lazard Asset Management: » 30%  
Colonial: » 10%

#### FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	19.64	19.45
2 years	15.61	14.83
3 years	1.97	0.14
5 years	-	-

### AMP Capital Global Property Securities Fund



#### REGIONAL ALLOCATION (FUND SIZE: \$168.1 MILLION)

North America: » 54.0%      Australia: » 12.4%  
 Europe: » 17.1%            Other: » 3.6%  
 Asia: » 12.9%

#### FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	39.10	38.48
2 years	40.78	40.51
3 years	4.15	2.15
5 years	-	-

### AMP Capital Conservative Fund



#### ASSET ALLOCATION (FUND SIZE: \$499 MILLION)

NZ Cash: » 26.1%      Australian equities: » 1.1%  
 NZ fixed interest: » 30.2%      Global shares: » 16.0%  
 Global fixed interest: » 17.7%      NZ property: » 2.3%  
 NZ shares: » 4.9%      Global property: » 1.9%

#### FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	8.66	7.72
2 years	7.87	7.41
3 years	6.95	5.06
5 years	6.85	5.32

### AMP Capital Balanced Fund



#### ASSET ALLOCATION (FUND SIZE: \$1,048 MILLION)

NZ Cash: » 5.3%      Australian equities: » 2.9%  
 NZ fixed interest: » 20.3%      Global shares: » 37.3%  
 Global fixed interest: » 12.8%      NZ property: » 6.8%  
 NZ shares: » 11.5%      Global property: » 3.1%

#### FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	13.01	12.54
2 years	10.07	10.10
3 years	4.09	3.57
5 years	4.47	3.49

### AMP Capital Growth Fund



#### ASSET ALLOCATION (FUND SIZE: \$721.7 MILLION)

NZ Cash: » 7.4%      Australian equities: » 5.0%  
 NZ fixed interest: » 3.9%      Global shares: » 56.6%  
 Global fixed interest: » 0.0%      NZ property: » 7.5%  
 NZ shares: » 14.5%      Global property: » 5.1%

#### FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	17.14	17.20
2 years	12.03	12.35
3 years	0.65	1.16
5 years	1.87	1.29

### AMP Capital Responsible Investment Leaders Balanced Fund



#### ASSET ALLOCATION (FUND SIZE: \$4.7 MILLION)

Cash: » 4.7%      Global shares: » 37.1%  
 NZ fixed interest: » 20.2%      NZ property: » 10.0%  
 NZ shares: » 15.3%      Global fixed: » 12.7%

#### FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	13.82	13.89
2 years	-	-
3 years	-	-
5 years	-	-

### AMP Capital Listed Property Securities Fund



#### ASSET ALLOCATION (FUND SIZE: \$6.1 MILLION)

NZ Property Securities: » 78.7%  
 Australian Property Securities: » 5.3%  
 Cash: » 16.0%

#### FUND PERFORMANCE AS AT 30 JUNE 2011

	Fund (%)	Benchmark (%)
1 year	20.55	22.81
2 years	15.68	17.12
3 years	-	-
5 years	-	-

Morningstar Fund Manager of the  
Year Award winner for 2008, 2009  
and now 2010.

That's where you end up when you  
don't follow the crowd.

At AMP Capital, we think differently. We think wider than other fund managers, encompassing a broader perspective to benefit investors. Globally we have over 200 in-house investment experts that specialise in every asset class, offering a collective brain trust that we believe is second to none in New Zealand.

That's why AMP Capital has received Morningstar's Fund Manager of the Year Award not once, not twice but three years in a row. It's recognition that our people, philosophy and strategy produce consistent long term results for our investors.

So, for our existing clients, it's good news. And for those that would like to come on board, we say welcome. Think wide - It can help you own tomorrow. [ampcapital.co.nz](http://ampcapital.co.nz)

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