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Investing in NZ shares

- a solution for investors

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When investing in New Zealand shares, a common question is "how do I?" The question stems from having not done it before, or from the fear of making a poor decision, or from not being confident to talk to a broker or adviser. In some cases, it stems from a previous 'bad' experience.

It is important to have a clear objective as to why you are investing and to be able to sleep at night.

There is no single answer to the question and many approaches have worked in the past and will continue to work. For most investors, the simple answer is to buy a low-cost index fund as this gives them the market return and does not require a high level of monitoring, if it is well diversified. It is likely to lead to an above average return after tax and costs. Some investors, however, will prefer to own their own portfolio of shares. If you buy shares direct and not via a managed fund or product, you can target shares with the income (ie dividends) and growth (market movement) characteristics more appropriate for your needs.

What follows is one option to build a portfolio that should provide good returns long-term. Because we are dealing with share investments, it must be remembered that no method can prevent negative returns over the short-term and someone somewhere may do better.

But, if you choose to use a product, the good passive funds (including ETFs (*exchange traded funds*)) offer a genuine long-term competitive advantage provided their fees are low. In some cases, products may have other advantages. For example, if they have PIE status, the maximum tax rate is limited to 28% and they offer convenient diversification and have minimal administration hassles.

When dealing direct, it is also better to deal with a genuine specialist share broker that provides independent thought, and not a financial adviser with a "wrap" account or monitoring service.

Also, when it comes to buying shares, unless you do all the ground work yourself, and have a genuine interest in researching companies, it is often better not to buy and sell via the internet and to use a "real person" instead. It is important though, that the real person provides advice and demonstrates an understanding of the market and can relate to your needs, personality and preferences. Whether you use a broker or go via the internet however, you must feel secure and confident in the process. As a rule, it is important to be able to sleep at night and understand what you have bought and why, and what would lead you to sell.

The process should reflect the purpose

When investing, it is important to have a clear objective. In this article, we assume that the aim is to invest in a range of shares designed to provide good long-term returns that are not based on chasing what is currently "hot". It is always tempting to buy based on short-term considerations – what is running hot or is 'cheap' – but unless you have available considerable resources (time), skill, experience, passion and confidence, the better process is a long-term, minimal-change process. This lets you ride out the short-term adverse events.

For a long-term objective, the appropriate process involves identifying the shares, with the characteristics of being able to produce good long-term returns and will be around in 10 years and invest in each. Having bought the initial shares, the portfolio needs to be reviewed from time to time, but not too often.

Note: *Comments in this article and all analysis, are of a general nature only. They do not take account of your specific circumstances. If you require personalised financial advice, you should seek advice from an appropriately experienced Financial Adviser.*

One process

As a rule, the investor should look to identify 15 to 20 shares that are expected to perform well over the medium to long-term. A portfolio of 15 to 20 shares should provide diversification by industry and company while keeping the portfolio manageable. If the share portfolio is significant relative to an investors' total assets, a higher number of stocks may be appropriate but probably not more than 25.

The portfolio should generally be constructed by equally weighting the stocks (ie buying the same amount of each). By investing equally in each you are not trying to pick which will be the "best winners", and you maximise the diversification.

The chosen stocks should be held with the intent of holding them for the long-term, at least 10 years, though they should be kept under review and formally reviewed every 12 to 18 months. There is no requirement to hold them 10 years.

Initial portfolio

A suggested selection process for the initial portfolio, is:

1. Identify two share brokers with whom you can relate to, and you feel comfortable with. This can only be achieved by talking to the brokers and ensuring a "comfort" level.

2. Each Broker should be asked *"I have $x to invest, I wish to invest it in NZ shares, and hold such shares for at least the next 10 years. I am generally risk adverse. What 15 to 20 shares do you recommend and why?"* In asking this question what is important is that the broker focuses on the long-term and not the next 3 months, and recommends a balance between different industries and types of shares, and an insight that you have not just read in the media.

3. Having got the views of each of the brokers, it is possible to compare the shares and reasons given. You should question each broker, using the views of the other, to understand the share's characteristics, particularly where there are differences in views. You do not need to rush your decision - good long-term shares don't suddenly become bad long-term shares overnight.

   Ultimately, from the shares suggested by the brokers (perhaps 30 in total), 15 to 20 shares, say, need to be chosen. Besides the commonality of views of the brokers, and the confidence you have in those, each share should pass the "common sense" test.

   As an investor, you should be able to understand where the future value will come from, and why that particular businesses should perform well. Ultimately the value of a share must reflect future profits, you need to be able to understand therefore, where those profits will come from and why its customers will continue to buy and might go wrong. Such shares should not rely on "speculation". Often the shares will involve companies that have predominantly a dominant position or are in industries that have sustainable growth characteristics. In most cases it will not involve companies that are currently not making profits. While they may prove to be the better buy, they come with risks and require a greater level of oversight. Your final list of shares should reflect different industries (eg finance, construction, transport etc.) and different types of companies.

4. To remunerate the brokers that assisted you, the actual share purchases should be done by splitting the $x between the brokers. They will receive brokerage from the transactions.

   There is no requirement for two brokers. You can use one if you prefer. What is important is that you have confidence, and the broker understands that you are a long-term investor, not wanting to speculate on short-term winners or rumours or hunches. You want to maximise your long-term income (ie dividends) and protect your capital over time.

Ongoing review

If the initial shares are good shares, there should be little need to change the portfolio particularly in the first three years. Patience is required to allow the reasons why the shares were originally chosen to come through in returns, though you should still monitor the portfolio regularly. A suggested review process is:

1. Other than general common sense, a review of the portfolio should not normally be undertaken for 12 -18 months. At the 12 to 18-month point, to go back to the same brokers (or alternative brokers if preferred), and ask the question *"if I had $x to invest, and I wished to buy 25 NZ shares, and not sell them for the next 10 years, what shares would you recommend?"* What is important is that the number of shares you ask about, is greater than what you hold (about 5 greater) and that you get the broker to focus on the longer term, and not the next 3 months. Between the two brokers, you will probably end up with 35 shares.

2. Again, after understanding any differences, and the reasons for the different views between the two brokers, you can review your portfolio. As a rule, if your current holdings are not included in the new list of 35, consideration should be given to selling that share and the brokers should be asked specifically "why it is now not recommended?" Any sale should result in a new purchase unless you want to reduce your exposure to NZ shares.

3. If your current shares are on the list of 35, then as a rule you should continue to hold them as they are still considered one of the "better" shares. You can, if you wish to, sell one or two for others on the list, but turnover should be kept low, because of the costs of turnover.

4. The review process should be repeated every few years.

Small amounts

In suggesting the above process, it is assumed that $x is large, perhaps above $100,000 or at least $45,000. What happens if $x is less, but there is intention to save and build it over time?

In such cases, there is no reason why the suggested process is not equally applicable, though it will need modification. At one extreme, assume that $x is nil, but you intend to save $y a month. In this case, it is a good idea to save the $y in a bank account until it is $z ($3,000 say). At this point you can go and buy the first share on your list. When you have saved a further $z, buy the second and so forth. It is still important to adopt a long-term approach. With less money, you probably should also favour a single broker and may benefit by building up your portfolio in the initial years through an ETF or diversified fund.

Conclusions

The above process is designed to produce a portfolio with relatively few risks other than market risks in a relatively straightforward way. It's also designed to reduce turnover and ensure that the focus of the portfolio is to generate long-term returns to you, and not fees to the broker. It may not produce the best returns every year and it is important that you don't fall into the behavioural trap of chasing what was 'hot'.

It is, however, also acceptable for you to manage part of your portfolio in share investments that perhaps are a little more 'speculative', but which have an 'interest' factor. In this case, you must understand that the returns from such investments may be more volatile and require a greater level of monitoring. Also, there may be merit in dividing your portfolio in two and having 80% to 90% in a long-term stable portfolio and 10% to 20% in a 'special interest' portfolio.

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