



Classic FM Business with John Fraser, 26/03/2009

“Risk Management,”

with Mike Estment CEO NFB Financial Services Group

JOHN FRASER: Investing in your future is vital, but there are some things you have to bear in mind - risk, what could go wrong. Obviously, your financial advisor can help you with that, but it is something that you personally must be aware of. To discuss this, the CEO of NFB Financial Services, Mike Estment, joins me. Just as a CEO of a company has to be aware of risk to plan for the future but not to avoid all risk, it's the same for the individual investor, isn't it?

MIKE ESTMENT: Yes indeed, it is. I think risk comes in various forms which we will hopefully be able to cover in the next few minutes, but indeed being aware of risk and acting around that reality and that recognition is more important than not doing anything at all.

JOHN FRASER: What are some of the risks that you should have on the horizon when you're putting your money into some form of investment?

MIKE ESTMENT: I think the popular perception of risk is the risk of loss, probably of one's capital. That we call credit risk where the institution, financial institution typically, that you invest in, gets into financial difficulty and is unable to repay the very investment value that you placed to them. That's probably the most notable risk. The other would be market price, so that if you're in something like a fixed deposit at a bank where traditionally people say the money is safe, I would tend to agree if you're in a very credit worthy bank, but if you're in a share or if you're in a property investment, you run the risk of the value of that particular investment either increasing or the rather nasty avoided reality is that the price can drop, and for every buyer you have a seller - someone's going to get it right, and someone's going to get it wrong. Market pricing is where people say I got it wrong. Probably, however, as you get into assets that tend to show a more volatile price trajectory, you're probably going

to get into an asset that if you're able to deal with it and stick with it and it's a quality property or a quality share, you will pan out better than if you were in a big fixed deposit in a bank over the medium to longer term.

JOHN FRASER: Of course your tolerance for risk will depend on your age - somebody just starting out their career might not worry too much about the fluctuations in the markets; somebody at 60 planning to retire in a year or two, has to think a little more strategically.

MIKE ESTMENT: I think that is true in broad terms, but probably this leads us into another very important perception or implication of risk and that is time versus timing. If you were 60 and the old Biblical term of three score and 10 applied, then you've got 10 years to live. As long as you make your money last so you can live comfortably for 10 years because your lights are going out at three score and 10, you're fine. But what if, through buyer technology, through the advance of medical science, through the urbanisation of the world and cleaner water and less big diseases and the like, you live to the age of 90 - you have a very different perspective on things. So this is where the time versus timing thing comes into it. Timing is trying to guess when the market's going to go up, and guess when it's going to go down. Time, on the other hand, as was described by Einstein, I believe, is the most powerful form - compounding happens with time, and that's a very powerful force. That's the one we look for. So if you were to retire at 60, I would probably argue that if you add excess cash to that which is needed to provide you with current income, I would put that in the market because the market is going to give you dividends, the market's going to give you capital growth, and the market's linked to inflation so the shares will appreciate as inflation kicks in, and if inflation wanes, you'd probably find interest rates dropping which would give your customer who was 60 a lousy return or a worse return than they were used to, get them panicking. The market will be rallying. At the worst possible time they'll panic and say it's timing because my friends are making money in shares, and then market price risk comes into play where they, like the rest of us, buy at the top.

JOHN FRASER: Also I suppose, you have to look at things like the tax implications of whatever you invest in.

MIKE ESTMENT: I think tax is probably something that is not too often considered by investors or their advisors. To perhaps describe what I mean by putting tax down as a point to discuss under risk, is if we said that we were in a money market investment that today typically is giving you 10% or perhaps 11%, that's a nice return and you say why should I take any risk on a share which is just going to pay me a dividend of 3% or 4% with a price risk attached to it? On the other hand though, if you say that's an 11% return before tax, and if the investor has an amount sufficient to put them into a 40% or maximum tax bracket, then they have a return of probably 7% after tax. Our hurdle rate now becomes 7%, and if the share is giving a dividend of 4%, the share price only has

to go up by another 4% for us to be in positive territory. As an advisor and as an individual investor myself, I think that's a reasonable bet to take, particularly if you look at the current market, not the overall market, not the crazily priced resource shares at the moment which might hold and might go further, but if you look at some of the top quality banking stocks and some of the industrials and retailers, they've really been hammered, and if you could get those shares with a dividend yield of 4%, or sometimes now even 5%, that's not a high hurdle for them to get us another 3% or 4% to put us into positive territory.