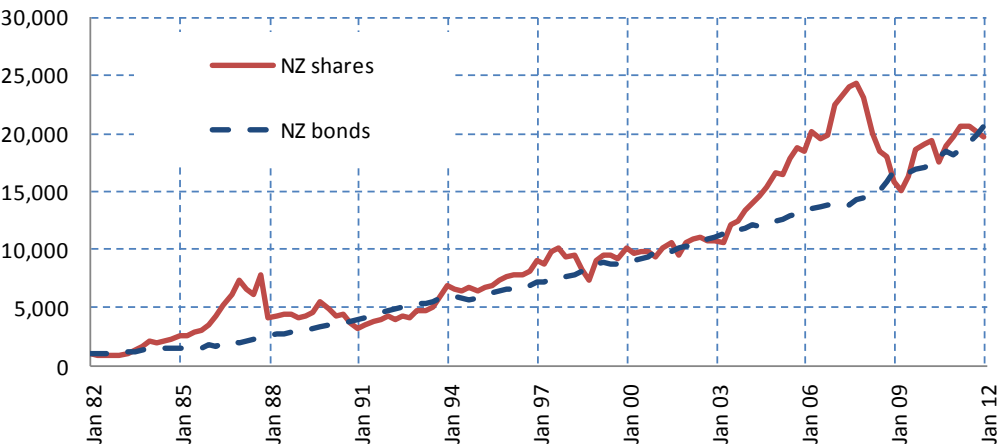




Some times, long term can be very long term.

Over the last 30 years, the average gross return from NZ shares was 10.4% p.a.. This compares with the average return from NZ bonds of 10.6% p.a.. We are told that if we invest in shares for the long-term shares will outperform bonds and 30 years seems like a long time.

Chart 1-Value of \$1,000 invested on 1 January 1982 (before tax)



The graph highlights the sharemarket crash of 1987 and the global financial crisis from 2007. It shows the more volatile path of share investments (shares go up and down more). Compared to shares, bonds appear “safe” and therefore better. But the gross return over time tells less than half the story.

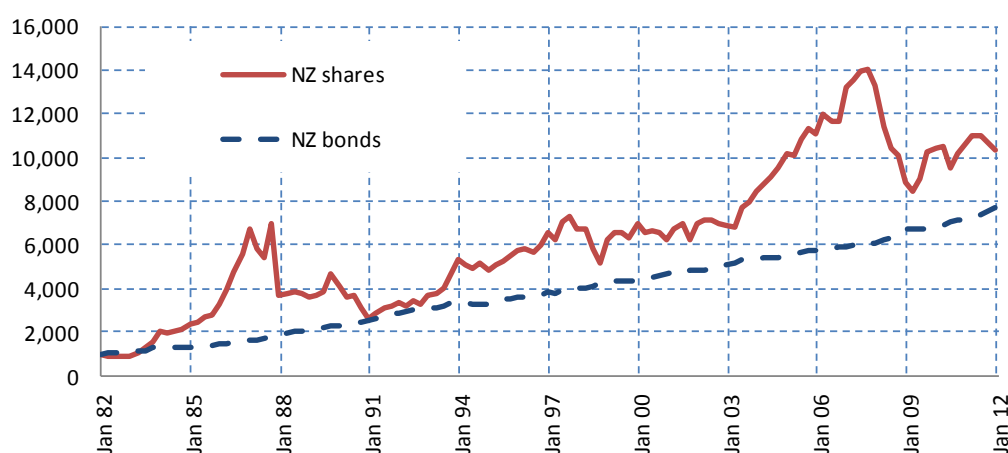
The average returns of shares at 10.4% and bonds at 10.6% were gross before tax returns. We also have to pay tax. With bonds, the full return is taxable so if the return is 10% and the tax rate is 28%, the net return to you is 7.2% (10% x (100%-28%)).

In contrast, with NZ shares only the dividend component is taxable and the market movement is tax free. This is good when the market movement is positive and not so good when it is down. However, we expect shares to go up, more than they go down. We therefore expect shares to have a tax advantage long-term. For example:

Share return	Gross	Tax	Net @ 28%
Dividend	7%	2%	5%
Market movement	3%	0%	3%
Total share return	10%	2%	8%

So at 28% tax and similar gross returns, shares have a return advantage after-tax that translates into a real dollar advantage; 8.0% after-tax is better than 7.2% after-tax. Note, in the example, we used a 10% return to illustrate the tax impact. We chose 10% as it was similar to the last 30 years and was easy to calculate. We do not think that 10% is a good indicator of the likely average return for shares or bonds over the next 30 years.

Chart 2 - Value of \$1,000 invested on 1 January 1982 (after-tax at 33%)



In the chart, we have used a flat 33% tax rate as an approximation to the average tax rate payable over the last 30 years. Currently, the maximum rate is 28% if invested through a PIE.

Chart 2 highlights the impact of tax on the end outcome. Growing the \$1,000 to just over \$10,000 after-tax for shares and just under \$8,000 after-tax for bonds is a material difference in the end position. This is one of the reasons why comparing returns of different funds and managers (e.g. under KiwiSaver) before tax, is not a good comparison. In an environment where the tax treatment of different asset classes is different, gross return comparisons can be meaningless and misleading.

Fees are also important. Fees, like tax, are a deduction from your returns and the higher the fees the bigger is the deduction. Unless a manager has a clear skill advantage that will generate higher returns consistently, it is better to be with a low cost provider. You do not need big differences in the returns each year, to get a big difference in the final total savings. Chart 2 also serves to demonstrate this point. The difference in the after-tax returns was 1% a year. So a 1.0% difference made a 25% difference in the ultimate savings level over the 30 years.

Conclusion

History shows that even over the long term (30 years in this case), the gross returns from shares may not be higher than that from bonds. But even when this occurs, because of different tax treatment, the reverse can be the case where comparing net of tax returns.

For most investors, it makes sense to:

- focus on the long term but on a period consistent with your personal time horizon,
- workout what is best for your circumstances and your willingness to see ups and downs in the value of your savings over the short-term,
- understand the impact of tax and fees and demand after-tax and after-fee return comparisons,
- question whether managers have a genuine skill advantage.

Footnote

In this article, 30 years was picked deliberately as it was, coincidentally, the period where the gross returns from NZ shares and bonds were similar. It allowed the impact of volatility and tax to be highlighted and why gross return comparisons tell you little of value.

But with statistics, you can “prove” many things. If you reduce the period to 25 years (also a long-period), you get a different picture because 25 years ago it meant that you invested just before the 87 crash. Likewise, if you increase the period to 35 years (a slightly longer long-period), shares were clearly better.

Chart 3 - Value of \$1,000 invested on 1 January 1987 (after tax at 33%)

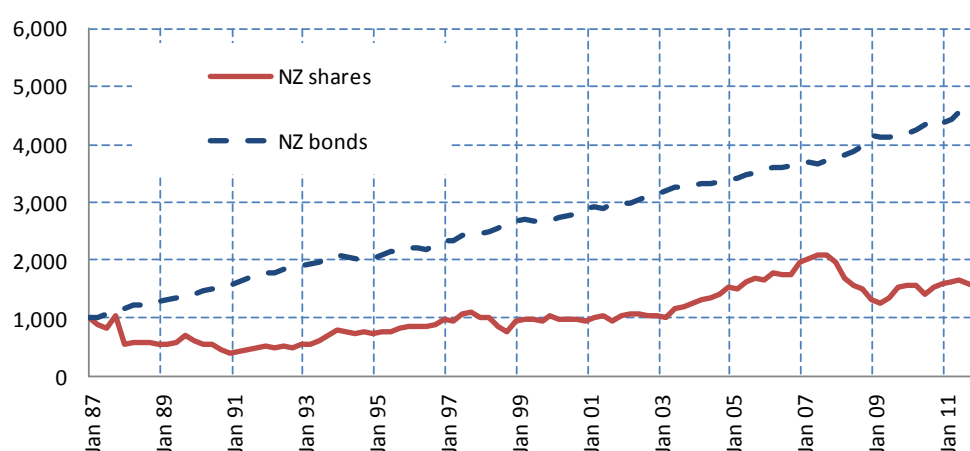
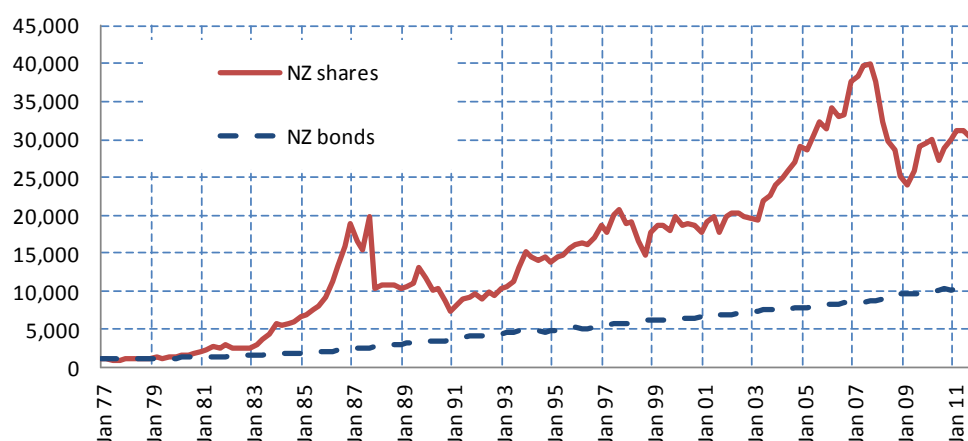


Chart 4 - Value of \$1,000 invested on 1 January 1977 (after tax at 33%)



The message from the charts is that it is important to understand why you buy shares and why you buy bonds. You should buy each primarily for the nature of the returns they produce and the compatibility of these with your goals. You should not just buy shares because someone told you they were good for the long-term and you have 10+ years to go until retirement. Both bonds and shares can be appropriate for the long-term. Bonds are good for steady income and shares are good for some income and some protection against inflation, but only where you are also willing to tolerate the ups and downs.

The legal stuff

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