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RODNEY'S RAVINGS

The idiots guide to investment

EXECUTIVE SUMMARY

Peter Lynch is one of the best performing equity investors of all time and his books *One Up on Wall Street* and *Beating the Street* should be compulsory reading for any serious equity investors (for more information on him try this link - http://en.wikipedia.org/wiki/Peter_Lynch). One of his many memorable comments was, "Go for a business that any idiot can run - because sooner or later, any idiot probably is going to run it." He succeeded by using more complex investment strategies than just buying shares in companies even idiots could run successfully, but with investors getting toasted in NZ on many fronts the idea of an idiot proof investment strategy seems appropriate.

"If it looks too good to be true it must be" is the obvious candidate to roll out as the investment strategy for idiots but it is too obtuse. And it is clear that many of the investors currently getting fingers, toes and in some cases whole limbs burnt off couldn't tell whether an investment looked too good to be true. In the hope of serving man and woman kind for the greater good I have drawn on my years of experience analysing investment markets to come up with a simple rule that can hopefully help even idiots avoid committing investment suicide. This Raving may well be Part 1 of my advice to investors on how to avoid investment death traps, but a "how not to do it" report is also something of a "how to do it" manual.



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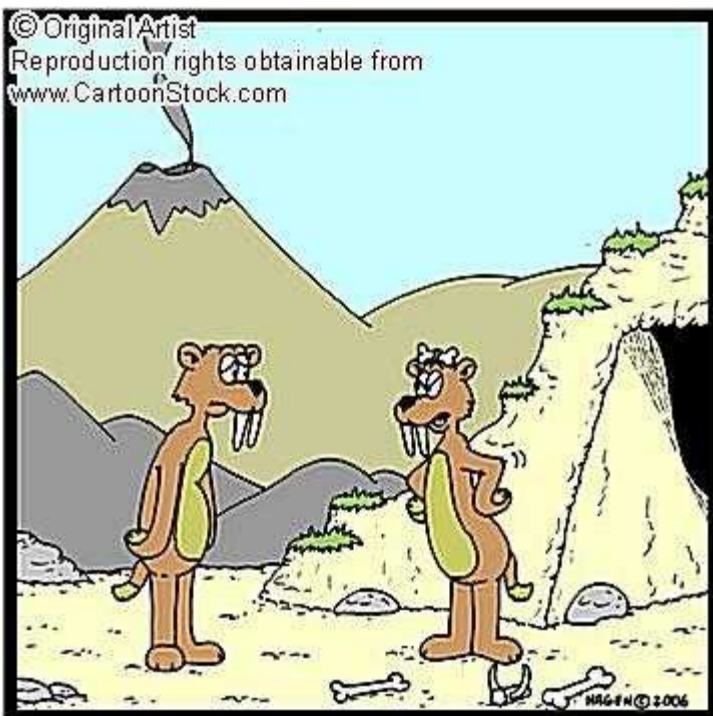


The Tiger Woods' approach to investment

Prior to addressing the golf ball to play a shot Tiger has done all his homework (i.e. assessed the best shot to achieve the outcome he desires, chosen the right club to achieve the outcome, taken into account the weather conditions and hit several zillion practise shots making sure he can trust his swing once he stands over the golf ball). Once he stands over the golf ball it is all about making it all come together. This does not involve thinking about whether he is standing too close to the ball, whether he should have a softer grip, whether he has enough club to carry the water or whether he should have taken a different club for his previous shot. When push comes to shove it is all about trusting his instinct and making it happen.

The small group of elite professional investors are the same. They have a massive amount of experience to draw on when assessing an investment, they do the homework needed before pulling the trigger and when push comes to shove they will trust their instinct. And much more often than not their instinct will be well founded and their decisions will achieve quality outcomes.

The trouble us mere mortals have, be it on the golf course or when choosing investments, is that our instincts can prove to be our weakest links. Anyone who has studied enough psychology to be dangerous will be able to tell you that the human race has some inbuilt behaviours that might be great for the survival of the species but mean we are particularly vulnerable to making dumb investment decisions (and from person experience we are also vulnerable to making some dumb decisions on the golf course).



Well, if you could make fire like those ape-like creatures, we would still be at the top of the food chain...

Sticking with the crowd is a great survival attribute when life or death involves avoiding being eaten by large predators. But when it comes to investment decisions this trait makes people vulnerable to making dumb decisions (e.g. buying an apartment in Auckland because Joe and Janet made a \$30,000 capital gain doing so last year or buying a coastal property because everyone says they aren't making any more coast line).

Trusting authority figures had merit in ancient societies because it was a good way of avoiding getting one's head cut off, but in investment decisions it makes people prone to believe the at times poor advice of investment advisors and people marketing investments.

Trusting what a member of the tribe tells you is a good survival attribute relative to trusting what someone in another tribe has to say, but this trait makes people particularly vulnerable to advice from friends and associates, which can prove to be the worst advice going.

And then there is the tendency to be overly confident. Psychological testing shows that 80% of people think they are better than average at everything. This means lots of people are overly confident in their ability to make quality investment decisions, which can be another route to rack and ruin.

Most people are no more equipped to make quality investment decisions than they are equipped to tee-up alongside Tiger Woods on a Sunday at a Major. And to make matters worse some professional investment advisors have little more insight (i.e. some, like economists, know enough to sound like they know what they are talking about but their partial knowledge can be just as dangerous as no knowledge). Just ask the people who were advised to invest in some of the finance companies that have failed over the last 18 months, the people who were sucked into investing in BlueChip apartments, the people who were advised to invest in US IT companies and international equities before the 2001-02 crash, or the people who invested in goats before the goat bubble burst and black tulips before the tulip market turned belly up.

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Angora goats can teach you almost everything you need to know

The first speculative bubble I was exposed to was the Angora goat boom in the 1980s. Mohair, which comes from Angora goats (left photo), came into fashion as a fibre in the early 1980s (probably for the umpteenth time). Rising international mohair prices started a fad of goat farming in NZ. My father was an early participant in this Angora boom, buying feral nanny goats for \$15 a head from the helicopter cowboys who had been capturing wild deer for farming before the deer market experienced one of its regular downturns. For a while the cowboys turned to rounding up feral nanny goats from the ranges around Taupo. Provided the feral nanny goats didn't have any ginger in their fleece they could be mated with purebred Angora bucks to produce cuddly little cash cows (the right photo, although the first crosses between the feral nanny goats and the Angora bucks were not as cuddly as this purebred specimen).



Initially a good living was to be made farming the goats for their mohair, but soon the demon capital gains came to town and the madness began. The scarcity of breeding stock soon saw the prices of the female progeny bid well above the \$15 a head paid for the feral nanny goats. And like many speculate bubbles tax breaks were involved that encouraged Queen St farmers looking for tax write-offs to get involved in buying young nanny goats to build up herds of Angora goats.

At its peak in around 1984 Angora nanny goats were fetching \$1,500 a head and the focus of goat farmers like my father had turned from growing fleece to selling nanny kid goats for a small fortune. In inflation adjusted terms \$1,500 in 1984 equates to almost \$3,000 in today's prices (i.e. enough to buy a good quality 42" flat screen TV and several Romney sheep).

Before leaving NZ in mid-1984 to work on secondment at the Bank of England in London studying the behaviour of international fixed interest markets for 19 months I advised my father that he should focus on breeding a herd of purebred nanny goats that would hopefully supply an acceptable income from the fibre. Unfortunately, the madding crowd believed the prices of Angora goats could remain totally out of kilter with the income stream generated by the mohair that sanity didn't prevail.

And like any speculative bubble banks were involved. For example, a Queen St farmer visits his friendly bank manager with a proposal to buy a farm in selenium deficient Taupo and to populate it with purebred Angora goats, the latest version of white gold. The main income stream will be from selling the progeny of the goats at current market prices (i.e. the prices that have no relationship with the underlying income stream from the mohair). The bank manager has no ability to forecast mohair prices or Angora nanny goat prices, but based on the current market prices for Angora goats and low quality farmland he lends the Queen St farmer a small fortune.

Maybe mohair prices fell or maybe the collective madness just ran its course, I can't remember because I was 12,000 kms away thinking about the autoregressive, heteroscedastic properties of international interest rates, but one day the penny finally dropped. With the aid of hindsight everyone realized that the \$1,500 a head prices for Angora nanny goats could only be justified if mohair prices were ten times what they were. And within a few months of the penny dropping anyone trying to sell Angora goats was lucky if they could get \$20 a head for them as dog tucker.

The lesson is that when the price of an asset or an Angora goat gets out of line with the underlying, sustainable income stream the asset generates then be wary. And if the boom continues and the price gets ever more out of line with the underlying income stream then be very wary. And if most everyone, including



people who should know better, start telling you that this boom is special and that the normal approach to valuation doesn't apply then get very, very happy you saw the writing on the wall and didn't invest your life savings.

Of course, speculative bubbles by their nature go on for much longer than rationality suggests they should, mainly because human nature isn't founded in logic, and along the way astute investors can make lots of money. But the focus of this Raving is on helping investors avoid committing investment suicide not on helping street-savvy investors buy low and sell high.

Every boom brings with it a new approach to valuation that defies gravity

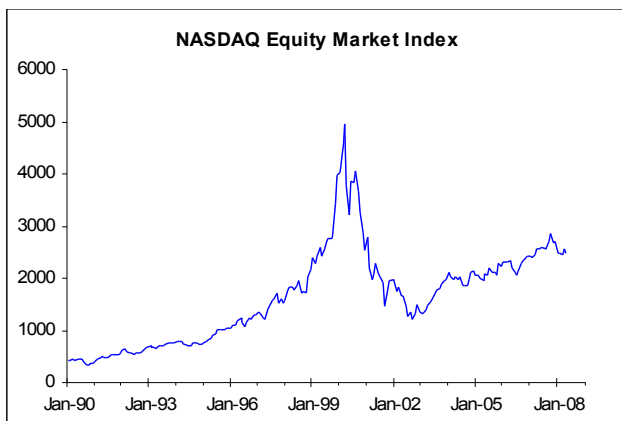
In early-2000 I was on a golf holiday in New Plymouth and noticed that on the front of a local share broking office was a large colour sign promoting the shares of US listed IT companies, it read something like "get your IT shares here". This was the era of the Nasdaq, the US equity market index that especially measured the performance of list technology companies (the chart below).

The week before the New Plymouth trip I had written a report comparing the boom in US IT share prices to the various agricultural bubbles New Zealand had experienced, like the Angora goat one. Out of curiosity I went into the share broking office to ask about buying IT shares and discovered that the resident share broker had no idea whether US IT shares were a smart investment option or not. His justification for marketing them aggressively was that if he didn't click the tick someone else would.

But it was much more than just provincial share brokers who got sucked into the US IT share price bubble. Some of the smartest brains on Wall Street wrote about why things were different this time around, and why traditional valuation methods didn't apply to the new breed of technology companies. And many investors went along for the ride with the Nasdaq index increasing 190% between late-1998 and the peak in early-2000 (see the chart). Quite a number of listed IT companies had close to zero earnings and had share prices that were astronomical multiples of the earnings per share. But the smart analysts on Wall Street convinced lots of investors to buy them despite the share prices being massively over-priced relative to even horrendously optimistic assumptions about future earnings potential on the basis of the new "clicks" valuation method.

Basically if a listed IT company had lots of people clicking onto its website then it seemed reasonable to assume that one day those clicks would turn into dollars. So the companies with lots of clicks got handsome reviews by the Wall Street analysts and their share prices went ballistic. But reality eventually hit town and the share prices of companies that had lots of clicks but few earnings tumbled, to oblivion in many cases. The companies that had some underlying earnings also suffered massive share price falls but once the dust settled and something vaguely resembling sensible valuations came back into vogue the share prices of the surviving companies had more sane relationships with earnings prospects.

The NZ coastal property market, an area we specialise in, has had some disciples preaching that new valuation approaches are appropriate. The Mark Twain saying that they aren't making any more land became popular in justifying that absolute beachfront section prices would never fall, while some argued that the NZ market had just been discovered by overseas buyers and so the massive increases in prices were justified on the basis of international comparative prices. Of course, for most coastal properties what really matters is the affordability to local would-be holiday home owners and on that basis the coastal market has experienced a speculative bubble that is yet to fully burst (see the for sale signs in the photo).



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The NZ housing market is a classic speculative bubble

As covered in the popular Ravings “**Are we heading for housing market hell?**” (the first link below takes you to this report) and “**Housing hell revisited**” (the second link), it has long been clear to me that NZ is experiencing a speculative bubble in house prices (and more so in section prices). No matter what market we are dealing with, when the price of the investment/asset gets massively out of line with the underlying income stream – in this instance the rental income on housing – then bad things are bound to happen eventually. <http://www.sra.co.nz/pdf/housinghell.pdf> and <http://www.sra.co.nz/pdf/housinghellrevisited.pdf>

These two Ravings tell the NZ housing market story in gruesome detail so I won't repeat it here, but the insights they and the other examples in this Raving provide warrant repeating.

The idiots guide to investment

The prices of Angora goats, IT shares and houses can get dramatically out of line with fundamentals or rational levels because it is in the nature of humans to do silly things when it comes to investing their hard earned money. We are programmed by the lessons learned by our ancestors over millions of years spent avoiding being eaten by predators that following the flock is a safe strategy. We take too much notice of authority figures, including people pretending to be authority figures, because not doing so to our ancestors meant the difference between life or death (i.e. being compliant and living in the safety of the clan versus getting ejected and eaten). We have too much faith in our own ability because by being this way we are adventurous and take risks which is good for the survival of the species even if it means quite a few misguided adventurers fall to their deaths. But doing what other people do is not smart investment practise, taking the advice of some investment advisors may not be good investment practise (although all investment advisors and all share brokers should not be tarred with the same brush), while going for it just because it has great superficial appeal and brings out the man in you (or the testosterone-fuelled woman in you) isn't smart either.

When it comes to investing if there is only one thing that you are going to use to stop you from making potentially dumb mistakes it should be considering whether the price of the investment looks cheap, “fair-value” or expensive relative to the underlying income stream generated by the investment. Capital gains come and go (i.e. can turn dreadfully negative after a speculative bubble). Investment crazes come and go. But if the investment has sound earnings prospects, of the sort that you can in some way independently verify (and the say-so of some investment advisors is not the same thing as independent verification), and the price of the investment looks attractive relative to the earnings prospects based on traditional valuation rules of thumb not new fan dangled investment methodologies, then you might well be onto a winner. And, of course, you will only make a killing if the price of the investment is cheap relative to its prospective income stream.

If you don't know the answer to this question (i.e. you have no way of telling whether the investment is cheap or expensive relative to its prospective earnings) you might be better putting your money in a safe fixed interest investment and sleeping with peace of mind. Contrary to what some investment advisors might tell you, great investments aren't born every day. Be patient, invest some shoe leather before you put your life savings on the line, and be confident in the fact that one day patience and your investment in shoe leather will pay off. In a future Raving I will present my “invest during recessions” strategy because you never know when a recession may come around the corner, while some debunking of the portfolio approach to investment is long overdue.