



**RODNEY'S RAVINGS** take an open-minded and at times irreverent look at topical economic issues. Unlike our pay-to-view reports, that are for the eyes of subscribers only, the **RAVINGS** are free and you may forward them to other people. You can sign up to the **RAVINGS** and the free **Property Insights** reports on our website – [www.sra.co.nz](http://www.sra.co.nz) – where you will also find information on our pay-to-view reports.

## RODNEY'S RAVINGS

### Recessions and investing in the share market

#### EXECUTIVE SUMMARY

Having worked in the share broking industry for 12 years as an economist, strategist and head of research I have an insider's understanding of why only a small proportion of investors are attracted to the NZ share market. It is a small market with a limited choice of quality companies, there has been a tendency for large listed companies to expand overseas and get burnt, new listings have at times been of dubious quality, while shares are more technical investments than housing in terms of what you need to know to make informed decisions. However, there is an approach I think would-be equity investors should consider that both reduces the risk of losing money and reduces the need to know as much.

My preferred approach to investing in shares is to wait for a good recession and when there are the early signs that the economy will soon emerge from the recession buy a selection of listed companies that have been particularly hurt by the recession but which are expected to live to fight another day. This Raving gives some insights into how would-be share market investors can take advantage of recessions.

Disclosure: I have taken my own advice and invested in a selection on NZ listed companies that give a reasonably broad-based exposure to especially a local economic recovery but also to a global economic recovery. History will judge whether I am right in suggesting that now is probably a good time for countercyclical share market investors to consider filling their boots. However, I am not recommending that anyone follows my lead but rather I am providing insights into what I am doing to help would-be share market investors understand how the share market works during economic cycles, including providing insights into why recessions can provide wonderful opportunities to setup a share market portfolio.

My family trust may hold shares in companies mentioned in this report. By viewing this report you acknowledge that you have received the disclosure statement that can be accessed via the following link to our website - <http://www.sra.co.nz/pdf/DisclosureStatement.pdf>.

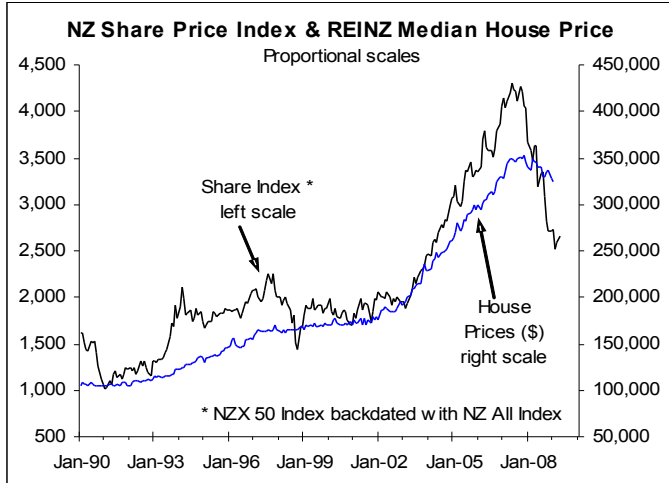


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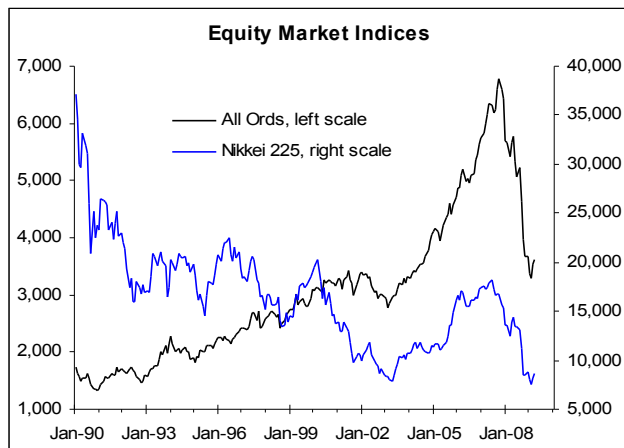
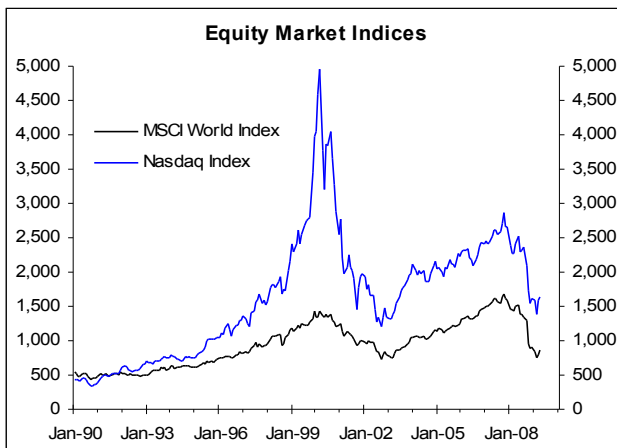


### Share markets and housing markets behave differently during recessions

The top chart shows the behaviour of the NZ share market (the black line, left scale) and the performance of the NZ national median house price (the blue line, right scale) since January 1990. What is most noticeable is the tendency for the share market to tank during recessions (see 1990/91, 1998 and 2008). This time around the housing market boom became a speculative bubble so house prices have also fallen. The national median house price has fallen 5% from peak based on the REINZ measure (10% based on the QV measure) but the share market has fallen 40% from the peak in 2007.



Greed followed by fear have been a feature of the housing market since 2002 but this love-hate relationship is more normally associated with the share market because of its greater tendency to do well during economic booms and to crash during recessions. Investors in equity markets all over the world are subject to the boom-bust behaviour from time-to-time as shown in the two charts below. In the latest attack of fear the MSCI World Index has fallen 52% from peak to trough, the Australian All Ords index has fallen 51% from peak to trough and the Japanese Nikkei 225 Index has fallen 58%. The largest fear story in recent years was the almost 75% fall in the ICT-orientated US Nasdaq index from early-2000 to late-2002.



### Recessions offer a great opportunity for would-be share investors

Having worked for 12 years in the share broking/investment banking industry (1989-2001) in the rolls of economist, strategist and two stints as head of research I have an insider's appreciation of why only a small proportion of investors are attracted to the share market in NZ. It is a small market with a limited choice of quality companies (i.e. companies that have generated strong earners growth over a protracted period), there has been a tendency for large listed companies to expand overseas and get burnt, new listings have at times been of dubious quality, while shares are more technical investments than housing in terms of both the language (e.g. P/Es, EBIT, franking) and what you need to know about the listed companies you invest in if you want to make informed decisions. However, there is one approach I think would-be equity investors should consider that reduces the risk of losing money and reduces the need to know as much.

My preferred approach to investing in shares is to wait for a good recession and when there are the early signs that the economy will emerge from the recession buy a selection of listed companies that have been particularly hurt by the recession but which are expected to live to fight another day. Preferably invest in companies that also have reasonable long-term growth prospects, although the choice of these in NZ is limited so at least focus on companies that have a tract record at growing dividend payments over time. While some companies have been hit hard by the current recession and have cut dividends the share market currently offers the opportunity to invest in a number of listed companies with dividend yields that

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are well above the return from money in the bank. An often overlooked feature of investing in shares is that quality companies will increase dividend payments over time so over periods of 20 years or more dividend income can end up dwarfing interest income on money invested in the bank.

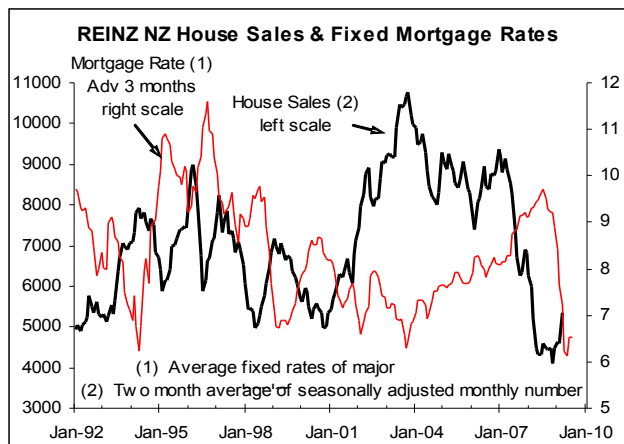
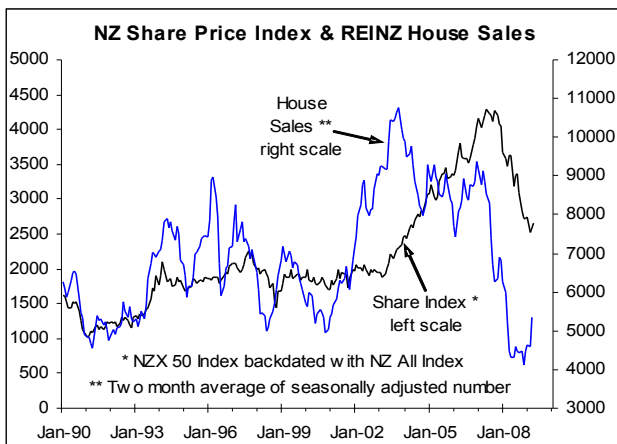
Share market is inherently more risky than putting your money in the bank but recessions, during which share prices often half even for quality companies, offer the opportunity to get access to future dividend income streams at a huge discount. If you invest in the depths of a recession the odds of losing money are greatly reduced even though this is when most investors are gripped with fear, while investing during the depths of recessions also means the odds of making long-term capital gains are much better.

I am not recommending people follow what I am doing but I am letting people know about the approach I am using because I believe the insights this offers will prove useful for people wanting to avoid the greed-fear cycle. The approach by too many investors is to buy shares when the share market has already done well and everyone is talking about it, by which time it is often already poor value. Just to get burnt and react to this by selling for fear of losing more money after prices have already fallen and when shares are finally starting to offer great value. My approach is to wait until there is blood on the street and then selectively buy some good listed companies at huge discounts.

The secret is to wait for a recession and the associated collapse in share prices then to watch some of the key leading economic indicators that give the first sign that an economic recovery is coming. The share market works in such a way that while general news about listed companies and the economy is getting worse then share prices fall but well before the economist step to the plate and declare that the recession is over the share market will already start improving. Investors in the share market are some of the first to sniff out the signs of an economic recovery and start pricing this into the share prices of companies that are particularly impacted by the state of the economy like listed retailers, manufacturers, exporters etc.

There was a deep and protracted recession in the early-1990s that resulted in a large fall in the NZ share market (see the black line in the left chart). The fall in the share market roughly coincide with the fall in the number of house sales reported by REINZ (the blue line). In the 1998 recession the share market also took a large hit and again the fall in share prices roughly coincided with the fall in house sales. House sales are particular useful in this context because they are highly interest sensitive and what normally drives the economy out of recession is large interest rate cuts. So when the number of REINZ house sales are starting to increase in response to large interest rate cuts is about when I believe investors should be looking at the share market. The blue line in the left chart shows that house sales have started to recover which is why I have been busily investing in shares recently.

The right chart is from our regular **Housing Prospects** report and shows the impact of mortgage interest rates on house sales with the red interest rate line advanced or shifted to the right by three months to reflect how long it normally takes for changes in interest rates to impact on the number of house sales. This cycle is different because of the global crisis and the impact it had on local banks, most notably the tightening in lending criteria instituted after the escalation of the crisis in September 2008. Consequently the upturn in house sales has been delayed this time around but with 6-12 month fixed mortgage rate still below 6% there is good reason to expect the rise in house sales to continue over the next several months. And as discussed in our monthly **Interesting Times** reports, where house sales go the domestic economy normally follows some months later.

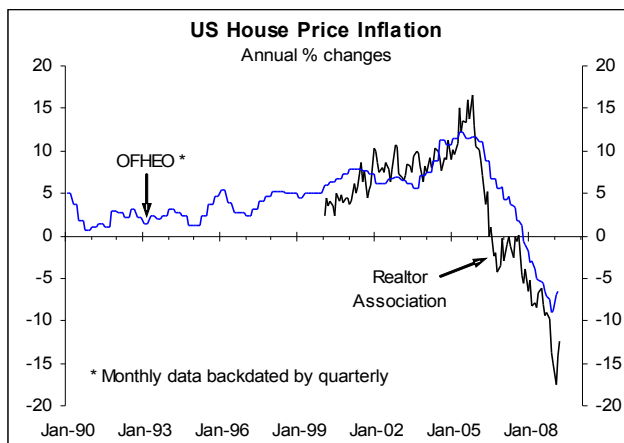
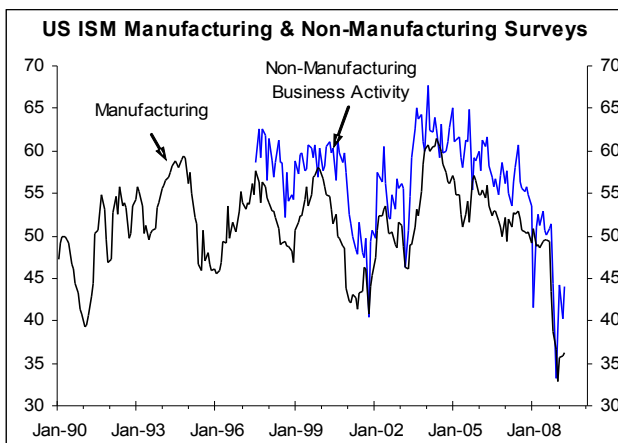
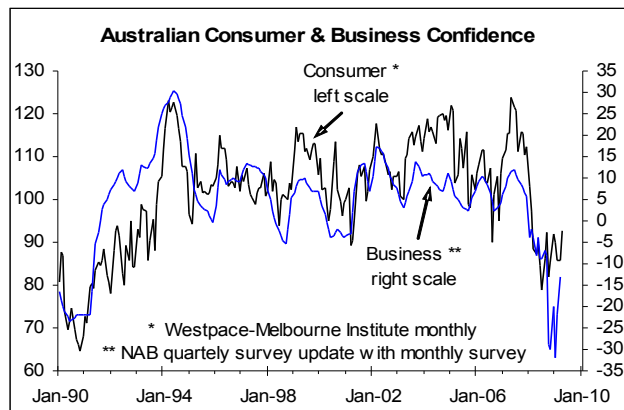
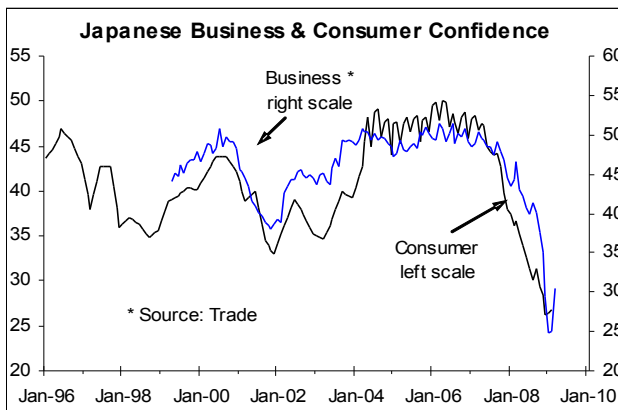




I am partly putting my faith in the RBNZ. Having been briefly a member of the RBNZ's Monetary Policy Committee and having since spent more than 20 years critiquing the RBNZ's operation of monetary policy and frequently finding them wanting you might find it unusual that I have faith in the RBNZ. To qualify my comment I don't have faith that the RBNZ will in general make quality decisions and run monetary policy as well as could be the case, but as I see it the RBNZ is duty bound to ensure that the unfolding rise in house sales blossoms and more generally that there is a recovery in economic growth. Monetary policy is not targeted at the housing market but with interest rates being the main tool of monetary policy and housing being the most interest sensitive industry it should always be the case that the first signs of an economic upturn are registered by REINZ house sales.

The sceptics will argue that the world economy is still heading south evidenced by the latest downgrade in forecasts of world economic growth by the IMF. If you haven't already read enough of the IMF's doom and gloom views click on this link - <http://edition.cnn.com/2009/BUSINESS/04/22/imf.forecast/index.html>. But as US economics professor Steve Hanke put it in a recent article: "After failing to predict a slow-down, let alone a panic, the International Monetary Fund finally issued a scary forecast on 19 March – just in time for the G-20 meeting." Hanke suggests that the IMF is using "scare tactics" to encourage the G-20 leaders to agree to a massive increase in resources for the IMF, which they did (i.e. the IMF doesn't have a great track record in predicting global growth while it has a vested interest in painting a negative picture). I have loaded Hanke's two-page article to our website so if you want to read his views on the IMF's subterfuge click on the following link - <http://www.sra.co.nz/pdf/IMFPanicApril2009.pdf>.

Just as we use NZ leading indicators in our various pay-to-view reports to help clients assess economic and industry prospects we also follow a range of key US and international leading indicators which get coverage in our **Interesting Times** reports. Leading indicators are useful in general to make sure we avoid the tendency of many economists to run their forecasts based on what they see in the rear-view mirror but they are particularly useful in helping assess turning points (i.e. when the economy or an industry that has been heading in one direction is about to make a sharp turn and head in the opposite direction). The charts below show a selection of Japanese, Australia and US leading indicators which are showing varying degrees of turning up. The IMF has pushed the panic button as the first signs of life after death are emerging. These indicators justify the recent rises in share prices in many countries.



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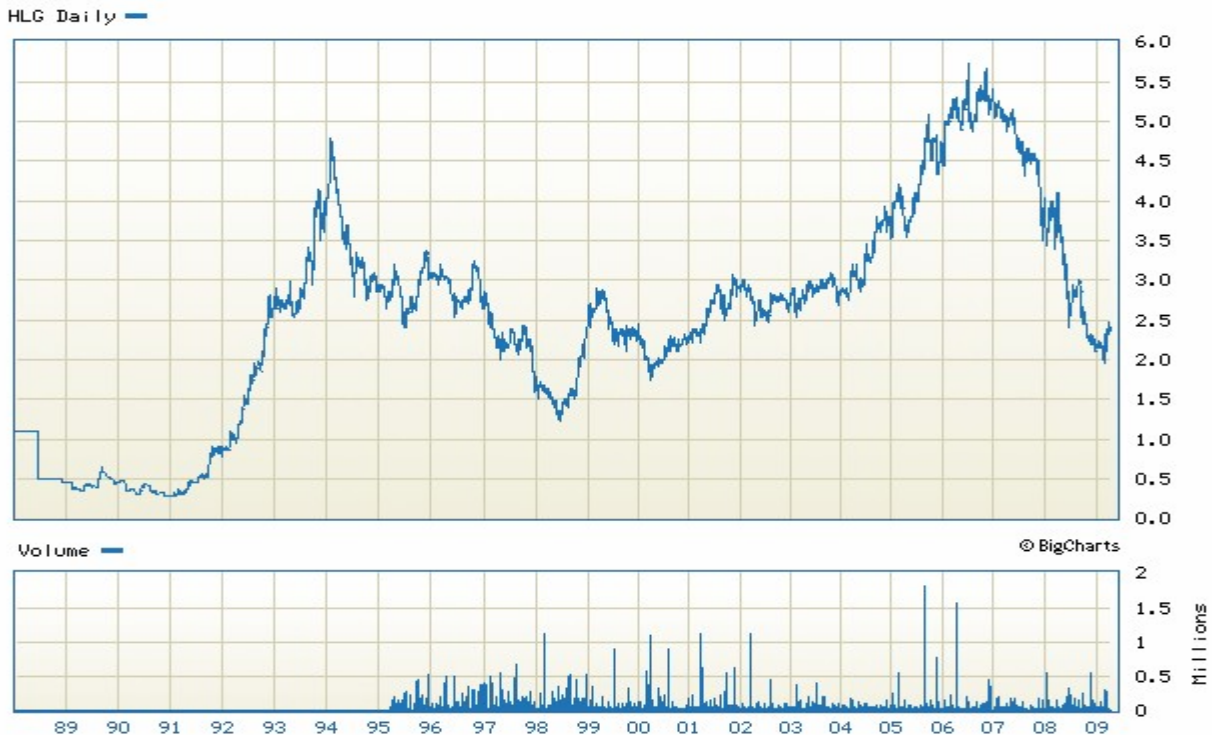
We reserve our analysis of why we are starting to see a number of leading indicators in NZ's major trading partners improve to clients of our pay-to-view reports, with the charts and commentary on the previous page provided to justify our view that now is most likely a good time for counter-cyclical share market investors to fill their boots.

**What sort of listed companies do I look to invest in after a recession does its work?**

My approach is to invest in a selection of listed companies that together provide general exposure to the economy, that have been hit by the recession, that offer good dividend yields and prospects for long-term growth in dividends, that have survived past recessions and that will survive the recession (although on the latter criteria I have had to rely on faith as much as insight with some of my recent picks). Ideally I would invest in a range of mainstream retailers, manufacturers, building-orientated companies, transport companies, exporters and service sector companies, but the choice in NZ is limited so in some cases I have invested in listed companies that don't meet all the criteria above. In a larger country like Australia there is a wider range of listed companies that will meet my criteria but being a reasonably small-time investor, having a tendency to stick to what I know best and not wanting to add explicit exchange rate risk to my investments I am sticking to the local market (buy NZ and all that!).

Hallenstein Glasson (HLG) is a good example of the sort of company I look to invest in when I think the economy is showing the first hints of recovering from a recession. The chart below shows the historical performance of HLG's share price since 1988. What I like about this chart is that the share price got hit in the last three recessions (early-1990s, 1998 and 2008), it recovered strongly coming out of the last two recessions, it rose when the economy performed strongly (e.g. 1992-94 and 2004-06) and it has an upward trend as well as showing major cycles.

HLG paid 27 cents per share in dividends in 2008, which is a gross yield of 11.2% compared to the current share price of \$2.41 although HLG is expected to cut its dividend payout this year and the forecaster I follow is predicting that the gross dividend yield will be 8.2% this year and 7.9% in 2010. Just as importantly it is reported to have increased its dividend payment by 5.3% per annum over the last 10 years, it has an acceptable prospective P/E of 12.3x and it doesn't have much debt. Although a number of the companies I have invested in recently have lots of debt with my expectation being that the economic recovery will enable them to pay down debt and thereby have more upside potential in their share prices (provided they survived the current debt challenge). Fisher & Paykel Appliances and Nuplex are companies that fit into the latter camp.



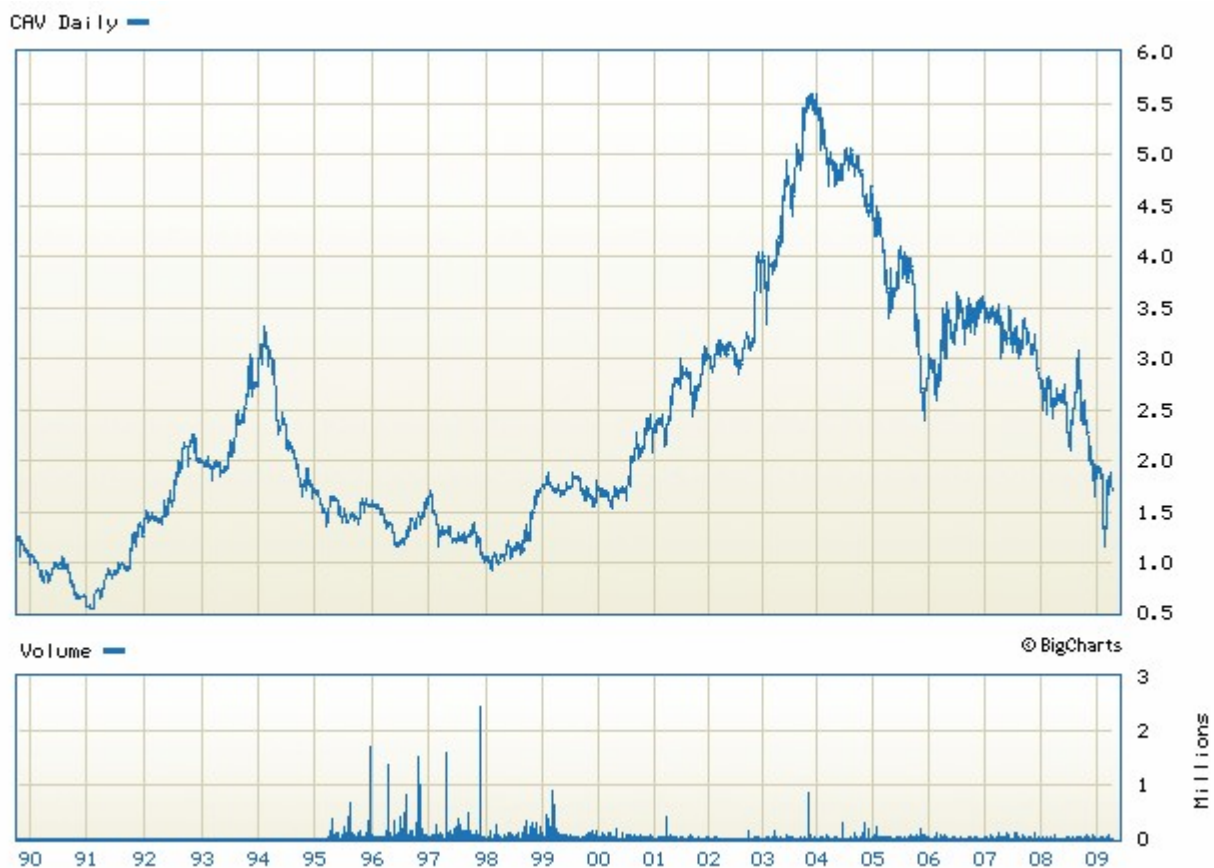
Source: [www.nzx.com](http://www.nzx.com)

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Nothing is a sure bet but I would much rather be buying HLG at \$2.41 after it has been ravaged by the recession and when it has a higher dividend yield than when the share price was above \$5, the dividend yield was lower and it was at risk of significant downside if the economy took a tumble.

The chart below is of Cavalier's share price, which like HLG fits into my criteria pretty well. Unfortunately the small NZ market doesn't have lots of HLG and CAV's to choose from. But knowing the criteria I have used to setup my portfolio would-be countercyclical share market investors can do their own homework, potentially with input from a helpful, experienced share market advisor, to compile a portfolio of listed companies that offer the potential to take advantage of the NZ recession and to a lesser extent the global recession. Again, key criteria are investing in companies that have shown the ability to survive recessions and prosper thereafter and are expected to survive the current recession, and investing in a selection of companies that give a diversified exposure to the economic recovery that appears to be budding. Doing this reduces the need to focus in depth on individual companies. It doesn't eliminate the risk that one or more of the companies I have invested in will go belly up, but even if one or two of the companies I have invested in do fail by investing during a recession it means the performance of the overall portfolio of shares should do well provided life as we know it continues after the recession.



Source: [www.nzx.com](http://www.nzx.com)