

What does a credit rating actually mean?

Have you ever seen a bank, insurance company, finance company or financial institution advertising their 'credit rating'? Given the plethora of information and all the different types of ratings, it's hardly surprising many people are confused about what they actually mean (it's certainly not as easy as ABC!)

However, with several finance company failures recently, it has never been more important to understand it all. So, let us try to explain.

Put simply, a credit rating is an objective, independent assessment of an institution's ability to meet its financial commitments (which might include interest payments and the repayment of your investment capital). Effectively it tells you how financially secure the company is (and therefore the likelihood of you getting your money back when you invest it).

This is important for three reasons:

1. Almost every investment carries risk, and credit ratings help you to gauge the level of that risk.
2. You can work out whether you are comfortable with the given level of risk.
3. We can then work out what sort of return would be appropriate for the investment. This is often reflected in the margin that the investment provides over and above the 'risk-free' rate.

For example, let's say you can invest into New Zealand Government bonds (which have the highest possible credit rating of AAA from Standard & Poor's) at 7.5% p.a. before tax (effectively, this is the risk-free rate). And let's say you are thinking of investing in a company like South Canterbury Finance, which is rated BBB- and is offering say 9% p.a. before tax.

Through the credit rating, the investor/adviser is able to assess whether the extra 1.5% offered by South Canterbury (over the risk-free rate) is sufficient return for the extra risk - because BBB- is a lower rating than AAA.

And how do you quantify the extra level of risk? The best way to do this is to look at what the credit rating means in terms of the probability of default (i.e. the risk that the company will be unable to pay interest and/or principal). This is shown in the following table from S&P.

	RATING CATEGORY	ESTIMATED PROBABILITY OF DEFAULT OVER AN AVERAGE ONE-YEAR PERIOD
Extremely Strong	AAA	0-0.01%
	AA	0.01-0.02%
Highly Vulnerable	A	0.05-0.1%
	BBB	0.2-0.4%
	BB	0.6-1.6%
	B	3-11%
	CCC	25-30%
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2007 will be remembered as the year RISK returned to investing. Investors in finance company debentures got a nasty wake up call. While this was going on some major changes were happening to the investing landscape. PIEs and PIRs were added to our investment language and KiwiSaver became a reality. To be well positioned for future regulation, your advisers have worked hard to achieve best practice certification.

We would like to take this opportunity to thank you, our valued client, for your support and business over the past 12 months and wish you and your family a safe and prosperous festive season. We look forward to contact with you again in the New Year.



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So, as you can see, over a 12-month period, the investments that are rated AAA have a risk of defaulting of between 0.00% and 0.01% (or a one in 20,000 chance).

Meanwhile, a company like South Canterbury (BBB-) has a somewhat higher risk of default (a one in 3,333 chance). However, the risk tends to increase exponentially once you get to a rating of 'single B' and below.

Generally companies rated below BBB- are considered to be 'sub investment grade', which basically means they carry a higher degree of risk. It does not mean you should never invest in these securities, but it is important the return is commensurably higher in order to justify the extra risk.

And a word regarding the rating agencies – we tend to favour companies rated by the 'big three' international, mainstream rating agencies (Standard & Poor's, Moody's and Fitch). They all have well-developed processes, long track records and substantial sets of default data (which show how accurate their ratings are). While several non-bank finance companies in New Zealand still have no form of rating, we believe they will in the future have no choice (and that can only be positive for the consumer).



life's tip #1:

"Sometimes your joy is the source of your smile, but sometimes your smile can be the source of your joy." – Thich Nhat Hanh

A Christmas gift idea...

- To your enemy, forgiveness.
- To an opponent, tolerance.
- To a friend, your heart.
- To a customer, service.
- To all, charity.
- To every child, a good example.
- To yourself, respect.

– Oren Arnold.



The Dr Michael Holt Story

At the recent ING conference in Queenstown, we heard an amazing story that we wanted to share with you, because it has some very important lessons for all of us.

One of the speakers at the conference was Dr Michael Holt. Here is his story (briefly).

- Dr Holt was a young, successful and dynamic orthopaedic surgeon in a successful private practice in Brisbane with everything to live for (he had the perfect life).
- In a split second his life was ruined after he was struck by a car crossing the road. He was simply going about his business and lost concentration for just a moment.
- He was almost killed and his life hung by a thread for days. Although he survived, he was left with permanent and seemingly debilitating injuries.
- His beautiful life was irretrievably lost, and at the time it was thought that with his partial blindness, partial deafness and other injuries, no-one would ever let him be a surgeon again.
- Dr Holt had to drag himself out the depths of depression and hopelessness to rebuild his life both physically and mentally. Dr Holt attributes his eventual success to the love of his family and the financial security through having adequate insurance in place.
- Thanks to his persistent and diligent financial planner, Dr Holt had extensive trauma insurance and total and permanent disablement cover. Because of this, Dr Holt was able to rebuild his life.
- After a four-year battle to establish his credentials and ability, Dr Holt was able to return to the life he once led in private and public Orthopaedic practice and continues to lead a very full life.

His presentation was stunning and it resonated with all of us present. The messages are clear:

1. Insurance can make a massive difference to your life (Holt said without it, he would have lost his home, his career and maybe his family).
2. Although many find the cost of insurance unpalatable, no one ever complains about the cost if they need to make a claim!

If you or anyone you know is unsure about their risk management needs, we would urge you to contact your adviser sooner rather than later.

- Insurance could make a massive difference in your life
- Credit ratings provide a valuable assessment of an investment's risk

Top seven tips to avoid Christmas financial chaos

With Christmas fast approaching, we thought it useful to remind you of some simple steps to help you avoid those large credit card bills in the New Year.

1. Work out how much you want to spend on presents and don't exceed this. Keep in mind that most people (except the kids and grandkids) aren't too fussed about what you get them, so there's normally no need to go overboard.
2. Start saving early by putting regular, small amounts into a dedicated account each month. (Could you start putting money away for Christmas 2008 now?)
3. Try and buy presents gradually through the latter half of the year (and avoid those huge last-minute shopping queues).

4. Try to avoid using your credit card. Remember the old saying - "those who understand interest earn it; those who don't, pay it".
5. Save for the cost of your holidays as well (this is often an area where families get caught out, as the costs quickly mount up when you go away).
6. Maybe use Christmas as a great opportunity to teach your children about money. Could you make a donation for example to UNICEF? What about establishing a KiwiSaver Account for them or opening an education trust?
7. Have fun.

From all of us, have a wonderful Christmas with your family, and we look forward to further helping you achieve your financial goals in the New Year.

life's
tip
#2:

"The function of leadership is to produce more leaders, not more followers."
– Ralph Nader

Move that palm!

Those of you still crying into your beers about the All Blacks' disappointing loss in the Rugby World Cup may be interested to know that Western Samoa's first rugby international was against Fiji in 1924. That's not so surprising, but what is, is the fact the game kicked off at the unusual hour of 7am, so the Samoans could go to work afterwards!

Also, the match was played in a local park - with a tree in the centre of the pitch!

The more things change, the more they stay the same

A lot has been happening to the investment markets on the back of some significant economic events over the second half of 2007. These include:

- The New Zealand dollar soaring to over 80 cents against the US dollar, only to fall back below 68 cents in a matter of weeks (at the time of writing, it was trading between 72 and 78 cents).
- Overseas sharemarkets have experienced significant volatility, following the fallout from the US sub-prime mortgage market (though markets have stabilised lately).
- A number of finance company failures in New Zealand.
- A focus by the media on several heavily leveraged credit-type investments that have suffered capital write-downs and liquidity issues.

However, it is important for all investors to maintain a balanced perspective in the current environment, and to steer through the 'noise' generated by the media. Why?

1. In times of investment market volatility, investors often believe it is best to sell their investments or reduce their exposure in favour of 'safer' investments. This is one of the classic errors of behavioural finance (i.e. making an important decision that will affect you over the long term, based on short-term performance).
2. Globally, company balance sheets remain strong and earnings have grown (so fundamentals are still robust). Company default rates are actually at all-time lows.
3. History has proven that those who try and 'time the market' invariably get it wrong. By contrast, those who maintain 'time in the market' often end up with the strongest performance over the long term.
4. One of the major detractors of performance in the international equities sector has been the rise of the New Zealand dollar. Maintaining exposure to international assets will help you benefit from any decline in the currency if/when it occurs.

5. Many of the managed funds that invest internationally are diversified across multiple securities (so if a few fall, your whole fund won't be affected nearly as much as if you only held a few securities). Most of these funds are also liquid, so you can switch between funds at any time.
6. The current volatility actually creates a great buying opportunity for the astute investor. Shares remain a robust option for long-term investors. Wouldn't you have loved to buy international shares following the 'dot.com' crash in 2000?
7. The recent PIE tax changes mean that the after-tax return on many managed funds will be higher going forward.
8. Make sure you revisit your original personal goals and objectives. If none of these has changed, there is unlikely to be a need for changes overall.

The message in summary is to ignore the short-term noise and focus on long-term fundamentals, because there are many reasons to maintain a disciplined approach to investing.

summing
up

- Enjoy your Christmas, but make sure you don't blow out financially
- Don't over-react to volatility in investment markets. Nothing has changed fundamentally

Out of volatility comes opportunity

We have certainly seen quite a high degree of volatility in investment markets recently (as a result of finance company failures, the global 'credit crunch' and currency fluctuation). One of the key lessons for investors is that this volatility creates a fantastic opportunity to buy good quality assets at a discount. This is currently the case in bond markets.

Let me explain what I mean. A bond is essentially an IOU. It means that if you invest your money with the Government or a company, they will give you regular interest payments (generally six monthly) and pay back your principal on maturity. You can also buy and sell these bonds on the secondary market (so you can get out if you need to).

Now, the more complicated bit - how bonds are priced. The key thing to remember is that the price of a bond is inversely related to its market interest rate (known as the yield). So this means if the interest rate goes up (as many have currently as a result of some of the factors listed above) the price of the bond goes down (and vice versa).

Let's take an example. You invest \$10,000 into a new issue bond which has an 8% coupon (i.e. the interest rate that you get per annum). After nine months, the interest rate you can sell the bond at (the yield) has increased to 9%. This means that because there is an inverse relationship between interest rates and bond prices, the value you could sell the bond for has decreased.

So the bond may be worth say \$9,200 if you were to sell it. But the key is that this creates a great buying opportunity for a new investor looking to enter the bond market. Effectively it means that a new investor would only have to pay \$9,200 for a bond with a face value of \$10,000 and get a more attractive yield of 9%.



This is because the amount of interest you receive (the coupon of 8%) does not change and you effectively receive this income on the full \$10,000 face value (not the \$9,200 you have paid) so the overall return is much higher.

Let's talk about this in relation to a product from ING called the Regular Income Fund¹. This fund invests into Collateralised Debt Obligations (CDOs) which are effectively like repackaged loans and are traded like bonds. The fund has no leverage and has an average BBB- rating from S&P. The fund has been affected by the global credit crunch and has suffered mark downs in its value as a result of mark to market (i.e. paper) losses from its underlying securities, even though the fund remains fundamentally robust.

However, this creates an opportunity. The fund is still receiving regular coupon income of around 8% p.a. However the unit price of the fund is below 90 cents, which means the running yield for a new investor would be around 11% gross. Now, where can you get an 11% return for a diversified portfolio of BBB- securities?

The lessons?

1. Don't just put your money in the bank. Look at some of the outstanding buying opportunities in the market as a result of recent volatility.
2. Buy in the gloom and sell in the boom, because no one ever got truly rich by following the herd!

¹ An investment statement is available via www.ingnz.com or from your financial adviser.

life's tip #3:

*"We make a living by what we get,
but we make a life by what we give."
– Winston Churchill*

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