

Investors Should Remember Caveat Emptor

This year has been a mixed bag as far as regulation of New Zealand's capital markets is concerned.

It began badly with the government scrambling to simplify its cumbersome and costly financial advisers legislation, which was a response to the finance company collapses.

As drafted, the regime threatened to heavily regulate even the simplest of conversations in a bank and to treat sophisticated or 'wholesale' customers in the same way as 'mum and dad' investors.

The government eventually listened to industry and improved it, but even so some of New Zealand's best and most experienced financial advisers are retiring rather than jumping through the regulatory hoops.

The end of the year has seen the introduction of legislation establishing the new 'super-regulator', the Financial Markets Authority.

However, this 250-page bill is again overkill. It deprives investors of rights of action without their consent and exposes the stock exchange to new and costly intrusions by regulators and politicians.

Submitters have called for the bill to be stripped back to what is needed to establish the FMA and for other issues to be dealt with as part of the current review of securities law.

These events are unfortunate given that 12 months ago the government received a high quality report from the Capital Markets Development Taskforce chaired by Rob Cameron (one of the critics of the FMA bill).

The Taskforce rightly saw the main aim of policy in this area as being to promote the efficiency of our capital markets – to encourage a plentiful supply of savings and channel them to investors to allocate in the most productive way.

By contrast, 'investor confidence' (or 'investor protection') cannot sensibly be elevated as the overriding goal of capital market regulation. Any investment paying more than the government stock rate has a likelihood of loss that no adviser or regulation can remove.

The Taskforce explained the limits of regulation clearly in its final report.

"'Market discipline', where bad practices are driven out by competition or transparency, or 'self discipline', where participants have their own capital or reputation at risk, are the frontline and most powerful tools for a sound capital market", it said.

Capital market efficiency requires that those who allocate funds to risky investments are *not* protected against the consequences of their decisions.

The government's proper role in investor protection is to crack down on fraud and misrepresentation, not to protect investors from business risks and folly.

The approach of minister of commerce Simon Power has been inconsistent.

On the one hand he has acknowledged that "the government and its agencies cannot ... remove the risk from investment decisions". They can only ensure that "investors are supported with relevant and accessible information, and ensure that market participants adhere to the rules."

On the other hand the minister has overseen a barrage of new and intrusive legislation in the name of promoting 'investor confidence', most recently the FMA bill.

Cautionary remarks about misplaced trust in regulators go back a long way.

Adam Smith, for example, wrote, "The statesman who should attempt to direct private people in what manner they ought to employ their capital would ... assume an authority which could safely be trusted, not only to no single person but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it."

Reading the job specification for the chair of the FMA (“has an air of authority and confidence that when statements are made the markets listen and take each message seriously”) brings to mind Smith’s words about folly and presumption.

A moment’s sober reflection suggests that the finance company losses reflected *too much* investor confidence. Investors need to understand that higher returns are always associated with greater risk. The onus must fall on them to bear that risk, not on taxpayers.

The supreme folly of governments underwriting investors’ risks is being played out in Iceland and Ireland. We have had our own version with South Canterbury Finance and similar failures.

The basic rules of investment are old and time-tested:

- don’t invest money you can’t afford to lose
- steer clear of products you don’t understand or seek competent advice
- if you want minimal risk, buy short-term government stock
- don’t put all your eggs in one basket (diversify across investment products and countries)
- ‘buy and hold’ is a sensible strategy.

Other useful techniques are putting the same amount of money into the market at regular intervals (‘dollar cost averaging’) and ‘rebalancing’ to keep a portfolio consistent with a desired level of risk tolerance.

For the vast majority of investors, caveat emptor strategies of this kind are far sounder than reliance on ‘investor protection’ by regulators.

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