Perpetual

THE PSYCHOLOGY OF TULIPS

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We can thank the Dutch for more than Van Gogh. They also delivered what is arguably the world's first asset bubble – *Dutch Tulip Mania*. It's an interesting story in light of today's low yield world because it highlights the dangers of investment 'group think'. But more on that later – let's get back to those tulips.

They were all the rage in 17th century Holland after their introduction from Turkey. People couldn't get enough of the unique flower. Demand pushed prices up. Then the tulips contracted a friendly virus (called 'mosaic') which transformed them into something even more beautiful, creating the flames of colour we now see on their petals. Prices hit the stratosphere. The demand for new tulip varieties escalated to a point where a person could trade a single tulip bulb for an entire estate.

Everyone wanted a piece of the action, buying bulbs and speculating on the tulip market. Before long these perfumed assets were trading so far above their value that some investors decided to sell and take their profits. A chain reaction of selling followed, panic set in and the market crashed. In the end a tulip was worth the price of a common onion. That's enough to bring water to your eyes.

Why do tulips matter? Because 'herding' – what behavourial finance experts call our inborn tendency to follow the crowd when we invest – is flourishing in Australia and around the world.

Today many investors are challenged by a low yield environment. They're seeking money to live on – but at low risk. Cash is flowing into a few select asset classes, assets perceived to offer that crucial combination of low risk and reliable income. Paradoxically, instead of finding greater safety, investors may be concentrating their risk **and** driving the price of some defensive assets into dangerous territory.

Yield to market forces

The Reserve Bank of Australia has reduced the official cash rate to 1.75% and our 10-year bond yields have fallen to the lowest levels on record (it could actually be worse – you could be in Japan or Germany where rates are ***negative)***. These are particularly challenging times for those relying on cash and bond returns for their income.

Some investors have sought a solution by buying into defensive stocks – those seen as safe investments because the companies involved operate in sectors insulated from a broader economic downturn. The consumer staples sector (grocery stocks) is one example. The utilities sector is another – people need services like electricity and gas, whatever the broader economic outlook.

The problem arises when the volume of money flowing into these stocks (and into certain other assets like real estate or bonds) inflates their price. Every asset becomes a risk at a certain price – overpay for defensive assets and they aren't defensive at all.

In a low-return world the temptation to seek safety and stable income in the obvious places may work against you. There's no perfect solution when economic forces combine – at least in the short-term – to work against you, but there are some key principles you need to remember…

So how does Perpetual protect clients in a low yield world?

The essence of the Perpetual approach is "protect first, grow second". That's why we keep our clients out of assets that our analysis suggests are overvalued – even if they are obvious short-term generators of income. We want to reduce the risk of the portfolio because in the medium-to-long term, losing money chasing income is just as counter-productive as losing money chasing growth – you end up with less capital, which ultimately leads to less income in the future.

The other key to our approach is smart – and wide – diversification. When obvious sources of income are too risky and too expensive, we use our **global** investment view to find what we believe are different sources of income, that don't rely on the performance of stock markets to generate a return.

If we can avoid buying what looks like tulips, but actually turns out to be onion bulbs when held close up, we can protect our investors' savings over the long-term.