



Fisher Funds

Investor Education Centre

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Government regulation

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By now you will have digested this year's Budget and considered the bits that have an impact on you and your lifestyle. Whatever the impact on you, spare a thought for New Zealand businesses.

Every Budget or government announcement can potentially make or break a business, and a single rule change can fundamentally alter the investment appeal of a particular stock.

We believe that the investment appeal of a stock is inversely related to the amount of government regulation that a company is exposed to. The more regulations surrounding an industry or a business, the less appealing it becomes.

Government regulation is typically at its worst in monopoly situations. Where a business does not have a lot of competition, the Government will step in with regulation to ensure that the business does not take advantage of its market position by, for example, charging high prices.

We often see government regulation, or the threat of regulation, in public utilities such as electricity, telecommunications, and water companies – industries that have high barriers to entry making it difficult for a newcomer to get a competitive foothold.

We have seen the impact of government regulation on businesses like Telecom, Contact Energy and Auckland Airport and will likely see more in the future, not only in the infrastructure sectors, but across the economy.

Over the last few weeks, property companies have waited in trepidation for the Budget announcement, as the Government has made it clear that they want to make investment in the property sector relatively less attractive, so that investors will spread their wealth further throughout the economy.

While utility sector monopoly businesses like power companies are appealing because they seem to have a licence to print money, their attractiveness for share investors is ultimately limited because the government will never let them earn super profits.

Investment master Warren Buffett is known to avoid regulated industries and commodity businesses with limited pricing power. Put simply, he wants to invest in companies that can price their products however they like. If their product or service is so good that customers are prepared to pay the asking price, then let the company charge that price. And if their profitability keeps rising because their product is so good, then so be it.

There are good monopolies and bad monopolies.

For share investors, the bad ones are those that are limited by government regulation. The good ones are monopolies that have emerged by virtue of a company being significantly better than its competition. Buffett refers to these monopolies as 'franchises'. Examples in Buffett's portfolio include Coca Cola (strong brand name), The Washington Post (market dominance and leader), Furniture Mart (the lowest cost in the industry).



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Where 'bad' monopolies come into their own is in the area of fixed interest investing. While the profitability of regulated monopolies might ultimately be capped, the certainty of their income is very desirable for an investor seeking a regular income and preservation of capital. It is comforting to know that the company you have lent money to has no competition and will generate consistent returns for years ahead.

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