QUARTERLY REPORT: September 2008

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Market Commentary

The collapse of the US investment bank Lehman Brothers in mid September proved to be a dramatic turning point in markets this year - amplifying fears and further declines in stock values that have accelerated in early October.

Appended is your portfolio performance report for the quarter and the valuation report as at 30 September. In light of the continuing rapid developments, this commentary provides perspectives on both the quarter and early October markets up to the date of publication.

The deepening financial crisis that started in the US mortgage market, and now envelops the world banking system, has lead to dramatic falls in share market indices around the world. Fear was the dominant emotion motivating sell orders and tumbling values for the week ending 10 October. The 'credit crunch' has now spread to the 'real economy' (denoting the part of the market that represents productive industry - companies that make and sell economic goods and services) prompting fears of a worldwide recession. The International Monetary Fund (IMF) has labelled this the most dangerous financial shock in mature financial markets since the 1930's. However, they add, *"with the right macro [economic] and financial policies – and these policies are available – we can ride out the storm and expect recovery to start in the course of 2009"* [(1)].

[(1)] IMF Chief Economist, Oliver Blanchard – World Economic Outlook

In the midst of the turmoil we observe very different reactions from market participants. Some panic selling has certainly occurred. Short selling of stocks (where speculators attempt to sell shares that they do not own with the expectation of repurchasing the share at a lower price before they are required to settle the trade) has been evident again following the lifting of restrictions on such practice on 2 October. On the flip side of these trades are buyers, purchasing what they believe are over-sold securities at bargain prices.

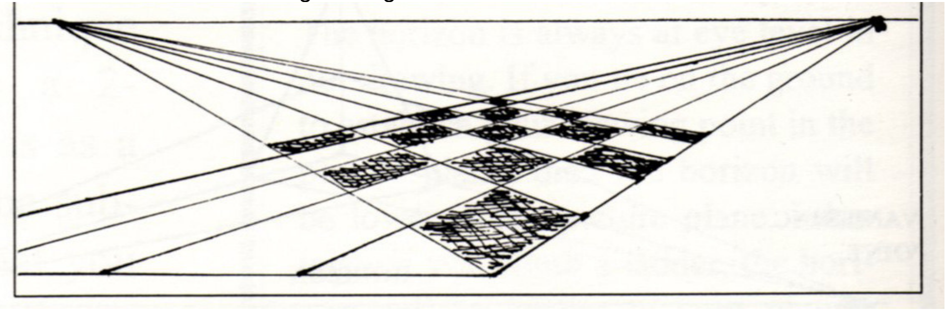
But the greatest proportions of investors have held their portfolios and are riding out the current crisis. This is the prudent approach supported by history as the best way to avoid the costly mistake of exiting the market after a fall, cementing losses and missing the recovery that follows. Further, it is what sophisticated investors (such as the large pension funds and institutions) are doing. Similarly, we are maintaining client asset allocations and not responding with any kind of knee jerk reaction to the unfolding events.

This is not a share market problem, but an economic problem. Apart from cash and government-backed securities, no asset class has been unscathed by these recent events:

- Commercial and residential property, formerly seen as a safe asset class (many people falsely believing that property values never go down) is now well off the peaks reached in 2007. It is difficult to know how soft this market has become as most property is not for sale and therefore an accurate valuation is not available in real-time. However, anecdotes indicate a substantial reduction in values has already transpired.
- Commodity values including oil, gold and other precious metals have declined in step with the tumbling stock markets. (Gold for example has fallen over US$100 an ounce, or 10% from its peak in January this year).
- Primary produce values have dropped sharply (Dairy prices falling 7.9% in September following a 4.9% drop in August).

Events in Perspective

The week ended Friday, 10 October, saw unprecedented falls in share market indices around the world. The weekend that followed saw further internationally co-ordinated action by government policy makers with a fresh round of initiatives to stabilise the banking sector. Government guarantees for retail deposit holders were announced along with further injections of central bank funding to financial institutions and a plan in some jurisdictions for government money to re-capitalise banks themselves. The markets responded positively with dramatic rises in share indices recorded on Monday, 13 October recovering some of the previous week's losses. (The US Dow Jones Industrial Average made headlines with an 11% one day gain). However, by Wednesday the sentiment had turned negative again.



These huge swings in market pricing are symptomatic of trading based on the emotions of fear and greed. Benjamin Graham said: *"In the short run, the market is a voting machine but in the long run, the market is a weighing machine".* The swinging voter has vacillated between a 'doomsday view' and one of 'measured optimism' that the worst is past.

We have seen market volatility before, and historically there have been significant bear markets before, namely, the oil shocks of the early 1970's followed by a period of 'stagflation' (or low growth and high inflation); the 1987 share market crash where stocks fell up to 20% in a single day; the US savings and loan crisis of the 1990's ; the Asian crisis of the late 1990's and the busting of the inflated bubble in values of technology stocks in 2001/ 2002. But is it different this time?

Whilst the circumstances of each bear market period have been different, the way that the market processes the information is similar. The future remains unpredictable, and the timing and extent of the recovery surprises as much as the initial downward shock.

Markets don't always get pricing right in the short term. That's the nature of risk. However, they are always moving towards equilibrium (with every seller requiring a matching a buyer) based on all the currently available information. A century of financial analysis, as well as the insights from the field of behavioural finance, suggests that investors who bail out of equities at times like these are almost always making the wrong decision in terms of their long term financial well being.

Asset Class Returns

A summary of the gross returns in New Zealand dollars (NZD) for the key asset classes we track and which form the core of most client portfolios, are listed in the table below.

In summary, the September quarter delivered negative returns with the exception of cash, bonds and interestingly Global Property. The numbers for a full year to 30 September are materially negative for International, Australian and New Zealand growth assets alike. The depreciation of the NZ dollar against the USD during the period has softened the decline in reported values for global assets, apart from the Vanguard Large Company Trust where the hedging to the NZD neutralises this benefit of a sliding currency. Conversely, the NZD has strengthened against the Australian dollar (up from 0.77 in August to 0.91 in early October) exacerbating the poor underlying equity returns.

We draw your attention to the 5-year (p.a.) column in the table below. Whilst the recent falls in value have reduced the compound returns over this period, the per annum results are positive and in most instances remain in keeping with long-term expected returns.

NZD Returns to 30 Sept 2008

	3 months	1 year	3 year (p.a.)	5year (p.a)
International Shares				
Australian Core Equity	(13.7%)	(26.0%)	n/a	n/a
Australian Large Companies	(15.5%)	(25.4%)	6.5%	13.0%
Australian Value Companies	(12.3%)	(20.5%)	6.6%	14.1%
Australian Small Companies	(18.2%)	(23.6%)	9.0%	14.4%
International Core Equity	(2.8%)	(17.0%)	n/a	n/a
Global Large Companies	(1.6%)	(15.1%)	2.4%	4.8%
Global Large Companies (NZD Hedged	(10.6%)	(21.6%)	2.7%	9.7%
Global Value Companies	(1.4%)	(18.3%)	1.9%	7.4%
Global Small Companies	(0.1%)	(15.6%)	0.9%	6.2%
Global Real Estate	4.7%	n/a	n/a	n/a
Emerging Markets Companies	(8.9%)	(18.0%)	10.9%	16.3%
International Fixed Interest				
Diversified Fixed Interest (AUD class)	(5.5%)	7.0%	7.6%	6.5%
Diversified Fixed Interest (NZD class)	0.7%	7.4%	6.8%	n/a
New Zealand Assets				
NZ Share Portfolio	(2.0%)	(25.6%)	(0.8%)	8.4%
NZ Property Companies	(4.3%)	(15.7%)	4.0%	9.6%

Notes:
* Returns are reported after fund management expenses and are pre-tax.
** Past performance is not necessarily an indicator of future performance.

Downturns and recoveries

The following is an update on the article we wrote for our March Economic Commentary: As share prices have slumped around the world over the last year investors have been confronted with a barrage of grim news – falling home prices, rising costs for food and fuel, collapsing banks and concerns over the fragile health of the global banking system (although this has been somewhat mitigated more recently with the deposit guarantees being provided by Governments throughout the Western World).

Some investors and commentators have concluded that the current state of affairs bares little resemblance to the past and are questioning the wisdom of maintaining a consistent exposure to shares at all. They are wrong.

The table below examines U.S share market returns since 1916 from their peaks to their lowest points and subsequent returns for one and ten years following the low points. Whilst the data applies to the U.S market it is also a useful barometer for global developed share markets.

US Stock Market Returns - the Market Always Recovers

High Point	*Low Point*	*Length of Downturn (months)*	*Size of Downturn*	*Size of Recovery One Year Post Low*	*Size of Recovery Over Next 10 Years*	*10 Year Average Return*
Oct-1916	Jul-1920	46	-41%	10%	345%	35%
Aug-1929	Jun-1932	35	-89%	105%	233%	23%
Mar-1937	Mar-1938	13	-47%	48%	75%	7%
Oct-1939	Apr-1942	31	-38%	44%	183%	18%
May-1946	Feb-1948	22	-21%	6%	169%	17%
Dec-1972	Sep-1974	22	-46%	39%	161%	16%
Nov-1980	Jul-1982	21	-22%	53%	277%	28%
Sep-1987	Nov-1987	3	-30%	21%	312%	31%
Mar-2000	Oct-2002	32	-46%	22%	87%*	17%*
Oct-2007	???	???	-43%^			

Data: Dow Jones Industrials Index 1910 to 1950, S&P500 Index 1950 to present.
Notes: * Five year period to and including September 2007
^ October 10 2008

The table shows that throughout history investors who have had the patience and fortitude to maintain their investment discipline during periods of market weakness have often been well rewarded in the subsequent year and decade. What's more the returns have come as a very pleasant surprise for investors whose expectations had been unduly depressed by the bear market just past.

An example of this diminished expectation is a headline in Time magazine dated September 9 1974 **"Seeking Relief from a Massive Migraine".** The article goes on to say *"Investors have been frightened of an economy that seems out of control….. The stockmarket has scarcely been so shaky since 1929……… A Gallup poll found that 46% of adults feared a depression similar to the classic one of the 1930s".*

And yet in the twelve months following the 1974 Time magazine article the market went up 39% and over the next decade 161%.

This is not to say that the world sharemarkets are set for an imminent bounce or prolonged rise in returns. It is a reminder though, that if investors ride out the volatility, stay disciplined, remain well diversified and keep focused on their long term goals they will put the odds of success in their favour and be well positioned to reap the rewards.

Government Bank Guarantee Scheme

To help rebuild some confidence in our financial system and economy and in response to moves by other central banks around the world The Reserve Bank has announced a Deposit Capital Guarantee Scheme. The scheme proposes to provide a Government guarantee for depositors placing funds with '*approved'* participating New Zealand registered banks, building societies, credit unions and finance companies. Primarily the Scheme will cover retail deposits and other debt securities made by residents and overseas people who are New Zealand tax payers or New Zealand citizens.

Who is covered?

The Scheme potentially covers all banks and non bank deposits and as long as an institution is not in breach of their trust deeds they are eligible to apply to the Reserve Bank. We expect that all institutions that meet the criteria will apply and will inform the market as soon as they are approved.

Does It Cost Me?

Initial announcements indicated that The Scheme would be free for institutions with total retail deposits less than $5 billion and a 0.1% p.a. fee would apply to larger organisations. This could have resulted in Banks subsidising smaller and more "risky" organisations. More recently the Reserve Bank have modified their proposals and indicated that Scheme fees will apply to smaller organisations. No doubt the regulations will change over the next few weeks and while there will be no direct charge to the investor these additional costs will need to be passed on which could result in lower deposit rates.

Market Considerations & Opportunities

The Government's move to shore up depositor confidence *could* create short term opportunities to profit by investing with riskier institutions offering higher returns than one might ordinarily consider, purely because these investment options can now be 'approved' and guaranteed under the scheme.

Time will tell, however. Our view is that these potential loop holes will be addressed by legislation as it comes into effect or prices will rapidly adapt to compensate.