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Asset Class Returns

Returns in New Zealand dollars (NZD) for the key asset classes we track, and which form the core of most client portfolios, are as follows:

NZD Returns to 30 September 2006			
	3 months	1 year	3 year (p.a.)
Australian Large	(4.0%)	19.8%	22.2%
Australian Value	(0.8%)	17.3%	23.2%
Australian Small	(1.0%)	19.3%	21.7%
Global Large	(2.5%)	21.2%	12.7%
Global Large (NZD Hedged)	5.7%	17.2%	20.1%
Global Value	(2.4%)	25.7%	19.2%
Global Small	(6.0%)	19.3%	16.2%
Emerging Markets	(1.0%)	25.1%	25.0%
NZ Equity Portfolio	(1.6%)	13.0%	20.2%
NZ Property	2.1%	18.6%	18.6%
DFIT International Bonds	2.4%	5.3%	n/a
(NZD Hedged)			
CDO International Bonds	n/a	9.7%	9.2%
(NZD Hedged)			

Market Commentary

The effect of the rise in the New Zealand dollar over the quarter can be seen in the returns table. It is most clearly demonstrated with the Global Large Cap funds. The NZD hedged fund returned 5.7% for the quarter while the unhedged fund was down 2.5%.

Ignoring the New Zealand dollar currency movement, the underlying investment assets are performing well. The appreciation of the currency has had a significant effect on the NZD reported results. If the performance for the quarter is reported in Australian dollars (thereby neutralising the effect of the AUD/ NZD cross rate) one can see healthy returns across international markets.

Returns for the Quarter ended 30 September 2006			
	NZD	AUD	Currency Effect
Australian Large	(4.0%)	6.0%	(9.9%)
Australian Value	(0.8%)	2.6%	(3.4%)
Australian Small	(1.0%)	5.8%	(6.8%)
Global Large	(2.5%)	4.2%	(6.7%)
Global Value	(2.4%)	4.1%	(6.6%)
Global Small	(6.0%)	0.4%	(6.4%)
Emerging Markets	(1.0%)	5.8%	(6.8%)

The recent rise in the kiwi dollar this quarter partially reverses the downward trend in the New Zealand dollar that we saw in the previous two quarters. Economists continue to advise that the downward trend is appropriate based on economic fundamentals and that the recent rally is based on short term sentiment related to interest rate differentials.

Of course, it is worth remembering that when the New Zealand dollar is high, it is a good time to invest offshore should you have additional funds available.

The impact of the rise in the currency on investments is discussed further in this report.



The Impact of Currency on Investments

Over the last quarter we have experienced a substantial rise in the New Zealand dollar (NZD) versus the Australian dollar (AUD), US dollar (USD) and Japanese Yen.

	1 July 06	30 Sep 06	Change
NZD / AUD cross rate	0.8183	0.8743	Inc 6.8%
NZD / USD cross rate	0.6083	0.6542	Inc 7.5%
NZD / Yen cross rate	69.51	77.08	Inc 10.9%



In part this movement has been driven by the high interest rates prevailing in New Zealand compared with other developed countries. For example, New Zealand's 90 day bank bill rate for September was 7.56% compared with Australia at 6.20%, the US at 5.25% and Japan at 0.25%.

This is fuelling strong demand from international investors to purchase kiwi dollars to invest in NZD denominated bonds. The Reserve Bank continues to signal concern about inflation and thus the market does not anticipate a decrease in our interest rates anytime soon.

The rise of the currency has impacted investments held in unhedged offshore equity asset classes, with New Zealand dollar returns showing moderate losses for the quarter. In all cases, the underlying asset class returns are stable with the negative returns being predominately related to the movement in the currency.

Why do we not hedge all currency exposure?

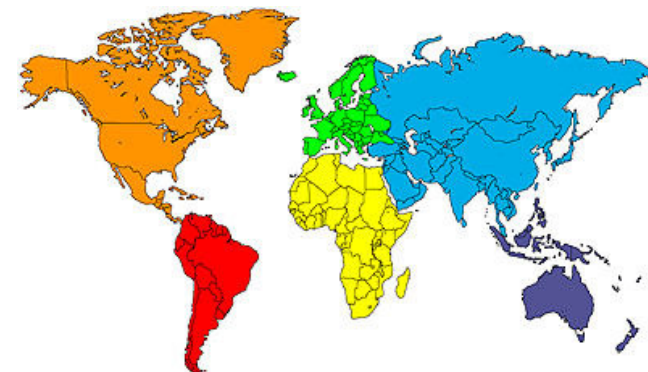
It is worthwhile reiterating the reasons for investing offshore and why we do not hedge the currency exposures for all equity asset classes.

- 1. Matching of assets and liabilities** – In this context liabilities include expenditures on consumables such as food (mainly

Australia), appliances (e.g. China, Japan), motor vehicles (e.g. Australia, Japan, USA).

As the New Zealand dollar rises [falls], the value of the offshore investments correspondingly falls [rises]. Thus offsetting the change in expenditure costs on items such as listed above. I.e. unshielded exposure to offshore currencies creates a natural hedge between investments and the future consumption needs of clients.

- 2. Diversification of investments into the other 99% of the world's economy to protect wealth in the event of a catastrophe befalling New Zealand.** A major earthquake or an outbreak of foot and mouth disease are examples of events that would have a disastrous impact to New Zealand's small and narrow agricultural economic base. It is very likely that in the medium term the NZ dollar will fall substantially following a natural disaster reflecting the economic losses experienced.
- 3. To gain unmasked access to economies with greater growth potential than our own domestic economy.** Historically, New Zealand has experienced slower economic growth than other developed countries. The boom of the past few years is faltering with talk of a possible 'hard landing' ahead to peg back inflation. Diversified international investment enables investors to participate in the benefits of ownership of corporate enterprise in economies with different strengths to those of New Zealand.





Risk

Stress testing your portfolio for

Stress comes in all shapes in sizes. Work, relationships and money can all do their bit to introduce stress into our lives. But financial stress - or rather the understanding of it - can also be a useful tool in your financial planning process.

We find ourselves frequently talking to clients about the risk and return trade-off. However, investors understandably focus more on the reward part of the equation - particularly in buoyant markets like we have enjoyed for the past three years.

This year New Zealand investors with international investment assets enjoyed substantial returns for the March quarter, which have been followed by a drift sideways and modest decline for the succeeding two quarters. Did that induce a financial stress attack? Hopefully not, but the way we feel about our portfolio depending on the numbers that we see reported at quarterly intervals does tell us something about our attitude to risk.

We employ the FinaMetrica risk profiling tool to gain an objective assessment of each client's risk tolerance. This helps us set portfolio parameters so that short term fluctuations in value do not create undue anxiety for each individual investor. Our mutual focus must remain on the underlying long term trend of growth in capital markets and client long term goals and how their funds serve these goals. FinaMetrica provide a mechanism for determining 'comfort' with a given level of risk. How clients react to an unfavourable outcome (loss tolerance) is not predictable with any certainty.

Recent volatility may have provided a prompt to revisit how you feel about risk. We can help you put your portfolio and savings plans to the stress test by revising your FinaMetrica profile and investment objectives.

Changes to Proposed Investment Tax bill - Fair Dividend Rate

A major change to the Government's proposed taxation policy for investors was announced in mid September. Initially the proposal had been to introduce a capital gains tax on overseas investment (i.e. investment outside of NZ and Australia) above a threshold of \$50,000. However, following a record number of submissions to the Parliamentary select committee, these plans have been dropped. An alternative scheme gaining traction with policy makers is a tax on the higher of actual dividends received or 5 per cent of the average market value of the overseas shares. Share investments in New Zealand and Australia are proposed to remain tax free apart from dividend income received.

Finance Minister Michael Cullen and Revenue Minister Peter Dunne are calling this compromise the "Fair Dividend Rate".

How would it work?

The "fair dividend rate" would apply based on the market value of shares held at the start of the year.



We have modelled scenarios for a typical Red/ Axiome investor with a 30% New Zealand and Australian component and calculated the potential additional tax at 0.4% assuming a 10% gross return. This is far less onerous than the original proposal, but will nonetheless prompt a review of client asset allocations once we have certainty of the overall legislative framework.

We will continue to keep you informed on any further updates on the tax bill.



The Benefits of Diversification



Once again, the case for diversification has been made abundantly clear with the failure of one time stock market darling Feltex and the spectacular share price tumble experienced by NZX giant Telecom in recent months.

Feltex was floated on the stock market nearly three years ago to “Mum and Dad” investors at \$1.70. Its fall from grace saw the share price plummet to as low as 1c. It has recently been purchased from the receivers by Australian firm Godfrey Hirst, shareholders having lost all of their money.

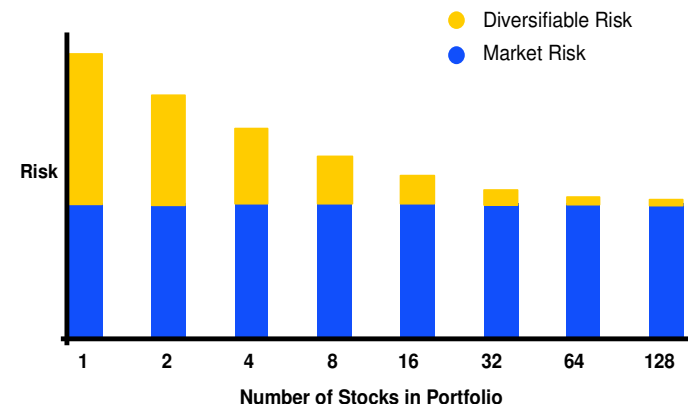
Telecom fell foul of government policy earlier this year with the announcement that the Government was unbundling the telecommunications network, thereby opening up the broadband market to all competitors. The resulting tumble in Telecom’s share price saw it fall from over \$6.00 to close to \$4.00.

The lesson from these two examples is that diversification allows you to reduce the risk in your portfolio, by not “putting all your eggs in one basket”. If you had picked either (or both) of these shares for a directly held portfolio you would have suffered substantial loss. However, by having a widely diversified portfolio, any individual company losses are countered by gains on assets in other areas of your portfolio.

How many shares are required to effectively diversify?

The impact of an individual company failure or downgrade in a portfolio can be eliminated by diversification (accordingly it is termed diversifiable risk). Whilst this risk can be substantially reduced by owning upwards of

twenty shares, statistically it can be entirely removed by owning hundreds of shares (refer to the graph below drawn from research by Lawrence Fisher and James H Lorie; and others ⁽¹⁾). Low cost funds are the most effective way to achieve this diversification. However, market risk (loss from the entire market falling), persists notwithstanding the increase in stocks held.



Diversification by Asset Class

The theory behind diversification is that a portfolio of different kinds of investments will, yield higher returns with lower overall risk. Diversification is available across asset classes, countries, industries and securities. By spreading your investment across a number of different asset classes, you reduce the impact of negative events on your investment.

Research has shown that diversifiable risk of one asset class underperforming can be virtually eliminated through the process of investing across the market in the full range of market sectors. On the whole, markets are efficient, and the investor is not likely to be rewarded for taking individual share risk or share group risk over the long term.

We believe that structured asset classes are an ideal tool in which to invest in a diversified portfolio. More than 750 Australasian securities can be accessed with minimal trading costs through our Australasian funds. This extends to more than 9000 securities in our global portfolios. This effectively provides massive diversification of risk at low cost.



The Rise of Asset Class Investment Strategies

Passive versus active investment strategies have been in the news once again. Journalist John McCrone reported recently in the Christchurch Press and the Dominion that passive investment is evolving with baffling speed. Increasingly research is pointing to the fact that you are more likely to make money on your investments without the assistance of an expensive fund manager! Instead you are best to put your funds in a low-cost, passively run, index or asset class fund. This is exactly the approach adopted by Red via Axiome Consultants.

Recent Standard & Poor's (S&P) results show that over a five year period a simple passive approach will beat 67% of all active money managers. In the US so far this year, the representative S&P Index has beaten active fund managers:

- 68% of the time for 'small cap' stock funds,
- 60% of the time for 'large cap' stock funds, and
- 80% of the time in emerging markets funds!

So much for the heavy investment in corporate research and stock picking techniques of the large investment houses! It's worth remembering that most fund managers charge 2-3% in management fees alone, not including trade by trade transaction costs, taxation and other hidden fees. Passive funds on the other hand are less expensive to run, attracting management fees typically less than 0.5%.

Interestingly, a number of the large Wall Street firms have now introduced their own index type funds in addition to their active strategies. What does this tell you of their faith in their own research and marketing claims that they can outperform?

Asset Class investment strategies have evolved from the original tracker or "vanilla" index funds, predominately through the work of a number of Nobel Prize winning economists. Their work has refined the passive strategies that are being used by Red/ Axiome and number of other investment advisors in NZ and overseas. Using techniques such as asset class investing and more recently 'core equity' strategies, to enable the market to work for you, rather than trying to continually beat the market

through costly stock picking and other active strategies, involves taking a consistent, long term, disciplined approach.

A portfolio designed with a core allocation to structured asset classes will harness the best aspects of passive management without the inefficiencies of some index strategies. Asset Class investing utilises advanced portfolio engineering that is founded on the evidence that structured exposure to relevant market dimensions will deliver the highest returns over time.

As McCrone noted in his article, perhaps the reason that passive investing gets little publicity, is that its low cost, market matching approach sounds too dull! Yet the results speak for themselves. And in the meantime, the science behind passive portfolio engineering continues to develop new strategies for making the most of your investment dollars.

Footnotes

⁽¹⁾ Lawrence Fisher and James H. Lorie, "Some studies of variability of returns on investments in common stocks," *Journal of Business*, April 1970; Edwin J. Elton and Martin J. Gruber, "Risk reduction and portfolio size: An analytical solution," *Journal of Business*, October 1977; and Meir Statman, "How many stocks make a diversified portfolio?" *Journal of Financial and Quantitative Analysis*, September 1987.