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In this report we comment on market influences over the past quarter and update asset class return statistics. Additionally, we feature short articles on:

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Market Commentary

2008 has proved to be a shocking year for investors worldwide. What started out as an issue in the US housing sector, ballooned into what has become known as the “credit crunch” which was the catalyst for a number failures of large financial institutions. Globally there is now talk of a deepening recession.

October proved to be the worst month for share markets around the world since the crash of 1987. Huge volatility was seen with markets dropping by record figures one day, only to bounce back by equally record breaking figures a few days later. By the end of December the S&P 500 index (comprising the 500 biggest listed companies in the US) was down 38% and the NZX was down 31% from a year earlier.

There has been significant government intervention through this period. The US Federal Reserve Bank has stepped in to prop up a number of financial institutions including Freddy-Mac and Fannie-Mae, AIG and Citigroup. The US government also responded with bail out funding for giant car makers General Motors and Chrysler – politically and economically the stakes are high as the US auto industry employs more than three million people. The financial crisis has now spread to the ‘real’ economy affecting industrial output, services and employment.

There have been few safe harbours in this environment. Property prices, commodities (energy, precious metals and agricultural goods) have also fallen as market participants have moved to raise cash and meet commitments.



The credit crunch has led to a substantial de-leveraging of positions where investments have been funded on bank debt and other forms of credit.

The share markets whilst suffering sharp declines have in many respects been operating effectively in distinct contrast to the credit markets that have been frozen necessitating the government bail-outs. For every seller there has been a willing buyer and trades have been settling efficiently (with the exception of share markets in some “emerging” economies, such as Russia where the stock exchange was forced to close temporarily). In this respect, for developed economies the stock market has been a source of liquidity for distressed sellers that have needed to raise cash at any price.

The market distress has also brought to light the folly of poor investment practice and the lack of transparency in complex and secret structures often described as ‘hedge funds’. The most notable example of this has been the exposure of Bernard Madoff, who for decades has operated a hedge fund by way of a ‘ponzi’ scheme (a fraudulent investment operation that pays returns to investors out of the money paid in by subsequent



investors). Up to US\$50billion has been misappropriated. Public protection from regulatory supervision over hedge funds has always been limited with investors foregoing usual safeguards under the pretence that they are sophisticated high net worth clients.

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.

NZD Returns to 31 December 2008

	3 months	1 year	3 year (p.a.)	5year (p.a)
International Shares				
Australian Core Equity	(20.6%)	(38.4%)	n/a	n/a
Australian Large Companies	(16.1%)	(33.9%)	0.1%	7.8%
Australian Value Companies	(17.1%)	(30.3%)	0.3%	8.7%
Australian Small Companies	(28.9%)	(45.2%)	(2.1%)	5.6%
International Core Equity				
International Core Equity	(11.7%)	(22.4%)	n/a	n/a
Global Large Companies	(11.1%)	(20.9%)	(3.0%)	1.7%
Global Large Companies (NZD Hedged)	(22.4%)	(37.9%)	(7.3%)	2.0%
Global Value Companies	(16.9%)	(27.4%)	(5.5%)	2.3%
Global Small Companies	(13.2%)	(20.5%)	(5.3%)	2.7%
Global Real Estate	(31.2%)	(39.3%)	n/a	n/a
Emerging Markets Companies	(17.6%)	(33.3%)	1.1%	10.6%
International Fixed Interest				
Diversified Fixed Interest (AUD class)	3.9%	12.1%	9.9%	7.0%
Diversified Fixed Interest (NZD class)	3.2%	8.5%	7.7%	n/a
New Zealand Assets				
NZ Share Portfolio	(12.4%)	(31.4%)	(4.3%)	4.0%
NZ Property Companies	(9.6%)	(20.8%)	(1.8%)	6.4%

Notes:

* Returns are reported after fund management expenses and are pre-tax.

** Past performance is not necessarily an indicator of future performance.

Investments that were denominated in global currencies tended to fare better than Australian, New Zealand and securities that are hedged to the New Zealand dollar.

There was an uneven movement in exchange rates across the currencies we monitor as reflected in the table below.

NZD value change compared to:	USD	GBP	AUD	Yen	Euro
	December Quarter	-17%	0%	1%	-29%
2008 Calendar Year	-28%	-2%	-6%	-41%	-21%

As credit conditions have tightened internationally there has been a flight to perceived safe haven currencies and a repatriation of funds to the domestic currency of many currency speculators. This was expressed as a relative strengthening of the US dollar and Japanese Yen in comparison with the British pound, the Australian dollar and the New Zealand dollar.

Extreme Volatility

The volatility seen in the equity markets over the past few months has been extreme. During October for instance the headline United States share market index – the Dow Jones Industrial Average - rose or fell by more than 5% on six trading days. A daily change of this magnitude occurred only once in the 1950's, once in the 1960's, and once in the 1970's. It never moved more than 5% during the six-year period prior to September 2008.

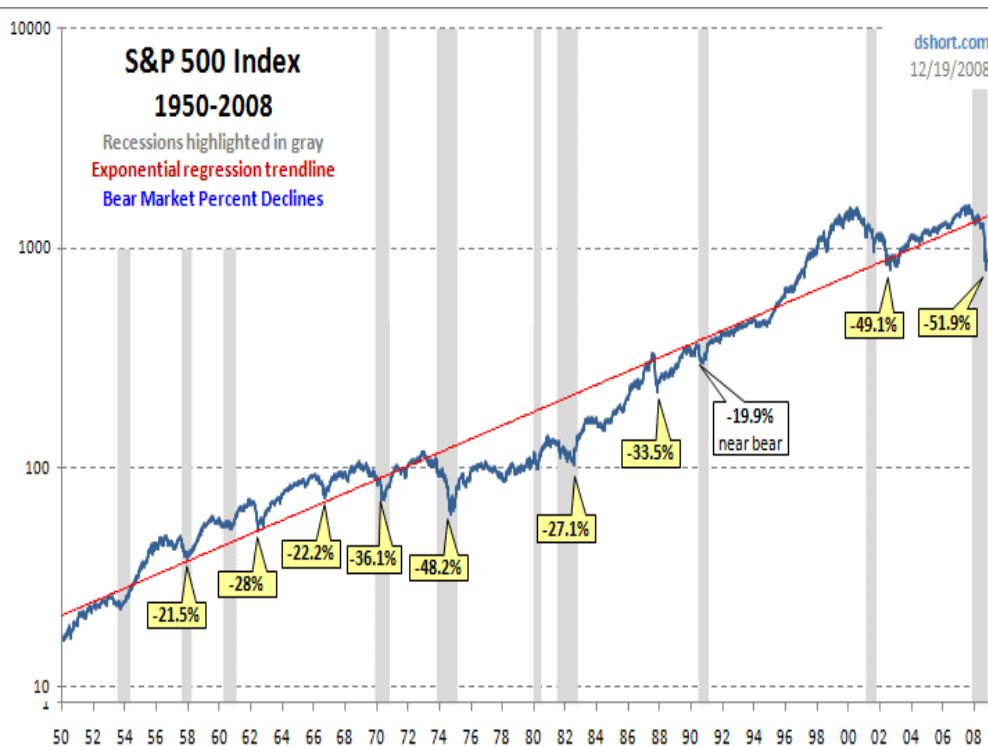
The degree of recent volatility is still no match for the level reached in the 1930's. The Dow Average rose or fell by more than 5% on thirteen days in 1931, 37 days in 1932, and 20 days in 1933.

The Dow jumped more than 10% on two trading days in October 2008 (13th and 28th), the strongest one-day advances since March 15, 1933. On that day, the Dow Industrials soared 15.3%.



To a lesser degree, this volatility continued into November and December. Markets moving to this extent, and news headlines amplifying the worst aspects of the uncertainty, are a test of any investor's fortitude. The events of this market present new challenges for policy makers – but the way we see the world today is undoubtedly different from how we will view it 12 months from now.

The graph below helps to put the current situation in context of the eight other 'bear markets' (falls of more than 20%) in the United States that have occurred since 1950. Notwithstanding the severity of many bear markets in the past 58 years, clients will notice a long term trend line of superior returns exists, which is the underlying reward for accepting the risk of fluctuations in short term share market prices.



Should one continue to invest in this environment?

We continue to advise our clients that investing is not about speculating when to get into, or out of, the market. Nor is it forecasting which individual securities or sectors will out perform the others in the future. Rather, it is about making informed choices about what strategy has the best probability of achieving individual client goals, then adopting a disciplined and patient application of that recommended portfolio structure.

The fall in market values around the world presents an opportunity to buy a greater share of future company profits with your investment capital than existed six or 12 months ago. With the diversified funds that we use as building blocks for client portfolios, this is represented by purchasing more fund units than was previously possible.

Ultimately risk and return are related. In this present environment of recession concerns and the scramble for liquidity, there are more distressed sellers than anxious buyers, which ultimately represents an opportunity for the buyers. As risk is perceived to have increased, the commensurate return expected, by way of future dividends and capital growth, has also risen for those in a position to patiently wait for it.

We can not reliably predict a recovery in market values within any particular timeframe. Similarly, the current poor economic outlook, pessimism and the slew of bad news do not reliably indicate a continued slide in share prices. All publicly available information is already factored into current prices.

It is generally accepted that timing the bottom of the market and investing just prior to the next recovery is extremely unlikely. Market prices are based on expectations and have proved to rebound before the reality of an economic recovery is apparent. However, human psychology influences many to be particularly reluctant to stick to their intended plan of progressive investment until they feel the market has turned upwards. In doing so an investor ensures they miss the initial surge in values that typically accompanies a recovery. Smart financial practice benefits from taking the emotion out of investment decisions.



One way that clients can help themselves to overcome the natural hesitancy to invest more funds in a 'down market' is to 'tranche' or chunk capital into the market at defined intervals – say monthly. This practice is often termed 'dollar cost averaging' as it smoothes the entry price over the period. Dollar cost averaging reduces the need to try and decide the best time to buy, accepting that this can only be determined with hindsight.

In the same manner that selling assets after a market fall cements in losses, suspending future investment during a downturn will limit your participation in the upside when the market recovers. With this in mind, and considering that interest rates are at historic lows (essentially delivering a zero return net of inflation and tax), retaining overweight cash balances suggests a pessimistic outlook for many years into the future. In simplified mathematical terms, one should only accept a 2% return if you do not believe you will see a 10% return inside the next five years.

Government Deposit Guarantee Scheme – in practice

To date some 30 financial institutions including banks, finance companies and credit unions have been accepted by the New Zealand Deposit Guarantee Scheme.

The Government Guarantee covers interest and capital repayment defaults for two years commencing 12 October 2008 and ending 12 October 2010 with cover capped at \$1 million per depositor per institution.

We believe that while the scheme is very positive for investors, caution still needs to be applied when selecting an institution with which funds are to be placed.

While gaining the Government Guarantee requires each financial institution to meet certain governance criteria, it does not require any qualitative review as to how well the organisation is managed. With this in mind we urge that investors consider the fundamentals with respect to the creditworthiness of any financial institution and also be mindful that we are now more than three months into the guarantee period. There might also be a risk of another run on funds of the weaker financial institutions as we approach October 2010.



Central Bank and Government Action

The events of the past quarter have been dramatic – breathtaking day-to-day market volatility, rising default rates, financial instability, banking strains, worsening economic indicators across the manufacturing, service and financial sectors, and the global nature of the crisis.

However, policy makers around the world have been quick to act, central banks and governments working at times in unison. A great deal has been learned from the mistakes of earlier crises. Comparisons with the depression of the 1930's may make alarming headlines that sell newspapers but they are largely spurious. Critically, and in contrast to present scenario, in the 1930's the US Federal Reserve tightened monetary policy at a time when the system needed additional liquidity.

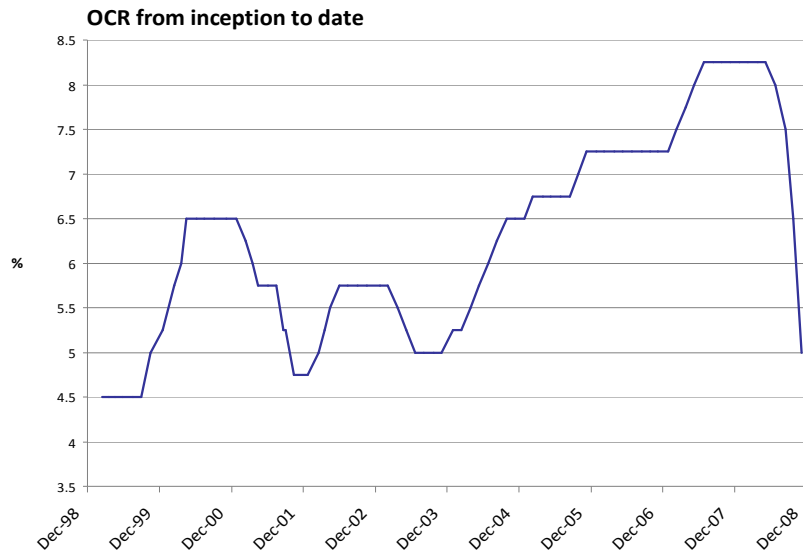
Without wishing to downplay the seriousness of the current situation, a balanced appraisal of the historical context of the 1930's reveals many contrasts with recent events:

- Co-ordinated interest rate cuts by central banks
- Economic stimulus packages aimed at un-freezing credit markets
- International corroboration via new bodies such as the G7, G20 and International Monetary Fund



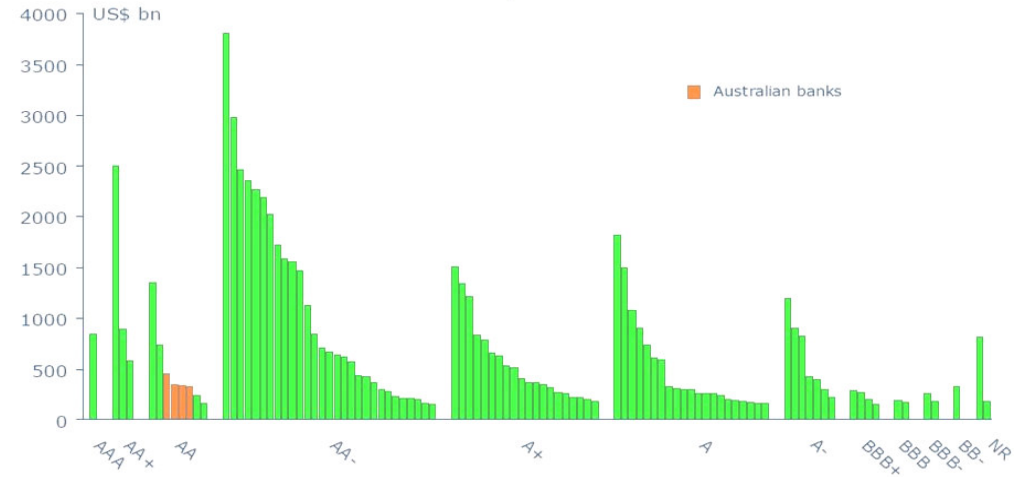
Domestically we have seen our own Reserve Bank cut interest rates (by way of the Official Cash rate or 'OCR') by 3% since September. Analysts are anticipating a further reduction in interest rates at the next OCR announcement due 29 January.

Whilst the loosening of monetary policy is aimed at providing liquidity and increasing confidence in the markets, looking forward it will also reduce the income generated by cash and short term deposit securities within client portfolios.



Finally, in contrast to the 1930's depression when thousands of banks failed in the United States, just a handful of banks have recently failed on both sides of the Atlantic. In terms of vulnerability in our part of the world, the Australian owned banks operating in New Zealand remain highly profitable and enjoy AA credit ratings. This places them among the strongest financial institutions internationally as represented in the chart below.

Credit ratings of the world's largest 100 banks by assets



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