



Introduction

This report contains the usual market summary and report on asset class returns. Our emphasis is that investors have been rewarded for their discipline, which is especially apparent from the latest quarterly returns. Feature reports are provided on:

- The New Zealand dollar; and
- The announcement of change in government tax policy

Finally, in a short excerpt entitled 'Theory to Practice – keeping focused on what matters' we restate a core element of prudent investment policy.

Appended is a table exhibiting asset class returns from 1992 to 2005, which provides graphical representation of the need for diversification. Lastly your portfolio performance summary for the quarter and the period since inception is provided together, with an up to date valuation of asset holdings.

Tax reporting for the financial year ended 31 March 2006 is presently being compiled and will be forwarded to clients under separate cover in early May.

Market Summary

The first quarter of 2006 has delivered investors significant rewards capping off strong returns for the financial year ended 31 March 2006. This is especially welcome for those clients that held offshore investments before the downturn in international markets experienced in 2001 and 2002. Ultimately investor discipline is rewarded.

The experience for New Zealand investors with offshore portfolios over the past five years has been influenced by a substantial rise in the kiwi dollar



as much as international markets. This dampened the recovery in local currency terms of increasing value of overseas assets. The recent fall in the kiwi dollar has essentially unmasked the healthy returns across underlying asset classes. Further comment on the exchange rate influence and outlook is provided on page 2.

Asset Class Returns

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

NZD Returns to 31 March 2006			
	3 months	1 year	3 year (p.a.)
Australian Large	17.7%	39.1%	28.2%
Australian Value	16.4%	35.1%	32.5%
Australian Small	19.4%	34.5%	35.9%
Global Large	18.7%	36.6%	18.9%
Global Large (NZD Hedged)	7.3%	27.4%	26.8%
Global Value	21.7%	42.0%	27.3%
Global Small	25.3%	48.5%	32.3%
Emerging Markets	23.2%	64.5%	40.0%
NZ Equity	14.1%	26.4%	27.5%
NZ Property	1.0%	19.0%	16.6%
DFIT International Bonds	0.7%	5.8%	n/a
(NZD Hedged)			
CDO International Bonds	n/a	9.9%	n/a
(NZD Hedged)			

In past reports we have appended benchmark graphs plotting the progress of the funds that make up most client portfolios against each relative benchmark index. Client feedback suggests that we needn't produce these graphs every quarter; however, they will continue to feature from time to time.

The colourful table of asset class returns that is represented on page 5 is perhaps our most popular graphical representation of the asset classes into which we invest. The reason why diversification across a broad number of these asset classes is important is apparent by the somewhat random pattern the colours make when the returns are ranked highest to lowest year by year. This serves as a useful reminder that last year's winning performer does not provide any basis for forecasting where best to invest next.



NZ Dollar Fall

The kiwi dollar fell 10 cents against the US dollar in the first quarter of 2006. This is widely seen as the start of the anticipated trend down with key currency drivers being:



- The local economy being on the cusp of recession, albeit most likely a shallow downturn, but certainly reflecting weakness in comparison to global economies.
- Softening in the commodity prices that are most relevant to the New Zealand agricultural base, having seen 10 consecutive months of decline.
- A closing interest rate differential between New Zealand and international economies. (The Official Cash Rate (OCR) as set by the Reserve Bank is widely anticipated to decline in 2007 vis-à-vis tightening monetary policy likely in the US, Australia, Japan and Europe).
- Exposure to offshore investor sentiment changing towards the risk appetite for New Zealand denominated bond issues. This will be heightened by the NZ Eurobond market with rollover decisions pending on some \$9 billion of maturities this year and a further \$16 billion timetabled for 2007.

The potential for very rapid falls in the dollar during the anticipated period of decline can be seen in the two charts below that plot the New Zealand dollar against the US and Australian currencies. This reflects the huge volume of foreign exchange contracts traded in the market and the propensity for dealers to collectively abandon the kiwi dollar on occasion.

In fact for a small trading economy, where equity markets represent less than 0.1% of world share market capitalisation, the New Zealand dollar receives a lot of attention. It is the 15th most traded currency in the international foreign exchange markets. As such it is at the behest of hedge fund managers and currency speculators. Accordingly currency value can range well outside economic fundamentals for prolonged periods as we have discussed in previous reports. Whilst our belief is that markets set prices efficiently – in that there is no proven ability to out manoeuvre or anticipate the next short term movement to advantage – we

also believe that ultimately fundamental values will influence a return towards fairer value. This is what we are presently seeing in foreign exchange markets for the New Zealand dollar. The trend may be down, but how fast, to what extent and whether there is an under/ overshooting of various fair value opinions is unknown.



Our policy with respect to currency positioning remains the same. International bonds should be hedged to remove the unwelcome source of volatility from what should be a stable anchor in portfolio structures. Further, a portion of global equities can be prudently hedged to neutralise the full effect of currency cycles. The extent of appropriate hedging across the international equity asset classes will differ between clients depending on their risk profile, asset allocation and time horizon. Long term there is no expected return in foreign currency positions. It is a matter of how best to manage the journey.



The rationale for maintaining an un-hedged element is more obvious presently, compared to the period when the currency has been rising. Given the small size and openness of the New Zealand economy, the consumption of imported goods and services has a large influence on the domestic economy. The price of petrol, which has risen



recently in response to both the falling currency and the rising price of oil on international markets, is perhaps the most obvious example. However, a falling dollar influences also the pricing of many locally produced goods and services even where there is little imported content. This is especially so where the domestic market competes against the export market for product – for instance the price of lamb in our supermarkets increases to match the higher export prices farmers receive from a lower NZ dollar. Therefore the rising value of international portfolio values creates a natural hedge to the inflationary pressures brought to bear on local consumption from the depreciating dollar.

Announcement on Tax

Prior to Easter the Minister of Finance made some critical announcements on government taxation policy for investors. As anticipated, the policy makes a distinction between overseas investment (other than into Australia) and local investments on the taxation of capital gains.



The investment playing field for shares is tilting substantially towards a favoured tax treatment for domestic and Australian assets, but only if the assets are held through a Qualifying Collective Investment Vehicle (QCIV). Where so, all capital gains will be tax exempt whether the fund is actively trading or holding the investments passively.

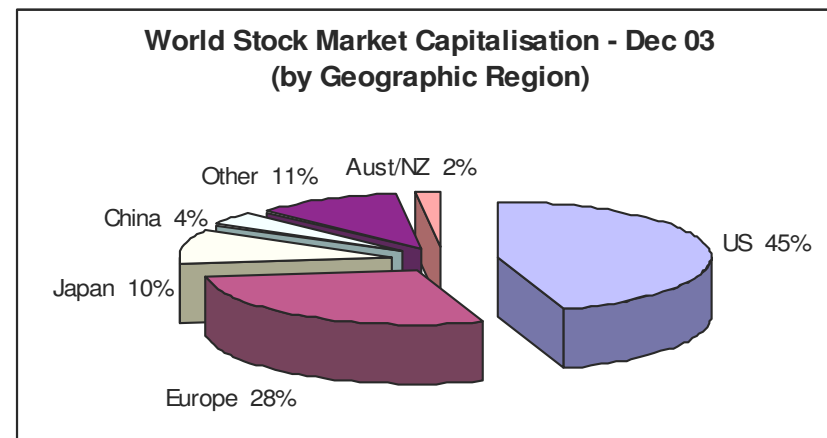
The proposed taxation of international share investments whether directly or through a QCIV will require substantially more compliance effort. Dividend income and 85% of accrued capital gains will be taxable. However, in the case of the accrued capital gains, the remittance of the tax to the Revenue may be deferred, to the extent that this component pushes total taxable income over 5% of the opening investment value for the year in question. Substantial deferred tax obligations will likely result. These need not be settled until the funds are repatriated to New Zealand.

The QCIV fund will administer tax obligations on behalf of investor's at their requisite marginal tax rates withholding and returning tax to the Inland Revenue (the fund accordingly becomes responsible for final tax compliance for most investors).

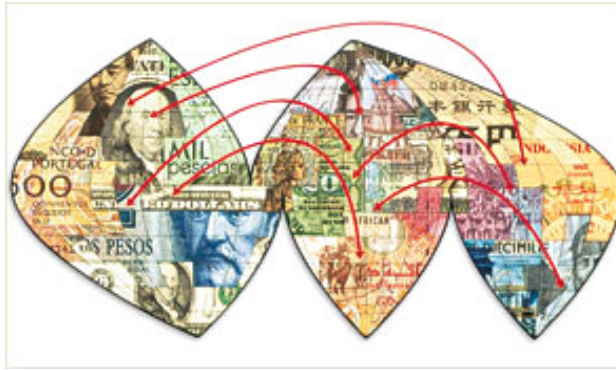
Direct investors in the local market will have the same trader vs. long term passive test as to their tax status. An investor that holds securities abroad directly will be subject to the same taxation regime on income and accrued capital gains as that imposed on the QCIV. However, an exemption applies where the international equity asset holding for an individual is \$50,000 or less as at 1 April 2007.

We echo the numerous submissions that have been made to government with regard to the introduction of a tax distortion in favour of local investment assets. We see this as counterproductive to the long term wealth creation and wealth preservation for New Zealanders. Tilting the relative taxation incentives towards Australasian investment requires added discipline on the part of investors to maintain prudent diversification.

The proposed policy incentives are completely at odds with the reality of the relative standing of Australia, let alone New Zealand in the global economy – collectively Australasian stock exchanges represent just 2% of world equity market capitalisation. As at December 2003 international share markets were valued at US\$37 trillion (or 37,000 billion compared to the NZ equivalent of less than US\$30 billion).



Finally, a regional bias in asset ownership is inconsistent with the growing integration of investment and trade in the global economy. A recent study by McKinsey & Co on international capital markets noted that international financial markets are becoming increasingly integrated with a steady growth in cross-border holdings of financial assets and cross-border flows of capital. Today, for example, foreigners hold 12% of US equities, 25% of US corporate bonds, and 44% of Treasury securities. Cross-border capital flows have more than tripled, and they now total upward of US\$4 trillion annually.



Implications for Axiome portfolios

The government is running a ridiculously tight schedule on these changes. The law is unlikely to become clear until the end of this year and yet the target implementation date remains 1 April 2007. We are presently planning for the anticipated changes and are well placed to develop recommended adjustments on behalf of clients as appropriate.

Assuming that the final legislation is substantially consistent with announced proposal, we see a twofold review being necessary:

- Concerning the recommended asset allocation for each client;
- Moving quickly to adopt the QCIV structure to cement the tax advantage of capital gains for New Zealand and Australian equity securities; and
- Taking practical steps in the establishment of the QCIV for global asset classes subject to the more complex tax compliance in order to keep this administration efficient for clients.

Changes where recommended will be discussed with clients. This change is likely to bring challenges and some limited opportunities for our clients. There may be planning opportunities available for clients able to segment their portfolios between trust holdings and investments held directly in their

own names. Further, components of client portfolios that were always taxable, such as fixed interest holdings, will in some instances be advantaged where held through a QCIV in future.

In conclusion, our stance on tax policy remains the same. Tax in itself should not drive the asset allocation decision or the means of effective implementation. However, we are resolute in our effort on behalf of clients to deliver the highest after tax and after costs returns – which necessitates a careful review of these issues as the legislative framework becomes more certain.

Theory to Practice – keeping focused on what matters

Theories don't always get translated into practice. This is a truism in the field of finance, where top academic researchers stress diversification and the futility of active management, only to see their graduates join the army of hedge fund managers and stock pickers that dominate the employment market of financial institutions.

The established principles of Market Efficiency are:

1. **Markets work** (for investment purposes assets are fairly priced)
2. **Structure explains performance**
3. **Risk and return are related**
4. **Diversification is the key**

Portfolio theory tells us that you only get compensated for taking risk, and more specifically risk that you can not diversify. Markets are not expected to compensate (by way of generating higher returns) for taking risk that you can reduce by adding other assets to your portfolio.

According to this logic, a sensible strategy is to structure your portfolio towards sources of risk you can best tolerate, and then diversify like crazy. After you're fully diversified, you can't do much about risk except to understand it and hang on through inevitable periods of volatility, resting in the assurance that your long term interests will be best served by sticking to the plan. Investment is a discipline, and we should avoid the temptation to lapse into any behaviour that is reactionary to sentiment.



Asset Class NZD Returns: Winners & Losers

	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
NZ Cash (30day Bills)	6.73	6.34	6.49	8.97	9.41	7.63	7.27	4.62	6.33	5.80	5.56	5.45	6.01	7.02
NZ Govt 5yr Bond Yield	7.87	6.69	7.48	7.94	8.04	7.21	6.47	6.13	6.85	6.12	6.28	5.51	5.95	5.98
NZX50 Equities	10.83	47.85	-7.16	20.12	17.31	4.30	-4.42	13.29	-8.04	13.93	-1.17	25.62	25.05	9.99
NZSE Property		-5.56	2.79	13.87	23.32	6.61	4.80	-6.39	7.34	12.12	19.02	13.40	20.00	19.69
Global Bonds (NZD Hedged)	10.14	15.62	-1.95	19.97	15.78	10.86	10.64	3.39	6.83	8.68	12.07	6.94	8.56	6.45
Australian Value	8.29	45.81	-9.32	21.18	15.92	16.00	12.36	34.82	6.99	15.06	-7.14	29.31	28.07	18.10
Australian Large	-7.11	28.97	-8.92	13.96	12.02	12.39	13.72	26.99	7.81	8.47	-18.85	21.30	20.27	21.24
Australian Small	-8.24	49.39	-9.12	5.53	26.69	-2.53	7.35	35.20	-12.61	0.24	-15.62	45.91	23.50	13.92
Global Value	11.50	25.79	-8.88	19.51	5.02	34.70	25.37	13.14	24.14	0.19	-29.11	13.54	12.45	18.61
Global Large	-0.25	10.37	-8.88	19.95	4.97	43.11	36.15	27.39	4.72	-10.58	-34.79	5.97	4.45	14.89
Global Large (Hedged 2003+)												39.47	13.47	20.47
Global Small	1.25	16.96	-6.09	10.00	0.82	12.27	13.71	25.44	16.26	6.12	-25.97	24.52	12.95	20.08
Emerging Markets	6.49	66.89	-19.25	1.57	4.18	-0.91	0.48	76.13	-15.85	-0.78	-27.41	28.52	18.70	36.49

Highest Return

Lowest Return

	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
	11.50	66.89	7.48	21.18	26.69	43.11	36.15	76.13	24.14	15.06	19.02	45.91	28.07	36.49
	10.83	49.39	6.49	20.12	23.32	34.70	25.37	35.20	16.26	13.93	12.07	39.47	25.05	21.24
	10.14	47.85	2.79	19.97	17.31	16.00	13.72	34.82	7.81	12.12	6.28	29.31	23.50	20.47
	8.29	45.81	-1.95	19.95	15.92	12.39	13.71	27.39	7.34	8.68	5.56	28.52	20.27	20.08
	7.87	28.97	-6.09	19.51	15.78	12.27	12.36	26.99	6.99	8.47	-1.17	25.62	20.00	19.69
	6.73	25.79	-7.16	13.96	12.02	10.86	10.64	25.44	6.85	6.12	-7.14	24.52	18.70	18.61
	6.49	16.96	-8.88	13.87	9.41	7.63	7.35	13.29	6.83	6.12	-15.62	21.30	13.47	18.10
	1.25	15.62	-8.88	10.00	8.04	7.21	7.27	13.14	6.33	5.80	-18.85	13.54	12.95	14.89
	-0.25	10.37	-8.92	8.97	5.02	6.61	6.47	6.13	4.72	0.24	-25.97	13.40	12.45	13.92
	-7.11	6.69	-9.12	7.94	4.97	4.30	4.80	4.62	-8.04	0.19	-27.41	6.94	8.56	9.99
	-8.24	6.34	-9.32	5.53	4.18	-0.91	0.48	3.39	-12.61	-0.78	-29.11	5.97	6.01	7.02
		-5.56	-19.25	1.57	0.82	-2.53	-4.42	-6.39	-15.85	-10.58	-34.79	5.51	5.95	6.45
												5.45	4.45	5.98