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Market Commentary

The December quarter delivered negative returns across most asset classes excepting New Zealand dollar fixed interest investments.

This quarter's negative returns have contributed to what has proved to be a flat year for markets generally – one commentator described 2007 as a “rollercoaster year with the market ending up basically back where it started”.

This is in stark contrast this with the previous three years where Australian and New Zealand shares returned 20% p.a. and where international shares also provided strong returns tempered by a strengthening NZD over the period.



The volatility in returns over the last three quarters has been experienced globally, as markets have reacted to worsening news regarding the ‘credit crunch’ – defaulting home loans, in the United States which has resulted in massive losses for some institutions and a general tightening of liquidity in the financial sector.

These variable returns, once again reminds us that to achieve desired investment returns over longer periods, a number of negative periods are likely to have been incurred. It is the compound returns over several years

that provide the most relevant measure of performance and the attainment of your long term investment objectives.

“The average long-term experience in investing is never surprising, but the short-term experience is always surprising.”

Charles D. Ellis

Do these short term events tell us anything new about your risk tolerance?

How someone feels about taking risk in choosing between alternative courses of action which include the possibility of unfavourable outcomes (“risk tolerance”) is one thing. Interestingly, how people will subsequently feel if one of the possible unfavourable outcomes actually occurs is another. Risk tolerance is very relevant as to its influence on how people make decisions and then perhaps more importantly change their decisions should the short term circumstances change once.

Unfortunately how someone reacts to an unfavourable event after the fact is not predictable with any certainty. So if the last quarter results “rattled your nerve”, it may be time to review your objectives and adopted asset allocation. But first, please ensure you read the sections below entitled ‘Market Timing’ and ‘Understanding Risk’ – they restate key investment principles that are essential to understand.

Asset Class Returns

Contributing factors to the returns for the December quarter were:

- Globally equity markets have been down as the concerns emanating from the US continue to worsen and their impact spread.
- Currency, the NZD strengthened by approximately 3% against the US and Australian dollars and over 4% against the UK pound. This has a direct bearing on the performance of overseas equities if not hedged back to NZ\$. Vanguard’s international share fund is the only hedged fund we currently use.
- With Australia and New Zealand remaining in a tightening phase of their monetary policies while Canada, the United Kingdom and United States are easing their interest rates, there is a widening



interest differential between our region and major international economies, which can only continue to put upward pressure on our currency.

- Asian and other emerging markets have generally fared better overall. There are growing signs that these economies are reaching a stage that they are less reliant on the fortunes of the US in particular, and will prosper irrespective of what may happen. This may well be the first signs of a “changing of the guard” in the importance of the US in the world economic scene.

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

NZD Returns to 31 December 2007

	3 months	1 year	3 year (p.a.)
International Shares			
Australian Core Equity	(4.7%)	15.4%	n/a
Australian Large	(5.4%)	18.0%	22.5%
Australian Value	(5.4%)	11.6%	19.6%
Australian Small	(0.9%)	24.4%	25.0%
International Core Equity	(5.6%)	(3.6%)	n/a
Global Large	(4.5%)	(0.7%)	9.9%
Global Large (NZD Hedged)	(2.0%)	8.0%	15.9%
Global Value	(6.5%)	(5.4%)	11.3%
Global Small	(7.9%)	(8.3%)	8.7%
Emerging Markets	1.3%	23.8%	28.3%
International Fixed Interest			
Diversified Fixed Interest (AUD class)	(0.9%)	8.5%	7.1%
Diversified Fixed Interest (NZD class)	2.2%	8.3%	7.1%
New Zealand Assets			
NZ Equity Portfolio	(5.1%)	(2.0%)	11.6%
NZ Listed Property	(3.9%)	(4.3%)	12.7%

Notes:

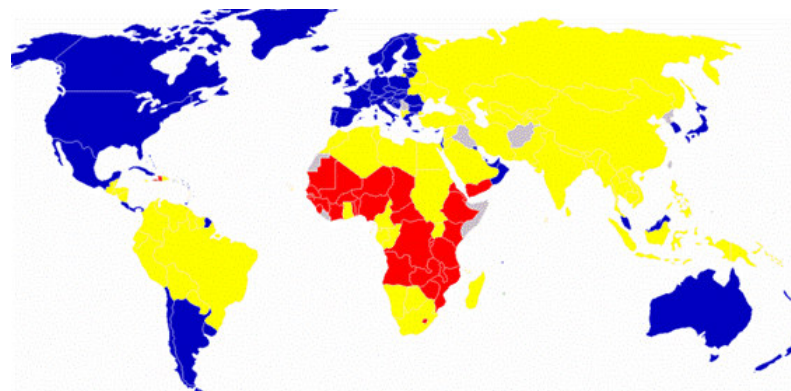
* Returns are reported after fund management expenses and are pre-tax.

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

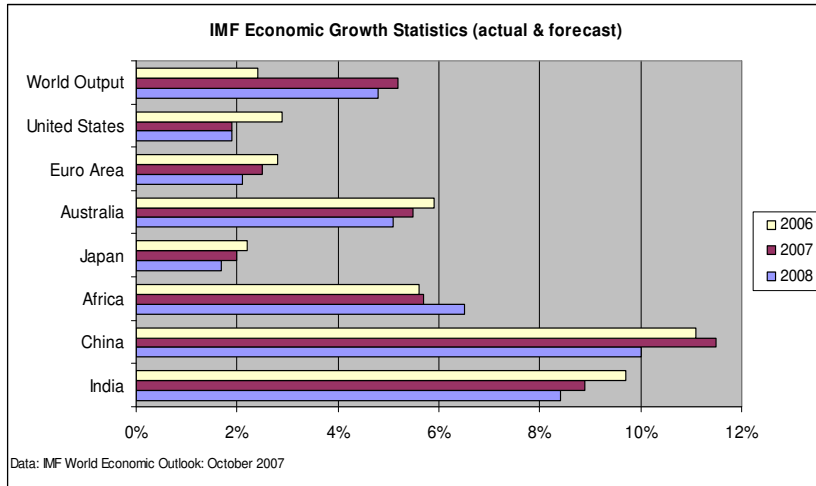
Recession concerns..?

There has been growing talk of the prospect of recession in the United States for the first time in several years. The precursor for this sentiment is the US sub-prime mortgage debacle – where billions of dollars in loans were advanced to aspiring US home owners who in reality were borrowers with low credit worthiness. These loans were then packaged up in parcels sold to investors around the world and traded between financial institutions (via a process termed securitisation).

With US property prices in decline following a period of rapid appreciation in value, many of these housing loans a going bad – with financial losses counted in the hundreds of billions. The effect of this crisis on the US economy has rippled around the world and we have seen concerted action by central banks to ease interest rates and inject massive amounts of cash into the banking system to maintain liquidity.



Whilst the US housing sector has been hit by a sharp slowdown; other sectors have continued to perform relatively strongly to date. Similarly, whilst the US economy may be wavering, other economies are doing comparatively well and overall world growth is expected to slow only moderately. There is strong momentum for continued economic growth evident in emerging economies (represented in yellow on the above world map) – and especially China and India – International Monetary Fund (IMF) forecasts below.



Nevertheless, the future outlook remains uncertain: will the impact of the sub-prime crisis tip the US economy into recession, and, if so, what is the implication for global financial markets and investors?

A recession can be defined as a “significant decline in economic activity across the economy lasting more than a few months.”⁽¹⁾ Unfortunately, economists have a poor track record in forecasting recessions, just as they have in predicting the course of global share markets, interest rates and currencies. There is an old saying in financial markets: “Economists have successfully forecast nine of the past five recessions.”

For example, in early 2003, investment bank Morgan Stanley boldly forecast a global recession based on disruptions caused by the Iraq war, geopolitical uncertainties and severe impact on Asia of the SARS virus.⁽²⁾ (Does anyone remember SARS now?). The outcome proved to be very different from the forecast with the 2003 – 2007 period representing four years of consecutive strong growth for the work economy.

So how should investors respond? In reality, the future is always uncertain and prudent investment strategies are remarkably consistent

whatever the latest forecasts. Adherence to the following principles is ultimately key:

- Ensure your portfolio comprises assets that are appropriate for your risk profile and investment objectives
- Be diversified by geographic regions, asset classes and security numbers
- Maintain discipline –acknowledging that the forecasts are unreliable and that current market pricing is compensating for all presently identified risks and opportunities. Therefore, either overweighting or underweighting market exposure is merely gambling on an uncertain future.

(1) 'Business Cycle Expansions and Contractions', *National Bureau of Economic Research*
 (2) 'Morgan Stanley Forecasts World Recession', *Reuters*, April 4, 2003

Market Timing – is there a right time to retreat to cash?

It is in the nature of markets to suffer significant corrections from time to time. But predicting just when they will happen is tough. Indeed, huge volumes of academic research show it is extremely difficult, even for professionals, to time entry and exit points correctly.

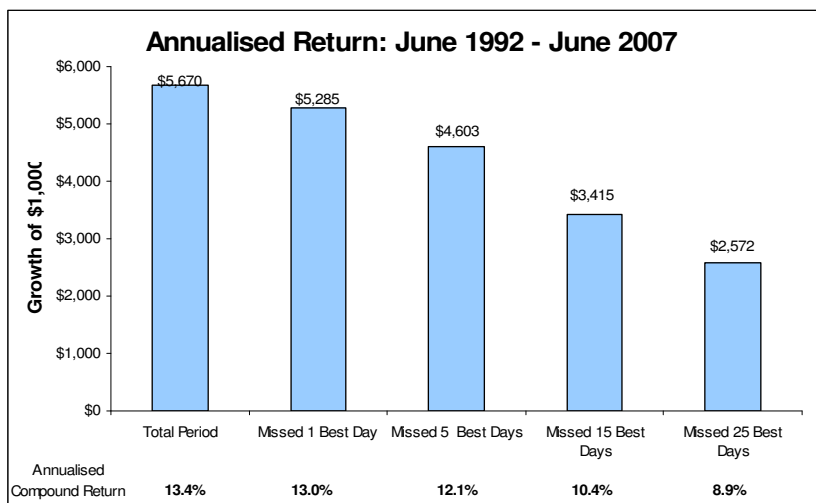


A recent Monash University study⁽¹⁾ on Australian superannuation funds found that, consistent with previous studies on this subject, there was only limited evidence in support of strong market timing ability. And you do not have to be out of the market for months or years to make a substantial difference to the returns you enjoy. Even missing a few days of strong gains can seriously hamper your portfolio performance.

The chart below shows that if you had invested \$1,000 in the S&P/ASX-300 accumulation index in June 1992 and left it there for 15 years, you



would have had a balance of \$5,670 by June this year, representing an annualised compound return of 13.4 per cent.⁽²⁾ But if you had missed just the five best trading days in that 15-year period, your balance would have been shaved back by nearly 20 per cent to \$4,603, an annualised return of just over 12 per cent. Missing the best 15 days or best 25 days—just a month in 15 years—would have made an even more substantial difference.



To be fair, your portfolio would have performed even better had you managed to miss the worst days in the market in the past 17 years. But the trick there is timing your re-entry point. Experience shows that many people who get out at, or near, the top leave it too long to come back in after the initial correction.

This all goes to show that unless you have perfect foresight, you are better off riding the ups and downs and resisting the temptation to base your investment strategy on what you think will happen next.

(1) George Woodward and Robert Brooks, 'The Market Timing Ability of Australian Superannuation Funds', Monash University, Feb 2006

(2) Dimensional Fund Advisers

Understanding Risk – in principle and in practice

Risk and reward are related. If you want performance, you're going to have to accept a degree of risk. Everyone knows that by now, right? But here's the user warning that tends to be ignored as investors load up their portfolios with derivatives or hedge funds: **Not all risks are worth taking.**

What's more, the danger of taking on uncompensated risks is magnified when people don't understand what they are investing in. Unfortunately, those who succumb to this danger are often those least able to afford the consequent losses.

This is the key point here: **When making an investment you must first ensure that the risks you are taking on are commensurate with the rewards.**

Sadly this is a concept that has been lost on many retail savers who were enticed to invest in Finance Companies offering just one or two percentage points in interest above bank deposit rates. The string of Finance Company collapses has now close to \$1.5 billion in permanent losses – which is very different from the short term negative fluctuation discussed above.

Many investors, stung by their experience of equity markets in 1987, turned to fixed interest investments, such as finance company debentures. Unfortunately, what many did not realise was that they were in fact investing in a fixed interest product with huge underlying credit exposure. As these credit risks materialized, it quickly became apparent that the level of returns had not compensated investors sufficiently for the levels of risk they had taken on.

The more considered approach is to diversify all unnecessary risk, and focus on asset classes that compensate fairly for your willingness to accept the uncertainty of short term fluctuations in return.



The share picking game

For the past five years the NZ Herald has polled a number of New Zealand broking firms for their top five share picks for the year ahead and has then viewed the results one year later against the NZSX 50 gross index. This always makes for entertaining New Year reading and serves to underscore the inability of active managers (or anyone for that matter) to accurately predict what will happen in financial markets in any given year.

What is most interesting when analysing the 2007 results is that they cover all ranges of the return spectrum. Some were lucky with their picks made good returns whilst others made similar sized losses, in a year where the NZSX 50 gross index total return was just 0.4%. See table below

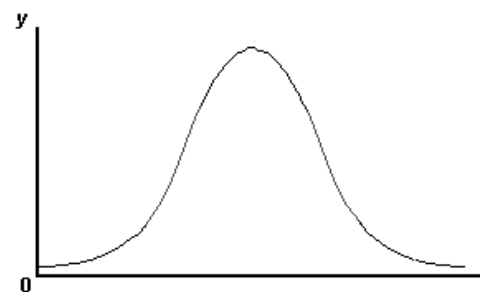
Broker Picks 2007 – Results

Broker	Total Return	Broker Comparative Ranking		
		2007	2006	2005
Direct Broking	15.5%	1	5	8
ABN Amro Craigs	13.6%	2	n/a	3
First NZ Capital	2.3%	3	1	1
Forsyth Barr	1.3%	4	8	9
NZSX 50 Gross Index	0.4%			
McDouall Stuart	-0.9%	5	7	4
ABN Amro	-3.6%	6	4	5
Goldman Sachs JB Were	-7.2%	7	6	7
Hamilton Hindin Greene	-10.2%	8	2	n/a
ASB Securities	-12.9%	9	3	2
UBS		n/a	n/a	6

Analysis of the returns data over a 5 year period, show a similar picture. The total NZSX 50 gross return more than doubled for this period, with five firms achieving higher returns with their top five share picks and six firms posting results less than the NZSX 50.

Of course the usual criticism of such studies is that it assumes a holding of just the five selected shares and assumes they are held constant for the whole year. However, academic research consistently has shown that investment returns derived by active managers are spread around the average performance of an index and form a bell curve distribution.

A bell curve, such as the one below, is a statistical tool used to represent how a group of data clusters around an average or mean. It describes the volatility or fluctuations that an investor can experience around an average return provided by the market. A normal distribution of results forms a graph with the bell like shape shown below, with half the investors achieving above market average returns, but the other half achieving below market returns.



Numerous studies have confirmed these results and show that some active managers will deliver results above the market some of the time and others will deliver results below the market some of the time. The trick is to know which broker will have a good year and which will not! Of course, the same studies have shown that past performance is no precursor for future performance - the broker who performed well in one particular year will probably not be the broker who performs well in subsequent years (refer broker comparative ranking in table above).

All of this simply reinforces our belief that successful long term investment is derived by following a disciplined, diversified investment strategy. It is the growth in the market itself, rather than the skill of individual brokers that delivers investment returns. Our task is to harness that growth in broadly diversified asset classes appropriate to each client's objectives and risk tolerance, and manage tax and costs to efficiently deliver market returns to each of our clients.