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Investment Market Review

What a difference three months can make. When we last reported to clients in April global markets were still wildly volatile and the negative returns for the March quarter compounded a poor finish to 2008. This made the six month results for growth assets and overall portfolio returns particularly bleak reading.

Since early March investment markets have rebounded strongly, as we would expect them to at some stage after such large falls.

The table below shows the returns for various markets from previous highs to their recent lows and the subsequent gains from the low points:

Index	Date of Low Point	% Fall From High to Low Point	% Rise From Low Point to 14 July 09
US (S&P 500)	9 March 2009	-56.8%	+33.9%
UK (FTSE 100)	3 March 2009	-47.8%	+20.7%
Australia (ASX All Ords)	6 March 2009	-54.6%	+24.0%
NZ (NZX 50)	3 March 2009	-44.2%	+13.6%
Emerging Markets (MSCI)	27 October 2008	-66.0%	+62.8%

In review, returns since March 2009 have been positive, however the one and two year results to June 2009 remain significantly down.

Economic Review: A Global Perspective

"I'm not an economist, and we all know economists were created to make weathermen look, good but it's increasingly clear that the worst is over" – **Rupert Murdoch, CEO of News Corporation, one of the largest global media empires. May 2009.**

Is Rupert right? Advertising revenue has long been an important barometer of the economy, so being at the coal face may give Rupert an insight. Around the same time as Rupert made his comments Peter Orszag, the White House budget director, said that the US economy had almost bottomed out and that the sense of economic free-fall was over¹.

The global gross product (or value of goods and services produced around the world) is expected to decline in 2009 - the first time in many decades². This isn't happening simply because of the subprime debt crisis in the US – there has been a knock-on effect on consumer and business confidence, and as a result expenditure has fallen.

As people everywhere became more fearful about the future, firms and households did what you would expect – they postponed discretionary purchases. This created a synchronised slump in global demand, especially for consumer durables (e.g. motor vehicles and whiteware) and investment goods. At the same time global credit markets tightened, putting company balance sheets under stress.

Countries hardest hit by the downturn have been those involved in the production and export of high-value consumer goods, like Japan and Germany. For example, Japan's economy has contracted by 9.7%, the UK and most of Europe by 4%, the US by 2.5% and New Zealand by 1%.

Global economic growth over the past decade was in large part fuelled by citizens of developed countries pursuing their ideals of consumerism. The desire for a plasma TV, the latest mobile phone and overseas travel caused saving rates in the developed world to fall, whilst emerging countries like China experienced large trade surpluses as a result

¹ *'Economic free fall is over: US budget chief'*, Sydney Morning Herald, 18 May 2009

² *'The Road to Recovery'*, Reserve Bank of Australia Governor Glenn Stevens, 21 April 2009



of manufacturing and exporting consumer goods to Western Countries. China subsequently invested its surpluses in debt securities (e.g. bonds and government bills) issued by the developed world, effectively lending money to fund the lifestyles of Westerners. Clearly this economic model was not sustainable over the longer term.

The Governor of the Reserve Bank of Australia (RBA), Glenn Stevens, recently outlined **four conditions required for a sustained global recovery**:

1. **Growth in the United States economy needs to occur and “normal commercial activity” needs to resume in the United States, United Kingdom and European financial systems.** This would require ‘bad assets’ to be quarantined and for banks to have ongoing funding. It has been evident recently that confidence in financial markets is improving, though it does remain fragile.

Recent ‘stress tests’ of the 19 largest US banks determined that they needed to raise an additional US\$75 billion in order to withstand another significant economic downturn. Following these results, many banks undertook capital raisings that were generally oversubscribed by investors. In June 2009 some US banks even started to repay Government borrowings, which allowed the US Government to generate a US\$1.8 billion profit on their loans to banks.

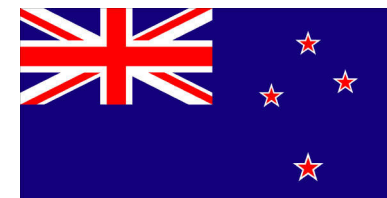
2. **Governments need to promote and support demand**, through easing monetary policy (lower interest rates) and fiscal policy (increased Government spending). This has occurred in New Zealand as well. Our Official Cash Rate (OCR) is now 2.5% and the Government has announced schemes, such as the recent home insulation initiative, to help stimulate economic recovery.
3. **Develop exit strategies for governments to reduce equity stakes they have been compelled to acquire in banks and other companies** and remove guarantees on bank deposits. It is noteworthy that many banks in New Zealand and Australia have recently issued debt to the market (i.e. to raise capital) without the need for Government guarantees.
4. **Avoid perpetuating the ‘global imbalances’ of the developed world that has occurred through issuing debt to finance household demand.**

Most observers believe that demand in the developed world will be subdued for a few years as households continue reduce their debt levels. The consensus is that global growth will be modest at first, which should continue to see a decline in global inflation (and therefore downward pressure on interest rates). However, one should never discount the possibility of a surprise rise in global growth, particularly in the medium term.

After a sharp contraction in the December 2008 and March 2009 quarters evidence has continued to emerge that the global economy is stabilising. The turnaround appears clearest in China and some other emerging countries, with estimates that China’s production had already recovered all previous losses by the end of March 2009.

The level of global demand over the short term is expected to be lower than before. However the Chinese economy will still exhibit strong growth, fuelled by domestic rather than global demand as the Chinese Government invests in infrastructure. This bodes well for a more durable expansion, rather than one which relies on the developed world increasing its debt levels to buy goods from the developing world.

Economic Review: A New Zealand Perspective



The global financial crisis didn’t play a significant role in the early part of New Zealand’s recession, which started in the second quarter of 2008 and was initially driven by drought, falling house prices and high petrol prices. The effects of the financial crisis in the real economy only started to be seen in late 2008 and were less severe than seen in other parts of the world.



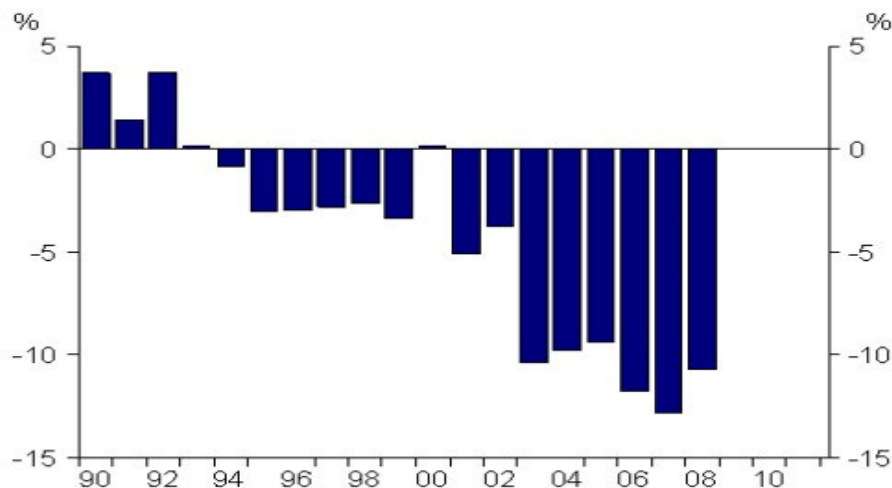
New Zealand's ability to weather the financial storm better than many of our Western counterparts has been due in part to our sound banking system, government finances being in a strong position and production of goods the world needs (e.g. food) as opposed to goods the world wants (e.g. consumer goods such as appliances and other high-tech products).

Although it appears that we may start recovering ahead of other countries there are still challenges to rebalance the economy and to reduce the vulnerability to future shocks.

Household Behaviour Needs to Focus on Saving

In the years leading up to the crisis, the household savings rate plummeted (see chart below). Falling house prices have also left households with a very large debt overhang. With future income growth expected to be moderate for the next few years, this debt will need to be paid off by lifting the household savings rate in the years to come.

NZ Household Savings Rate - % of disposable income - 1990-2008



Source: Statistics New Zealand and Reserve Bank of New Zealand

New Zealand Retains AA+ Credit Rating

Following the cut backs in spending announced in this year's budget, Standard & Poor's removed the negative watch from New Zealand's AA+ foreign currency rating.

Retaining the AA+ rating is important as it allows for New Zealand to continue accessing offshore funding at competitive interest rates. However, budget cut backs mean that the government has limited room for additional spending to assist the economic recovery.

With the pressure on households to constrain their spending, the New Zealand recovery is likely to be fragile, however, on a relative basis New Zealand is still doing better than most. According to Alan Bollard, the Reserve Bank Governor, "we expect the recovery to be somewhat stronger than those recoveries of many of our developed trading partners".³

Why Diversify?

Over the longer term research tells us asset classes provide reasonably predictable positive returns. For example, large companies as an asset class have averaged around 10% return per annum, whereas small companies have averaged over 12% per annum. However, it is a little known fact that the majority of individual stocks and shares tend to post negative returns over the long run.

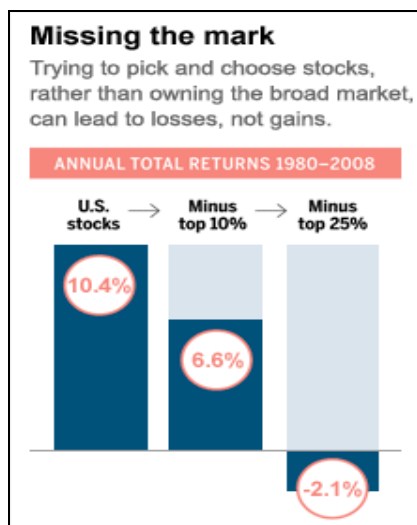
Researchers at Dimensional Fund Advisers found that between 1980 and 2008 the top performing 25% of all US companies were responsible for all of the gains in the broad market, as represented by the University of Chicago's CRSP total equity market database. The bottom 75% of companies collectively generated annual losses of 2% over the same time frame.⁴

³ Dr Alan Bollard 'An address to the Hawke's Bay Chamber of Commerce' 14 July 2009

⁴ 'Are stocks a loser's bet?' William J. Bernstein, Money Magazine, 9 May 2009



This is why it's important to diversify as widely as you can when investing. With a small list of shares it is easy to miss out on the top 10% of performers. According to the study, missing out on this top 10% would have cut your annual returns to 6.6% from 10.4% over the past 29 years. The graph below highlights this:



Source: Money Magazine and Dimensional Fund Advisers

This mightn't seem like much, but the power of compound interest says otherwise. A \$100,000 investment in 1980 would have grown to \$1.76 million by 2008 at 10.4% per annum. That same amount at 6.6% per annum would have only grown to \$638,000 – or 64% less.

Exchange Rate Movements & Asset Class Returns

As mentioned earlier in this report equity markets around the world have produced strong positive returns over the last quarter. At the same time the New Zealand Dollar (NZD) has appreciated against other currencies. The appreciation of the NZD has dampened the returns from offshore assets. The table below illustrates the change in the NZD over the quarter:

Exchange Rate movement

	31-Mar-09	30-Jun-09	Change
NZD / Australian dollar	\$0.8262	\$0.8058	-2.5%
NZD / US dollar	\$0.5621	\$0.6523	16.0%
NZD / Euro	€ 42.62	€ 46.32	8.7%
NZD / Japanese Yen	¥54.83	¥62.71	14.4%
NZD / British Pound	£0.3945	£0.3936	-0.2%

Source: RBNZ historical series

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 following table:

NZD Returns to 30 June 2009

	3 months	1 year	3 year (p.a.)	5year (p.a)
International Shares				
Australian Core Equity	19.5%	(19.6%)	n/a	n/a
Australian Large Companies	13.1%	(19.3%)	(2.6%)	9.7%
Australian Value Companies	21.2%	(16.1%)	(0.7%)	10.5%
Australian Small Companies	28.4%	(25.0%)	(0.5%)	10.9%
International Core Equity				
Global Large Companies	5.5%	(16.9%)	(10.0%)	(0.7%)
Global Large Companies (NZD Hedged)	16.6%	(28.1%)	(7.7%)	1.5%
Global Value Companies	14.5%	(19.7%)	(12.5%)	(0.2%)
Global Small Companies	11.4%	(13.3%)	(11.1%)	0.1%
Global Real Estate	16.0%	(38.2%)	n/a	n/a
Emerging Markets Companies	19.2%	(9.6%)	2.4%	13.9%
International Fixed Interest				
Diversified Fixed Interest (AUD class)	3.7%	4.9%	7.2%	9.0%
Diversified Fixed Interest (NZD class)	1.0%	6.1%	7.6%	7.5%
New Zealand Assets				
NZ Share Portfolio	7.8%	(12.4%)	(8.8%)	2.5%
NZ Property Companies	0.8%	(18.6%)	(6.3%)	3.8%

Notes:

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

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