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Investment Market Review

Share markets around the world have continued their strong recovery that began in March 2009.

The New Zealand market, as measured by the NZX50, has risen 31% since it hit bottom on 3 March 2009 (note it needs to rise by 78.5% to get back to the top). Other markets, as shown in the table below, have made even greater gains from their low points:

Index	Date of Low Point	% Fall Since Previous High	% Rise From Low Point to 9 October 09
US (S&P 500)	9 March 2009	-57%	+58%
Europe (DJ Eurostoxx600)	9 March 2009	-60%	+54%
Australia (ASX All Ords)	6 March 2009	-56%	+53%
NZ (NZX 50)	3 March 2009	-44%	+31%
NZ Listed Property	7 May 2009	-47%	+20%
Emerging Markets (MSCI)	27 October 2008	-66%	+108%

One of the many drivers of the recovery in world share markets is profit expectations for 2011 and beyond. After many companies reduced costs over the past 18 months in anticipation of a prolonged economic downturn (which now seems less likely) the markets now anticipate an improvement in future sales to drive company profit gains beyond 2010. The fear of companies having too much debt has also passed and the perceived risk of a second economic crisis occurring has reduced.

The recent events remind us once again how difficult it is to pick the highs and lows and to “time the markets”. Any investor who did not remain disciplined and sold out of share markets in early 2009 would have missed out on the 50% plus rebound of the last six months.

A summary of the gross returns in New Zealand dollars 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 30 Sept 2009	3 months	1 year	5 year (p.a.)	10 year (p.a.)
International Shares				
Australian Core Equity	22.2%	13.8%	n/a	n/a
Australian Large Companies	19.0%	13.6%	13.0%	9.8%
Australian Value Companies	26.6%	21.2%	14.2%	13.3%
Australian Small Companies	22.4%	12.2%	13.8%	9.6%
Global Core Equity	7.6%	(6.5%)	n/a	1.1%
Global Core Equity (NZD Hedged)	17.3%	n/a	n/a	n/a
Global Large Companies	4.5%	(11.7%)	1.8%	(1.9%)
Global Large Companies (NZD Hedged)	14.8%	(7.7%)	4.4%	n/a
Global Value Companies	10.9%	(9.7%)	3.1%	2.6%
Global Small Companies	7.0%	(7.1%)	3.2%	4.4%
Global Real Estate	21.2%	(28.4%)	n/a	n/a
Emerging Markets Companies	8.3%	7.5%	15.3%	8.6%
Fixed Interest				
Diversified Fixed Interest (NZD class)	3.2%	8.6%	7.5%	8.0%
NZ Bond Fund PIE	4.1%	n/a	n/a	n/a
NZ 90 Day Bank Bill Rate	0.7%	4.7%		6.6%
New Zealand Assets				
NZ Share Portfolio	14.3%	2.3%	4.0%	7.3%
NZ Property Companies	17.1%	(0.3%)	6.5%	9.0%
Notes:				
* Returns are reported after fund management expenses and are pre-tax.				
** Past performance is not necessarily an indicator of future performance.				

Source: Dimensional Fund Advisers (DFA), Mercer, Vanguard, NZX



Over the past ten years, Australian Equities has been the best performing asset class followed by New Zealand Listed Property trusts and Emerging Market shares, whilst Global Large Companies returned -1.9% per year.

Investors may very well ask the question about investing in overseas large companies as they clearly have not been adequately rewarded for taking the risks associated with investing in shares compared with what they would have received by investing in short term bank deposits. However, such an occurrence is not new. Between 1965 and 1981 the S&P 500 Index (America's top 500 companies) returned 6.3% p.a. compared to 6.7% p.a. for one month US Treasury Bills. In the 18 year period that followed (from 1982 to 1999) the S&P 500 Index returned 18.5% p.a. compared to 6.2% p.a. for one month US Treasury Bills. Since 1930, the S&P 500 Index has provided an average annual return of approximately 9.4%. Maintaining exposure to global shares (of which the US market represents around 50%) remains essential to providing portfolio diversification because yesterday's worst performing asset is so often tomorrow's winner.

Government Intervention - Does an Expanded Government Role Impact Investment Returns?

The severity of the global financial crisis necessitated government intervention around the world to help restore confidence in the financial system. Unwinding this expanded government role in the global economy may take many years. Does this mean that the business environment will be less favourable in coming years?

This question is not a new one. In the face of severe recession, the cover of Time magazine in July 1975 asked 'Can Capitalism Survive?'. In the 1930's US President Franklin D. Roosevelt financed the construction of power plants around the country, which caused an outcry from large privately owned energy producers. In New Zealand Michael Joseph Savage's Labour Government helped stimulate the economy with state housing and public works programmes.

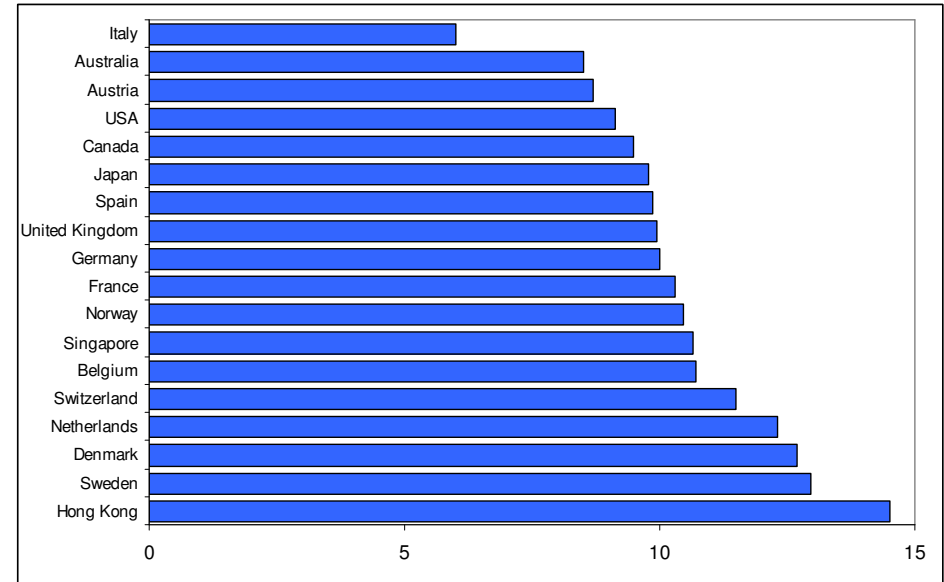
In 1984, the Continental Illinois Bank failed, which was the largest banking failure ever at the time. The US Government became the majority owner of the bank for the next 10

years. In the early 1990's the Bank of New Zealand was essentially insolvent and required a government injection of \$620 million to support it. The BNZ survived and the government sold its 57% shareholding to National Australia Bank (NAB) for \$850 million in November 1992.

It is difficult to determine whether widespread government involvement in the economy hampers economic growth, as it is only one of many factors that affects share market returns. Even if we can predict government policy, we cannot use this knowledge to predict stock returns.

The graph below illustrates the annualised share market returns for a number of economies for the 39 year period ending 31 December 2008:

Annualised Share Market Returns (%) 1970 - 2008



Source: 'Government Intervention & Stock Returns', Westin Wellington, MSCI data, July 2009



This graph suggests that countries with typically high levels of government involvement in the economy, such as Sweden, Denmark and Canada, do not appear to have experienced stifled economic growth relative to countries where government involvement is more limited, such as the United States.

Please remember that any one time period however does not necessarily predict another. For instance, whilst Australia ranked 17th out of the 18 countries in returns for the 39 years as illustrated in the previous graph, it has been amongst the strongest performers over the past 10 years outperforming the US market by 8% per annum and the UK market by 7% per annum.

Interestingly the New Zealand market's return of a modest 7.3% per annum over the last 10 years has been superior to those generated by most other western economies but lower than the 12.6% per annum return for the 73 year period 1931 to 2004.

Again we are reminded of the need to be patient and remain invested in many different countries and economies.

Economic Review – A Global Perspective

In 1776 Adam Smith, the 'father of economics', wrote in *The Wealth of Nations* that the banking sector must be carefully regulated to protect society from the "exertions...of a few individuals", even if some people consider such actions to be a "violation of natural liberty".

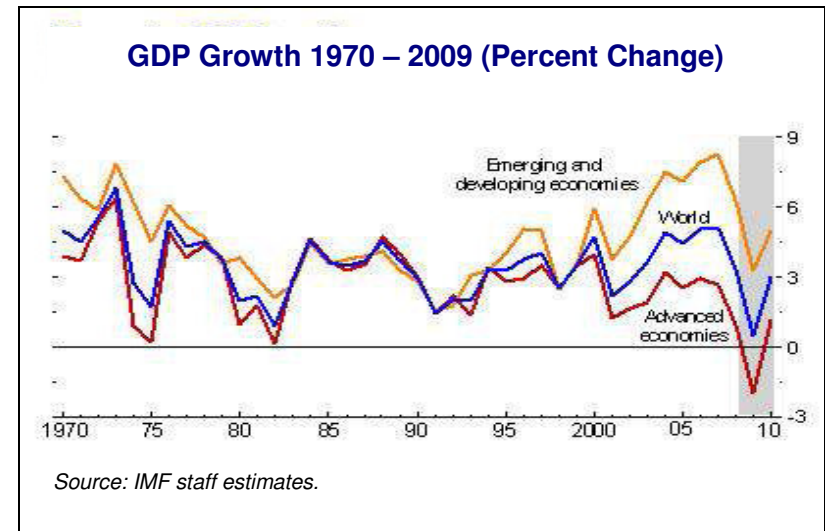
Given the impact excessive risk-taking could have on society, Smith saw a clear distinction between the free market for goods and services and the banking sector. Indeed, 232 years later his fears about excessive risk-taking were realised. Unfortunately, in the year since the collapse of Lehman Brothers the US Government has yet to implement any meaningful structural changes to its financial system.

In 1933, President Roosevelt forced JP Morgan & Co. to split into two separate entities due to concerns that it was too big to fail. Today, the US Treasury has identified 25

financial institutions that may fit this category, but there appears little impetus at present to force any of them to reduce their size.

Today, the four largest US banks hold 46% of all deposits that are covered by a US Government guarantee. This is up from 38% one year ago. If the Obama Administration chooses not to place 'limitations on the success' of US banks, then US taxpayers will effectively end up providing a permanent guarantee to support banks considered too big to fail. It is unlikely that additional regulatory oversight will be sufficient to offset this moral hazard and discourage undesirable actions by banks. A fundamental change in behaviour is still required.

It is important to remember that questionable banking activities, not a lack of capital, brought about the global financial crisis. Every big bank that experienced difficulties in late 2008 had capital reserves exceeding minimum requirements in the US and would therefore have received a tick from regulators. Against this backdrop of regulatory reform, the global economy has been experiencing a downturn in some regions and a recovery in others. The International Monetary Fund (IMF) forecasts that global GDP growth will be 2.5% in 2010, with emerging and developing economies fuelling this recovery:





Financial conditions have improved more than expected due to the scale and speed of government intervention around the world. Despite these positive signs, many countries remain in recession, although the US Federal Reserve Chairman Ben Bernanke announced in September that the US recession is likely over. However, he warned that the US economy faced some 'ongoing headwinds' such as unemployment, which is currently at a 26 year high.

Economic Review - A New Zealand Perspective

The good news is that the worst of the recession seems to be over and there are signs of a modest recovery. On a more negative note some commentators are concerned that the "recovery" is due to government stimulus rather than self-sustaining growth. In addition, housing market strength and a stronger NZ dollar could create an unbalanced recovery with too much domestic demand and not enough exports.

Allan Bollard, Governor of our Reserve Bank, has indicated that interest rates are unlikely to rise until late 2010. However, market expectations are increasingly forecasting an earlier start to a tightening in monetary policy. In Australia (which did not officially go into recession at all) interest rates have already started to move up. Their equivalent of our official cash rate ("OCR") was recently increased from 3% to 3.25% (New Zealand's OCR is currently just 2.5% by comparison).

The New Zealand dollar fell rapidly in the worst months of the global financial crisis as liquidity dried up and funds were repatriated to bolster the balance sheets of large financial institutions in other parts of the world. Subsequent recovering economic confidence has been accompanied by an increased appetite for risk internationally. This willingness to take on risk has seen speculative funds flow back into higher yield currencies such as our own with this demand resulting in an appreciation in the value of the New Zealand Dollar ("NZD"). Consequently, the strong positive returns produced by share markets around the world have been partially dampened NZD terms.

In our March 2009 update we discussed how movements in exchange rates can affect the capital value and income return from offshore investments and advised our long term policy of having 50% of global assets hedged to the NZD. With this approach, portfolios achieve a natural insulation to the effect of our volatile dollar, whether it goes up or down quarter by quarter. Whilst portfolio rebalancing has not hit the 50% target in many instances, most clients have been protected from the rising dollar to some extent via the Vanguard NZD hedged International Shares fund and/ or the DFA Global Core NZD Fund.

The table to below illustrates the extent of change in the NZD value during the past quarter:

	30 June 09	30 Sept 09	Change
NZD / Australian dollar	\$0.8058	\$0.8207	1.8%
NZD / US dollar	\$0.6523	\$0.7149	9.6%
NZD / Euro	€0.4632	€0.4903	5.9%
NZD / Japanese Yen	¥62.71	¥64.45	2.8%
NZD / British Pound	£0.3936	£0.4480	13.8%

Source: Reserve Bank of New Zealand