



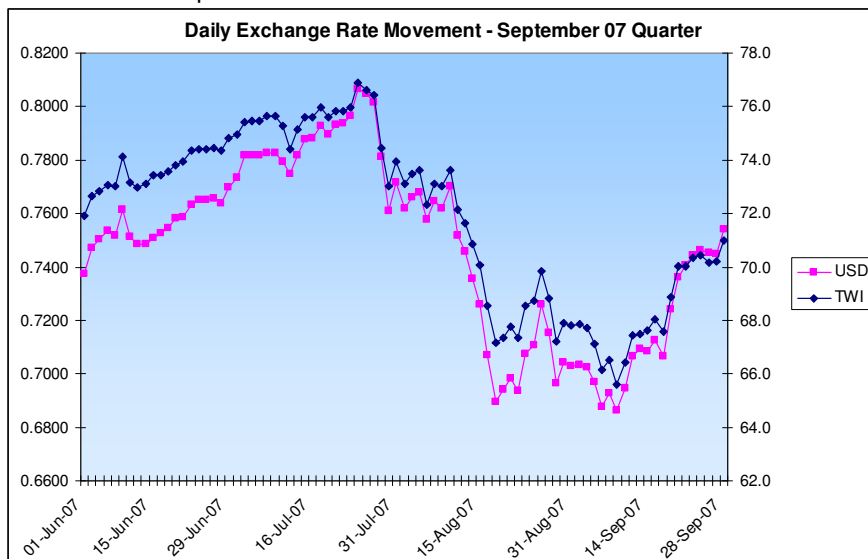
### Contents

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### Market Commentary

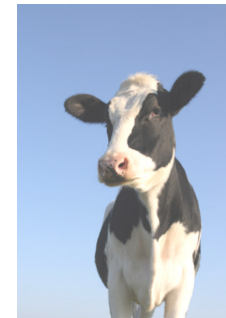
The September quarter proved to be a rollercoaster for exchange rate markets. There was a dramatic 14.5% drop in the value of the New Zealand dollar (NZD) against the US dollar (USD) between end July and mid August as many 'carry trade' currency speculators sought to unwind their New Zealand dollar positions in the face of global liquidity concerns. However, the US Federal Reserve reduced the target federal funds rate by 0.5% which served to reassure markets and by 30 September the NZD had steadily recovered ground against major currencies and closed within 6% of the June quarter values.



Economists previously game to forecast exchange rates on fundamental values have ceased their predictions. The markets have made all such assessments appear foolish.

The NZD is the 7<sup>th</sup> most traded currency in the world, which is quite ridiculous when one considers the relative size of the economy. As such the Kiwi dollar is prone to speculative sentiment by traders working with substantial funds that far outweigh the monetary value of the real economy (measured with reference to actual traded goods and services).

The outlook for the New Zealand economy continues to be positive, which is adding to the confidence of the speculative currency traders. Commodity prices for primary produce are high – and especially so for dairying – where farmers are enjoying the best returns for 30 years notwithstanding the impact of the high NZD. The scale of the financial stimulus of these higher produce returns is estimated to range up to \$3.6 billion (or an additional cash injection close to 2.2% of the nation’s Gross Domestic Product). This extra cash flow is seen as inflationary when the economy is straining at the full capacity mark in terms of employment and infrastructure. Accordingly the Reserve Bank has no room for interest rate reductions for the medium term and inflation continues to nudge above the Bank’s target range.



This high interest rate environment will serve to support the NZD for the foreseeable future. However, as we observed in early August, market sentiment can change very quickly due to factors unrelated to our own economy causing the NZD to plummet.

### Asset Class Returns

**We are pleased to report that fantastic returns continue from our Australian asset class trusts.** The one year returns range from 30% to 42%, and even on a 3 year compound basis results average close to 29%. The resources boom in Australia is having positive economic impact – similar to our dairy boom only better and sustained in a lower interest rate environment. This good news is driving share prices.



Global asset class returns reported in NZD terms are less spectacular, but nonetheless quite respectable on a 3-year average basis. The appreciation of the NZD relative to the USD, Euro and other international currencies has taken the gloss off very healthy underlying returns in these markets over this period. The impact of currency is most clearly seen in the comparative returns of the NZD hedged Global Large asset class vis-à-vis the un-hedged fund noted in the table below. We make a more detailed analysis of hedging strategies later in this report.

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 30 September 2007**

	3 months	1 year	3 year (p.a.)
<b>International Shares</b>			
Australian Core Equity	9.4%	33.7%	n/a
Australian Large	13.3%	35.3%	29.7%
Australian Value	7.1%	29.9%	26.3%
Australian Small	6.7%	42.0%	30.5%
International Core Equity	1.9%	n/a	n/a
Global Large	4.6%	4.2%	13.3%
Global Large (NZD Hedged)	0.2%	18.7%	20.1%
Global Value	(0.3%)	3.0%	16.4%
Global Small	(0.8%)	2.1%	14.4%
Emerging Markets	11.6%	33.0%	32.3%
<b>International Fixed Interest</b>			
Diversified Fixed Interest (AUD class)	8.5%	8.6%	8.7%
Diversified Fixed Interest (NZD class)	2.4%	7.7%	7.2%
<b>New Zealand Assets</b>			
NZ Equity Portfolio	0.0%	16.0%	16.9%
NZ Listed Property	(5.6%)	12.5%	17.7%

**Notes:**

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

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

**Currency hedging alternatives**

A natural question to ask given the environment of currency volatility noted above is whether it is advantageous to hedge the offshore exposure in your portfolio.

The rising NZD has been good for Kiwis consuming imported goods and reduced the cost of overseas travel. However, the overseas investment returns once converted back to NZD have been less favourable than local NZD denominated investments. Those that had overseas investments but ran an overlay of foreign exchange hedging contracts to mitigate the currency movement have fared far better.



Hedging overseas currency exposure is not without some cost or risk. Whilst the NZD has been rising, the rolling currency contracts have paid for themselves – with both an interest rate differential and the monthly resettlement on average being cheaper than each previous roll of the contract.

Notwithstanding the heartening positives presently in focus for the New Zealand economy briefly reviewed in our opening market commentary, there are still structural economic concerns. For instance the economy is running substantial negative current account and trade deficits even with the commodity price boom. Further, total foreign liabilities at \$140billion represent 90% of GDP (Comparable figures for the USA are 20% and Australia 60%). This represents risk to foreigners advancing these funds and render New Zealand disproportionately vulnerable to any change in sentiment. In a global currency trading environment of some US\$3.2 trillion per day, rapid refocusing of priorities as occurred with the US sub-prime liquidity concerns can result in a flight of foreign funds dramatically depreciating the NZD. At such points the cost of rolling the contracts actually has a negative impact on returns.

Some currency diversification is a good thing. The proportion of a portfolio that is directly exposed to global assets on an un-hedged basis will rise in value should the NZD fall. This will naturally offset the ensuing higher



costs of imported goods and services that come with a lower exchange rate.

The appropriate level of NZD hedged and domestic investment compared to global assets will be a matter to customise for each portfolio with reference to client objectives and overall circumstances. In making this assessment it is important to recognise that the long term volatilities of hedged versus un-hedged equity portfolios is similar. They just show a different pattern of returns.

As a matter of policy for many (but certainly not all) clients, we recommend the offshore currency exposure should be a maximum of 50% of their total portfolio. The other 50% may be a mixture of global assets, hedged to the NZD plus domestic denominated securities. Of the un-hedged balance we are comfortable that a large percentage relates to Australian assets – given the narrower band in which our two currencies tend to trade in comparison to the US dollar or Euro for example. Further, given Australia's status as our largest trading partner and the degree of affinity between Australia and New Zealand, there is a sense in which most clients are somewhat more comfortable to treat Australian assets as just a bigger pool of the domestic pond in their portfolio asset allocation.

Of course if we could predict the currency movements we might choose to move in and out of hedging contracts anticipating the every next shift in the cycle. Unfortunately, this is not possible. In the words of Alan Greenspan, revered former governor of the United States Federal Reserve Bank: **“forecasting foreign exchange rates is no better than a coin toss”**. So the question arises: If even professionals can't pick turning points in the currency market, what chance has the small investor got? Again, the discipline to adhere to a well thought out strategic asset allocation (and hedging policy) will maximise the prospect of a successful investment experience.

## PIE Mania

The new Portfolio Investment Entity (PIE) tax rules came into affect on 1<sup>st</sup> October with the legislation aimed at better protecting the interests of those investing in Unit Trusts or collective investment vehicles than had

been the case previously compared to investors that invested directly in the New Zealand Share market.



In many cases investing through a PIE could be even better than investing directly. The introduction of PIE rules is tied to KiwiSaver, which commenced on 1 July this year. All KiwiSaver funds are PIEs.

### *How do PIEs work?*

PIEs will pay tax based on the applicable rates of tax advised by the investors in the fund. The top tax rate that can be applied is based on the company tax rate of 33% (which is to be reduced to 30% from 1 April 2008).

Investors need to advise their fund manager(s) of their Prescribed Investor Rate (PIR). This is based on the following criteria:

- 0% for Charities, PIEs, Companies and Superannuation Funds. This rate also applies to Family Trusts unless they elect to use a rate of 33% (reducing to 30% from 1 April 2008).
- 19.5% for individuals below certain income thresholds in either of the two years immediately before the current taxable year: < \$38,000 taxable income; and up to \$60,000 taxable income and PIE income combined.
- 33% reducing to 30% (in line with the new company tax rate from 1 April 2008) for all other tax payers. Effectively, this will be individuals who do not meet the criteria for the 19.5% and trusts that choose to use this rate.

Investors that select 0% will still need to include the income they receive from a PIE in their own tax returns along with any tax credits attached to the income. For other investors the tax is paid their behalf by the PIE and PIE income does not need to be included in tax returns.



This has the following potential structuring advantages for some clients:

- Those investors earning \$38,000 or more will benefit from the lower tax rate applied to their PIE income.
- Investment income earned through a PIE will not be factored into calculations for various government social benefits that depend on declaring taxable income.

PIEs that invest offshore apply the Fair Dividend Rate calculation for taxation of foreign investment companies that was introduced from 1 April 2007. PIE's are unable to take advantage of the Comparative Value option for calculating tax under these new rules and accordingly global investment is more tax efficient outside the PIE structure.

### **Trustee Investors**

Trustees who have investments in a PIE have to decide which investment tax rate to use – 0% or 33%. Choosing 0% means that the PIE income will be taxable to the Trust at the trustee's rate of 33% unless it is distributed by the Trust to beneficiaries to be taxed at their marginal tax rates. There will be an advantage in doing this if there are low income beneficiaries on a 19.5% tax rate.

Choosing 33% (reducing to 30%) means that that a Trust will not have to include the PIE income in its tax return. A beneficiary of a Trust receiving PIE income also does not have to return that income in their tax return. This is an advantage if income is to be retained in the Trust or distributed to the beneficiaries on higher incomes.

### **Conclusion**

Over the next few months we will be working with you to best establish how we can assist you to minimise your tax liability and optimise your returns.

We are presently undertaking a feasibility study to establish PIE structures for New Zealand and Australian shares in an asset class structure and a separate PIE for the New Zealand fixed interest component of your portfolio. We will continue to liaise with you as we progress this matter to your benefit.

### **Picking stocks with Mary Sue**

A waitress with no knowledge of the share market recently put herself in poll position to win a \$1m TV stock picking contest by virtually choosing shares out of a hat. Left eating her dust were thousands of financial professionals with computer databases, complex trading models and information overload.

Mary Sue Williams, 46, who has been waiting tables for 20 years, was in 6th place in the final round of the 13-week competition on CNBC, but stood to be elevated to 1st because of trading irregularities by some of the leaders. To put this effort into context, this is a competition broadcast nationally in the US and attracting 375,000 contestants with 1.6 million virtual portfolios.

Many of the contestants watch business cable TV religiously and track news on their favoured stocks minute to minute on their personal digital assistants. Thousands of these people are financial professionals with multiple degrees, employing complex computer trading models.



Yet, a woman who has never bought or sold shares in her life has emerged from the pack to challenge the richly informed cognoscenti. Mary Sue works out of an Italian restaurant overlooking an interstate freeway in a small town in Ohio. Her husband is a cook. Neither spends time fretting over share prices. Asked by reporters to list the factors behind her rare stock picking skill, Mary Sue confided that it was a combination of gut feeling, common sense and oh, "some eenie-meenie-minie-moe". (Cue the entrepreneurs looking for the publishing rights to 'Mary Sue's Stock Picking Secrets').

Cynicism aside, there are some simple lessons here for every investor. **Stock prices follow a 'random walk' and speculation is futile.** Assume that market pricing is right and concentrate on capturing the returns of those asset classes that offer higher expected returns over the long term. After all, if the 'smart money' can't pick stocks better than Mary Sue, what hope have the rest of us?