QUARTERLY REPORT: June 2010

axiome

Contents

- Investment Market Review
- Economic Review: A Global Perspective
- Economic Review: A New Zealand Perspective
- NZ Government Budget
- The Lost Decade in Equities
- Own Goals

Investment Market Review

The second quarter of 2010 began on a positive note with signs of economic recovery in most major markets. However, weakness in European economies, measures in China to reduce the supply of money and lower commodity prices led global markets to fall by, on average, 10% - their worst quarterly result since December 2008.

Some of the factors contributing to the falls included:

- The pace of expansion in the US economy, whilst still positive, has disappointed some investors and raised the possibility of a double-dip US recession.
- Ongoing concerns about European sovereign (Government) debt levels and the ability of European Banks to withstand further shocks in the region.
- China's actions to curb excessive bank lending and cool its property market, by increasing the cash reserves banks must hold to support lending activities.
- This is the third such increase in cash reserve requirements this year and demonstrates that China's policy makers are concerned that their economy may well be growing too rapidly.

The following table illustrates how sharemarkets around the world have retreated over the three months to 30 June 2010. Returns for the twelve months to 30 June, however, have been strong. The 7 year global share market returns have been below long-run averages and we refer to this in the short article on page 4 – "The Lost Decade in Equities".

NZD Returns to 30 June 2010

	3 months	1 year	5 year (p.a.)	7 year (p.a)
International Shares				
Australian Core Equity	(16.4%)	12.2%	n/a	n/a
Australian Large Companies	(15.5%)	11.2%	7.2%	10.8%
Australian Value Companies	(17.6%)	12.1%	8.1%	13.0%
Australian Small Companies	(15.9%)	16.4%	9.7%	14.0%
Global Core Equity	(9.9%)	6.0%	n/a	n/a
Global Core Equity (NZD Hedged)	(10.8%)	16.1%	n/a	n/a
Global Large Companies	(9.6%)	3.4%	0.2%	2.0%
Global Large Companies (NZD Hedged)	(11.0%)	12.7%	1.2%	6.0%
Global Value Companies	(10.5%)	7.1%	0.1%	4.0%
Global Small Companies	(7.0%)	10.7%	1.5%	5.3%
Global Real Estate	(4.6%)	26.2%	n/a	n/a
Emerging Markets Companies	(5.8%)	16.3%	12.8%	15.2%
Fixed Interest				
Diversified Fixed Interest (NZD class)	2.8%	9.3%	7.2%	n/a
NZ Bond Fund PIE	1.9%	10.2%	n/a	n/a
New Zealand Assets				
NZ Share Portfolio	(9.7%)	9.1%	0.2%	6.3%
NZ Property Companies	(4.4%)	10.6%	1.9%	5.9%

Notes:
** Returns are reported after fund management expenses and pre-tax, except NZ Bond Fund which is gross of fees and taxes.*
*** Past performance is not necessarily an indicator of future performance.*

Economic Review: A Global Perspective

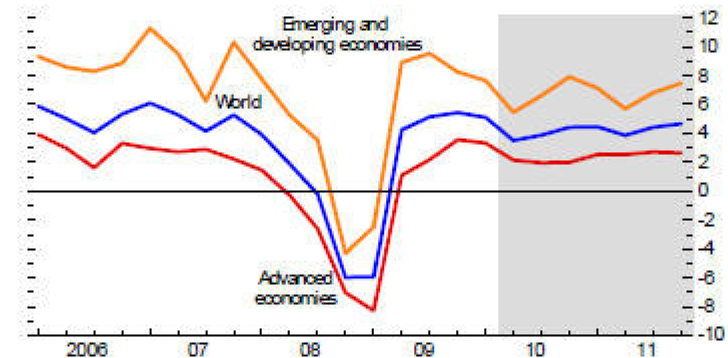
Despite the disappointing investment returns over the last quarter, overall world economic growth continued to gather momentum with the International Monetary Fund (IMF) revising its forecasts for 2010 upwards to growth of 4.5% and 4.25% in 2011 as shown in Figure 1.

The upwards revision was mostly due to robust growth in Asia. Overall, macroeconomic developments during much of the quarter confirmed expectations of a modest but steady recovery in most advanced economies and strong growth in many emerging and developing economies.

Nevertheless, recent turbulence in financial markets reflects a drop in confidence in government balance sheets, fiscal sustainability, government policy responses and future growth prospects and has cast a cloud over the outlook. This drop in confidence stemmed from concerns about the ability of the Greek Government to collect sufficient taxes to maintain its current levels of expenditure (including interest payments) and commitments and also the lack of competitiveness within Greece and other vulnerable economies such as Spain and Portugal.

The Western world's approach to economic growth and rising living standards through borrowing has also seen a marked change. The old-school economics of credit growing at two-to-three times the rate of income growth now seems dead and buried. This model, it seems, has contributed to excessive risk taking, unsustainable current account deficits (countries importing more than they export) and asset valuations that were driven by excessive borrowing (based on expectations of capital gain) rather than based on fundamentals.

Figure 1. Global GDP Growth
(Percent; quarter-over-quarter, annualized)

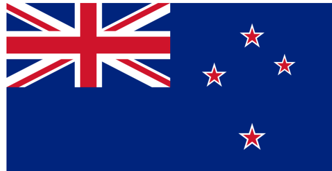


Source: IMF staff estimates.

In the process of recovery, the global economy is undergoing a period of change. Debt cannot continue to grow in excess of the growth of Gross Domestic Product (GDP measures the total value of all the goods and services produced within an economy). The graph above demonstrates the disparity between advanced Western economies and Emerging or developing economies in terms of GDP growth. During this period of below average GDP growth in the West, consumption has grown unabated.

Regulation and prudential policy is forcing changes in behaviour. Households, businesses and governments are focussing on reducing their borrowings. Challenges remain, particularly in rebalancing the global economy which will involve less spending in the West and more spending in the East. But, if excessive leverage (borrowing) got us into the 2008/09 pickle, then leverage will not get us out - hence the need to change.

Economic Review: A New Zealand Perspective



Over the past quarter the New Zealand economy has continued to recover and this partly reflects a normal cyclical upturn as the economy rebounds from recessionary conditions. The rebuilding of inventories is also expected to boost growth in the short-term. Low interest rates are also playing a key role in helping to stimulate the economy but increased bank funding costs and tight lending conditions imposed by the banks suggest that financial conditions are still far from buoyant. It is probably best however, to make slower steady progress towards recovery as moving too quickly would in all likelihood create inflation problems.

Signs of the global recovery are clearly evident in commodity prices, which have rebounded from last year's dip. New Zealand's export commodity prices have firmed to all time highs, both in world prices and NZ dollar terms. This is expected to translate into improving terms of trade and will hopefully underpin domestic spending growth. Business and consumer sentiment has also risen, with investment and employment intentions firming. This is good news for New Zealand's unemployment levels.

NZ Government Budget

The budget announcements in May provide the most comprehensive rethink of tax policy seen in many years. The personal tax scales have been reduced and flattened from 1 October 2010; GST will increase from 12.5% to 15% from the same date; and the company tax rate will fall from 30% to 28% from the next income year (1 April 2011 for standard balance date companies).

One of the government's stated intentions with these changes is to reduce taxes on income generating activities, which are considered harmful to economic efficiency and growth. *"Taxes on consumption such as GST, tend to be less harmful to growth as, unlike income taxes, they do not apply to savings, and therefore do not discourage this activity" (IRD Tax Policy – www.taxpolicy.ird.govt.nz).*

Opinion and reaction to the budget has been well publicised in recent weeks. However, there is a raft of consequential changes that affect investors which are relevant to recap for clients:

Personal income tax thresholds from 1 October 2010:

Income up to $14,000	new tax rate:	10.5%
Income between $14,001 and $48,000	new tax rate:	17.5%
Income between $48,001 and $70,000	new tax rate:	30.0%
Income over $70,000	new tax rate:	33.0%

Resident Withholding Tax (RWT) deducted on New Zealand interest earned will automatically adjust from existing rates to reflect the new scales from 1 October.

Portfolio Investment Entities (PIE) tax rates are aligned to personal income tax thresholds with a maximum rate set at the company tax rate – however, the new top rate of 28% for PIE's will be introduced on 1 October before the rate change is effective for most companies. Clients will be aware that some PIE funds are included in our portfolios. Your Prescribed Investor Rate (PIR) of tax appropriate for PIE investments (that we recently had you review and update where necessary) will automatically adjust from 1 October without the need to make a fresh election.

Our diversified portfolios, which access a combination of PIE funds, and offshore investments that are taxed under the Fair Dividend Rate (FDR) or Comparative Value (CV) methodologies remain efficient for tax purposes following these budget changes.

Another significant policy shift is the elimination of depreciation deductions permitted on commercial buildings and rental properties from 1 April 2011. This change is intended to make the tax rules more neutral between different classes of investment. The government has taken the view that buildings generally increase in value rather than diminish, and that depreciation on top of continuing tax deductions for qualifying repairs and maintenance represents an unwarranted double tax concession.

The Loss Attributed Qualifying Company (LAQC) regime, often utilised by property investors to offset losses against other income, is also being overhauled. The tax rules for these entities are to be amended so that they are taxed like Limited Liability Partnerships thereby restricting the loss that one can deduct through an LAQC in any given financial year to the amount that the shareholder has invested in the LAQC. The balance of the loss will then be carried forward to future financial years. This ring-fencing of losses will likely neutralise tax as a prominent driver in many property investment decisions.

The Lost Decade in Equities

Jeremy Siegal of Wharton Business School (University of Pennsylvania) recently surveyed every 10 year period for the U.S. market since 1871 and found that equities averaged a net real return (after inflation) of 6.7% p.a. Within this 140 rolling ten-year periods he found 14 ten-year periods of negative returns, including the ten-year period ending 30 June 2010.

What is interesting to note is that in every single one of the previous 13 negative episodes, real returns in the following ten years exceeded 10% p.a. – well above the long-term average.

Whilst we cannot predict the future and what will happen in investment markets over the next 10 years “mean reversion” (reverting back towards the long-run average) seems to be a very powerful force in investment markets. Periods of below average returns seem to be followed by periods of above average returns. Lets hope that history does repeat itself and we have stronger than average returns over the next 10 years to make up for the below average returns of the last 10 years!

Own Goals - Football and Investing

The financial media constantly tell investors that in volatile markets they need to pick the best companies with the strongest balance sheets. Sort of like backing Italy in a World Cup soccer match against New Zealand.

Soccer is the national sport in Italy and, other than Brazil, they are the only country to have won the World Cup twice in succession. The Italian team is crammed with highly paid stars, many of whom play for glamour European clubs.

Given this, it was no surprise that most fans picked top-ranked Italy as the favourite to win this pool match in South Africa against the All Whites, who were the 78th-ranked side in the world. Choosing who to actually bet their money on though was a far harder decision. All of the information about the teams and their previous records was known by the bookmakers and was factored into the odds they offered.

So, betting on an Italian win offered the skinniest of returns and therefore the lowest expected profit. As we all know, in what was one of the biggest upsets of the competition, the All Whites held the four-time world champion Italian team to a one-all draw and those who backed Italy lost their bet.

In investment terms, the Italian side was a growth stock or share - an entity that was very familiar, a market darling highly popular and with a good track record. But these solid prospects were reflected in a low expected return as revealed in the odds offered by online bookmakers. In contrast, the All Whites were a value stock – largely unknown and untested, a risky proposition that offered high expected returns.

The huge online betting market surrounding the World Cup is an example of a highly competitive market in which information is quickly assimilated into prices. It is not enough just to know who the best teams are to be able to make a consistent profit on your bets; you also need to know how the odds offered are "wrong".

Taking a bet on a "sure thing" is still no guarantee of a return. In addition, the fewer bets you make the more you leave yourself open to specific events that can blow your strategy to bits. Take France as another example, who were finalists (along with Italy) at the previous World Cup. Full of star players, the French national team were highly favoured this time but imploded in the early stages of the competition. Their star striker was sent home for abusing the coach, thus triggering a player boycott and a subsequent humiliating loss to tournament hosts South Africa.

The sheer unpredictability of sport and the difficulty of beating the bookmakers is an analogy worth reflecting upon when you look at media stories recommending concentrated stock portfolios to get you through volatile times.

One magazine in Australia, for instance, has put together a list of "10 Must-Have Shares in a Tricky Market". The list includes picks that "provide a mix of balance sheet strength, exposure to upside growth potential and an ability to weather any further erosion in economic conditions". The chosen stocks are all well-known and highly reputable blue-chip companies. But don't you think all that good news is already reflected in the share price? The market already knows that these are solid companies with good prospects. But does that make them good investments? It's a different thing.

Secondly, it's not often appreciated that building a portfolio around glamour blue-chips (the equivalent of Italy's blue-chip Azzurri soccer side) often means accepting a much lower expected return for the supposed surety they provide. A good company is often priced at a premium to the market.

Thirdly, as we've seen, there's no guarantee anyway that idiosyncratic risk will not mess up your "safe" blue-chip gamble. Take BP for instance, a long time blue-chip company which on 20th April 2010 had a market capitalisation of £117 billion and had reported £9 billion of profits for the previous financial year. Fast-forward the clock 2 months to June - market capitalisation had fallen to some £57 billion (a decline of 59% on April) and BP is in a fight for its very survival following the devastating oil spill in the Gulf of Mexico.

BP is one example of why a concentrated portfolio of blue-chip stocks provides no guarantees. You are simply taking non-systematic risks that you are not rewarded for; i.e. risks that can be removed through diversification. The way to remove this risk is to diversify, accept that good prospects are almost always in the price already and to understand that low prices relative to fundamental factors mean higher expected returns. The mix of "good" and "bad" companies in your portfolio will depend on your appetite for risk.

Using our World Cup analogy, you may have to accept that you need both blue-chip Italy and value New Zealand in your portfolio. Otherwise, you risk an own goal.