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Investment Market Review

The first quarter of 2010 has provided very satisfactory returns for share market investors. The table to the right shows positive returns of between 5% and 7.5% across most asset classes. Global Small Companies provided the highest returns with a 10% gain and our own NZ share market produced a lower return of 3.4% for the broad index and -2.6% for property stocks.

This is the fourth positive quarter in a row and annual returns to 31 March 2010 now range from 21% to 78% across equity asset classes.

Interestingly, for the first time in many quarterly intervals there was no appreciable difference between global shares that are either hedged or unhedged to the NZ dollar. Although the NZ dollar declined nearly 2% against the US dollar it was up against other international currencies – notably nearly 6% against the Euro and British pound.

The gains in equity markets have occurred despite new concerns dominating the financial press during the past quarter. Concerns such as the default risk of Greek sovereign debt and ballooning government debt in many other economies funding various stimulus measures made prominent headlines. These new worries have superseded other equally significant concerns that were previously the focus of the financial press and now fail to grab attention.

None of this news is helpful to the long term investor. In this age of rapid global information flows, aided by web based distribution, news is incorporated into individual stock market prices almost instantly. A geopolitical development like a bomb blast in a

Moscow subway, economic news such as an agreement on a bailout for Greece, or company specific news like a Chinese firm buying Volvo from Ford all tends to find its way into market prices before the average person is aware that the event has even occurred.

NZD Returns to 31 March 2010

	3 months	1 year	5 year (p.a.)	7 year (p.a.)
International Shares				
Australian Core Equity	5.3%	60.2%	n/a	n/a
Australian Large Companies	5.9%	49.0%	12.1%	15.2%
Australian Value Companies	5.4%	64.8%	13.0%	17.9%
Australian Small Companies	4.8%	77.6%	13.5%	19.3%
Global Core Equity	7.7%	29.4%	n/a	n/a
Global Core Equity (NZD Hedged)	7.3%	n/a	n/a	n/a
Global Large Companies	5.6%	20.7%	2.7%	5.0%
Global Large Companies (NZD Hedged)	5.1%	47.6%	4.4%	10.2%
Global Value Companies	7.4%	36.9%	2.9%	7.7%
Global Small Companies	9.9%	32.5%	3.7%	9.0%
Global Real Estate	6.3%	53.5%	n/a	n/a
Emerging Markets Companies	5.9%	47.1%	15.4%	19.2%
Fixed Interest				
Diversified Fixed Interest (NZD class)	1.9%	7.4%	7.4%	n/a
NZ Bond Fund PIE	2.0%	9.0%	n/a	n/a
NZ 90 Day Bank Bill Rate	0.7%	2.9%	6.4%	6.5%
New Zealand Assets				
NZ Share Portfolio	2.3%	30.2%	3.7%	9.2%
NZ Property Companies	(2.6%)	16.7%	4.0%	7.4%

Notes:

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

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

What is less apparent from the news headlines are the good stories underpinning individual share prices. In aggregate, the worries that may presently influence overall market sentiment have been more than offset by improving confidence in the future cash flows and earnings of companies.



The narrative continues to change as the press moves from highlighting one issue to the next. Investors that maintain their asset allocation and who do not react to the negative press (which is only of historical relevance once released) reap the long term rewards. The past 12 months is a particularly pronounced demonstration of this principle.

Economic Review: A Global Perspective



The global economy is healing courtesy of aggressive steps taken by policymakers. World GDP in the second half of 2009 was positive and leading indicators suggest that this has been maintained into early 2010.

However, the general pick up masks contrasting fortunes around the world. For many advanced economies where the financial crisis was centred, such as Europe, Japan and the US the recovery is expected to be much slower. The International Monetary Fund (IMF) has also predicted that high unemployment is likely to be the key policy challenge facing these economies. Whilst the IMF is expecting that employment growth will be positive at some point during 2010, they are also expecting the unemployment rates of these regions to remain high through 2011 and beyond.

This forecast is in stark contrast to the prospects of many emerging economies, where output has already returned to levels seen before the crisis. East Asia seems to be leading the global economy, with real GDP growth poised to rise to 8.7 percent in 2010 after decreasing from 8.5 percent in 2008 to 7.0 percent in 2009.

Australia, which is enjoying the expansion of trade in the region, has also seen strong investment in the resource sector. With the risk of serious economic contraction having passed some time ago, the Reserve Bank of Australia has moved early to reduce the

monetary stimulus by raising the cash rate to 4.25%. Notably, this is now 1.75% higher than New Zealand's Official Cash Rate (OCR).

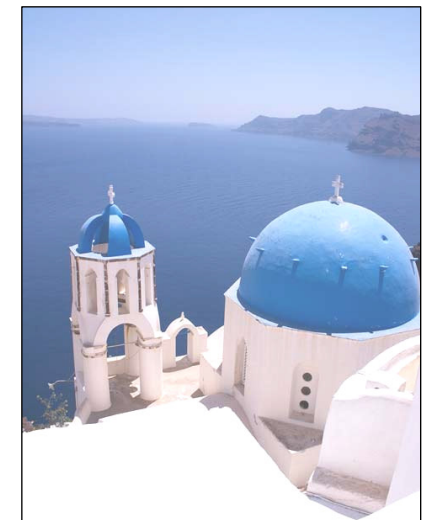
Last year, when banking problems stole most of the media headlines, you could be forgiven for thinking that all banking systems around the world were in crisis. However, whilst all banks were affected to some degree by the seizing up of markets in late 2008, most banks were not affected by the sort of asset quality and capital issues that bedevilled a relatively small number of large US, UK and continental European banks. This meant that banks in most countries, including Australia and New Zealand, were able to function effectively once the panic of September and October 2008 subsided.

Sovereign Debt Levels

In early 2010 the anxiety about excessive debt levels spread from banks to numerous countries, including a number of governments that had bailed out their banks. Since late 2009, when Dubai World requested a six-month standstill agreement on its debt repayments, Portugal, Ireland, Greece and Spain (commonly referred to as the "PIGS") have attracted the most attention.

There is little doubt that the financial crisis and subsequent recession in many developed economies has placed a heavy burden on the fiscal positions of some nations. The IMF has forecast average general government gross debt in advanced countries to rise from 75% of GDP in late 2007 to about 110% of GDP by the end of 2014.

In Greece, the government budget deficit for 2010 was forecast to be 12.7% of GDP – far above the 3% limit imposed by the European Union (EU) on member countries.





Much of Greece's deficit has been attributed to uncontrolled spending in the lead up to the October 2009 national elections. Austerity measures have been introduced – namely reductions to pensions and public servant bonuses – in order to gain EU support for a financial rescue package.

However, many of these savings are being offset by higher interest costs on new Greek Government bond issues, which are currently around 7% (or twice the German borrowing rate). The Greek Finance Minister recently conceded that his Government will not be able to afford to borrow at these rates for an extended period of time.

Greece is a small country – accounting for just 0.5% of global GDP – but its significance is that its currency is the Euro. As such, member countries of the EU are currently trying to formulate a plan to bail out Greece. The markets are unable to devalue the Greek currency as this has been replaced by the Euro. Currency devaluation enhances economic growth by making exports cheaper to the rest of the world, which then boosts production and employment and subsequently assists countries in emerging from tough recessions.

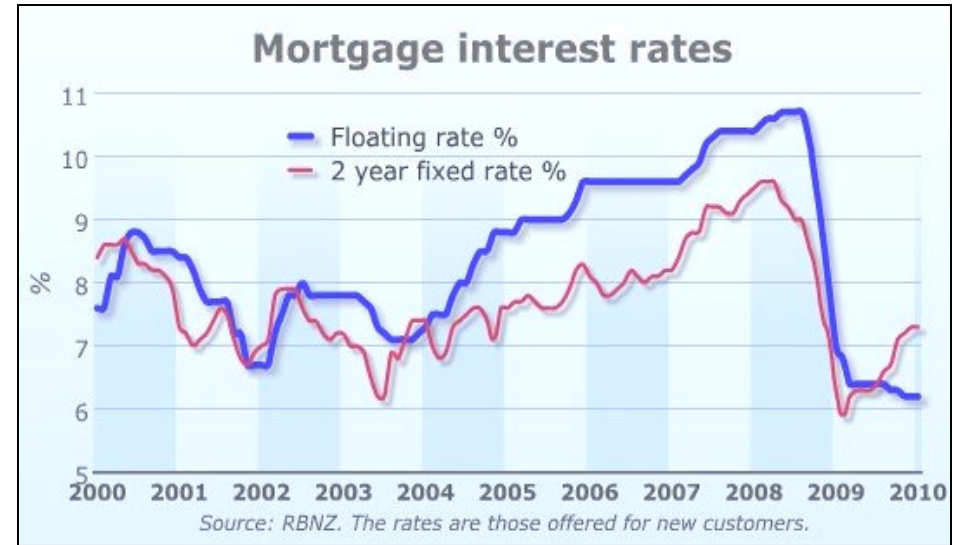
Economic Review: A New Zealand Perspective



The steady recovery in the New Zealand economy has continued into 2010 and is broadly in line with market expectations. Judging by the rebounds seen in business and consumer confidence, the economy should continue to gain momentum throughout the year, helped in part by the strength of our trading partners in Australia, China and the remainder of Asia.

Given this backdrop the Reserve Bank has stuck to it's script of keeping the Official Cash Rate (OCR) at the current low level of 2.5% for an extended period. Pundits are now picking "around the middle of 2010" for a rate rise.

Higher funding costs for banks have already done some of the Reserve Bank's work by taking stimulus off the table. However, this has reduced the extent of future interest rate rises, with the Reserve Bank expecting the OCR to rise to around 6% by the end of 2012.



Tax Changes & NZ Property

Despite an early upswing in the property market as the economy emerged from the recession, recent data from Quotable Value (QV) indicates that growth in sales and prices has stalled. Much of this has been put down to the uncertainty created by the upcoming budget in May, in which the Government is expected to take some of the tax benefits of holding property investments off the table.

Many of the more radical proposals suggested by the Tax Working Group (TWG), such as a comprehensive capital gains tax or land tax, have already been ruled out by the Government. This leaves changes to depreciation and ring-fencing of losses as being the most likely candidates for change.



Pre-budget announcements have also laid the ground work for increases in GST and a reduction in the top rate of personal tax, both of which are likely to be effective from 1st October 2010. Like you, we will have to wait until 20th May for all the details and this year's budget promises to be one of the most eagerly anticipated in recent years.

Is There Outperformance in Norway?

Norwegians have a well-deserved reputation for sound stewardship of their substantial oil wealth and, based on a recent study, may become further noted for making a significant contribution to the debate as to whether active fund management adds or detracts from investment returns.

In 1996 the Norwegian Government founded their sovereign wealth fund, which is now one of the world's largest with over \$500 billion of assets. Quite rightly, the Norwegian Government has given a great deal of thought as to the best way to manage this store of wealth for future generations.

Norges Bank Investment Management, an affiliate of the Norwegian central bank, carries out the investment mandate and has a current target asset allocation of 60% equity (diversified across 46 countries) and 40% fixed income.

The fund is an unusually sophisticated market participant. With no current distribution requirements and a time horizon measured in generations, the fund is the quintessential patient investor and, with its ample resources, can afford to hire the best and brightest managers the world has to offer.

The fund devotes considerable effort to the process of hiring external money managers, seeking out not just successful organisations but specific individuals within those organisations with desirable characteristics. Combined with the traditional Scandinavian virtues of thrift and thoughtful analysis, the fund appears well-positioned to achieve its ambition, as described by the Norwegian Ministry of Finance, "to be the best managed fund in the world".

Following a disappointing performance in both absolute and relative terms in 2008 (the fund fell 23.3% for the year, trailing its benchmark by 3.3%) the Ministry of Finance engaged an international team of experts to "evaluate the experiences in active management in Norges Bank". The resulting 220-page report provides an unusually detailed examination of an institution's investment experience for more than eleven years and the Ministry of Finance deserves credit for encouraging such a detailed independent investigation.



The conclusion? The authors' "key finding" is that despite having an internal staff of 249 and hiring hundreds of external money managers, **the average active return from January 1998 to September 2009 was statistically indistinguishable from zero.**

It therefore seems that even the world's most talented active fund managers are not able to beat the returns offered by the market as a whole. It's another reminder that "asset class selection" explains performance and activities such as individual stock selection and market timing are far less important than the construction of the portfolio as a whole.