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Investment Market Review

News concerning the Greek debt crisis has continued to reverberate through investment markets this past quarter. The European troubles and mixed signals of economic recovery in the United States have dampened investor sentiment and global growth appears to have lost momentum. In Asia, Japan's economy has stabilised following the earthquake and tsunami in March and Chinese economic data was generally solid with inflation tracking somewhat lower than expected.

These factors have created a strong overhang to investment markets with all growth assets (apart from NZ property companies) reporting negative returns for the quarter. Notwithstanding the pull back in quarterly growth, annual returns remain solid.

Despite ongoing seismic ructions in Christchurch, the New Zealand economic situation appears on a relatively firm footing. The continued appreciation of the NZ dollar (NZD) against the US dollar is providing a strong headwind to export sector. While frustrating, this is somewhat offset by record commodity prices for primary producers and weakness against the Australian dollar.

The strong NZ dollar has influenced investment returns as seen in the difference between global equities and global hedged equities in the table below. In fact since 1 January 2010 the NZD has risen nearly 7% against the US dollar; 6% against the Yen; 2% against the Australian dollar and 3% against the British pound.

NZD Returns to 30 June 2011

	3 months	1 year	5 year (p.a.)	7 year (p.a.)
International Shares				
Australian Core Equity	(10.0%)	18.5%	n/a	n/a
Australian Large Companies	(8.0%)	17.4%	3.8%	11.0%
Australian Value Companies	(10.6%)	17.1%	5.2%	11.7%
Australian Small Companies	(13.2%)	26.4%	7.7%	13.8%
Global Core Equity	(8.2%)	9.6%	n/a	n/a
Global Core Equity (NZD Hedged)	(0.8%)	26.6%	n/a	n/a
Global Large Companies (NZD Hedged)	0.0%	24.8%	2.1%	n/a
Global Large Companies	(7.2%)	8.6%	(3.9%)	1.2%
Global Value Companies	(9.4%)	8.8%	(4.9%)	2.0%
Global Small Companies	(8.4%)	14.7%	(2.3%)	3.6%
Global Real Estate	(4.1%)	14.3%	n/a	n/a
Emerging Markets Companies	(10.5%)	5.3%	5.6%	12.9%
Fixed Interest				
Diversified Fixed Interest (NZD Hedged)	2.9%	6.2%	7.7%	7.6%
NZ Bond Fund PIE	2.4%	7.3%	n/a	n/a
New Zealand Assets				
NZ Share Portfolio	(0.5%)	14.8%	(1.0%)	5.1%
NZ Property Companies	7.5%	22.1%	2.2%	7.2%

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.



Navigating through the gloom

The backdrop of negative geopolitical events and global economic concerns tends to promote indecision and procrastination with investment decisions. But whilst the current events look ominous, does a quick review of other times of economic uncertainty remind us of lessons past learnt?

Have there been 'if only' moments when we recognise what a buying opportunity presented itself after the 1987 share market crash; or who might have foreseen the market rally that followed the tech bubble crash a decade ago.

The discipline to invest through extreme market events points to the value of having a realistic and clear financial plan. Investor discipline is not so much about identifying short term opportunities – we have reiterated many times that market timing is a fraught endeavour – but rather continuing to manage and control risk. Mechanisms for doing this include rebalancing your portfolio (selling winners and re-investing in asset classes that have reduced in value) and continue to invest new funds progressively in accordance with your financial plan (often referred to as dollar cost averaging).

Greece – concern in perspective

There has been a lot of coverage of Greece in the media. As late as June, the Greek government had not followed through on many of the pledges it made in return for its bailout from the International Monetary Fund (IMF) and European Union (EU) last year. Many doubt the Greek government's willingness and capacity to increase taxes and decrease services.

As a result, Standard & Poor's lowered its credit rating of Greek debt to CCC, only two notches above default. Markets believe it's highly likely Greece will default, and the price of Greek debt has fallen to reflect this. Two year Greek government bonds were yielding 26% in late June.

In early July Europe helped pull Greece back from the brink after the Greek government passed austerity measures. An 8.7 billion Euro lifeline will keep Greece operational and allow more time to find a long-term solution. Markets around the world responded by

recording gains and the Euro strengthened. There is still considerable debate between the IMF, EU and European Central Bank (ECB) on how to structure future bailouts of Greece. Unfortunately, Greece is still effectively bankrupt.

Nevertheless, there is hope for Greece. For example, tax collection in Greece is woeful. Many of the rich do not pay taxes and there are few consequences for not doing so. This leaves the mounting tax burden on lower and middle classes. This is the source of much of the recent unrest. Seeing tax-evaders in handcuffs may convince Greeks that their tax authorities have new teeth and will improve collections.

The government owns approximately 70% of the land in Greece. Clearly assets can be sold, but like many other government agencies the land register is poorly organised. So it must be improved before sales can go ahead.

A Greek default could cause Greek banks to implode and inflict major damage on the larger banks in France and Germany. Spain, Ireland and Portugal, which have high levels of government debt, could also be adversely affected.

Some commentators have warned that Greece's debt crisis could spark "contagion" across Europe, with Italy, already plagued by domestic political crises being touted as the next European nation to experience difficulties. The apparent inability of European authorities to agree on a second bail out of Greece or a longer term European fiscal strategy continues to make markets jittery. Other commentators have a less dramatic outlook on these dire forecasts for Europe.

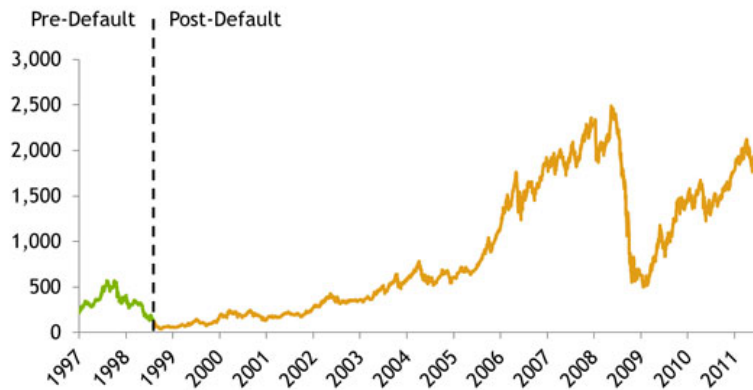
Comparisons have been made between Greece and Lehman Brothers, but there is a difference. The collapse of Lehman Brothers was an unexpected shock whereas the Greek troubles have been developing for months. The sensationalist media headlines and conflicting opinions provide the context for current market trading and are factored into market prices as the pessimists and optimists trade with each other until market prices are set.



While it is rare, countries can and do default on their debt. There are actually two recent examples. How many people recall Russian stock, bond and currency markets collapsing and inflation of 84%? This happened in August 1998. Russia is a country of 140 million people, Greece a country of 11 million. The IMF provided loans to Russia at the time, similar to what they're providing Greece today.

Most of the decline in the Russian stock market occurred leading up to the default, as shown in the graph below:

Russian Stock Market
Jan 1997-June 2011



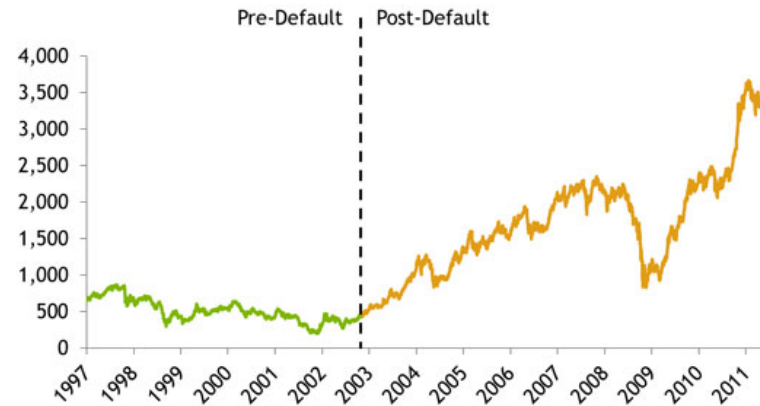
Source: Source: Daily History of the RTS Index (RTSI), <http://www.rts.ru/618>

Shortly after the default, markets started to gradually recover. But are the longer term outcomes dire? Not in Argentina, home of 40 million people.

Again, many probably don't recall Argentina defaulting on its government debt in 2001 - 2002. How has the Argentinean stock exchange performed post default? In New Zealand dollars, its stock market has returned approximately 18% per annum whereas the New Zealand market returned just over 6% pa for the same period.

Argentinean Stock Market

Jan 1997-June 2011



Source: Yahoo, <http://ar.finance.yahoo.com/q/hp?s=ISEMERY>

It is important to remember that economic growth is not directly linked to bond or stock market performance.

The Russian and Argentinean examples demonstrate that markets continually adjust prices to reflect expectations and they move on. Governments' defaulting on debt is not necessarily destructive to their countries' future investment opportunities. Perhaps a similar story will play out in Greece? We don't know, but we do know that investors' speculating on the outcome with their retirement savings is a bad idea.

The events in Greece and Europe today are bad and the possibility of default by Greece is real. This possibility is already priced into fixed interest, property and equity markets. But we've seen this before and while we may not want to be Greeks if it happens, markets will react and move on. Greece will probably even become a better place to invest because of it.



Geographic Diversification

Diversification is widely accepted as a prudent way to reduce investment risk. For New Zealanders this may start with moving beyond a single asset class, such as property, to embrace a portfolio of shares and bonds. The New Zealand market is a very small component of the investment universe with our stock market representing less than half of one percent of world equity markets. Prudent diversification will inevitably lead to consideration of offshore markets.

The information age in which we live facilitates secure access to global opportunities as an investor. Our approach is to spread risk across the developed international markets and to a lesser extent the fast expanding emerging markets.

It is interesting to note how international markets have grown and changed over time – the chart below references the relative sizes of markets over 100 years ago, when empires more than nations were the powerhouse of trade. There has been a significant shift in relative wealth with the passage of time as seen in the second pie chart. What will a chart similar to this look like in another 20 years? No doubt somewhat different again, and diversification will provide the framework to adapt to the inevitable changes that will arise.

Figure 1
Relative sizes of world stock markets, end-1899

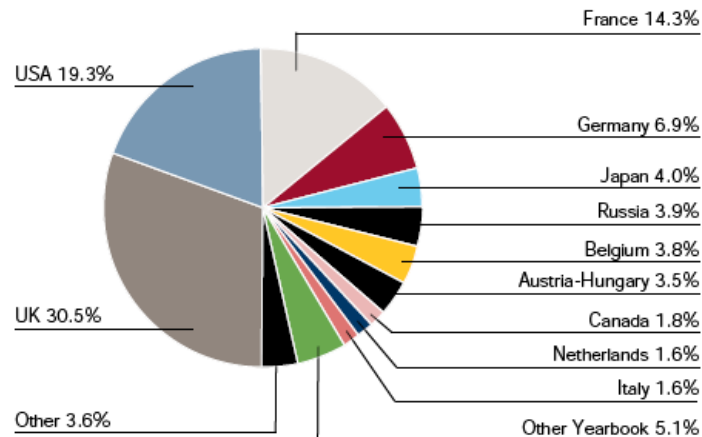
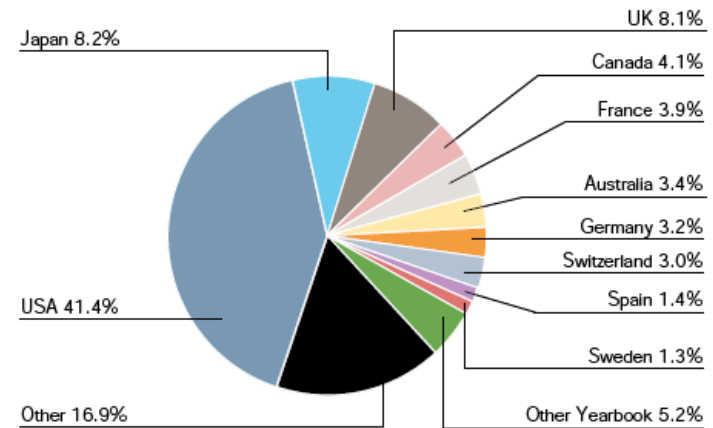


Figure 2
Relative sizes of world stock markets, end-2010



Source: Elroy Dimson, Paul Marsh and Mike Staunton, Credit Suisse Global Investment Returns Sourcebook 2011.

The second reason that diversification across geographic markets makes such good sense, notwithstanding the inter-related nature of today's global economy, is that economic circumstances and equity market returns still differ across the world. The table on the following page provides a year by year snapshot of the best and worst performing equity markets from 1986 to 2010. The message is simple, a spread across available markets positions the investor for returns that will vary year by year somewhat unpredictably geographically and inevitably shift strategically overtime. Clients in our global portfolio are well positioned for these movements in low cost efficient funds.



Equity Returns of Developed Markets

Annual Return % (AUD)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Highest Return	Spain 127.08	Japan 31.65	Belgium 29.89	Austria 120.60	UK 12.77	H.K. 51.79	H.K. 45.74	H.K. 119.19	Norway 8.20	Switz. 50.48	Spain 31.07	Switz. 75.90	Belgium 78.21	Sing. 86.14	Switz. 25.17	Australia 10.38	Austria 5.95	Sweden 22.96	Austria 64.86	Canada 37.20	Spain 38.71	H.K. 26.94	Japan -10.95	Norway 45.20	Sweden 17.46
	Italy 113.78	Spain 26.02	Denmark 29.08	Germany 58.24	H.K. 11.63	Australia 35.67	Switz. 29.16	Sing. 69.90	Japan 6.33	USA 43.20	Sweden 28.41	Italy 65.21	Italy 62.03	Sweden 67.79	Canada 24.57	Austria 2.43	Australia -10.30	Germany 22.42	Belgium 37.95	Japan 34.22	Sing. 36.25	Germany 21.55	Switz. -12.56	Australia 36.94	Denmark 14.81
	Japan 104.67	UK 24.34	Sweden 25.41	Norway 57.44	Austria 8.72	USA 32.04	USA 17.21	Switz. 47.47	Sweden 3.62	Sweden 39.25	H.K. 24.54	Denmark 64.04	Spain 59.25	Japan 50.79	Denmark 22.33	Belgium -3.26	Norway -15.69	Spain 18.42	Norway 33.02	Austria 33.28	Norway 34.78	Norway 18.15	USA -21.47	Sing. 35.02	H.K. 8.23
	Belgium 83.08	Canada 4.84	Norway 20.40	Denmark 55.72	Norway 2.91	Sing. 26.86	Sing. 17.09	Norway 43.68	Neth. -2.19	Spain 35.57	Norway 20.38	USA 62.65	France 50.37	H.K. 48.92	Norway 17.21	Spain -3.77	Italy -15.75	Austria 17.31	Sweden 30.98	Denmark 33.13	Sweden 33.17	Canada 16.48	Spain -25.27	Sweden 27.42	Sing. 7.27
	France 83.05	Denmark 4.22	France 16.57	Sing. 53.91	Denmark 1.32	France 19.62	France 13.26	Sweden 38.56	Italy -2.31	Neth. 33.35	Canada 20.30	Spain 52.93	USA 38.26	Canada 43.52	Italy 16.68	Norway -4.71	Japan -18.44	Canada 15.54	Italy 27.34	Norway 32.87	Denmark 28.88	Sing. 15.39	France -28.64	H.K. 24.31	Canada 5.78
	Sweden 69.96	Australia 0.56	Australia 15.33	France 47.30	USA -0.97	Neth. 19.59	Neth. 12.70	Germany 37.19	Belgium -5.22	Belgium 31.44	Neth. 19.33	Germany 51.90	Germany 37.50	Norway 22.94	Neth. 13.42	USA -4.89	Switz. -18.46	Australia 11.70	Denmark 25.74	Switz. 24.39	Belgium 26.92	Australia 15.37	Canada -31.46	Belgium 22.24	Japan 1.38
	H.K. 60.23	Belgium -0.70	Japan 14.47	Neth. 46.91	Neth. -1.02	Denmark 18.33	Belgium 8.55	Neth. 36.83	Sing. -6.59	H.K. 27.98	UK 19.25	Neth. 50.93	Switz. 31.24	France 20.67	France 13.16	UK -6.69	Sing. -19.13	Denmark 11.55	Australia 25.28	Australia 24.06	Austria 26.81	Denmark 12.91	Germany -31.91	Canada 21.23	USA 0.80
	Sing. 49.00	Neth. -1.45	Sing. 12.72	Sweden 42.58	Switz. -4.13	UK 17.78	UK 6.14	Australia 36.73	Australia -7.71	UK 26.62	USA 15.34	UK 49.53	Neth. 30.91	USA 13.82	Australia 6.49	Denmark -7.51	Canada -21.08	Norway 10.69	Spain 23.92	Sing. 22.30	Germany 26.30	Spain 11.43	Sing. -33.77	Spain 11.37	Australia 0.58
	Australia 46.03	Norway -2.74	H.K. 8.33	USA 40.66	Germany -7.32	Switz. 17.53	Germany -1.15	Denmark 34.34	Germany -8.35	Denmark 24.03	Denmark 13.98	Belgium 38.47	UK 25.15	Germany 12.06	UK 4.62	H.K. -11.65	Belgium -22.70	France 4.79	H.K. 20.12	Neth. 21.74	France 24.89	Neth. 8.41	Denmark -34.03	UK 11.23	Switz. -1.82
	Neth. 44.45	USA -5.28	Germany 1.97	Switz. 36.55	Belgium -8.98	Spain 17.39	Austria -1.56	Spain 31.28	Denmark -9.14	Canada 23.53	France 13.42	Sweden 37.70	Sweden 21.07	Australia 9.80	Austria 4.12	Canada -13.62	UK -22.94	H.K. 3.21	Sing. 17.52	Sweden 17.95	Italy 23.05	France 1.80	Neth. -34.86	Austria 11.15	Norway -2.56
	Germany 38.86	Sing. -5.86	Canada -1.01	Canada 34.47	Sing. -9.68	Sweden 16.16	Australia -1.75	Italy 30.01	Switz. -9.34	Germany 21.55	Australia 9.02	Canada 37.55	Denmark 15.78	UK 4.97	USA 3.07	Switz. -14.65	Spain -22.99	Italy 3.01	Canada 17.46	Germany 17.54	Neth. 22.02	UK -2.58	UK -35.02	Neth. 10.41	Austria -3.50
	Austria 38.30	Austria -5.91	USA -3.09	UK 31.85	Canada -11.05	Belgium 15.50	Canada -3.22	Austria 29.56	USA -11.44	France 19.15	Germany 6.29	France 36.51	Australia 12.69	Denmark 4.61	H.K. 0.82	Neth. -15.43	Denmark -23.66	Sing. 2.84	UK 14.93	France 17.50	Australia 21.53	Italy -4.66	Sweden -36.93	Denmark 6.00	UK -4.49
	Switz. 36.89	Sweden -6.13	Neth. -3.45	Italy 29.20	France -11.89	Canada 12.77	Sweden -5.71	Japan 26.92	UK -13.86	Australia 16.10	Italy 5.37	Norway 29.56	Japan 11.60	Neth. -0.22	Germany -0.18	France -15.72	H.K. -25.26	Japan 1.57	France 13.88	Belgium 16.60	UK 21.30	USA -5.21	Italy -37.07	France 2.33	Germany -4.77
	UK 30.30	H.K. -11.74	Spain -4.01	Belgium 26.89	Spain -11.91	Japan 10.58	Japan -13.46	UK 25.87	Canada -15.10	Sing. 11.15	Belgium 4.85	Austria 23.86	Austria 6.61	Spain -2.14	Spain -0.50	Germany -15.74	Neth. -28.03	Belgium 1.14	Germany 11.66	H.K. 15.91	H.K. 21.06	Switz. -5.35	Australia -37.95	Italy -1.76	Neth. -10.65
	USA 19.35	Switz. -16.66	Italy -5.76	Spain 18.75	Australia -15.68	Germany 9.80	Spain -13.92	Belgium 24.93	Spain -16.64	Norway 10.70	Austria -2.19	Australia 9.21	H.K. 3.14	Italy -6.89	Belgium -1.67	Sing. -16.86	France -28.35	Switz. 0.21	Japan 11.36	UK 14.79	Switz. 18.32	Austria -8.15	H.K. -38.82	USA -2.00	Belgium -12.54
	Canada 12.84	France -20.67	Switz. -10.22	Australia 18.25	Italy -17.37	Italy -0.33	Italy -14.31	France 22.30	France -16.98	Italy 5.51	Switz. -4.28	H.K. -6.45	Canada -0.28	Switz. -13.20	Sweden -6.92	Italy -20.30	USA -30.08	UK -1.30	Switz. 10.49	USA 12.43	Canada 9.41	Sweden -9.55	Norway -55.01	Switz. -2.74	France -15.79
	Denmark 3.91	Italy -27.57	UK -10.42	H.K. 17.26	Sweden -19.22	Austria -10.90	Norway -14.39	Canada 18.93	Austria -17.93	Japan 5.14	Sing. -12.84	Japan -6.92	Sing. -7.44	Austria -15.16	Sing. -14.53	Sweden -20.94	Sweden -36.81	USA -4.03	Neth. 7.88	Spain 11.64	USA 6.50	Belgium -12.55	Belgium -57.84	Germany -2.86	Italy -25.36
Lowest Return	Norway 0.05	Germany -30.73	Austria -14.97	Japan 10.04	Japan -34.67	Norway -14.21	Denmark -20.95	USA 10.40	H.K. -37.74	Austria -0.52	Japan -20.92	Sing. -14.70	Norway -25.69	Belgium -19.96	Japan -15.05	Japan -23.36	Germany -39.26	Neth. -4.27	USA 5.86	Italy 8.96	Japan -1.33	Japan -13.91	Austria -60.26	Japan -17.53	Spain -31.46