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Market Commentary

Over the last quarter financial markets continued their roller coaster ride that commenced mid 2007. The financial year to 31 March 2009 has been one of the more tumultuous periods to be an investor. Share market returns across all asset classes have been negative. Quality fixed interest securities and cash have been the only safe harbours.

The markets did, however, stage a significant rally towards the end of March – the United States S&P 500 index rising over 20% in a three week period. Whilst the long awaited depreciation in the New Zealand dollar from US80c last year (briefly falling below US50c during the quarter) has softened the impact of global share declines, it too has staged a rally in past few weeks contrary to expectations. The fallibility of short term forecasts and the need to focus on long term structure is as evident as ever in this environment.

Asset Class Returns

A summary of the gross returns in New Zealand dollars (NZD) for the key asset classes we track and which form the core of most client portfolios, are listed in the following table.

NZD Returns to 31 March 2009

	3 months	1 year	3 year (p.a.)	5year (p.a.)
International Shares				
Australian Core Equity	(1.9%)	(29.9%)	n/a	n/a
Australian Large Companies	0.5%	(23.7%)	(5.1%)	7.0%
Australian Value Companies	(4.8%)	(25.7%)	(6.2%)	6.4%
Australian Small Companies	0.4%	(37.1%)	(7.6%)	4.8%
International Core Equity				
Global Large Companies	(9.9%)	(20.4%)	(11.5%)	(0.7%)
Global Large Companies (NZD Hedged)	(11.1%)	(38.2%)	(12.9%)	(1.0%)
Global Value Companies	(14.4%)	(31.1%)	(16.0%)	(1.7%)
Global Small Companies	(10.2%)	(21.5%)	(15.3%)	(1.0%)
Global Real Estate	(26.1%)	(50.7%)	n/a	n/a
Emerging Markets Companies	1.1%	(24.6%)	(5.4%)	9.6%
International Fixed Interest				
Diversified Fixed Interest (AUD class)	3.2%	11.5%	8.0%	7.0%
Diversified Fixed Interest (NZD class)	1.0%	7.3%	7.8%	7.1%
New Zealand Assets				
NZ Share Portfolio	(5.2%)	(24.6%)	(10.0%)	2.0%
NZ Property Companies	(6.6%)	(20.3%)	(4.4%)	4.1%

Notes:

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

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



Questions and Answers

There are a lot of statements made about investing at the best of times. In difficult periods such as the world economy is presently experiencing the claims can be even more worrisome.

Are equity markets working?

Emphatically yes. For every seller there is a buyer, all trades continue to settle every day. On one side of every transaction there is an optimistic buyer - believing the pricing of the day represents an opportunity to accumulate shares in a particular company. The market closes in equilibrium every day.

Whilst investors may not enjoy the paper losses experienced in their portfolio values over the past eighteen months or so, the securities are marked to market value (or a realisable sale price) on a constant basis. In comparison, the credit markets which trade many fixed interest securities and numerous structured derivative products, have been 'locked up' and at times there has been no market to trade some credit securities at all – resulting in much of this sector being labelled as 'toxic assets'. Similarly, the realisable value of many property holdings is less clear in the current environment. Properties that do sell are taking longer to sell. The difference of course is that most property is not on the market and therefore is not having its realisable price updated on a daily basis as is the case with equities.

Essentially the equity market is presently working better than most other financial markets during this difficult period.

Is diversification relevant or are stock specific picks and active trading more beneficial in a bear market?

This question was recently put to leading financial economists Eugene Fama and Ken French. Their response is paraphrased as follows:

"When overall market volatility increases, security-specific volatility also tends to increase. For example, market volatility is currently high and the dispersion of returns between

individual shares is also unusually high. Diversification has no effect on the volatility of the overall market, but it reduces the volatility between individual securities and hence the effect on a portfolio's return. To put it differently, active investment (involving individual stock picking) is a riskier strategy when volatility is high because active portfolios are, almost by definition, poorly diversified. In short, diversification is now more important than usual".

Credit Crunch – where are we now?

The markets have taken a battering over the past 18 months and understandably you may well be questioning whether there is an end in sight. So much has happened and at such a pace. By now we are all very well aware of the beginnings of the financial crisis with the emergence of sub-prime mortgages having rapidly developed into a global crisis destabilising the world financial systems. Constraints on capital have quickly led to severe contractions in economic activity.

Over the past months policy makers have employed a range of measures to alleviate the impact of the global financial and economic crisis.

The first stage was to ease monetary conditions by injecting liquidity (cash) into the financial systems. As the problems of the banking sector intensified, even greater efforts were made to stabilise the world's financial systems by Government bank deposit guarantees and direct government equity injections into various banks around the world.

The second stage which has yet to achieve full traction, involves the public sector buying a far greater range of securities from banks to introduce additional liquidity. These distressed assets are being packaged with the support of governments to share the burden and attract investors.

The third stage involving massive fiscal stimulus such as; personal tax cuts, cash handouts and increased government spending on infrastructure is well underway. The level of the stimulus is measured in terms of Gross Domestic Product ("GDP") being the



total value of all goods and services produced in a country in a given year. Announced stimulus packages range from 2% of GDP in India, to 7% of GDP in the USA and a massive 14% of GDP in China. Both Australia and New Zealand are looking to increased Government spending and tax cuts in an effort to soften the effects of the current economic recession.

Stages one and two seem to have been broadly successful shoring up the banking and global financial systems. Official interest rates have been cut to record lows and businesses continue to access bank credit at easing borrowing rates. However, we now wait to see whether stage three will improve the global economic performance and stimulate global economies.

Consumers so far have responded by increasing their level of savings and putting away the credit cards. It's very much a 'wait and see' game.

Some commentators believe that the economic conditions don't have to deteriorate much further to match The Great Depression of the 1930. However, times were different then, with the US economy contracting by more than 30% and unemployment reaching 25%. Others are anticipating an economic recovery forecasting the US economy will grow by 3.5% GDP into 2010.

While markets are considered cheap, with company short term earning prospects remaining uncertain, investors are demanding higher 'risk premiums' as reflected in the current share prices. Prospects remain for continued market volatility with share markets likely to rally before economic data shows any real improvement. This is normal market behaviour during recessions with equity markets generally starting to pick up some months before the economic indicators show the first signs of recovery.

Time will tell whether we are near the bottom of the recession but let's not forget the significant changes and plans that are being implemented. Lastly, equity markets, as they have done in the past, are likely to signal the turning point well ahead of any economic recovery being felt.

Currency Hedging



A currency is a medium of exchange rather than an asset with an inherent value. As such there is no expected return from currencies over time. However, the changing value of the New Zealand dollar ("NZD") impacts on the returns of offshore assets. Currency hedging removes the currency volatility from a global portfolio and allows the risk / return characteristics of the assets you are investing in to be delivered.

Exchange Rate movement over the last year			
	31-Mar-08	31-Mar-09	Change
NZD / AUD	0.8661	0.8262	-5%
NZD / USD	0.7935	0.5621	-29%
NZD / JPY	78.51	54.83	-30%

Source: RBNZ historical series

The table shows the movement in the major currencies against the New Zealand dollar ("NZD") over the past year. Most investors focus on the return of their portfolio expressed in NZD and the affect of currency can be an unhelpful distraction.

The long term returns of international assets are not increased by foreign exchange hedging. Neither is short term volatility reduced. When the NZ dollar rises, hedged portfolios will win, but conversely they will lose value when the NZD depreciates. We have previously noted that anticipating the direction of currency movements is speculation with odds no better than a coin tossed.

Accordingly we are recommending that clients adopt a strategic position of hedging around 50% of the offshore equity portion of their portfolios. This way, portfolios will

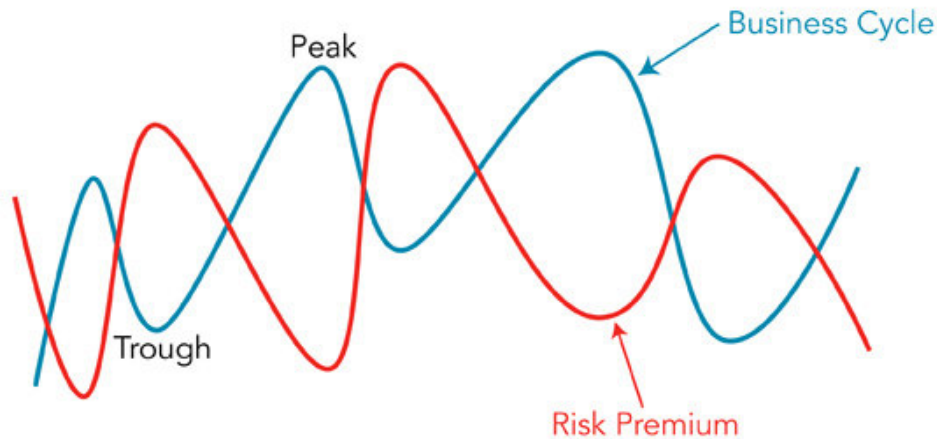


partially benefit from future appreciation in the NZD, but also be protected when the NZD falls, reinforcing the neutral long term position.

Economy & Markets

The volatility experienced in markets recently has resulted in a general reluctance to take on risk (risk aversion), which is reflected in the fact that returns on cash assets are at historical lows (currently 3% in NZ, with the likelihood that it may fall further).

During tough times when risk aversion rises, the expected return from riskier assets goes up whereas at the peaks in the business cycle, the expected return from these assets is less favourable (lower risk premium), as depicted in the chart below.



Source: Inmoo Lee, 'Risk Premiums Across Business Cycles', DFA

Those who tend to hold their portfolios in "safe" assets such as cash and government bonds during times of downturn, are in effect foregoing the opportunity to get the benefit of the bounce back in "riskier assets", such as shares, when markets recover.

Markets tend to price in turning points in the economic cycle before an enhanced sense of economic wellbeing is apparent. This explains the difficulty of timing the market and reinforces the benefit of staying disciplined with your chosen asset allocation.

There is no evidence of even professional money managers consistently anticipating the bottom of the cycles with any accuracy.

Volatility

The CBOE Volatility Index, or "VIX", is a measure of the market's expectations of volatility over the next 30-day period and is often referred to as the "fear gauge".

VIX values greater than 30 (as plotted on the chart below) are generally associated with a large amount of volatility as a result of investor fear or uncertainty, while values below 20 generally correspond to less stressful, even complacent, times in the markets.

VIX Index 2008/9





The VIX has been trading at elevated levels since October last year, but recently dipped below 40 for the first time since early January, a potential signal of investor willingness to take on more risk. As markets become more settled, the VIX will fall below 30.

Since the S&P 500 hit its recent bear-market closing low on March 9, the VIX has fallen nearly 18%, and there has been a corresponding rise of more than 23% in the S&P 500 share returns.

Why we don't invest your money in Hedge Funds *(Not to be confused with currency hedging)*

Hedge funds are exempt from many of the rules and regulations that offer protection to investors primarily on the grounds that their availability is restricted to supposedly sophisticated and wealthy clients. This permits them to follow aggressive and risky strategies such as option trading, derivatives, and short selling. These risks are often multiplied further by the hedge fund manager borrowing against the client funds to leverage the speculative positions taken. The pay-off can be significant but the losses can also be catastrophic.

News broke late last year about the biggest hedge fund collapse in history at US\$50 billion. The once esteemed Bernard Madoff had earned a reputation for delivering generous returns on a stable basis – unlike typically erratic hedge fund performance. His clients now understand, the reported performance was completely fictitious and Madoff has pleaded guilty to numerous fraud charges.



Authorities have seized Bernard Madoff's yacht "The Bull"

Investigations are now underway into the lack of due diligence by "feeder funds" – hedge funds who invest client monies in a number of other hedge funds. A report from the Massachusetts Secretary of State states: "The answer, quite simply, is that they were blinded by the fees they were earning, did not engage in meaningful due diligence and turned a blind eye to any fact that would have burst their lucrative bubble,"

Some glaring problems with Madoff's fund were ignored for years:

- Madoff had custody of his firm's assets
- An obscure one man band was engaged as the auditing firm
- If you asked for details of the investment strategy, you were not allowed to be a client

We make use of asset class funds that are very transparent. So how are the specialist fund managers we use different from Madoff and other hedge funds?

- We invest client moneys in unit trusts and mutual funds that are tightly regulated in New Zealand, Australia and the United States. Hedge funds are generally not as regulated or as transparent as asset class funds.
- There is a separation of responsibilities in the management of client assets between independent parties, which provides prudent checks and balances. Custodial and fund management functions are audited by large international accounting firms.
- Remuneration earned for advice, fund management, custodial and trustee services are all structured on a fee only basis documented in client contracts. There are no commissions, volume incentives or any other potential conflicts of interest. Conversely, hedge funds typically reward the manager for taking risks with client funds. The manager gets a handsome share of any profit from taking speculative bets but the client carries all the downside risk when losses occur.