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Asset Class Returns

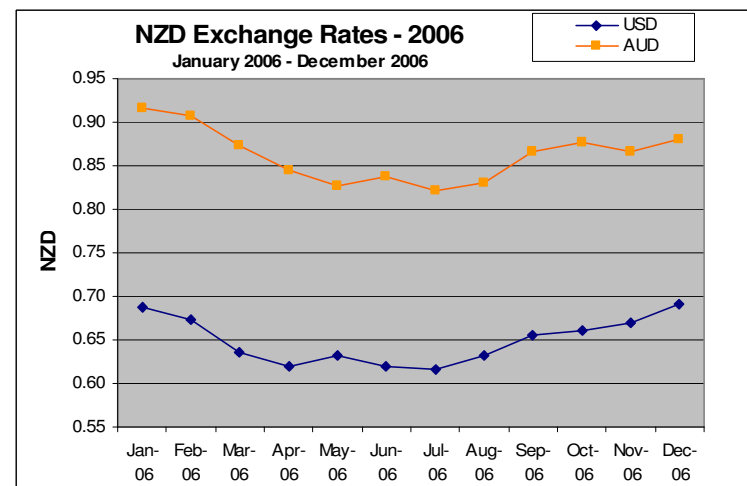
Returns in New Zealand dollars (NZD) for the key asset classes we track, and which form the core of most client portfolios, are as follows:

NZD Returns to 31 December 2006			
	3 months	1 year	3 year (p.a.)
Australian Large	8.5%	28.5%	23.2%
Australian Value	10.1%	29.8%	25.0%
Australian Small	13.2%	37.8%	24.4%
Australian Core	10.4%	n/a	n/a
Global Large	0.2%	16.3%	11.6%
Global Large (NZD Hedged)	7.6%	19.6%	18.6%
Global Value	1.8%	22.9%	17.7%
Global Small	2.5%	16.5%	16.2%
Emerging Markets	8.8%	25.0%	26.0%
NZ Equity Portfolio	12.3%	30.4%	21.8%
NZ Property	12.9%	24.9%	21.5%
DFIT International Bonds (NZD Hedged)	1.6%	6.4%	n/a
CDO International Bonds (NZD Hedged)	n/a	9.9%	9.4%

Market Commentary

The December quarter produced a further rally in share markets locally and around the world. The unevenness of performance over the calendar year demonstrates again the need for patience as an investor. The March quarter delivered strong returns, which was then followed by two relatively flat quarters before the rally in the December quarter capping off another year of strong growth overall.

Off-shore markets made a useful contribution to this excellent result in spite of the rise in the New Zealand dollar (NZD). In fact the Kiwi currency ended the year valued slightly higher than its January start against the US dollar, and just 4% lower against the Australian currency. Currency movement over the year can be seen in the chart below.



Economists from the major banks had been predicting substantial depreciation in the NZD during the course of 2006. The resilience of Kiwi dollar demonstrated again the folly of short term exchange rate forecasting, and we note that economists are now far more reticent in their short term predictions. However, the view remains that the NZD will ultimately fall based on economic fundamentals and that it is merely timing this correction that is highly uncertain.



Planning & New Year resolutions

Some people start the New Year by making promises to themselves on any number of issues. This is possibly accentuated in New Zealand by the calendar year rolling over in the midst of our holiday season – when we have time to reflect on events of the past and contemplate what we might like to change in the future.

Whilst goal setting and planning are laudable activities, overestimating the importance of an event (such as the date being 1 January) to mark a successful turning point can be problematic. In reality, most successful change is incremental and is rooted in process and discipline towards a goal. People seldom maintain an overnight shift fuelled by the best of intentions to tap greater reserves of willpower.

Successful investing is also about good process and discipline, not one-off decisions or lucky breaks. Adopting a portfolio structure (often referred to as asset allocation) appropriate for an investor's personal circumstance, needs and long term goals is critical. Purchasing investment securities consistent with the planned asset allocation and maximising diversification is the next step. Finally, sticking to the plan when personal or environmental concerns might otherwise shake ones resolve will secure the best outcome. Success through each of these phases is enhanced by obtaining and retaining good advice.

Appropriate planning and positioning of a portfolio provides assurance that what can be managed has been managed. Hopefully, this alleviates any natural propensity to worry about the future – which will always include an element of uncertainty.



**Worrying really works...
90% of the things I worry about never happen!**

2006 in review

What were the analysts predicting for 2006?

At the beginning of 2006, local brokers pointed to the high relative valuations of NZ shares and the potential for a weaker dollar and concluded that international shares looked like a better bet.

“We like stocks with minimum domestic exposure, given our cautious view on the local economy”, *Goldman Sachs JP Were*.

“.. our outlook for NZ is for an economic slowdown, with the potential risk of a harder landing..” *Forsyth Barr*.

“..top 5 picks for the year include cash..”, *ABN Amro*.

Not surprisingly no-one predicted the events that actually filled last year nor accurately forecast how they would influence returns from investment markets.

What actually happened?

2006 has seen much volatility:

In New Zealand:

- Oil prices rose significantly and then fell again by 30% in August and September putting pressure on many sectors of the economy, particularly those relying on transport or distribution networks.
- Currency – the NZD fell sharply in the first quarter, only to rise again through the second half of the year. This fluctuation has been felt across the board, but more so in the export sector who are experiencing lower incomes in NZD terms.
- Interest rates – the official cash rate (OCR) set by the Reserve Bank remained high compared to the rest of the world. This contributed to the high currency by attracting foreign investment and speculative capital flows to NZD denominated securities. The





Reserve Bank continues to signal that rates may rise further to combat inflation.

- High profile collapse of three players in the finance company sector resulting in \$440 million capital losses for their clients.
- Feltex receivership and subsequent sale – loss of capital for investors.
- The Government announced policy change to unbundle the telecommunications sector – resulting in volatile swings in Telecom's share price.
- Significant changes to the investment arena, with the passing of legislation introducing KiwiSaver and a 'fair dividend' tax on overseas investment income.
- The NZ stock market continued to lose major listed companies – Graeme Hart completed his \$3.3 billion purchase of Carter Holt and private equity funds, mainly Australian, have purchased a number of New Zealand firms including Tegel and Waste Management.

Overseas:

- Continued conflict in the Middle East, dramatically affected oil prices, with prices peaking when Israel invaded Lebanon mid year.
- Negative economic data continued to come out of the US during the year, pointing to a consumer slowdown – yet the Dow Jones Industrial Index rose 16.3% for the year and investors fared well.
- Non-Japan Asia had a strong year – particularly interesting is that this region appears to be decoupling from its dependence on the US and growing on its own economic fundamentals.
- China and India both saw growth rates near 10%, with very little inflation.

Conclusion

Despite the above volatility in the markets, an Asset Class investment approach has yielded outstanding returns for 2006, as depicted in the table on page one of this report. We believe a well constructed investment strategy implemented with discipline will optimise returns, whatever the events that seemingly threaten the markets.

Investment Tax Changes

The Taxation (Annual Rates Savings Investment and Miscellaneous Provisions) Bill was passed in Parliament on 12 December. The Labour government was forced to make the legislation a confidence issue with its coalition partners New Zealand First and United Future to ensure an adequate majority.



The tax changes will apply from 1 April 2007 and affect our clients in that the DFA and Vanguard funds, which are key portfolio components, are Australian Unit Trusts (AUT's). AUT's are treated as offshore companies for New Zealand taxation purposes and fall squarely into the new tax framework.

We are seeking an external taxation opinion on how some aspects of the legislation will apply to our clients and we will be reporting further to you once the implications have been fully analysed. But at this point, it is fair to say that the outcome is better than expected. Certainly the intensity of negative feedback contained in over 3000 submissions held considerable sway with the politicians to back away from their first capital gains tax proposals.

Unfortunately, the legislation we have ended up with has been rushed due to the Government's Kiwi Saver agenda and we have law based on policy distilled through the select committee process. In its revised form this



policy was subject to very narrowly based consultation. Inevitably the new tax rules will have anomalies, and some appear advantageous rather than adverse to clients at this point.

Off-shore investments

Broadly speaking, clients investing directly, or through a family trust, into overseas markets will derive taxable income capped at a deemed "fair dividend rate" of 5% of the value of the investment at the start of the year. Gains above this threshold are outside the tax net. Alternatively, in years where total return (including both dividends and capital gains) is less than 5%, tax will only be payable on the actual gain. (However, any loss incurred will not be carried forward to future years).

This is not an additional 5% tax, as taxation liability previously applied to actual income received (typically 4% in dividends from Australian companies and averaging 2% in offshore markets beyond Australia). Further, it is apparent that deductible expenses may offset the deemed income amount. Thus the net effect of this new tax may be substantially mitigated.

Portfolio Investment Entities (PIE)

One creation of the new legislation is the concept of a Portfolio Investment Entity (PIE). A PIE will have special tax status on Australian and New Zealand share investments and we are carefully examining whether this structure will be of benefit to clients. Our view at this point is that the distinct rules for a PIE are of questionable advantage.

In summary, a PIE will be liable to account for tax on a mandatory 5% income even when returns are lower than this in a given year (as opposed to a cap of 5% through an AUT). Further, the PIE will involve considerable establishment and additional management expenses compared to present structures.

In respect of Australian and New Zealand listed shares (as opposed to broader global shares) the PIE will carry an exemption on all capital gains. Thus there will be an advantage for active money managers to structure their business activities through this new vehicle. However, this merely solves a problem that Asset Class portfolio investors (i.e. our clients with a long term buy and hold policy) do not have to begin with.

Predicting the Future – the ‘World’s Top Analysts’

Financial analysts and brokers pride themselves on the ‘value’ they purport to add by forecasting movement in share prices. At this time of year these ‘experts’ often go public with their picks of the winners and losers for the coming year. But just how successful is this “stock-picking” approach in reality?



Bloomberg Markets magazine ran an article in their November 2006 edition entitled ‘The World’s Top Analysts’. The magazine surveyed the recommendations issued by more than 350 firms over a two year period and weighed the accuracy of their individual forecasts for the world’s 200 largest companies by market value.

Ranking first in terms of accurate calls was Merrill Lynch, with a score of just 34%. In other words Merrill analysts were right about a third of the time. Put another way **they got it wrong two thirds of the time**. Remember, this is a story about ‘the world’s top analysts’. We are talking about well-resourced investment banks with highly paid analysts plugged into every conceivable source of information. It gets worse from this point – Citigroup at 10th position were right just 16% of the time. The article drops the detail from this point and we are unaware of the statistics for the 350th ranked firm.

The irony is that this article was written as a promotional piece for the research services provided to active fund managers, and at the extreme end of the active spectrum –the hedge fund managers. To our way of thinking, being labelled the best when your forecasts are judged wrong two thirds of the time just doesn’t seem that great.

If during this period you had purchased a basic large company index fund covering the world’s 200 largest companies by market value, you would have made a return of 22 percent. The Bloomberg study provides further evidence that the risk of undershooting the benchmark index by enlisting the help of Wall St analysts (or any other forecaster) is highly probable.