

Diversified INVESTMENT STRATEGIES

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DIVERSIFIED'S VIEW

July, 2007

“No warning can save a people determined to grow suddenly rich.” Samuel Jones-Loyd, 1st Baron Overstone, British Banker & Politician, 1796 – 1883.

Abstract

- Whether you are keen, contemptuous or carefree, KiwiSaver is here. Participation and selection are pressing considerations for all working Kiwis. Public awareness of financial markets may lift ahead as well as awareness of managed funds.
- Next up is the start of NZ's Portfolio Investment Entity tax regime on October 1st, and with material tax-advantages from April 1st, 2008. The FDR method of calculating Foreign Investment Fund tax on portfolios is already impacting on provisional tax-payers.
- Capital values for long-bonds and lower-grade corporate bonds have started to retreat recently, but we still find most asset classes – Bonds, Property, Shares and Commodities – generally fully priced. Gold is an exception by still being short of old highs.
- Although the buoyant global economic setting supports high prices for now, our emphasis on preservation of capital, required *Diversified* model strategies to have progressively moved to more cautious asset allocations than earlier, and to favour defensive-capable investment styles.
- The consequence of portfolios being less exposed to risk (and capital better safeguarded), is that short-term returns are likely to be less spectacular than in recent years.
- *Diversified's* View is that a brisk pace of economic growth will endure in most places globally – including the USA - throughout our one-year to 18-month, tactical horizon. We believe wages, and inflation rates will surprise to the upside, testing Central Banks almost everywhere. Debt stretched parties hoping for rate-cuts will be disappointed, and sadly some will fail.
- As Kiwi investors are in the vanguard of discovering, currencies volatilities assume a heightened importance in the context of modest movements in underlying assets. Investment theory incorrectly equates volatility with risk. *Diversified* believes the high value of our kiwi dollar, and its potential for volatility, present capital risk to long-term investor's wealth. Subdued returns while our reporting currency scales new peaks may be cheap insurance.

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DIVERSIFIED INVESTMENT STRATEGIES LIMITED

Website: www.diversified.co.nz

Expertise You Can Trust for Private Client Portfolios and Trustees

New Zealand – changes distract from fundamentals

1) KIWISAVER

The new, centralized pay-roll deduction savings scheme kicked off on July 1st (though proceeds will accumulate at IRD until October 1st). The first-year grant and tax subsidy for contributing make at least initial participation a “must-do” for all but those in exceptional circumstances. Our local managed fund industry has succeeded in its dream. Government collusion enforces their use; tax-collectors are their marketing arm, while their wares become tax-advantaged. KiwiSaver is a very complicated scheme, with elements of tax-incentive, grants, tax concessions, salary sacrifice, subsidised fees and matching employer contributions (progressively) – but it is the system we have.

If you can't beat 'em, join 'em.

Diversified Investment Strategies Limited has for some years advised The Law Retirement Plan (a law industry owned and focussed, registered superannuation scheme), on its structure and holdings, contributing to its record of superior performance. We are closely involved in the LRP's 'bolt-on' sequel, The Law Retirement KiwiSaver Scheme, pursuing the same investment philosophy.

As the opportunity is more widely recognized, KiwiSaver will become an increasingly crowded field, including aggregators re-branding existing product. But it is the old lags - including some of the “Default Providers” – with most to gain by obscuring their past record of consistently poor investment returns, avaricious fees and profligate expenses deducted directly from investors' funds.

Selected Track Records

| | 7-yrs % p.a. | 5-yrs %p.a. | p.a. Loss 2001/02 |
|----------------|---------------|---------------|-------------------|
| AMP (PRP) | +2.90% | +5.59% | -6.04% |
| ASB EasyPlan | +2.82% | +6.54% | -8.11% |
| AXA (FLP) | +2.34% | +4.89% | n.a. |
| ING (SIL) | +3.83% | +7.30% | -4.77% |
| TOWER | +3.22% | +5.53% | -5.05% |
| WESTPAC | +1.83% | +5.19% | -10.27% |
| Sector Average | +3.32% | +5.92% | -5.46% |
| Cash (gross) | +6.38% | +6.56% | +5.65% |
| NZX All Ords | +14.07% | +16.80% | +13.56% |
| NZX Property | +16.73% | +18.08% | +12.23 |

Source: FundSource Managed Funds Performance Stats to 30/06/07

The Law Retirement KiwiSaver Scheme aims to continue its best-of-breed investment style, under the watch of its actively involved Trustee, The Law Retirement Plan.

2) PORTFOLIO INVESTMENT ENTITIES

Commencing this coming October 1st, some collective investment vehicles may be awarded a concessionary tax status, know colloquially by the “PIE” acronym. Features will include higher tax-step thresholds for PIE income than for earned income; marginal tax rates of 0%, 19.5% or 33% internally; exemption from tax on trading profits in designated assets (including property), and escape from Provisional Tax-payer obligations on PIE income. **The announced cut in NZ's corporate tax rate to 30% from 1st 2008, will also apply to 'PIE' funds.**

Individual advisors will assess each investor's status under the changes, recommending alterations to private client portfolios where appropriate, or when benefits are identified in excess of drags.

3) NZ's INVESTMENT CLIMATE

Amidst the noise and haste, amendments, revisions, new FDR taxes and new developments, it is necessary not to lose sight of the longer-term goals - which remain paramount for good investment strategy. Local fads, tax distortions, or even winners picked by our current government, are unlikely to materially affect financial markets in the longer term. Economic parameters provide some sober counter-balance to rabid home country bias:

Key Economic Forecasts

| | 2007 | 2008 | 2009 | 2010 |
|------------------------|-------|-------|-------|-------|
| NZ's GDP | +2.3% | +1.3% | +2.8% | +3.4% |
| Trading Pntr GDP | +3.7% | +3.6% | +3.7% | +3.5% |
| Non-tradable Inflation | +4.2% | +3.8% | +3.3% | +3.2% |
| CPI Inflation | +2.5% | +2.8% | +2.4% | +2.5% |
| CAD | -7.5% | -7.3% | -7.3% | -7.4% |
| TWI | 70.0 | 62.8 | 61.8 | 63.8 |
| 10-yrBond yield | 6.6% | 6.8% | 6.6% | 5.9% |

Source: National Bank Quarterly Economic Forecasts

Diversified is less persuaded that CPI inflation is contained, noting the problem is greatest among unresponsive non-tradables, and finding imported deflationary offset doubtful if the NZ\$ tumbles.

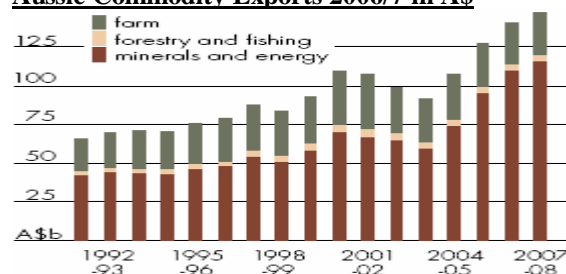
The relatively simple business of long-term investing is mostly unfazed by local machinations. *Diversified's* model strategies persist in a fundamentally economic approach. Inducements and incentives are certainly considered, but mostly at the margin and usually in selecting actual investments.

Australia – Still the Lucky Country

The Australian economy is humming along, almost a little too quickly. Economic growth of around +3.5% in 2007 is expected to be followed by a similar pace in 2008, with inflation kicking up toward +2.7%. Some 39,400 new jobs in May alone add most all other sectors, to already buoyant mining and engineering. However wage pressures are showing, opening the likelihood of their Reserve Bank of Australia will hike OCR to 6.5% ahead.

Leveraging off global growth, Australia benefits from a lengthening history of development-friendly policies, and its fortuitous proximity to burgeoning Asia. Minerals are the main driver of export growth, with agriculture, forestry and fishing simply maintaining.

Aussie Commodity Exports 2006/7 in A\$



Source: ABARE

Although our nearest neighbour, and culturally familiar to most, Australia provides important investment diversification for NZ-based investors.

International – 10-years after the Asian Crisis, global growth is strong and widespread

The “Asian Miracle” of the 1990’s ended a decade ago this month, triggered by the collapse of the Thai baht (‘Bahtulism’), but exposing economic weaknesses that should make Kiwis uneasy. Asia pre-1997 was characterized by easy credit, fuelling rampant overinvestment in building, industrial expansion and infrastructure. This was funded by foreign debts (reaching 45% to 140% of respective GDPs), amidst massively over-valued local currencies, while each of the Thai, South Korean and Malaysian economies were happily tolerating Current Account Deficits in excess of 10% of GDP.

Before the end of 1997, stock prices had halved, and exchange rates tumbled by a similar amount throughout the Asia Pacific region. Two years of severe recession followed; banks collapsed, and the IMF injected over US\$50 billion.

Lessons were learned. Distressed currencies have been floated, accounting standards and disclosure hiked. Corporate profitability is now emphasized over the old size or market share. The greater Asian legacies are:

i) that countries, companies and individuals have become reluctant borrowers - **Asia is under-leveraged relative to the rest of the world.**

ii) China’s emergence as the region’s economic leader.

Today’s global growth outlook favours the region.

Global Growth outlook (% p.a.)

| | 2007 | 2008 |
|----------------------|-------|-------|
| Non-OECD Asia | +7.9% | +7.7% |
| Latin America | +4.9% | +4.2% |
| Estn Europe | +5.5% | +5.3% |
| OECD | +2.3% | +2.5% |
| World | +4.5% | +4.5% |

Sources: ABARE, IMF, OECD

Japan’s PM, Shinzo Abe’s leadership is on the line in this month’s elections, but growth looks assured – at maybe +2.6% this year and +2.3% next, accompanied by return of inflation at 0.4% p.a.

Diversified advocates broad global exposure, including regions of expected higher growth, proportional to their economic importance.

Fixed Interest – difficulties in good times

The surprise to either of USA’s ‘sub-prime’ lending defaults, or receiverships for NZ finance companies (BridgeCorp, Provincial, National 2000, Western Bay and MoneyManager’s *FirstStep*), should be that they occurred amid buoyant economic conditions. Business cycles have not been abandoned, and the performance of lower grade debt – especially illiquid instruments – in the context of inevitable downturn someday, remains ominous.

Ideally, the Fixed Interest asset class would be uncorrelated, or even inversely correlated, with equities, thereby smoothing portfolios’ returns. ‘Yield enhancers’ relying on Equity risk are inefficient.

Compromise had been necessary in recent years, while high quality yields sunk to derisory levels, and Cash

became king. While still short of attractive (considering currency and inflation risks), bond yields are on the rise globally. NZ Gov’t Bonds are again over coupon levels - our Government is having a sale!

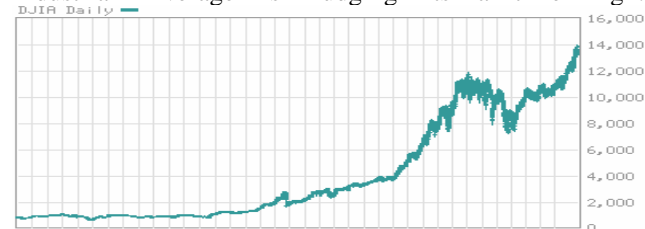
NZ Government stock; AAA Rated

| Maturity | Coupon | Yield | Price/\$100 |
|----------|--------|-------|-------------|
| 15/07/08 | 6.00% | 7.83% | \$98.27. |
| 15/07/09 | 7.00% | 7.63% | \$98.80 |
| 15/11/11 | 6.00% | 7.16% | \$98.37 |
| 15/04/13 | 6.5% | 6.89% | \$98.37 |
| 15/04/15 | 6.00% | 6.89% | \$95.95 |

Consistent with our concern inflation may surprise on the upside, *Diversified* continues to find Cash attractive along with a range of other measures to counter sharemarket risk.

Equities – Strong rallies disguised for Kiwis

Global sharemarkets are on a tear. The USA’s Dow Jones Industrial Average is nudging its all-time high.

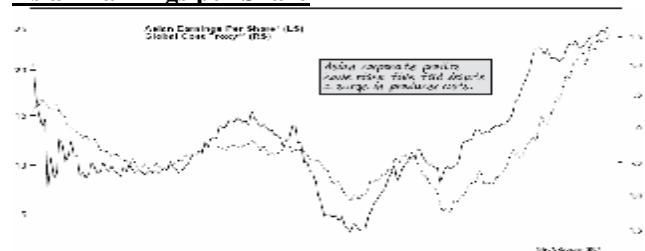


UK, European and Hong Kong markets are also making new highs, while even market pariah, Japan’s Topix is at its highest level in seven years. But profit from these market highs are withheld from Kiwi’s by the concurrent rise of our NZ\$ reporting currency.

But corporate earnings have also grown at least commensurately, propelled by the power and duration of the global economic expansion. **Global sharemarket valuations are not excessively challenging by most valuation measures.**

Asia is a prime example, with soaring profitability outpacing even a strong market advance.

Asian Earnings per Share



Emerging Markets contributed 50% of world growth in 2006, compared with 20% in 1998. *Diversified*’s model strategies incorporate this reality and strongly advocates all long-term investors should consider the opportunity.

Property – Investment only

Diversified has no view on NZ residential property price trends, and can demonstrate a long history of useless opinions to support this stance. In omitting the Residential sector from our portfolio repertoire, we also

note government is the largest player in that field, operating on a non-commercial basis.

Our model strategies currently advocate an allocation to listed commercial property. Share prices have recently been re-rated upward by about 15% - with running yields reduced accordingly – anticipating benefits from the onset of the PIE regime from October 1st.

Diversified is currently assessing alternatives for funds which will result from the take-out of core recommendation, Investa Property Group.

Commodities – Base-metal balance?

Normality may be returning the torrid pace of price increases in metal and bulk commodities markets of recent years. Top Officials now warn that China's demand for iron ore this year, at 376 million tonnes, will fall short of analysts' projected 400 million tonnes. Production of iron ore in 2008 may be in small surplus.

Simultaneously, global analyst GFMS, predicts a modest oversupply in base metals is also possible in 2008, noting particularly, nickel prices are "incredibly inflated".

Nevertheless, the overwhelming expectation is robust demand and good prices will prevail, on near capacity volumes for most commodities.

Diversified's specific Resources allocation has been eliminated from models, deferring to generalist investment managers.

Gold Bullion The hiatus in gold's advance – when Spain Swiss central banks sold and the US\$ rallied – has waned.

A reversal of that European behaviour, was Qatar's Central Bank adding 9 tons to official reserves last year. Gold shares traditional out-performance over a price rise in gold bullion's rise – traditionally about three-fold - is yet to be demonstrated in this rally.

We are relieved by the speed with which Newmont Mining Corp's new CEO, appointed July 1st, has divested baggage, and regained the attention of analysts in that company.

Currency – "The market will eventually do whatever is needed to infuriate the greatest number of participants". Justin Mamis.

The Economist's simplistic but insightful, Big Mac Index, is a useful first approximation of the fair value of currencies - relative to US\$

Summary Big Mac Index

| Country | Local Cost | In Dollar | +/- US\$ |
|------------------|------------|-----------|----------|
| NZ | NZ\$3.59 | \$1.35 | +5% |
| Australia | A\$2.95 | \$1.01 | -14% |
| Britain | £1.99 | \$4.01 | +18% |
| Euro | €1.17 | \$1.12 | +22% |
| Japan | ¥280 | \$2.29 | -33% |
| China | ¥11 | \$1.48 | -58 |

All other things being equal, long term investors should prefer undervalued currencies, and avoid overvalued currencies, anticipating reversion toward fair value. *Diversified* persist in advocating a spread of currencies resulting from portfolio diversification. Derivatives or hedging to NZ\$ are not used.

Salient Rates, Indices, & Exchange Rates

Following are the June 30th, 2007 rates and selected equity market indices, relevant currencies, with their percentage gain or loss from that of three months, six months, and one year earlier. Figures are before taxation, fees or any impact from NZ currency.

| ACTUAL | 30/06/07 | 3 Months | 6 Months | One year ago |
|---------------------------------------|----------|------------------------|----------|--------------|
| Prevailing Monetary Conditions Index. | +1488 | +1082 | +1052 | +333 |
| Prevailing NZ Cash Rate (90-day) | 8.36% pa | 7.95% pa | 7.74% pa | 7.47% pa |
| Prevailing 2006 NZ Gov't Stock Yield | Exp | Exp | Exp | 6.97% pa |
| Prevailing 2011 NZ Gov't Stock Yield | 7.17% pa | 6.54% pa | 6.32% pa | 5.95% pa |
| Prevailing 2015 NZ Gov't Stock Yield | 6.76% pa | 5.94% | | |
| CHANGE | Value | Gain or loss since ... | | |
| NZX NZ Gov't Stock [Bond] Index | 883.40 | -1.1% | -0.2% | +1.8% |
| NZSE 50 (Gross) | 4234.29 | +2.4% | +4.4% | +18.1% |
| NZSCI (Gross) | 27001.00 | +0.4% | +6.3% | +22.5% |
| S&P/ASX200 (Australia) * | 6275.00 | +5.5% | +10.7% | +25.6% |
| MSCI World Index (Capital)* | 1602.36 | +5.8% | +8.0% | +21.4% |
| Dow Jones (USA) * | 13409.00 | +8.5% | +7.3% | +19.8% |
| NASDAQ | 2603.00 | +7.5% | +7.3% | +19.7% |
| FTSE 100 (UK) * | 6608.00 | +4.8% | +6.2% | +14.1% |
| Nikkei DJ (Japan) * | 18138.00 | +4.5% | +5.3% | +20.0% |
| Hang Seng (Hong Kong) * | 21773.00 | +9.0% | +7.2% | +37.2% |
| NZD/USD | .77 | +7.6% | +9.4% | +26.3% |
| NZD/AUD | 0.91 | +3.3% | +2.0% | +10.8% |
| NZD/JPY | 95.09 | +12.6% | +13.1% | +37.4% |
| TWI | 75.04 | +7.4% | +7.8% | +23.1% |
| Gold (US\$ / oz., troy) | 649.35 | -2.2% | +2.1% | +5.9% |
| Crude Oil (WTI, US\$/bbl) | 68.95 | +4.6% | +14.2% | -5.0% |

*Indices, figures and performances in respective local currencies unless otherwise stated.

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