

Diversified INVESTMENT STRATEGIES LIMITED

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DIVERSIFIED'S VIEW

July, 2009

"One of the features of lengthy post-bubble contractions is the bewilderment about so much hardship in a world of plenty. By plenty is meant lots of supply and little money with which to consume. It has puzzled the establishment for hundreds of years", Bob Hoye, Institutional Advisors', 'Commodities', June 30th, 2009.

Diversified Wealth Management's 'Balanced' PIE Fund, which mirrors our 'Balanced' model strategy, advanced +5.29% for unit holders in the Quarter to June 30th. The Unit Price was independently determined at \$1.055 on 30th June. Investors with smaller sums or wishing to avoid onerous new tax-filing requirements can access *Diversified's* strategies via the Fund.

Summary

- The Great Recession of 2008 is drifting astern. With hindsight, it is probable we saw the nadir back in the melt-down of October/November of 2008, with an echo in March 2009.
- As has usually been the case historically, financial markets portend recovery well ahead of economic statistics or broader sentiment. Obtusely, the best quarterly performances by growth markets, often coincide with the depth of an economic recession.
- Late followers miss out on the strongest gains, condemning themselves to higher risk by re-engaging more expensively, and to mediocre portfolio growth over the longer term.
- Emerging Markets and Commodities led the market rebound. *Diversified's* models were well positioned. As forewarned, the conventional, old-world sharemarkets so favoured by the MSCI World Index, materially underperformed the rebound.
- Looking ahead, the big test is whether successful reflation brought on by massive stimulus, can translate into a durable economic expansion. A period of fluid indications, and of sectoral & regional reversals, is likely. *Diversified* gauges expansion will eventually win out, but we have insufficient conviction to cancel portfolio 'insurances'.
- A key principal of Modern Portfolio Theory, and of *Diversified's* process and models, is that the merit of each holding should be assessed in relation to the mix of other assets in the portfolio. Assets which may seem risky in isolation may be acceptable and add valuable diversification, in a portfolio.
- Particularly across the Developed World, 'de-leveraging' by households, corporates and eventually of national treasuries, will be an enduring force – maybe for decades. Property, Private Equity and highly geared enterprises, face continuing headwinds. We expect more will succumb yet.
- Disturbingly, New Zealand in among the most indebted, but also slower to recognize the sea-change. Perhaps content with 'stopping the rot', government seems reluctant to sneak up on change. Economic recovery will likely lag.
- Inflation is not of concern anywhere within our one-year to 18-month, tactical horizon.
- *Diversified* Investment Strategies Limited is proud of the 15-year record of proprietary strategies. Our original aim of, 'Preservation of wealth with a competitive rate of return', remains intact and unwavering. Each \$100 invested by 'balanced' profile clients invested in 1994, is now worth over \$220.

Norman W. Stacey (n.stacey@diversified.co.nz)

An Adviser Disclosure Statement is available on request and without charge, or may be accessed via our website.

DIVERSIFIED INVESTMENT STRATEGIES LIMITED

Website: www.diversified.co.nz

Expertise You Can Trust for Private Client Portfolios and Trustees

New Zealand – leading from the back

While apparently not yet of local concern, New Zealand's troubling economic trends - high indebtedness, sticky inflation, low productivity gains and low economic growth – are starting to bother Rating Agencies.

Five consecutive quarters of contraction have driven inflation to the mid-point of the Reserve Bank's 1% to 3% target range. NZ's Consumer Price Index, while a tamer +1.9% p.a. to end June, camouflaged persistent hotspots. The 'Central and Local Government Charges' sub-component, is still barrelling along at +5.4% for the same year.

Government could help. The New Zealand Centre for Political Research estimates government spending consumes about 42% of NZ's GDP. The 2009 Budget confirmed core Crown expenditure set to increase by 45% in the five years to June 2010.

Aside from commanding resources which could potentially be more productively utilized, NZ's government is crowding private savings. Statistics NZ reports (using 2004 data) our government's total tax & non-tax receipts take, is 8.2% more of GDP than Koreans pay; 7.1% higher than the Japanese; 7.6% higher than Americans pay and even 3.2% greater than for the Swiss.

Fresh from Regulating the issuance of NZ\$7 billion dollars of saver's money, lost or impairment in Finance Companies, Property Companies, CDO Funds, closed Mortgage Funds or SMS Software rorts etc., NZ's regulators are turning their ample resources and talents on NZ's Advisory sector. Atop new Advisor Disclosure rules (good), are three more 'Discussion Papers'. Our Securities Commission seeks to bless Advisers with its 'regulation' and 'supervising', while a separate strand looks at adviser 'competence'. The latter measures are to be overseen by NZQA, the folks who give us NCEA. (All NZ's advisors can enjoy a *hoi* average standard too). Additional costs of Anti-Money Laundering regulations, and funding of 'Dispute Resolution' mechanisms, each ultimately detract from the potential productivity of New Zealander's wealth. Whilst some operators will no doubt welcome government endorsement of their trade, *Diversified* notes Dog Registration has had little impact on the worst offenders - nor on unregistered dogs. Kiwi investors would be well advised to satisfy themselves as to an Advisor's competence, rather than rely on a Gov't *billet-doux*.

Demurring from RBNZ boosterism, *Diversified* finds economic growth in NZ more likely to remain subdued, and to lag near our neighbours. We hope we are wrong, but the projections below seem about right to us.

Salient NZ Economic Projections - March year

| | 2009 | 2010 | 2011 |
|---------------------|------|------|------|
| GDP % yoy | -1.0 | -1.2 | +3.2 |
| CPI % yoy | 3.0 | 1.8 | 1.6 |
| Unemployment | 5.0 | 6.9 | 6.4 |
| Employment | +0.8 | -1.5 | +1.6 |
| Curr. Acct as % GDP | -8.5 | -4.7 | -5.7 |

Source: Data from Westpac Weekly Commentary, July 13th 2009.

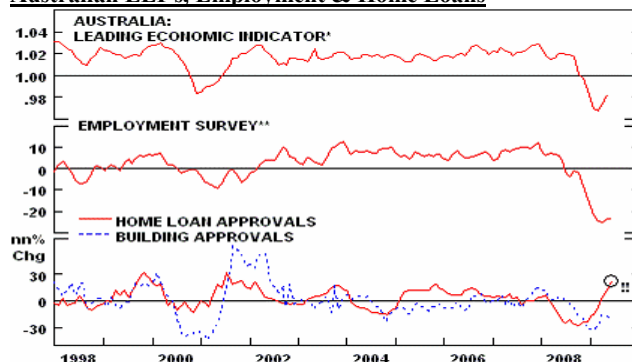
In summary, we expect recovery will lag that of NZ's major trading partners; NZ's Official Cash Rate will remain near the current 2.5% for our tactical horizon, and our currency continues to carry considerable risk.

Consequently, *Diversified's* model allocations to NZ assets remain modest, and slightly favouring the Equity Asset Class over Cash & Fixed Interest.

Australia – Bottomed. Scope for upside surprise

Australia has suffered severe slowing from its buoyant economic expansion of 2007/8, but has avoided an official recession. Business confidence is turning positive for the first time since December 2007. Inflation is subdued and an improving external environment supports optimism. The turnaround signalled by markets months back, is now being confirmed by statistics.

Australian LEI's, Employment & Home Loans



Source: BCA Daily insights. July 2009.

Given, i) Australia's proximity to the new global economic leaders in Asia; ii) their government's reluctance to withdraw stimulus, and; iii) the tendency of recoveries to mirror what was a sudden and intense slow-down, leads *Diversified* to believe the scope for economic surprise is weighted to the upside.

Key Economic Forecasts – Australia

| | 2009 | 2010 | 2011* |
|-----------------------|------|------|-------|
| GDP % p.a. | +0.1 | +0.5 | +3.1 |
| CPI % p.a. (headline) | +1.8 | +2.4 | +2.0 |
| Unemployment % | 6.1 | 7.8 | 7.6 |
| Curr. Account (% GDP) | -3.6 | -5.4 | -5.6 |
| Cash Rate | 2.5 | 2.75 | 4.75 |

Source: Data from ANZ Economic Outlook, July, 2009.

Diversified's models advocate a preference for Australian Equities and also for the A\$, with Australia dominant in our 'Australasian' sector allocation.

International – the Great Recession of 2008 is fading

Again, folks waiting for a bell to be rung to signal a bottom were naïve. Statistics invariably lag reality, but evidence is gathering that the worst has passed. The IMF this month revised upward its April global growth expectations for 2010, based on stronger than anticipated rebound in Asia.

New IMF Economic Growth Projections - % p.a., Calendar Yr

| Region | 2009 | 2010 |
|------------------|-------|-------|
| World | -1.4% | +2.5% |
| Developed World | -3.8 | +0.6 |
| - USA | -2.6 | +0.8 |
| - Euro Area | -4.8 | -0.3 |
| - Japan | -6.0 | +1.7 |
| Emerging Markets | +1.5 | +4.7 |
| - China | +7.5 | +8.5 |
| - India | +5.4 | +6.5 |
| - Russia | -6.5 | +1.5 |
| - Brazil | -1.3 | +2.5 |
| - Africa | +1.8 | +4.1 |

Source: IMF Overview of World Economic Outlook, July 8th 2009

Among the Developed World, the Euro area is the laggard. The USA's weak recovery is in part because households have re-established an 8% personal savings rate; retiring consumer debt at a US\$900 billion p.a. pace. Japan looks set to enjoy the greatest acceleration with a +7.7% turnaround in growth.

Emerging Markets escaped recession in aggregate in 2009, with growth projected to increase modestly next year. China led the recovery, and is taking its place in the world. Industrial Production has overcome 12 million displaced factory workers, effecting a 'V-shaped' rebound to pre-crisis levels - and 30% above 2006 levels.

Industrial Production



Source: *The Economist*, June 25th, 2009

Get used to Chinese leadership. With 55% of the population still rural, and per capita income at a mere US\$3,200 China's industrialization is only about one-third done. Although equalling USA's car sales by unit, only 4.3% of Chinese households yet own cars. GDP is 44% of USA's on a purchasing power parity adjusted basis.

A major outcome of the Great Recession, has been to defang inflation. The classic cause of inflation - an excess of demand over supply - is unthreatened by even massive government stimulus being a lot less than contracting credit.

Diversified model strategies have long counselled a global economic spread in accordance with regional economic size, as a neutral position. We are saddened that poorly advised Kiwi investors omit Emerging Asia in favour of the comfort and familiarity with low-growth old Europe apparently brings.

Fixed Interest – ASB, Deutsche & Rabo products amount to “return-free risk”

When contributing relative capital stability, Fixed Interest instruments contribute to a portfolio by moderating volatility in the growth asset classes. Preferred holdings should be marked-to-market pricing and readily liquid.

Several products, some by high-profile brands, have failed in this role. Issued as Cash-type instruments, ASB, RaboBank, or Deutsche Capital Notes, have trapped hapless investors with now paltry yields (typically 3.7% through 5% p.a. range), and faced with 10% to 30% capital losses to exit. Far from their intended 'risk-free return', holders ended up with 'return-free risk'.

Diversified favours conventional bonds of 2 or 3 years maturity, with the obligation to return investors money on a future date - for investors to decide a fair yield to reinvest. One consequence of successful reflation, is the opportunity of good capital gains as the enormous spread of investment grade corporate debt, over government stock, normalizes. *Diversified* recommended the supplementation of International Fixed Interest allocation, with Fixed Interest from Utilities, since December 2008, for good gains.

Equities – “The best quarter for shares often coincides with the worst quarter of economic contraction”. anon

The record shows that Equity market rallies generally portend economic recover. 2009 was no exception. In the

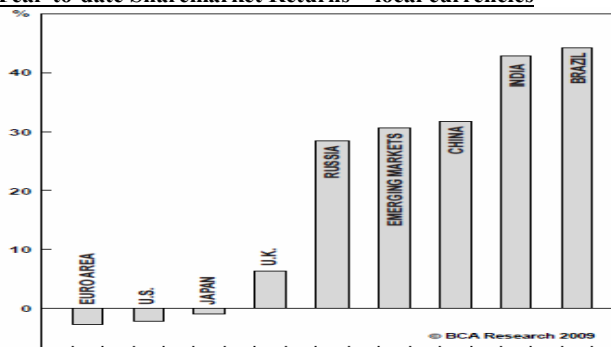
midst of media foreboding of parallels with the Great Depression – and with 'nervous nelliess' cashed up and on the sidelines - a powerful sharemarket rally unfolded, **US Sharemarket - S & P 500 Index, year to date.**



Source: CNN-Money, BigCharts.

Engaged investors have been rewarded. Impressive as it is, the rally in USA markets pales beside gains achieved in Emerging Markets.

Year-to-date Sharemarket Returns – local currencies



Source: BCA Research, Strategy Outlook II, July 2009.

Investor's gains in Asian regional Equities specialists, and Emerging Markets generally, have been spectacular. Profits should now be rebalanced to model weightings. While our research sources caution of possible correction from 'massively over-bought conditions' near-term, *Diversified* - in a portfolio context - remains supportive for our tactical horizon.

Contrasting with the economic re-acceleration projected (above), we find the Japanese market under-owned by global generalists, disliked by fund-managers and sharebrokers, yet providing locals with dividend yields well in excess of Bonds. Rallies spring from such conditions.

Whilst favouring Equities, *Diversified* remains ever aware of sharemarket risks. Some obvious ones include:

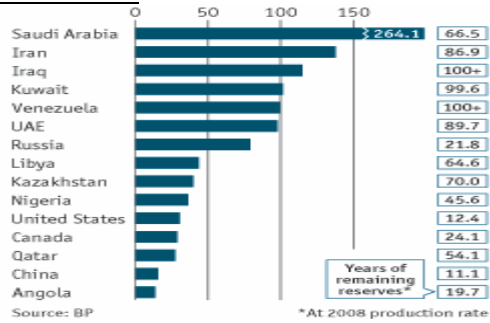
- That a major government, or collective governments around the world, act too quickly to withdraw stimulus, stifling a nascent market rally;
- That the Developed World directs recovery proceeds to reduce debt, by choice or at the directing of their bankers;
- Externalities such as plague, terrorist or another financial disaster; or
- That we are simply wrong in our analysis, and another down-leg of economic contraction unfolds.

A diversified investment strategy, systematically spread across lowly correlated asset classes, remains prudent.

Commodities – just another asset class, prone to hype sentiment & exaggeration

We are sceptical of the speed with which commodity prices have rebounded from 'marginal-cost-of-production' depths, and from sudden glut to supposed shortage. Tales of 'infrastructure bottle-necks' again, and up to 50 ships waiting off Australian ports, may need a reality check. Nor did we believe 'Peak Oil' last year

Global Oil Reserves:



Far from Oil 'running out', when the price of crude price was propelled to US\$147/bbl in 2008, official reserves are expanding. Actual, known and recoverable world oil reserves in 2008 stood at 1,258 billion barrels – fully 18% more than a decade prior.

Gold – portfolio insurance

Gold bullion & shares, much as predicted they might at some point, proved a drag on portfolios when the 'financial crisis' was perceived to abate last Quarter.

Gold demonstrated a valuable 'preservation on wealth' capability earlier in the Great Recession of 2008.

Diversified continues to believe diversification is needed, and that a new application for the Gold allocation may present within our one-year to 18-month tactical horizon.

During the Great Depression, the 1932 to 1937 bull market was triggered by devaluing the US\$ by 41%. This was US\$, effected by re-pricing gold from US\$20/ounce to US\$35/ounce. In the current 'recovery, individual and competitive devaluations are conceivable as nations endeavour to rebuild exports.

Diversified's models continue to advocate a significant allocation to Gold.

Salient Rates, Indices, & Exchange Rates

Following are the June 30th 2009 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 | 30/06/09 | 3 Months | 6 Months | One year ago |
|---------------------------------------|----------|-----------------------|----------|--------------|
| Prevailing Monetary Conditions Index. | -115 | -416 | -229 | +1003 |
| Prevailing NZ Cash Rate (90-day) | 2.84% pa | 3.37% pa | 5.10% pa | 8.66% pa |
| Prevailing 2011 NZ Gov't Stock Yield | 3.80% pa | 3.90% pa | 4.14% pa | 6.35% pa |
| Prevailing 2015 NZ Gov't Stock Yield | 5.42% pa | 4.85% pa | 4.51% pa | 6.34% pa |
| CHANGE | Value | Gain or loss since... | | |
| NZX NZ Gov't Stock [Bond] Index | 1057.53 | -0.5% | -0.7% | +9.8% |
| NZSE 50 (Gross) | 27696.11 | +7.9% | +3.0% | -12.5% |
| NZSCI (Gross) | 17939.98 | +12.9% | +6.5% | -19.1% |
| S&P/ASX200 (Australia) * | 3954.00 | +10.4% | +6.2% | -24.2% |
| MSCI World Index (Capital)* | 970.77 | +20.6% | +5.5% | -30.5% |
| Dow Jones (USA) * | 8447.00 | +11.0% | -3.8% | -25.6% |
| NASDAQ* | 1845.72 | +20.7% | +17.0% | -19.5% |
| FTSE 100 (UK) | 4249.21 | +8.2% | -4.2% | -24.5% |
| Nikkei DJ (Japan) * | 9958.44 | +20.5% | +12.4% | -26.1% |
| Hang Seng (Hong Kong) * | 18626.02 | +38.0% | +29.5% | -15.6% |
| NZD/USD | 0.65 | +14.7% | +11.8% | -15.1% |
| NZD/AUD | 0.80 | -3.1% | -4.1% | +1.0% |
| NZD/JPY | 62.22 | +13.6% | +19.4% | -23.0% |
| TWI | 61.42 | +7.6% | +9.0% | -9.4% |
| Gold (US\$ / oz., troy) | 926.00 | +1.1% | +6.4% | +0.1% |
| Crude Oil (WTI, US\$/bbl) | 71.47 | +47.4% | +79.3% | -48.8% |

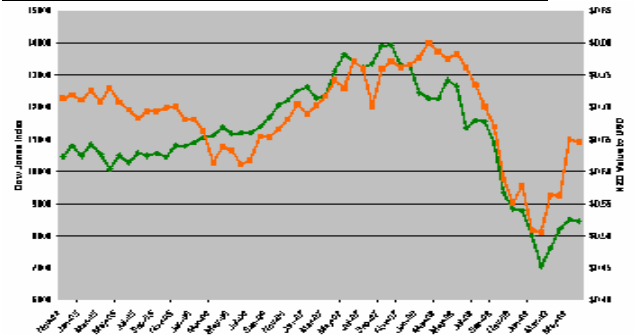
*Indices, figures and performances in respective local currencies unless otherwise stated.

NORMAN W. STACEY, INVESTMENT ANALYST – Corporate and individual Investment Adviser Disclosure Statements are available free of charge, or may be viewed on our website: www.diversified.co.nz

Currency - "... the S&P 500 and the New Zealand dollar/yen exchange rate have tracked each other almost perfectly. The S&P strengthens on days when the kiwi goes up, and drops on days when the yen recovers." - John Authers, London Financial Times, August 1 2007.

We continue to be puzzled by the relationship between our kiwi dollar's exchange rate and the trajectory of senior sharemarkets – and particularly the kiwi's use as a proxy.

Correlation between DJIA, & NZS/US\$, 2004 to 2009



Source: *Diversified's* Research

The correlation has existed only for the past 3 years, and could dissipate as rapidly as it commenced. Ultimately, we expect the influence of fundamentals to reassert. NZ needs a lower exchange rate to foster an export-led recovery.

Across a portfolio of diverse investments, our researched belief is that any single currency risk is best diversified. In the absence of a strong conviction that the NZ dollar exchange rate is set to rise imminently, the practice of hedging an array of offshore currencies to NZ\$, introduces risk.

The default position of our model portfolios is the spread of foreign currencies arising as a consequence of regional asset allocation. Investment Products hedged to NZ\$ are generally considered unworthy.