



Diversified's View

January 2011

"A single European currency would never accommodate all nations ... Germany would be 'phobic' about inflation caused by euro policies ... poorer countries would be 'devastated' due to their inefficient economies ... euro membership would lead to 'huge booms and deep recessions'".
Baroness Margaret Thatcher, PM of UK, 1979 – 1990, was demonstrating her insight.

Congratulations to fellow director, Vicki Watson, on becoming one of the first appointed 'Authorized Financial Advisor' (AFA) under the government's Financial Advisers Act regulations, to take effect from July 1st of this year. [The author is a mere Registered Financial Adviser, having passed Standard Sets 'A', 'B' and 'D', but lacking sufficient direct clients to qualify for Std Set 'C' – the client files section].

Diversified Investment Strategies Ltd (FSP28621), and *Diversified* Wealth Management Ltd (FSP9701). Both companies participate in the Insurance & Saving Ombudsman (ISO), Disputes Resolution Scheme.

DWM 'Balanced' Fund's Unit Price at 31st December was \$1.1602; up 0.95% for the month, and +8.19% on the year.
DWM 'Dynamic' Fund's Unit Price of \$1.0748 at 31st December was \$1.0748' up 1.67% for the month, and +8.58% on the year.

The Law Retirement KiwiSaver Scheme mimics *Diversified's* Balanced and Dynamic strategies. LRKS welcomes transfers from lesser performing schemes.

Investment Statements for KiwiSaver are available from the scheme's website:
www.lawretirement.co.nz.

Summary

- *Diversified's* conviction that successful global inflation is on-track has become mainstream. The mid-cycle slow-down of 2010 proved an hiatus, rather than the onset of something more serious.
- We recognize four facets where *Diversified's* view diverges from broad consensus:
 1. Economic growth around the world, and particularly in the USA, is likely to be stronger than the mid-point of official forecasts;
 2. The economic setting and current values strongly favour the Equities asset class;
 3. Interest rates are destined to move higher over our one-year to 18 month tactical horizon, resulting in capital loss to Bond values;
 4. The rise in interest rates will provide a head-wind to all leveraged products, notably Property and geared 'Infrastructure' plays.
- There are several secondary themes, including a powerful - if periodically volatile - Commodity Super-cycle, extending to rising Food prices. These opportunities provide scope for nimble specialist investment professionals to add value.
- Slow conversions by strident 'Bear' commentators, along with lingering investor hesitation, serve to extend and draw out the up-cycle. Early positioned investors should benefit.
- Generally, we find 2011 shaping up as a good year.
- But the good times will not last forever. Eventually, the massive fiscal and monetary stimuli currently operating must be withdrawn. Onsets of Official Cash Rate tightening cycles and lesser government profligacy are expected, particularly during the latter portion of our tactical horizon.
- 2010 was a year of very satisfactory gains available to portfolio investment, from levels of low risk. Investors who did not achieve a good annual return should be grilling their adviser, changing their investments, or both.

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An Adviser Disclosure Statement is available on request and without charge.

Expertise You Can Trust

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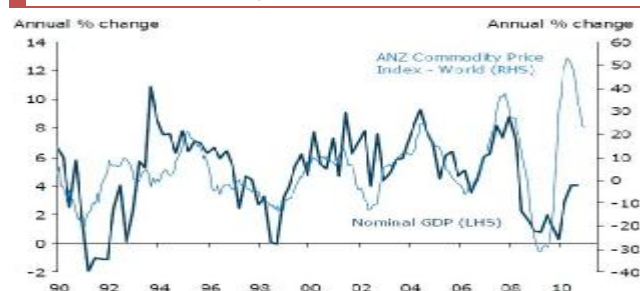
www.diversified.co.nz

New Zealand – A great place to live, but...

The Index of Economic Freedom (a measure of 10 economic parameters, created by the Heritage Organization and Wall St Journal), ranks New Zealand an impressive fourth of 179 countries; immediately behind Australia and ahead of Switzerland. While above average in most aspects – including top-ranked in the world for ‘Freedom from Corruption’ – there are weaknesses. Fiscal Freedom is a little ‘below average’ on account of NZ’s relatively high taxes. Government Spending was the greatest weakness with total expenditures aggregating 41.1% of Gross Domestic Product.

Growth over the coming year to 18 months should be solid, with a number of ‘one-offs’. These include the stimulus of the Rugby World Cup, rebuilding Christchurch, and tapering inflation when the GST spike passes. Generally, growth should be solid, coming off a very low base and backed by a very robust external environment. In short, the things New Zealand produces well are in strong demand again. High prices for primary products traditionally heralds prosperity in NZ.

GDP and Commodity Price Index



Source: ANZ Markets Focus, 17 Jan, 2011.

Moreover, this upturn in NZ’s growth may be more sustainable than recent debt-fuelled cycles. High food prices globally look persistent and boost NZ’s term of trade; national debts are modest by some international comparisons, and; NZ is mercifully remote from the sovereign risks or troubling inflation unfolding in other regions.

Key Economic Projections – Calendar year

	Dec 10	June 2011	Dec 2011
GDP % yoy	+1.0	+2.2	+5.1
Inflation (CPI) yoy	4.0	5.1	2.9
Unemployment	6.5	6.4	5.8
Curr.Acct (%GDP)	-2.3	-2.1	-2.5
90-Day BB % p.a.	3.23	3.7	4.0

Source: ANZ Market Focus, 17 Jan, 2011

On both valuation and prospective earnings criterion, NZ investments are more attractive than at more recent times. Awhile back our move to an ‘Australasian’ mandate, facilitates us pursuing the perceived best opportunities on either side of the Tasman, without the need for a change to asset allocation, or to switch holdings.

Australia – beautiful one day; flooded the next

Australia ranked just above NZ in the Index of Economic Freedom, attributable primarily to its lower government spending, held steady at 34.3% of GDP.

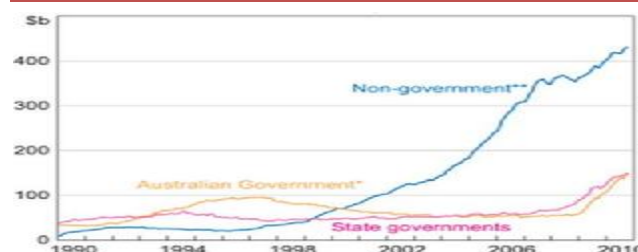
The Australian economy may experience a speed bump this quarter. Quarterly growth may dip to 0.4%, with resource exports and consumer demand impaired by floods. Overall, growth in 2011 is projected to be shaved only from 3.5% to 3.2% (GDP increase), representing 20 consecutive years of uninterrupted growth.

It is widely recognized the Asian / Resources boom has showered Australia with record prices (notably for iron ore and coal), burgeoning export earnings, prolific corporate profits, massive investment commitments, full employment and strong tax receipts. Australia’s prosperity is indelibly linked to Asian prosperity – for good or for bad.

Flood recovery and rebuilding will test capacities, coming as it does atop major government spending on infrastructure, and with numerous private resource developments competing for men and materiel. Inflation may hit 3.2% forcing the Reserve Bank of Australia’s hand to lift their Cash Rate above the current 4.75%, earlier than the market consensus seems currently to anticipate.

Even amidst all this good fortune, and while not to the extent of the more profligate parts of the Developed World, Australians have participated in the rising tide of debt issuance.

Australia – debt issuance



Source: RBA Chartpack, 8 December 2010.

Key Economic Forecasts - Australia

	Dec 2010	Q3 2011	2012
GDP % yoy	2.8	3.6	3.5
Inflation (CPI) yoy	2.7	3.2	3.2
Unemployment	5.3	5.0	4.8
Cash Rate	4.77	5.00	5.25

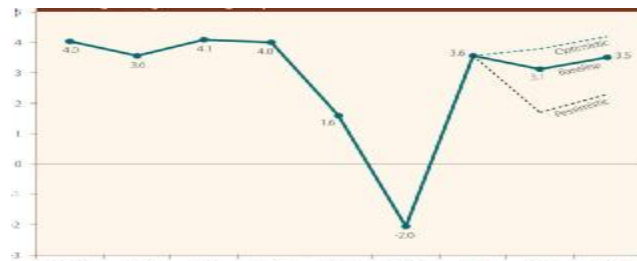
Source: Westpac Weekly, 14 Jan., 2011

Diversified’s model strategies include a substantial allocation to investments in Australia. However we are also mindful Australia’s impressive growth and further resource share price-gains now come from heady levels, amidst already high expectations, and carries Asian vicissitudes.

International - 2011 augurs for a good year

Most global economic think-tanks (such as the UN's World Economic Situation & Prospects - below), project robust growth in 2011, just slightly below 2010, and rising into 2012. *Diversified* finds a strong case for quicker growth in 2011 – a trajectory closer to the 'optimistic' path below.

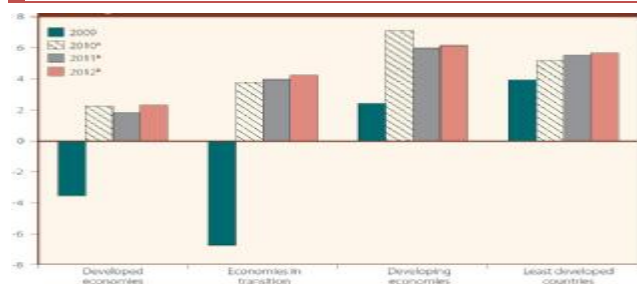
Global Economic Growth (% change GDP)



Source: UN WESP, Jan 2011

Irrespective of absolute pace of growth, informed commentators are universally of the view growth is dominantly reliant on Emerging Markets (Economies in transition, Developing economies, and the Least developed countries, in the UN Parlance below).

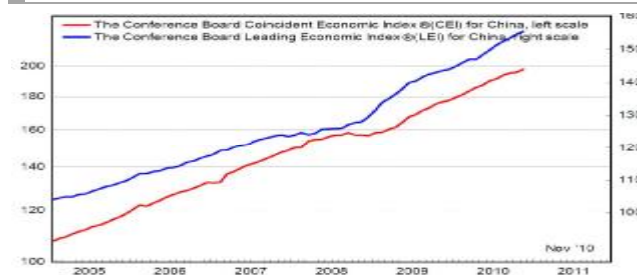
Regional Source of Growth



Source: UN WESP, Jan 2011

Diversified's optimism that the aggregate global growth rate may exceed broad forecasts, stems in part from our more buoyant expectation for the USA, combined with conviction politicians will only tardily withdraw stimulus. Further, we find fears of a hard-landing for China to be excessive. Whilst relatively new, the leading economic indicators for China have been back-tested, and accurately portended the 2009 slowing.

China – Leading Economic Indicators.



Source: The Conference Board, Jan 14th 2011.

In relatively lightly-taxed USA, households are significantly deleveraging (At a pace reducing household debt by US\$1 trillion each three years). With the savings rate now steady at about 6%, spending growth can resume proportional to income rises. Currency is cheap by most Purchasing Power Parity models, and long deferred corporate expansions looks set to rebound. January's Conference Board Leading Economic Index rose for the ninth consecutive month, beating forecasts. We find re-acceleration in US growth probable.

Conversely, economic growth across Europe in aggregate is slowing to negligible, and that beset by periodic banking or sovereign solvency eruptions. Problems have been deferred more than solved. Ultimately, Greece will default, forcing the European Central Bank to wear the debt. Werner & Wilhelmina are not best pleased. But if contained to peripheral Europe, challenges are manageable – the combined GDP's of Greece, Ireland and Portugal, is only 6.8% of total euro area GDP.

Inflationary pressures are divergent. Generally, a division is discerned between typical 'Flatflation' (around 2%) across the Developed World, but with inflation almost universally exceeding 5% (and accelerating) across Emerging Markets. We expect Emerging Markets' policy priority to shift to combating inflation (both higher Cash Rates and currency appreciation), within our tactical horizon.

Although rosy, the coming year to 18 months is unlikely to be without economic challenges. The obvious ones are if troubles spread beyond peripheral Europe, China tightens ruthlessly, or food or energy commodity prices trigger social unrest. However, overall we find the global outlook warrants a strongly pro-growth stance. *Diversified's* model strategies are positioned accordingly.

Fixed Interest – “renormalization”

From historic lows, Cash Rates are already on the rise in many places, and destined to rise in others. At least Australia, Norway, China, India, Malaysia, Korea and Taiwan have commenced tightening cycles. Prevailing Cash rates will progress towards neutral settings (Inflation plus GDP growth), as 2011 progresses.

Official intervention has also extended to artificially suppress bond prices – through liberal money supply, bank support, monetization of debt or direct bond market intervention. The need for, and affordability of, these measure has passed or is tapering rapidly. [The US Quantitative easing II purchase US\$600 billion of long-term treasuries, is scheduled to end June 2011]. Interest rate normalization will assert within our tactical horizon.

Far from 'safety', Bonds now present capital risk to investors. US 10-year Bonds are currently priced too low, with yield near 3.34%. A more normal rate, near 4.5% - 5%, is likely within our tactical horizon. We perceive an imminent risk of a fall in capital prices of Bonds. In that event, even high quality sovereign Bonds can become 'Certificates of Confiscation'.

The journey towards normalization of yields can be traced to a sharp slope-break in September 2010. Over just the past five

months, Investors in 20-yr Treasuries have already lost more than their prior two years of income.

Capital Value of US 20-year Treasury Bond – 6 mths



Source: after CNN Money.com Charts – TLT 20-yr Bond proxy.

Corporate bonds too are at artificially low rates. This entices companies to issue Debt instead of Equity. In an historic aberration, corporate debt is yielding significantly less than Shares in the same issuers – notwithstanding the latter carrying the prospect of capital gains as a bonus.

Selected Issuers, Corporate Bond Yields vs. Dividend Yields

Issuer	Debt Yield & Maturity	Dividend Yield
Auck. Int'l Airport	5.24%, (11/12)	5.24%
Telecom NZ	5.72%, (TCNZ 03/13)	10.09%
Telstra	4.13%, (11/11)	9.83%
Vector	7.00%, (06/12)	8.16%
Trustpower	6.77%, (12/12)	6.82%

Source: Diversified from published data

In an environment of rising corporate earnings the table above shows an average yield on typical Corporate Bonds (around 5.8%, can be lifted 40% simply by switching investments to Shares in the same issuers.

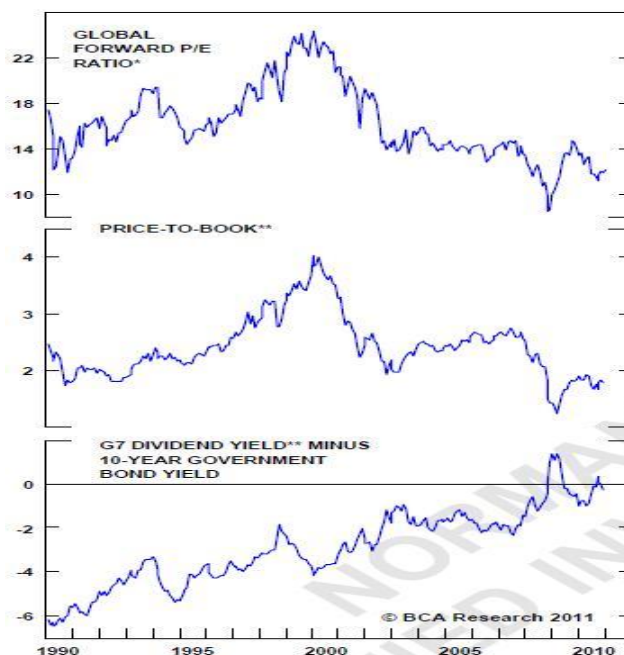
Diversified's model strategies are holding the allocation to the conventional Fixed Interest Asset Class at the minimal levels required for diversification purposes. Indicative portfolios also now include in the Class's allocation, instruments standing to benefit from a rise in Bond yields.

Equities – Cyclical Bull Market

The US Federal Reserve Board is an investor's friend – it wants asset price appreciation. Diversified finds strong evidence to support 2011 being a very good year for investors in the Equities markets. While interest-rate rises are anticipated, the extent should be readily manageable. Further, expected rises will only be towards neutral, and are precipitated by response to growth, rather than from a scarcity of capital.

The trusty BCA Research confirms that whether on the basis of economic outlook (prospective price-to-earnings ratio), absolute valuation (price-to-book), or relative to Bonds (Dividend yield minus Bond yield); Equities globally are currently a distinctly attractive asset class.

The Attractions of Global Equities



Source: The Bank Credit Analyst, Special Year End Issue, Outlook 2011, Jan 2011.

We find the US share market to be uncannily well positioned. Corporate profits have recovered to pre-crisis levels, Balance sheets are in good health, while orders have recently spiked up. Further, the lower US dollar is supportive, especially for the 34% of corporate profits that is now generated outside USA.

Diversified finds reasons why USA, Chinese and even NZ shares might outperform within our one-year to 18 month tactical horizon. Weight of money from Bonds and Money Markets, Earnings recovery and a revival of the Consumer are considerations in formulating our model strategies.

More Geology [sort of] – “Green” Energy

The flaw with most all forms of 'Green' electricity generation is their unreliability at times of peak load. If the wind is not blowing, the sun not shining, or the tide not pulsing during times of peak demand for electricity, then alternative capacity must be funded, built and maintained. Reality is that most 'green' energy connected to the grid is therefore redundant, and its cost of installation is a duplication and wholly dependent on subsidies. Hitherto, there has been no effective method of storing electricity in large quantities, beyond pumping water uphill.

The Holy Grail of green energy enthusiasts is grid-scale batteries. Research fostered by University of New South Wales may be on the cusp of a break-through. Vanadium Redox Flow Batteries (VRB's) are undergoing industrial scale testing. Vanadium is also used in Lithium /phosphate/ Vanadium batteries to extending the life and greatly shortens charge-times of rechargeable batteries. Fortunately Vanadium is relatively common being the 19th most abundant metal in the earth's

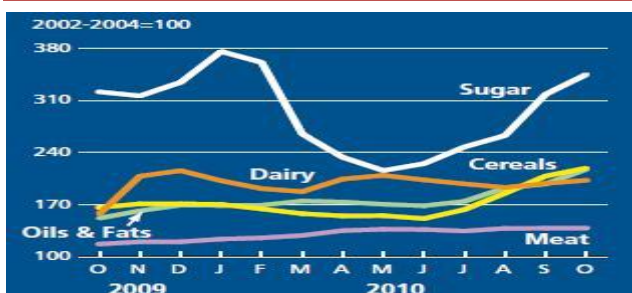
crust, and is widely used as a steel additive. Vanadium forms assays about 0.3% to 0.4% of NZ's black-sand deposits.

The advent of Grid-scale batteries – if commercially successful – would revolutionize intermittent producers, and also revolutionize the efficiency of conventionally installed electricity generating capacity. But it is hugely speculative with success yet to be determined.

Commodities – Super-cycle intact

Commodity prices generally have already risen very strongly; especially considering the yet early stage of the economic cycle we anticipate. To NZ farmers' delight, this commodity cycle has also broadened to include Agricultural prices.

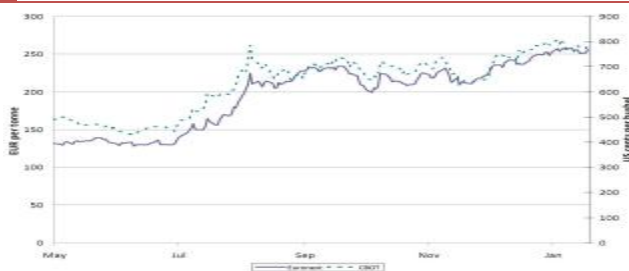
UN FAO Food Price Index – Oct. 2009 to Oct 2010



Source: FAO Food Outlook, Nov. 2010

Amidst tight supply balance globally, extreme weather such as the floods visited on Australia, are impacting on vital staples like wheat. Further, the market for Wheat Futures suggest the rise is not over indicating another 40% over 2011.

Wheat Futures – Mkts forecast further big rises



Source: Salman Partners, Metals Morning Note, Jan 18th

Diversified believes a powerful Commodity Super-Cycle may be in the offing.

But economics works: high prices bring on new supplies and even 'Peak Oil' may be deferred. 2010 was a great year for new oil discoveries – over 50 billion, and maybe 80 billion, new barrels were found. Brazil led new oil finds, but major discoveries were also made in Iran, Russia, Norway, Mexico, Ghana, USA (Texas, North Dakota, Montana & Colorado), Falkland Islands, UK, Angola and Oman. NZ's South Canterbury & Great South Basins are yet to be tested. Energy availability should not derail the expansion we anticipate.

Metals continue in high demand. Most cars contain about 20 kg of copper, and Electric vehicles at least double this amount. As with most commodities, *Diversified* prefers investment in the shares of producing companies, to Futures or Contracts. Companies such as Freeport McMoRan offer very effective exposure to the price of copper.

World's Top 10 Copper Producers (2010 data)



Source: Freeport McMoRan presentation to Macquarie Global Metals & Mining Conference, NYC, Nov 22. 2010

Diversified's model strategies currently include specialist allocations to producers of Energy, Metals and also to Hard Commodities. While some price volatility is probable following the strong run to date, we gauge most commodity prices are likely to be significantly higher, one-year to 18 months ahead.

Currency – the kiwi take flight

Our kiwi dollar rallied strongly in the closing hours of 2010, trimming the gains of investors' offshore holdings, when reported in NZ\$ on that date. The kiwi's appreciation is attributable to material increases in the price of primary export commodities, as well as being a haven from ructions in euro-land.

The Australian dollar recently achieved parity with the US Greenback, but mystique is waning as soaring commodity prices are 'in the market'. Further, the A\$ is perceived as vulnerable to caprice, upset or sudden policy jerks should China develop speed wobbles.

Diversified's core belief remains that currency risk is best diversified, at least in the absence of a strong belief. Short-term portfolio returns may be less than those of hedged funds during periods when the kiwi rises precipitously, but are restored when our volatile domestic unit wanes. We are happy to delegate exchange rate assumptions to the folk at BNZ.

NZ\$ Exchange Rate Forecasts - December Years

	2010	2011	2012
US\$	0.77	0.76	0.67
A\$	0.78	0.80	0.82
Euro	0.58	0.54	0.49
GBP (£)	0.48	0.45	0.40
Japan ¥	63.8	66.9	57.6
NZ\$ TWI	68.9	68.5	62.7

Source: BNZ Weekly Overview, 20th January, 2011

Salient Rates, Indices, & Exchange Rates

Following are the December 31st, year-end 2010 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 impact of NZ currency.

ACTUAL	31/12/10	3 Months	6 Months	One year ago
Prevailing Monetary Conditions Index.	+543	+387	+445	+264
Prevailing NZ Cash Rate (90-day)	3.18% pa	3.17% pa	3.13% pa	2.80% pa
Prevailing 2011 NZ Gov't Stock Yield	3.37% pa	3.43% pa	3.65% pa	4.29% pa
Prevailing 2015 NZ Gov't Stock Yield	4.71% pa	4.29% pa	4.65% pa	5.498% pa
Prevailing 2021 NZ Gov't stock Yield	5.82% pa	n.a.	n.a.	n.a.
CHANGE	Value	Gain or loss since...		
NZX NZ Gov't Stock [Bond] Index	1157.87	-1.3%	+1.4%	+7.0%
NZSE 50 (Gross)	3309.03	+4.1%	+11.3%	+2.4%
NZSCI (Gross)	21939.17	+8.0%	+15.3%	+4.7%
S&P/ASX200 (Australia) *	4445.00	+3.5%	+10.3%	-2.6%
MSCI World Index (Capital) *	1281.41	+8.2%	+22.3%	+6.8%
Dow Jones (USA) *	11666.00	+7.7%	+20.3%	+11.9%
NASDAQ*	2673.00	+12.7%	+27.9%	+17.0%
FTSE 100 (UK)	5899.94	+5.5%	+22.8%	+9.0%
Nikkei DJ (Japan) *	10228.92	+8.7%	+9.0%	-3.0%
Hang Seng (Hong Kong) *	23035.45	+3.2%	+11.8%	+5.3%
NZD/USD	0.77	+4.8%	+11.4%	+6.7%
NZD/AUD	0.76	-0.3%	-7.2%	-6.3%
NZD/JPY	62.78	+2.0%	+2.6%	-5.9%
TWI	69.04	+4.2%	+3.4%	+4.2%
Gold (US\$ / oz., troy)	1,380.65	+5.4%	+11.5%	+26.6%
Crude Oil (WTI, US\$/bb)	91.75	+20.5%	+17.3%	+16.4%

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

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Corporate and individual Investment Adviser Disclosure Statements are available free of charge, or may be viewed on our website