

Diversified's View

April 2011

"... if you manage the downside, the upside will take care of itself. Avoiding the big loss is the key to investment success. And, that's why when I think the odds are not tipped decisively in my favour I tend to be more cautious in my investment approach. Investment Strategist, Jeffrey D. Saut, in Raymond James' Investment Strategy of March 28th, 2011.

Diversified have been formulating investment strategies independently since 1994 - & its Principals & Associates for years prior to that. The Company's forté is our application of macro-economic research to asset allocations in anticipation of likely financial market developments. In-house analysis also covers a wide range of investments. The benefit of leading strategies to investors is their capture of superior, long-term performance. The same process is applied to *Diversified* Wealth Management's PIE Funds, to The Law Retirement KiwiSaver choices as well as to traditional individually managed accounts.

The Unit Price for *DWM Balanced 'PIE'* Fund at 31st March 2011 \$1.1937. The Unit Price for *DWM Dynamic 'PIE'* Fund (at 31st March 2011) was \$1.1132. An Investment Statement is available at www.diversified.co.nz

The Unit Price for *Law Retirement KiwiSaver Scheme's Balanced Fund* at 31st March was \$1.1622.
The Unit Price for *Law Retirement KiwiSaver Scheme's Dynamic Fund* at 31st March was \$1.1726.

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

Summary

- The Budget of May 19th will reveal whether the government's priority is preserving NZ's Credit Rating (i.e. for hard fiscal decisions), or continue electoral largesse in this election year.
- Elsewhere, the global economic situation is developing into one of more balanced but still very robust pace of growth.
- China's grappling with inflation appears to be winning – without derailing its economy.
- The USA's economic recovery is turning and self-sustaining, potentially allowing government to step back. The Euro economy is mixed, but best in economically dominant Germany. European peripheries are expected to get worse before getting better. Japan may be re-energized by the re-build
- For portfolio investors, the easiest gains may be past – but should be adequate ahead. Prices have risen strongly since the lows of two years ago. The success of global economic reflation is now substantially in market prices.
- Bond markets are in our view over-priced.
- Looking ahead, *Diversified* finds the Equity Bull Market intact, but with tapered returns and more frequent bouts of volatility more probable ahead. The common trait of revolution across Arabia, the Magnitude Nine earthquake in Japan earthquake, and a nuclear crisis, is that NONE WERE EXPECTED even very recently. Systematic diversification of investment portfolios remains the sole recognized defence against the unknown, as well as the best course for long-term investors.
- Strategy deals with probabilities rather than certainties. Systematic diversification in accordance with Modern Portfolio Theory, underpins all *Diversified's* strategy work.

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

Expertise You Can Trust

New Zealand – Big Gov't; Big Debt; Big Hopes

New Zealand was already flirting with a credit rating downgrade (from AA+), before the second and most destructive Christchurch Earthquake. The Budget scheduled for May 19th will be eagerly greeted if signalling our profligate government has plans to cease spending \$300 million (NZ\$15.6 billion p.a.) more than it earns. To do so may be a hard choice up against an election year, but government also has an opportunity to unfetter the wealth creating sectors.

At 40% of Gross Domestic Product, NZ's central government is far too big, yet is still growing. State bureaucracy races to regulate new vocations and to minister new activities, completely undaunted by comprehensive failure. Would anyone ever have bought a leaky home, without it having a *Code Compliance Certificate*? Did anyone buy a dodgy debenture that was not issued under a *Registered Prospectus*? How much did *government guarantee* deepen the tax-payer's SCF liability? Over 9000 pages of new regulations are created or amended each year, modifying NZ's 780 primary statutes and 3365 statutory regulations [Source: Don Nicolson, Federated Farmers President, Sunday Star-Times 10th April].

NZ's Productive Economy Requires Relief



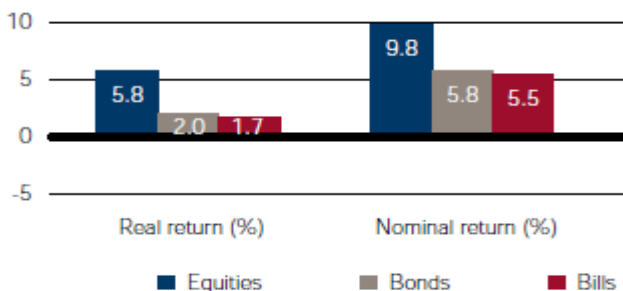
"Hello, I'm Ms. Lawson from compliance. What did you eat for lunch today?"

Source: Grant's Interest Rate Observer, April 2011.

Our NZ economy has lagged the strong economic rebounds enjoyed by Asian countries, neighbours and most all our trading partners. But it is from that low base and strong external environment which have sown a seed for out-performance of our NZ economy ahead.

Over the very long term, asset class return in NZ have compared reasonably. The average real annual return on Equities over 111 years has been 5.8% p.a., on Fixed Interest it has been 2% p.a., and on Cash ('Bills') it has been 1.7% p.a.

Long Term Asset Class Returns - NZ



Source: Credit Suisse Global Investment returns Yearbook 2011

Key Economic Projections – Calendar year

	June 2011	Dec 2011	Sept 2013
GDP % yoy	-0.3	+2.9	+4.4
Inflation (CPI) yoy	5.3	3.3	2.7
Unemployment	6.7	6.4	6.1
Curr.Acct (%GDP)	+0.2	-1.2	-4.8
90-Day BB % p.a.	2.7	3.1	4.2

Source: ANZ Market Focus, 18th April 2011

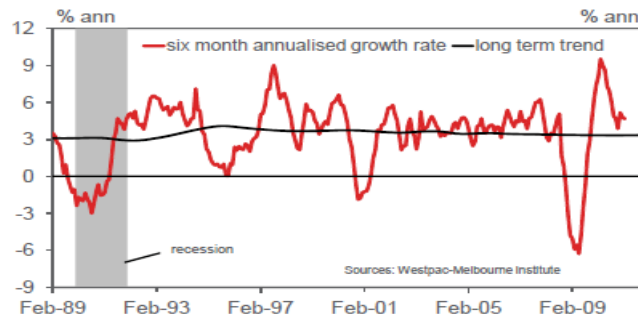
With higher prices now prevailing elsewhere, and the Rugby World Cup celebrations looming and massive Christchurch rebuild to come, NZ is a reasonably attractive destination.

Australia – Drying out

The Australian economy has been worse hit by natural disasters (its own floods and cyclones, as well as Japan's tsunami), that was initially estimated. Their Federal Budget due May 10th, is expected to revise down the rate of GDP growth for the current fiscal year (to June 30th), to 2.25%. Coal exports were severely disrupted, exports to Japan deferred and consumers have chosen to save more. But the immediate effect, compounded by the difficulty manufacturing exporters' face with their high exchange, has been a cut in their current growth rate, from the 3.25% pace envisioned one year ago.

Fortunately Australia's economy is resilient. In addition to correctly signalling a settling back from earlier excesses, the Westpac Bank-Melbourne Institute leading index of economic activity, now points to growth stabilizing ahead, at a pace above Australia's 3.3%, long-term average.

Westpac / Melbourne Inst. Leading Economic Index



Source: Westpac, April 20th 2011.

In summary, a good pace of growth is expected to resume in Australia.

Key Economic Forecasts - Australia

	Calendar 2011	Calendar 2012
GDP %	2.0%y-on-y	4.0%
Inflation (CPI)	2.6	2.6
Unemployment	4.8	4.5
Cash Rate	5.00 (Dec)	5.25 (June)

Source: Westpac International, 8th April, 2011

Based on relative valuations, as well as respective prospects, *Diversified's* model strategies have moved to a neutral stance between Australia and NZ, within the 'Australasian' context. (Note: The mandate rather than the actual domicile of individual holdings or operator is the relevant criterion).

International – Growth Outlook Intact

The 'Double Dip' palaver has passed. The expectation that a robust pace of aggregate global growth will transpire for 2011 and prevail for 2012 is now widespread. As anticipated, a good pace of economic expansion is unfolding in mighty USA. Also much as predicted, China is adeptly managing its inflationary pressures, whilst maintaining growth at an impressive clip.

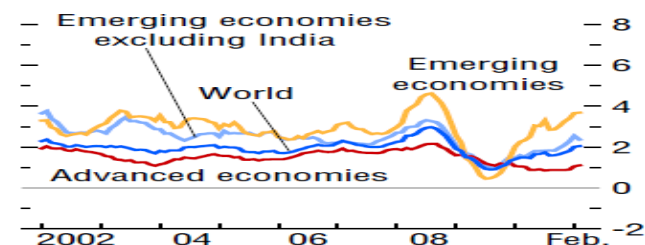
World economic Outlook - % gain in GDP

Area	2011 GDP Gain	2012 GDP Gain
World	4.4	4.5
USA	2.8	2.9
Euro	1.6	1.8
Japan	1.4	2.1
UK	1.7	2.3
Russia	4.8	4.5
China	9.6	9.5
ASEAN 5	5.4	5.7
Brazil	4.5	4.1
Arabia	4.1	4.2
Africa	5.5	5.9

Source: IMF WEO, April 2011. Note: Contributions are aggregated using Purchasing Power Parity. If market exchange rates were used, aggregate world growth would be reduced to +3.5% in 2011, and +3.7% in 2012.

The table above indicates that 'Advanced Economies' are projected to grow by a collective 2.4% in 2011, and by 2.6% in 2012, compared with Emerging and Developing Economies growing at a substantially brisker 6.5% in 2011 and in 2012. This two-speed global economy is similarly evident in Inflation expectations.

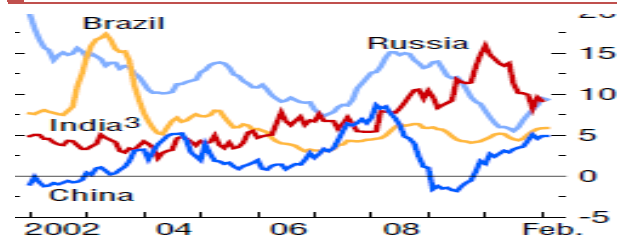
Global Inflation – A 'two-speed' world



Source: IMF WEO, April 2011

Key Emerging Markets are clearly testing their respective, non-inflationary limits of growth. Notwithstanding that levels are elevated, and with due wariness, *Diversified* gauges inflation will be managed without seriously impeding economic expansion, for our one-year to 18-month, tactical horizon.

Emerging Market Inflation – elevated but manageable



Source: IMF WEO, April 2011

Politics is again to the fore. Though there are many experts now, *Diversified* is unaware of any credible political analyst, correspondent, or pundit, who successfully foretold the Arab uprisings and revolution now sweeping the Maghreb and Middle East. After all, Gaddafi's Libya had been appointed to Chair the UN's Human Rights Commission in 2003, and joined the prestigious and powerful UN Security Council in 2007. [*Diversified* is relieved its Dynamic Fund's investment in the geologically rich Nile Gold deposit, placed in supposedly stable Egypt, was 100% recovered].

We do not perceive Arab world foment is yet an investment opportunity. Revolts may be a long and uncertain journey. History is not kind to the notion of speedy transition from revolution to enlightened democracy. Revolutionaries seldom achieve their dreams – at least on the first pass. The Shah of Iran's detractors are now mostly fugitives; Cubans deposing Battista subsequently fled 50-years of Castro; Liberal Russian revolutionaries were ruthlessly bested by the Bolsheviks, and; French Liberals succumbed to the guillotine at the hands of ruthless, but minority Jacobins.

Geologically, Magnitude Nine earthquakes were considered a continental risk, confined to places like Chile or Alaska. The fluidity of 'Island Arcs' - such as Japan or NZ – were thought susceptible only to lower order of magnitude Quakes. Japan was superbly engineered for lesser Quakes, and seawall protected from merely big tsunamis.

Nuclear Power generation safely is supposed to be impeccable. In event of emergency, chain reactions should shut down automatically (which did happen), but clearly spent fuel rods not safely deposited. Even accepting that Fukushima Daiichi has released mostly the isotopes which decay to harmlessness quickly, the estimate 9 month clean-up will knobble global nuclear renaissance.

None of these events were knowable, but all were managed comfortably in a systematically diversified investment portfolio.

Notable risks to our otherwise benign global economic outlook include rising food prices, or a spike in oil prices.

FAO – Food Price Index



Source: UN Food & Agricultural Organization, April 2011

Food prices tracked up by more than 30% over latter 2010, and have continued at elevated levels into 2011. The rise may have contributed to the Arab unrest and has by IMF count, plunged an additional 44 million persons into poverty. Most alarming are global food stocks. Global supplies of most all food commodities very closely match demand, without surplus. The World Bank

warns the globe is only one shock away from a crisis in food supplies.

Although oil prices have risen significantly (doing the dampening work that might otherwise require higher Cash rates), the hike does not necessarily endanger prosperity. Our trusty BCA Research provides persuasive evidence that it is the speed of oil price hikes, rather than the absolute level, that causes problems. Previous recessions were triggered by oil prices doubling within a year.

In summary, *Diversified* finds widespread global growth at a robust pace will most likely characterize the next year to 18 months. The high growth Emerging & Developing World is testing inflationary limits, but will most likely manage growth near current. This economic backdrop favours the Growth asset classes, including Emerging Markets.

Our next formal strategy review is scheduled to commence in May.

The Next Financial Crisis? (Government)

Financial crises have identifiable traits. Bubbles usually form in a new sector (I.T. and US House prices have had their turn). They have in common being perceived as evidently good in the early stages, while sucking in growing and eventually excessive amount of capital and resources. Competing sectors for investment are crowded. The usual rules for a reasonable return on investments, and of accountability become suspended. With hindsight it becomes apparent much of the later expenditure was of low quality.

In this context criterion, the growth of governments (particularly across the Developed World), must be of concern. 'Entitlement' payments have expanded to be reliant on structural deficits. Government employment is the favoured choice, offering higher wages, greater job security, lesser accountability, advancement and cushier conditions. Unfunded pension liabilities and clearly unsustainable deficits are ignored. Solvency tests are suspended.

Government Growth - % of GDP

	1870	1913	1920	1937	1960	1980	1990	2000	2005	2009
Austria	10.5	17.0	14.7	20.6	35.7	48.1	38.6	52.1	50.2	52.3
Belgium	na	13.8	22.1	21.8	30.3	58.6	54.8	49.1	52.0	54.0
Britain	9.4	12.7	26.2	30.0	32.2	43.0	39.9	36.6	40.6	47.2
Canada	na	na	16.7	25.0	28.6	38.8	46.0	40.6	39.2	43.8
France	12.6	17.0	27.6	29.0	34.6	46.1	49.8	51.6	53.4	56.0
Germany	10.0	14.8	25.0	34.1	32.4	47.9	45.1	45.1	46.8	47.6
Italy	13.7	17.1	30.1	31.1	30.1	42.1	53.4	46.2	48.2	51.9
Japan	8.8	8.3	14.8	25.4	17.5	32.0	31.3	37.3	34.2	39.7
Netherlands	9.1	9.0	13.5	19.0	33.7	55.8	54.1	44.2	44.8	50.0
Spain	na	11.0	8.3	13.2	18.8	32.2	42.0	39.1	38.4	45.8
Sweden	5.7	10.4	10.9	16.5	31.0	60.1	59.1	52.7	51.8	52.7
Switzerland	16.5	14.0	17.0	24.1	17.2	32.8	33.5	33.7	37.3	36.7
United States	7.3	7.5	12.1	19.7	27.0	31.4	33.3	32.8	36.1	42.2
Average	10.4	12.7	18.4	23.8	28.4	43.8	44.7	43.2	44.1	47.7

Source: The Economist, 19th March, 2011

The table above depicts the expanding in size of the 'Developed' State, from an average 10.4% of GDP in 1870 on average, through 28.4% in 1960, to 47.7% today. Stein's Law states: "If something cannot go on forever, it will stop".

Could sovereign debt be the next financial Bubble?

Fixed Interest – Bonds present Risk

Notwithstanding a recent rally, *Diversified* regards Bond markets as over-bought, capital values as expensive and running yields as inadequate. Even recognizing that markets can remain irrational longer than investors can remain solvent; the cost of entry is also an important influence on even long-term investment returns. Do not over-pay.

Using flagship US Bonds as an example, investors should be able to preserve the real purchasing power of their capital. 'Consensus' forecasts are for growth around 3.2% in USA in 2012, and 1.8% inflation. On this basis, fair yield for US 10-year bonds should be around 5% p.a. – versus the 3.4% p.a. yield currently on offer. Yields may have been depressed by the Quantitative Easing - reportedly responsible for 70% of US Bond purchases - which ends in June this year.

Official Cash Rates in most places still linger at the very low rates invoked to combat the Great Financial Crisis. Only the pace to normalization is in question.

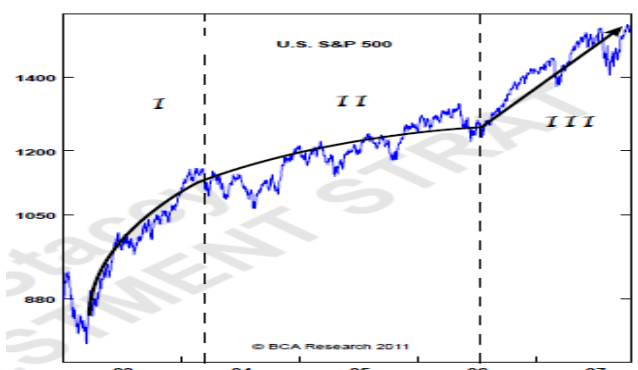
Diversified finds prevailing interest rates and Fixed Interest yields ranging from unattractive to inadequate. Model's allocations to conventional Fixed Interest are at the minimum levels required for diversification.

Equities – Bull Market Cont'd

Notwithstanding the spectacular rebound since the Bull began (March 2009), the Equities Asset Class still generally represents fair value. Economic expansion across the Developed World becoming self-sustaining, supporting continued growth of corporate earnings – albeit at a slower pace than recently – and irrespective of waning monetary and fiscal stimuli.

We fully expect the recent rate of advance by senior share markets to taper. Prior cycles exhibit a sequence of rebound from recession, mature market, before 'irrational exuberance' returns.

Typical Bull Market Sequence



Source: BCA Global Investment Research, April 15th, 2011

Diversified's model strategies currently favour the Equities Asset Class. Progress ahead may be a bit flatter than since March 2009, and that will likely be punctuated by greater volatility *Diversified* gauges Equities will likely be high over our one-year

to 18-month tactical horizon as a whole. Model Asset Allocations are set accordingly, even accepting that a soft Quarter may need to be absorbed.

Property – Still digging a Basement

As the Asset Class most amenable to leverage (along with 'infrastructure'), Property is now the Class most vulnerable to the rising interest rate cycle.

NZ Property junkies need be wary of spin. Realtors are not sources of unbiased advice: Houses are invariably either 'more affordable, 'a buyer's market', 'increased turnover', 'fewer days to sell' or 'up compared to last month/week/day'.

The more neutral Quotable Value NZ, (April 12th release) reported that NZ House prices had fallen on average by \$12,000 in the three months to March 31st; are now worth -2% less than a year ago and -5.9% less than at the market's peak in late 2007.

It is still far from clear that clobbered-down US House Prices have completed their correction. Despite much cheaper prices than Australian or NZ equivalents, US House prices may be on the cusp of another down-leg.

Case-Schiller Home-Price Index



Source: businessinsider.com. Data to 29/03/2011.

Beyond lifestyle assets, *Diversified's* model strategies continue to advocate a low weighting to Property, and that confined to the retail sector diversified globally, and standing to benefit from consumers' return.

Commodities – Super-cycle intact

Although well into the cycle, *Diversified* finds most Commodity prices likely to remain strong for at least the duration of our tactical cycle.

China's economic success is exemplar for the entire Developing World. China consumed 24% more copper, 59% more zinc and 31% more aluminium than all of USA, Euro land and Japan combined in 2010. In the near-term, Japans re-build will compound Emerging Market's burgeoning demand.

Elsewhere, commodity price excesses may be moderating. Most recent signals are of Food Price Inflation peaking. The share prices of oil producing companies have under-performed the spike in crude price by about 50% - could be construed as suggesting recent high price levels may not be sustained as earnings.

The best cure for high prices is high prices. Eventually, and we expect beyond our current tactical horizon, new supplies will come on stream. The long-term trend lower in commodity prices will re-assert. Commodity-related currencies will likely soften in anticipation.

Diversified's model strategies persist with a sizeable exposure to Commodities (depending on risk-profile). The preferred technique for portfolios is by investing in producer's shares, over holding Futures on Contracts, or owning of physical commodities.

Currency – kiwi takes flight again

The sudden resurgence of our Kiwi dollar's exchange –material as it is – reinforces that it is the plaything of powerful foreign dealers. Domestic fundamentals are a lesser factor in the short-term.

The high closing value of the NZ\$ at the end of March was unhelpful in depressing the reported value of offshore holdings. Still, *Diversified* continues to shun hedging to the kiwi. Quite aside to the fickleness of foreign currency-dealers, NZ remains a small and indebted trading nation, clearly subject to seismicity, to potential volcanism, pestilence, disease or other disaster.

Sound investment strategy requires diversification of risks. In the absence of strong conviction of imminent profit, *Diversified* notes that hedging to NZ\$ concentrates portfolio risk.

Those brave folks at ANZ venture the exchange rate predictions below:

NZ\$ Exchange Rate Forecasts - Month-end

	June 2011	June 2012	December 2012
US\$	0.74	0.75	0.70
A\$	0.73	0.73	0.73
Euro	0.53	0.56	0.52
GBP (£)	0.46	0.47	0.45
Japan ¥	62.9	66.0	66.5
NZ\$ TWI	65.6	67.3	64.4

Source: ANZ Market Focus, 18 April, 2011

Salient Rates, Indices, & Exchange Rates

Following are the March 31st, 2011 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	31/03/1	3 Months	6 Months	One year ago
<u>Prevailing Monetary Conditions Index.</u>	+342	+543	+387	+293
<u>Prevailing NZ Cash Rate (90-day)</u>	2.63% pa	3.18% pa	3.17% pa	2.67% pa
<u>Prevailing 2015 NZ Gov't Stock Yield</u>	4.40% pa	4.71% pa	4.29% pa	5.192% pa
<u>Prevailing 2021 NZ Gov't stock Yield</u>	5.68% pa	5.82p.a.	n.a.	n.a.
CHANGE	Value	Gain or loss since...		
NZX NZ Gov't Stock [Bond] Index	1186.69	+2.5%	+1.2%	+7.2%
NZSE 50 (Gross)	3440.00	+4.0%	+8.2%	+5.3%
NZSCI (Gross)	21658.790	-1.3%	+6.6%	+7.2%
S&P/ASX200 (Australia) *	4837.90	+2.0%	+5.6%	-0.8%
MSCI World Index (Capital)*	1334.93	+4.2%	+12.7%	+11.2%
Dow Jones (USA) *	12321.00	+5.6%	+13.8%	+13.5%
NASDAQ*	2781.008	+4.0%	+17.3%	+16.0%
FTSE 100 (UK)	6010.00	+1.9%	+7.5%	+8.2%
Nikkei DJ (Japan) *	9744.95	-4.7%	+3.6%	-12.2%
Hang Seng (Hong Kong) *	23495.88	+2.0%	+5.3%	+10.1%
NZD/USD	0.76	-1.1%	+3.7%	+7.4%
NZD/AUD	0.74	-2.5%	-2.7%	-4.5%
NZD/JPY	63.16	+0.6%	+2.7%	-4.1%
TWI	66.58	-3.6%	+0.5%	+0.7%
Gold (US\$ / oz., troy)	1,414.41	+2.4%	+8.0%	+28.2%
Crude Oil (WTI, US\$/bbl)	104.29	+13.7%	+37.0%	+27.4%

*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

