

## Diversified's View

June 2011

### "Perfect Hedges are found only in Japanese Gardens."

Bob Hoye, Institutional Advisor's  
Pivotal Events, May 26<sup>th</sup>, 2011

**Diversified's Investment Process is formulated with an eye on global, macro-economic trends one-year to 18 months on. (For more information on Diversified's Investment Process, readers may request a brochure of that title from [jess@diversified.co.nz](mailto:jess@diversified.co.nz))**

Diversified's model strategies are applied to:

- The Law Retirement Plan KiwiSaver Scheme;
- The Law Retirement Plan Superannuation Scheme;
- Diversified Wealth Management's 'Balanced' & 'Dynamic' PIE Funds; and
- Via AFA's as Individually Managed Accounts for Private Clients.

The Unit Price for **DWM Balanced 'PIE'** Fund at 31<sup>st</sup> May 2011 was \$1.1320. The Unit Price for the newer **DWM Dynamic 'PIE'** Fund (at 31<sup>st</sup> May 2011) was \$1.0414. An Investment Statement is available at [www.diversified.co.nz](http://www.diversified.co.nz)

The Unit Price for **Law Retirement KiwiSaver Scheme's Balanced Fund** at 31<sup>st</sup> May was \$1.1071.

The Unit Price for **Law Retirement KiwiSaver Scheme's Dynamic Fund** at 31<sup>st</sup> May April was \$1.09959.

Investment Statements for KiwiSaver are available from the scheme's website: [www.lawretirement.co.nz](http://www.lawretirement.co.nz)

### Summary

- *Diversified's* research finds the powerful global economic expansionary cycle to be intact. We fully expect it will reassert on financial markets well within our tactical horizon.
- Recent market softness appears of the nature of a mid-cycle transition. The expiry date for QE II stimulus in USA, Europe's management of its' peripheries sovereign debt problems, and Japan's supply train disruption, are all transitory.
- Long-term investors will find comfort the economic engines of this global expansionary cycle – China and USA - are intact and robust.
- The recent spike-up in the NZ\$ exchange rate was not helpful. Assets held in A\$ or US\$ were marked down at end May. (*Diversified* is a fundamental house. Policy seldom hedges to NZ\$). Those hedged to the NZ\$ were recently rewarded - but a stopped clock is right twice a day too.
- NZ's laggard economic recovery and relatively neglected markets, now present the opportunity of gains from a lower base. Australasian share markets (as well as major world share markets) are likely to be significantly higher in one-year to 18 month's time
- The economic setting underpins demand for Commodities continuing strong.
- Very low rate of interest prevailing, we find mostly unworthy – across the board (i.e. on Cash, Sovereign Bonds or Corporate Debt).
- Changes to KiwiSaver reduce its attractions – especially for the effectively self-employed from next year. Nevertheless, KiwiSaver participants still achieve super-profits to the extent of the subsidies for which they are eligible.
- The future is never knowable. Systematic diversification remains the sole recognized defence against the unknown.

Norman W. Stacey ([nstacey@diversified.co.nz](mailto:nstacey@diversified.co.nz))

Norman Stacey is an Investment Analyst and is Portfolio Manager of the *Diversified* Wealth Management PIE Funds

Expertise you can trust

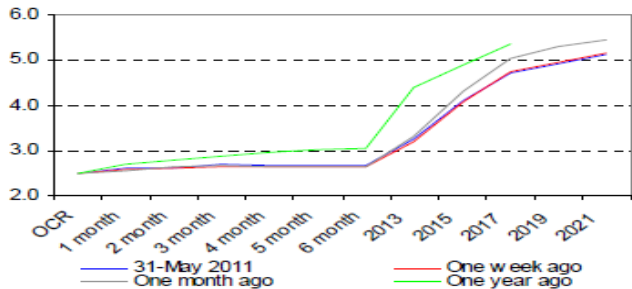
**Diversified** Investment Strategies Limited

[www.diversified.co.nz](http://www.diversified.co.nz)

## New Zealand – Economy Looking Up

New Zealand’s economic outlook and investment opportunity now compares favourably on a global basis. Having lagged the now more advanced and now priced-in recoveries elsewhere, acceleration is easier to achieve from NZ’s low base. The long-awaited, export-led recovery is this time underpinned by an apparently durable trend of high global commodity prices. Meanwhile, strong stimulus from both monetary and fiscal largesse remain operating, with additional one-off boosts from the Rugby World Cup (Sept & Oct, 2011), and looming rebuilding of Christchurch.

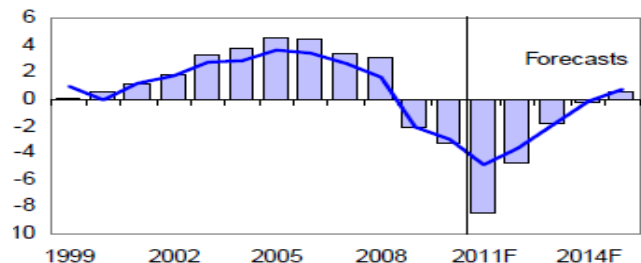
### NZ Interest Rates at Record Lows - % Yield



Source: First NZ Capital’s NZ Mkt Summary, June 2011.

Fiscal stimulus is intensified with the greatest ever deficit, despite the strong external environment. New Zealand’s enormous government is set to continue at a size considerably exceeding the tally of all taxes, levies and charges it collects.

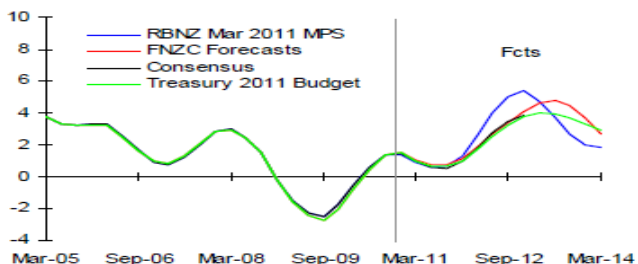
### Government’s Operating Deficit - % of GDP



Source: First NZ Capital’s NZ Mkt Summary, June 2011.

Nevertheless, economic commentators are in agreement, that currently weak growth in Gross Domestic Product will accelerate from latter 2011, persisting for at least the duration of Diversified’s one year to 18 month, tactical horizon.

### NZ GDP Forecasts – annual % change



Source: First NZ Capital’s NZ Mkt Summary, June 2011.

Confidence in the durability of this economic upturn is lifted by New Zealand moving closer to paying its way. Unfortunately the ‘largest monthly trade surplus in history’ delivered in April, was

later exposed as a distortion in counting the re-insurance payouts for Christchurch quake damage. Those aside, terms of trade depict a multi-decade improving trend.

### NZ Terms of Trade – 2ndQ 2002 = 1,000



Source: The Economist, June 16<sup>th</sup>, 2011

Of comfort too is that inflation (beyond the GST-hike inspired blip) looks to be constrained by excess capacities, and destined to return within the Reserve Bank’s mandate. Employment is robust, and the Current Account less worrisome that earlier.

### Key Economic Projections – Calendar year

	Dec 2011	Dec 2012	Mar 2013
GDP % yoy	3.7	+3.3	+3.3
Inflation (CPI) yoy	3.1	2.6	2.9
Unemployment	6.3	6.0	6.0
Curr.Acct (%GDP)	-1.3	-5.1	-5.2
90-Day BB % p.a.	3.1	3.7	>4.3

Source: ANZ Market Focus, 13<sup>th</sup> June 2011

### NZ’s Permission Society Extended:

In NZ, even science must now seek permission before pursuing knowledge. Now - and quite in addition to common law, to existing Commerce, Consumer and Criminal Laws, to professional standards or, to reputational, brand or business imperatives – Retail Financial Advisors from July 1<sup>st</sup>, but Trustees, Auditors, and Issuers from later dates, will also need new permissions to exist. Government bureaucrats’ messianic belief they will have any impact on rogues, improve security or ensure safety for investors is adorable. Certainties include their \$24 million p.a. in costs, and moral hazard. The precursor, NZ Securities Commission failed to protect as comprehensively as DOC’s platform over Cave Creek failed. Yet it is unlikely any victim of NZ\$8 billion in investor’s savings lost or impaired in various Finance Company debentures, CDOs, Mortgage or CashPlus Funds, would have been conned in the absence of Prospectuses approved for Registration.

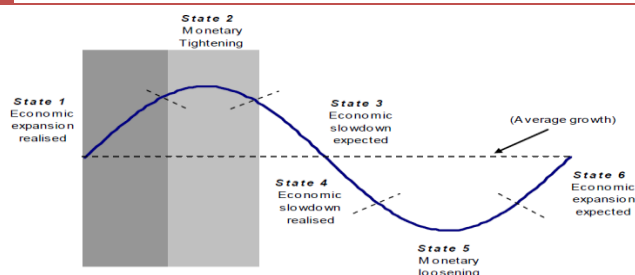
Diversified’s booth at Mystery Creek’s National Field Days, (June 15 – 18<sup>th</sup>) finds the hinterland inn good fettle, and refreshingly focused on wealth from production, over assumed capital gains. Farmers’ astute business canniness is at the fore.

On outcome of our formal Quarterly review of investment strategy, Diversified’s model allocations to NZ growth assets was lifted in June.

## Australia – Re-accelerating after floods

Australia's economy is at a more advanced stage in this economic cycle, than most anywhere in the Developed World. Australia is well into the Monetary Tightening phase.

### Stylized Economic Cycle



Source: reprinted from First NZ Capital, May, 2011.

Whilst individually devastating, Australia's floods and cyclones in the early months of 2011, have only temporarily clipped its strong growth pace. The earlier pace is now resuming. Crop losses are finite, repairs to infrastructure are mostly complete, and mining production has resumed rated capacity.

With the set-backs behind, The Reserve Bank of Australia is again focussed on inflation. Its' May 6<sup>th</sup> Statement Signalled an additional 0.75% to 1% in total hikes likely for their Cash Rate – already at 4.75% - by mid 2012.

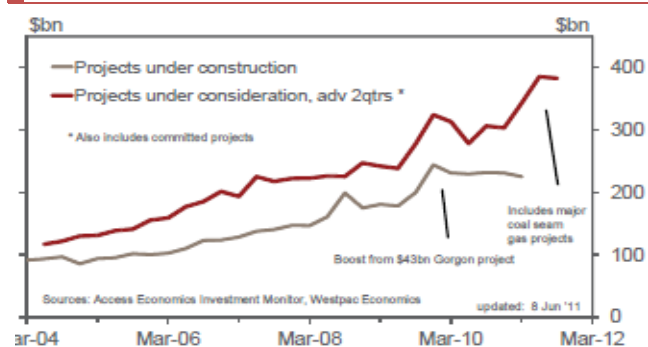
### Australian Key Economic Forecasts – Calendar Year

	2010	2011	2012
GDP %	2.7	1.6	4.0
Inflation (CPI) %	2.7	3.2	2.6
Unemployment s.a. %	5.2	4.9	5.0

Source: Commonwealth Budget, Overview. May, 2011

Australia's mining investment pipeline remains impressive, irrespective of their government prevaricating on super-taxing and proposed emissions penalties. Projects planned exceed those commenced.

### Mining Capex – considered and committed.



Source: Westpac Market Insights, June 2011

Australia remains an important investment destination worthy of a significant allocation. Allocations to Australia's deeper markets, and including enhanced Cash, were confirmed in *Diversified's* review.

## International - Changing Gear

*Diversified* demurs from recent negativity. We do not expect global economic slowing to be material. Further, we find of far greater probability, that the global economic expansion will sustain a trajectory near the current aggregate pace. Recovery from the Great Financial Crisis is proceeding – and is transitioning from the rebound phase – fuelled by twin stimuli and inventory re-build - into a self-sustaining expansion. Inflection around the transition phase is particularly vulnerable to sentiment, to unwarranted propagation of short-term signals and to spurious claims of impending doom. Global economic expansion is expected to reassert as 2011 progresses – and that heavily dependent on impressive contributions by China and India. Our expectations are reinforced by the International Monetary Fund's just updated, World Economic Outlook.

### World Economic Outlook - % gain in GDP, 1-yr ahead

Region/Country	WEO January 2011 (for 2012) % p.a.	WEO April 2011 (for 2012) % p.a.	WEO June 2011 (for 2012) % p.a.
<b>Developed World</b>	+2.5	+2.6	+2.6
- USA	+2.7	+2.9	+2.5
- Euro Zone	+1.7	+1.8	+2.0
- Germany	+2.0	+2.1	+2.4
- UK	+2.3	+2.3	+2.4
- Japan	+1.8	+2.1	+2.2
Newly Industrialized Asia	+4.3	+4.5	+5.3
<b>Emerging &amp; Developing World</b>	+6.5	+6.5	+6.6
- Latin America	+4.1	+4.2	+4.0
- Russia	+4.4	+4.5	+3.4
- India	+8.0	+7.8	+8.0
- China	+9.5	+9.5	+9.5
ASEAN 5	+5.7	+5.7	+5.8
Sub-Saharan Africa	+5.8	+5.9	+5.9
<b>Aggregate World Growth</b>	+4.5	+4.5	+4.4

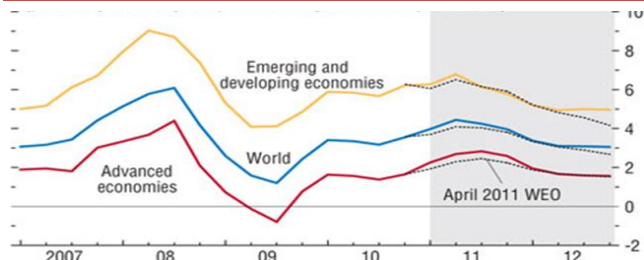
Source: IMF WEO, April 2011.

The defining development for Baby Boomers in the provisioning for, and throughout their lengthy retirements, is the economic renaissance of Asia. Far from peaking, the trend is broadening, intensifying and is durable. China's remarkable success with statist market economy in lifting prosperity is a model now discrediting despotic and indulgent regimes most everywhere. China has become the exemplar for Emerging Markets.

Not escaping astute investors is that Emerging Markets are not only forecast to contributing superior growth, and that with often lower risk. And the trend should endure. GDP's of the seven largest Emerging Markets ('E7' = China, India, Brazil, Russia, Indonesia, Mexico & Turkey) are projected to be 25% bigger than the currently dominant G7 by 2050, or 75% bigger, based in Purchasing Power Parity. Emerging Markets are an opportunity long-term investors cannot afford to miss.

World inflation is expected to be manageable for at least our tactical horizon, but is percolating regionally. Inflationary pressures are most subdued in USA and Japan, rising moderately across Europe but are increasingly broad-based and demand-pushed in Emerging Markets.

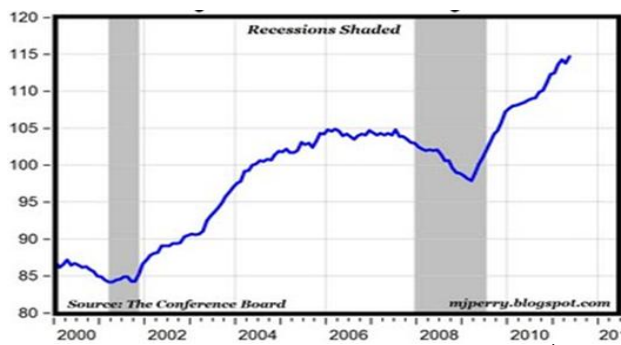
**Global Inflation – year-on-year, % CPI increase**



Source: IMF WEO, June 2011

Completion of the USA’s second round of Quantitative Easing (QEII) has been well signalled and should be fully priced into markets. Countering alarmists is that systematic Leading Economic indicators for USA portray rising growth and prosperity ahead, for the Developed World’s flagship economy.

**US Leading Economic Index**



Source: Conference Board data reproduced in Carpe Diem, 17<sup>th</sup> June

While in flagship USA, political posturing ahead of scheduled elections, including Presidential, in November 2012, largely ensures no change of the hefty fiscal stimulus now operating. That stimulus is expected to remain in place throughout our tactical horizon. 2011 has yet to extent the tradition of the third year of the Presidential cycle being kind to investors.

**Presidential Cycles - Influence on USA Share markets**

	MEDIAN % CHANGE IN S&P 500	PERCENTAGE OF DOWN YEARS
YEAR 1 OF TERM	5.0	44%
YEAR 2 OF TERM	6.9	38%
YEAR 3 OF TERM	18.9	0%
YEAR 4 OF TERM	9.0	20%

Source: BCA Research. Data 1949 to 2010

In summary, medium and long-term investors should find comfort that the overall economic situation augurs for 2011 being a good year. Further, *Diversified* finds the probability to be that the current soft patch is a temporary one, most likely to give way to buoyant growth resuming – and that maybe imminent.

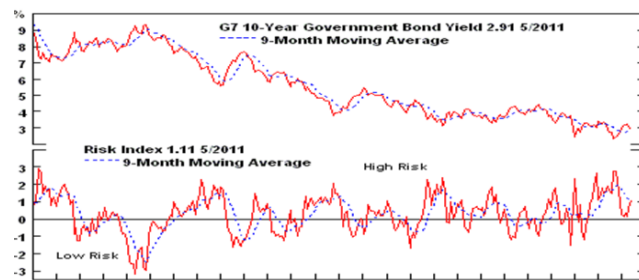
*Diversified* advocates an asset allocation standing to benefit from the strong growth, should be maintained. Shorter-term trading opportunities are delegated as the domain of active fund managers engaged in portfolios.

**Fixed Interest – Bonds Remain Risky**

Peripheral Europe is already wrestling to service its debt even at historically low rates of interest. Insolvencies are likely to intensify and the number of defaults (“restructurings”) to widen, as more normal rates of interest inevitably re-assert.

Sovereign Fixed Interest risks have latterly abated, but remain firmly on the riskier side of neutral. Meanwhile, yields are near historic lows, with little or no accommodation for risks rising.

**Global Fixed Interest Risk Index -**



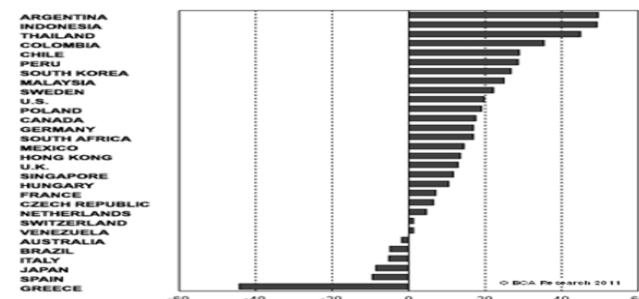
Source: BCA Research Fixed-Income Chartbook, Updated June 1<sup>st</sup> 2011

In general, *Diversified* advocates Fixed Interest holdings are limited to high-quality, investment-grade and readily liquid issues. Core to that belief is that the primarily purpose of including this asset class is diversification. Investor’s finite risk budget is better rewarded in growth assets. Our recently completed strategy review confirmed a minimal weighting to the Fixed interest Asset Class, supplemented by a variety of other diversification techniques.

**Equities – Outlook favours Growth**

To keep the recent Equity Market dip in perspective, a main event of the year has been very powerful and pervasive share market rally, most everywhere. 2011 has extended the rebound since the depths of the Great Financial Crisis - in local currencies terms, at least.

**Year-to-Date Share market Returns – in local currencies,**

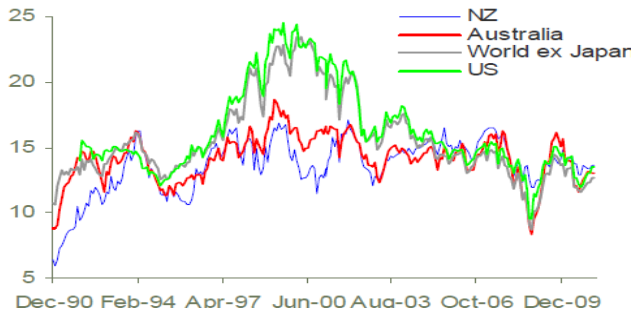


Source: BCA Research On-line Chartbook. Data to June 1st 29<sup>th</sup>

*Diversified* gauges the global rally in the Equities asset class is intact and is destined to resume, maybe as soon as the second half of 2011.

Despite the powerful advances since the depth of the GFC, commensurate earnings growth leaves equity valuations still not stretched.

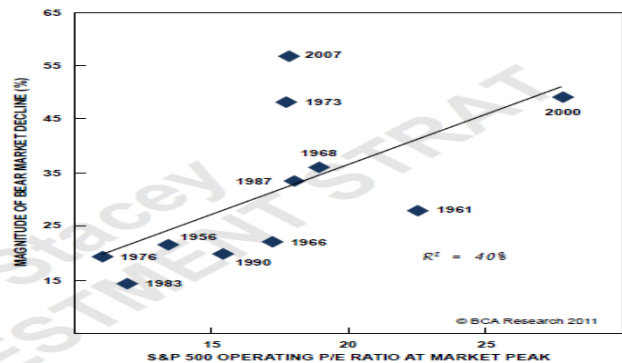
**Selected Markets, Price-to-Earnings Multiples Valuation**



Source: First NZ Capital, NZ Asset Allocation, May 2011

While Price-to-Earnings ratios have poor predictive value in signalling the onset of a bear market, they do provide a useful measure of potential risk of loss. Again using USA as example, history shows that share markets seldom dip by more than 10% or 15%, from PE ratios at levels of those prevailing.

**PE's Signal Low Risk in Current Share market**



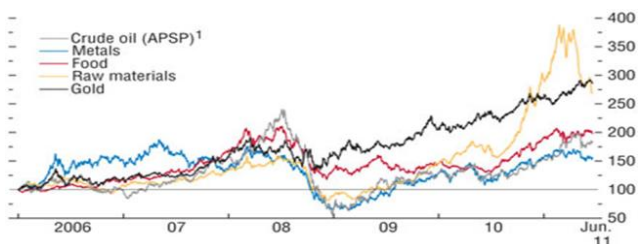
Source: BCA Research Special report, April 6th, 2011.

*Diversified's* formal strategy review confirmed a full weighting to Equities as an asset class. The allocation to the NZ sector has been raised. Holdings include direct shares, Exchange Traded Funds and active Fund Managers, in accordance with our process.

**Commodities – Selectively attractive**

Again - beyond the current soft patch currently preoccupying sentiment - the global economic backdrop supports continuation of strong commodity prices.

**. Selected Commodity Price Indices**



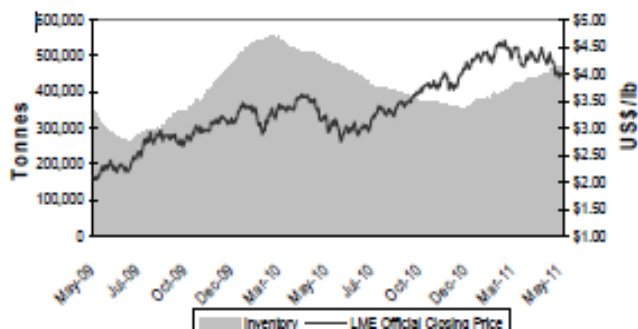
Source: IMF WEO, June 17<sup>th</sup>, 2011

Most commodity prices have enjoyed a continuous advance over an extended period commencing in late 2008. At this

juncture, *Diversified* prefers ownership in the Shares of commodity producers. Good earnings stand to be captured from prices at or near those current, even in the absence of further absolute advances.

Copper or 'Dr Copper' as it is often referred to, is the metal with a PhD in macro-economics. The price of copper has historically turning down sharply, imminent to economic downturns, to the point the copper markets are regarded as an economic harbinger. Currently copper markets are comforting; with its price remaining above US\$4/lb. Current copper prices confirm our view that current financial market malaise is more likely a soft patch, than the onset of something more serious.

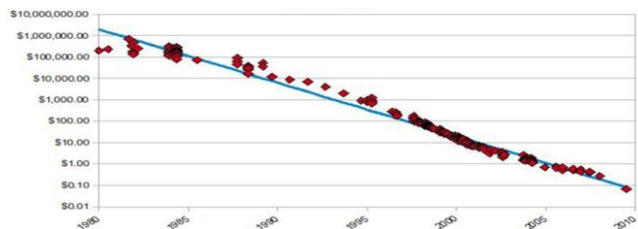
**Dr Copper- Price & Inventory**



Source: Salman Partners, Metal Morning Note, June 20<sup>th</sup>, 2011

Physical commodities differ manifestly from technological commodities – a fact which should not be lost of keeners for the Initial Primary Offering (IPO) of Facebook. Computer memory was once a proprietary gem too. Salutory is the 1,500,000-fold reduction in the cost of computer memory over the past 30 years. Hard disk space has declined from US\$100,000 per gigabyte in 1980, to US\$0.07 by 2009.

**Hard Drive Cost per Gigabyte, 1980 - 2009**



Source: Carpe Diem, 11<sup>th</sup> June, 2011

*Diversified's* models currently include an allocation to physical commodities, and their producers. We are happy to relegate Technology selections to better resourced, generalists.

**Currency – Hey, we got that wrong!**

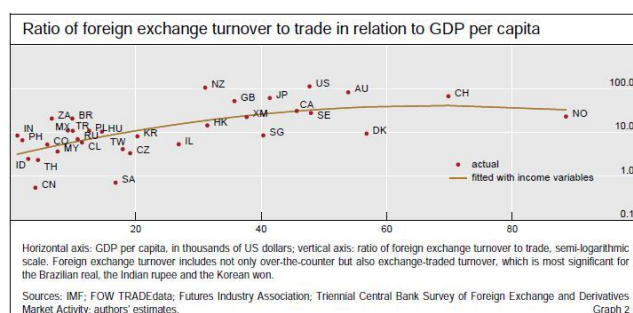
Undeniably, the powerful sharp rally by our NZ dollar's exchange rate over the past Quarter and month caught *Diversified's* model strategies poorly prepared. Holdings denominated in either of Australian Dollars or US dollars, were set-back by the extent of the currency gain, when reported in NZ\$.

### The NZ\$ Spike – Month & Quarter to 31<sup>st</sup> May, 2011

	Quarter	Month
US\$	+9.4%	+2.1%
A\$	+4.2%	+4.8%
GBP	+7.6%	+3.0%

Source: Selected data from FundSource, rounded

One challenge in managing the NZ dollar's exchange rate is that there are short and long-term imperatives, and that these often conflict. In the short-term, sentiment rules and NZ is a price-taker, captive of foreign trader's whimsy – either seeking exposure to our unit, or simply to avoid other currencies. Volatility can be very high, as the NZ\$ being amongst the most traded currencies in the world, and the most greatly traded in proportion to its float – reflected in New Zealand's Trade, and GDP per Capita below.



Source: Fore Blog, April 9<sup>th</sup>, 2011

In the medium and longer-term traders' fickle favour waxes and wanes, resulting in our NZ\$ exchange rate to oscillate around 'fair value'. The average value of the NZ\$ will be influenced by economic fundamentals over the medium and longer term.

*Diversified* is a fundamental house. Research focuses on macro-economic drivers, and on a one-year to 18-month tactical horizon for positioning investments. Try as we may, short-term exchange-rate volatility is to us unfathomable.

In the absence of strong conviction, *Diversified's* process continues to find diversification of currencies to be the least risk course for medium and long-term investors. We concede that when the NZ\$ spikes upward, holding a spread of major world currencies is less rewarded than peers choosing to concentrate their currency risks in NZ\$ through hedging to it. Such periods should be transitory. Again, we are indebted to folks at ANZ Research for currency cross-rate predictions.

### NZ\$ Exchange Rate Forecasts - Month-end

	June 2011	March 2012	Dec.2012
US\$	0.80	0.74	0.70
A\$	0.75	0.73	0.73
Euro	0.57	0.56	0.52
GBP (£)	0.50	0.47	0.45
Japan ¥	68.0	66.6	66.5
NZ\$ TWI	70.2	67.0	64.4

Source: ANZ Market Focus, 13 June, 2011

## Salient Rates, Indices, & Exchange Rates

Following are the Mat 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.

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

### ACTUAL

Salient Rates, Indices & Exch Rates	Current	3 Mths Ago	6 Mths Ago	2 Mths Ago	2 Yrs Ago	3 Yrs Ago
Prevailing Monetary Conditions Index	516	337	506	332	-227	1185
Prevailing 2011 NZ Gov't Stock Yield - p.a	2.61%	2.86%	3.47%	3.67%	3.56%	6.64%
Prevailing NZ Cash Rate (90-day) - p.a	2.69%	2.86%	3.20%	2.93%	2.78%	8.73%
Prevailing 2015 NZ Gov't Stock Yield - p.a	4.11%	4.35%	4.79%	4.88%	5.19%	6.48%
Prevailing 2016 NZ Gov't Inf. Ind. Yield - p.a	2.23%	2.33%	0.00%	0.00%	0.00%	0.00%
Prevailing 2021 NZ Gov't Stock Yield - p.a	5.10%	5.59%	0.00%	0.00%	0.00%	0.00%

### CHANGE

Salient Rates, Indices & Exch Rates	3 Mths Ago	6 Mths Ago	12 Mths Ago	2 Yrs Ago	3 Yrs Ago	5 Years Ago
Crude Oil (WTI, US\$/bbl)	7.02%	19.83%	38.21%	54.20%	-21.93%	43.17%
Dow Jones (USA)	4.24%	14.21%	25.40%	47.87%	-0.60%	12.55%
FTSE 100 (UK)	-0.07%	8.35%	16.01%	35.58%	-1.29%	4.65%
Gold (US\$/f.oz., troy)	8.70%	10.92%	27.71%	57.58%	73.94%	138.79%
Hang Seng (Hong Kong)	2.12%	2.94%	20.52%	31.21%	-3.41%	49.35%
MSCI World Index (Capital)	0.19%	13.49%	25.45%	39.65%	-11.22%	2.45%
NASDAQ COMP	2.06%	13.49%	25.62%	55.05%	12.39%	30.13%
Nikkei DJ (Japan)	-9.25%	-3.05%	-1.38%	1.17%	-32.80%	-38.25%
NZD/AUD	4.46%	-0.48%	-3.62%	-3.67%	-5.67%	-8.48%
NZD/JPY	9.29%	7.36%	8.68%	6.69%	-18.93%	-6.10%
NZD/USD	9.70%	10.35%	21.56%	26.69%	5.13%	29.99%
NZSCI (Gross)	-0.41%	4.11%	10.78%	22.12%	-5.13%	-0.16%
NZX NZ Gov't Stock (Gross Returns Index)	2.58%	4.93%	9.31%	14.42%	27.59%	40.19%
NZX50 (Gross)	5.26%	8.66%	15.87%	28.34%	-2.11%	-1.92%
S&P/ASX200 (Australian)	-2.53%	0.69%	6.29%	20.90%	-16.74%	-6.60%
TRADE WEIGHTED INDEX (TWI)	6.98%	4.68%	7.22%	18.86%	1.98%	12.61%

NORMAN W. STACEY, INVESTMENT ANALYST