



Diversified's View

February 2011

Diversified's Process

Diversified's proprietary strategies have been operating successfully for 17 years - following development in the decade prior to that.

Precisely the same process is applied to our PIE Funds, to the Law Retirement KiwiSaver Scheme, and to our Private Client portfolios.

Key steps include:

- 1) At core is ensuring diversification in accordance with Modern Portfolio Theory; the sole defence against the unknowable upset.
- 2) Independent, and fundamental analysis of the economic settings and outlooks is conducted.
- 3) Historic comparisons & our experience are used to gauge sector over-, or under-valuations.
- 4) Asset Allocations are then formulated with a one-year to 18-month horizon, formally reviewed quarterly.
- 5) Investments are analysed in-house, selecting from the widest universe on which good research can be maintained, irrespective of listed or unlisted status, NZ or international domicile.

Investment excellence drives

Diversified's process. Our selection of holdings is entirely free from conflict, and any may be sold without fear or favour. Diversified has no bias or requirement to use any product, tolerates no quota's and has absolutely no allegiance to any suppliers.

Summary

- Successful reflation and a robust aggregate pace of economic growth have established. But this is now the mainstream view and is mostly in-the-market.
- Investor's & Institutional risk aversion is fading rapidly. Growth asset classes are favoured recipients of weight-of-money – From Cash and Bonds to Equities and Commodities. But the first, easiest and safest fillip has been had – & captured by positioned investors.
- The cost of capital is on the rise. Official Cash Rates will lift toward neutral within our tactical horizon. Market & popular forces will also pressure politicians for unsustainable budgets.
- Conventional Bonds capital values are destined to fall. Leveraged assets such as Private Equity, Property and gearing infrastructure funds face headwinds. Some will not survive.
- Leading Emerging Markets are knocking on limits of growth. Inflation is rising, along with Cash Rates to combat it - but high growth is expected to persist.
- The pace of growth in the USA may surprise on the upside.
- Following their heady run, Emerging Markets and key commodities may take a breather for a quarter, or so, but will most likely be higher over our one-year to 18-month tactical horizon.
- Diversified's first formal strategy review of 2011 is currently in progress. The macro-economic setting gives cause for investor optimism.
- As ever, the future is never entirely 'knowable'. Systematic diversification remains the basis of model strategies.

Norman W. Stacey (nstacey@diversified.co.nz)

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

Expertise You Can Trust

New Zealand – ‘Value’ has arrived

One consequence of New Zealand's niggardly growth and lagging markets – especially by soaring trans-Tasman and Asian comparison – is that comparative value is now emerging. Economic growth is more easily achieved from a lower denominator; and both NZ's Bond and Share markets have been spared the excesses which may be lurking elsewhere.

The strong external environment supports NZ trade. Global growth is finally extending to demand for the commodities NZ traditionally produces. And burgeoning numbers are sufficiently affluent to pay for them.

Rising Commodity Prices – sub-groups (in NZ\$)



Source: ANZ Commodity Price Index, 31 Jan., 2011

Simultaneously, and helpful in the long-run, the quality of New Zealanders' collective investing may be improving. Kiwi's long addiction to less productive asset sectors - notably housing - may be on the wane.

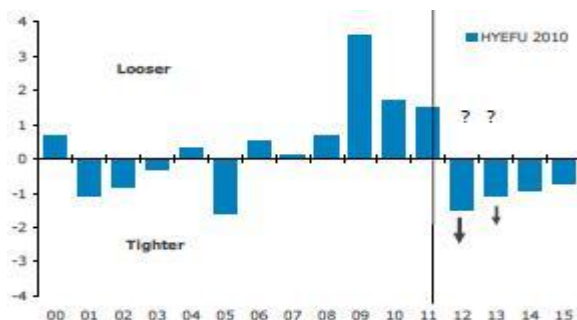
NZ Median House Prices – tapering since mid-2007



Source: BNZ Weekly Overview. Feb., 17th, 2011

NZ's Budget due on May 19th will be closely watched to determine whether government walks the talk in this election year. Recognition that NZ's size of government at 41.6% of GDP is excessive, unchecked and ultimately unaffordable, would welcome greater investment. Most all facets of government – national, regional and local – have in recent years expanded manifestly. With NZ's national deficits running at \$300 million per week and more locally, a trigger for fiscal prudence may be forming.

Budget's Fiscal Impulse - % of GDP (June Yrs)



Source: ANZ Market Focus, 14 Feb., 2011

NZ's economic outlook is rosier than at most any time recently. The build-up to, and pulse from, hosting of the Rugby World Cup (Sept. 9th through Oct. 23rd), should give Kiwi's a taste of economic growth rate routinely experienced by "high-growth" destinations – at least fleetingly.

NZ's inflationary 'blip' attributable to October 2010's GST increase is projected to pass without excessive flow-on damage. Unemployment is destined to taper, while exports will serve to subdue the Current Account Deficit at more manageable levels than in recent years.

Key Economic Projections – Calendar year

	June 11	Dec 2011	June 2012
GDP % yoy	+2.2	+5.1	+3.7
Inflation (CPI) yoy	5.3	3.1	2.5
Unemployment	6.4	5.8	5.6
Curr.Acct (%GDP)	-2.0	-2.3	-2.1
90-Day BB % p.a.	3.7	4.0	4.5

Source: ANZ Market Focus, 14 Feb, 2011

Interest rates will go up. In common with most western nations, NZ's Cash Rates are set to rise. Analysts are in agreement over the trend, throughout our tactical horizon and beyond, quibbling only over the pace and exact timing. At least in the early stages, higher Cash Rates are a positive in signalling higher growth rates.

NZ 90-Day Rate Forecasts

	RBNZ	FNZC*	Futures implied
March 11	3.3%	3.3%	3.2%
March 12	3.9%	4.3%	4.1%
March 13	4.4%	4.5%	4.6%

Source: Data excerpted from First NZ Capital, 3 Feb., 2011

Diversified's process regards NZ as part of an Australasian 'home country' allocation. Within that category, NZ is likely to receive greater attention ahead, than the minimal level that has characterized trans-Tasman operators in recent years.

Australia – From 'Lucky' to 'Battler'?

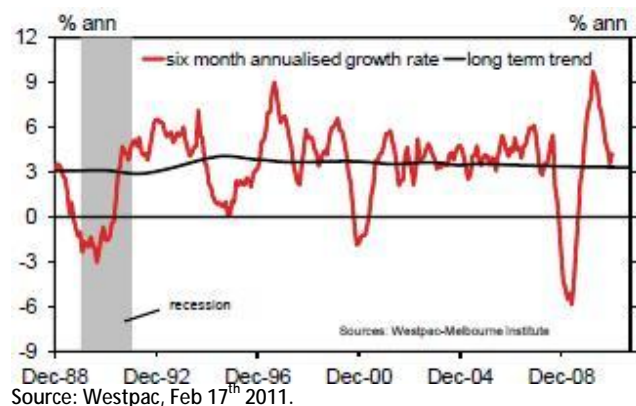
It seems a little unfair to refer to Australia as 'The Lucky Country' in the context of its string of natural disasters of recent.

Preliminary estimates are that flooding in the East has reduced agricultural production by A\$500-600 million, and coal exports by A\$2 – 2.5 billion. Gross Domestic Product may even contract (by perhaps -0.1%) in the first Quarter of 2011. The extent of the

setback will be more fully assessed in ABARES' premiere national forecast due on March 1st & 2nd. Fortunately, higher global prices as a consequence of supplies lost, serves to ameliorate the direct monetary loss (in aggregate if not for individuals).

But however personally devastating, Western bushfires, Victorian floods, Queensland's cyclonic travails and even shark attacks are all temporary. Australia's developed resource base, and its proximity to high-growth Asia, are indelible. As if to signal the worst has passed, Leading Economic Indicators recently up-ticked, consistent with a 4.2% pace of GDP growth in six months.

Westpac/Melbourne Inst. Leading Index (@Dec 31)



In summary, Australia's 'Lucky' status remains intact. Setbacks attributable to La Ninja are transient, with economic impact falling mostly in a single quarter. Over the medium and longer-term, growth is projected to resume at a pace requiring their Reserve Bank to again raise its Cash Rate vigilance.

Key Economic Forecasts - Australia

	First Q 2011	Calendar 2011	Calendar 2012
GDP %	-0.1%/Q	3.2%y-on-y	4.0
Inflation (CPI)	1.7%/Q	3.2	3.2
Unemployment	5.1	4.9	4.6
Cash Rate	4.75	5.00 (Dec)	5.25 (Mar)

Source: Westpac Weekly, 14 Jan., 2011

Diversified's research continues to find opportunities in Australia, but also recognizes the investment destination as now very crowded. Impressive growth and further resource price-gains are broadly assumed, and therefore vulnerable to setbacks, or even prevarications, in Asia.

International - Robust Growth ahead

The bottom line is that robust economic growth in aggregate is now expected to have positive contributions from most everywhere. Emerging Economies are projected to expand their economies, on average, at a rate more than double that of the Developed World. Further, the climate of prosperity is projected to envelope even the serial laggards, like sub-Saharan Africa.

GDP Growth - Robust Pace for 2011 & 2012

Region/Country	2011 % p.a.	2012 % p.a.
Developed World	+2.5	+2.5
- USA	+3.0	+2.7
- Euro Zone	+1.5	+1.7

- Germany	+2.2	+2.0
- UK	+2.0	+2.3
- Japan	+1.6	+1.8
Newly Industrialized Asia	+4.7	+4.3
Emerging World	+6.5	+6.5
- Latin America	+4.3	+4.1
- Russia	+4.5	+4.4
- India	+8.4	+8.0
- China	+9.6	+9.5
ASEAN 5	+5.5	+5.7
Sub-Saharan Africa	+5.5	+5.8
Aggregate World Growth	+4.4	+4.5

Source: IMF WEO Jan 25th, 2011

While so many eyes – and investment dollars - are mesmerised by newly Emerging Countries, *Diversified* also finds particular promise in the American economy. Our research is supported by leading economic indicators (a compilation of economic measures designed to foretell economic trends in six to nine months ahead). US LEI's have impressive historic accuracy of signalling downturn or upturns well ahead of actual (measured by coincident economic indicators). Currently, LEI's are signalling re-acceleration ahead.

US Economy to Re-accelerate?



Beyond the somewhat disturbing spike in Food Prices, inflation is on the rise, but perceived to be at manageable levels in most places. Fortunately, Food Prices are more responsive than most other commodities to supply signals, and the current spike could abate within our tactical horizon. But supply and demand for Food is in close balance, with little contingency should a major upset or crop failure occur.

Core Inflation - excl. energy & Food (% p.a. change)



The global setting of robust global economic expansion particularly favours the growth asset classes. *Diversified's* strategy review is expected to continue its tactical bias to the Equity and Commodity asset classes, but with considerable fine-tuning.

Fixed Interest – Bonds are Risky

At this point, *Diversified* has a high conviction that the cost-of-capital - Cash Rates, Bond Yields and competition - are set to rise, and likely to rise materially, over our tactical horizon.

Common wisdom is that Bonds or Cash represent safety. Throughout 2008, through the latter part of 2010 (in a context of financial turmoil, the great recession, and the fear of a double-dip or worse), institutional and retail investors piled into these asset classes. Wealth preservation was the investors sole priority, even at the derisory or zero income afforded.

The world has moved on, fears have abated and all drivers of that excess have reversed. Investors again seek growth. The legacy is of Official Cash Rates at historic lows, quantitative easing suppressing Bond yields, and the severely indebted western nations crowding into Bond markets to cover their gaping budget deficits.

Bond Yields began rising in September 2010, are still rising and will rise further. Fair value for 10-year Bond yields has traditionally been considered to be around GDP growth plus the rate of inflation. Finer points include each country's credit rating and, minor historic variances. Bond yields are still anomalously low; ergo, Bonds capital values are overly expensive.

Bond-Yields' Fair Value

Country	US	Euro	UK	Jap	GEM	NZ*
Current Bond Yield	3.7%	3.2%	3.9%	1.3%	6.2%	5.6%
Est. Fair Value	5.6%	4.3%	4.5%	3.5%	7.3%	6.0%
Yield hike looming	1.9%	1.0%	0.6%	2.2%	1.1%	0.4%

Source: Data after FNZC Global Equity Strategy, Feb 10th, 2011. * NZ = *Diversified's* estimate. GEM = Global emerging Markets.

As a rule-of-thumb, each 1% hike in the yield of a 10-year bond an investor might be holding will cost them about 7.4% of their capital. In terms of risk of loss to investor's capital, NZ Government bonds look to be the best of a bad bunch.

What's coming?

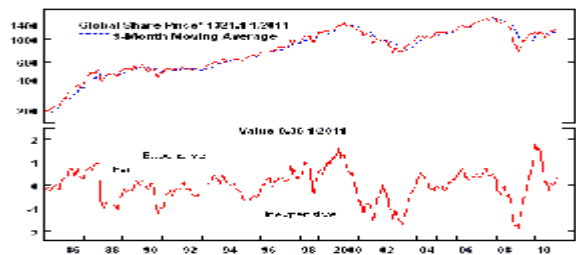
- 1) Losses on Global Bond Portfolios – maybe in the range of 10% - are conceivable when yields trend up to Fair value.
- 2) Most all leveraged investments, investment styles founded on cheap capital for gearing, and asset classes which rely on borrowing to gear underlying earnings – are at risk.

Diversified's strategy review is analysing the ramifications which the Basel III accord may have on selected 'Perpetual' issues. It is likely to confirm our current, tactical short position on conventional global bonds.

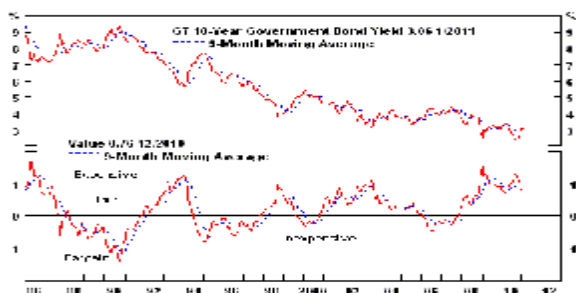
Equities – Bull Market Intact

Irrespective of the rising consensus for a promising global economic outlook, our research sources find global Equities are not yet over-valued.

Equities globally are not yet expensive...



... & especially relative to Bonds



Source of both above: BCA Chartbook, Data to Feb 1st 2011.

Tactically, we now find the US share market overdue for a period of catch-up, perhaps triggered by growth exceeding consensus estimates. Indeed, the US share markets have begun 2011 by out-performed Emerging Markets. We expect they may continue to do so for awhile yet.

US S&P 500 (Blue), vs. Emerging Markets (Green) – 6 Mths



Source: CNN/Money, using SPY and EEM index-trackers as proxies.

Given their higher rates of economic growth, sounder national balance sheets, superior returns-on-equity and under-valued currencies, the higher growth of Emerging Markets will reassert on a medium & longer-term basis. On a price-to earnings ratios, Emerging Market's could readily justify trading at 25% premium to US or Euro share markets.

From simply needing to be in Emerging Markets to boost Global Equities' returns in the past decade, it is probable that the selection or omission of specific emerging regions or countries will have a greater bearing on achieving superior returns ahead.

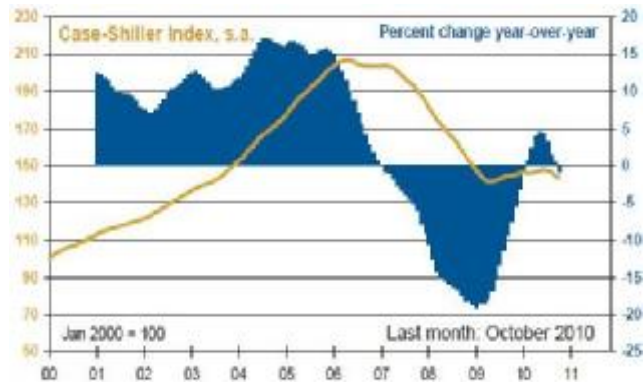
An 18th century Rothschild is credited with saying, "The time to buy is when there is blood in the streets". If so, then North Africa is screaming 'BUY' now. (Disclaimer: *Diversified's* Dynamic Fund is currently contemplating a prospect for gold-in-Egypt).

Diversified formal strategy review is underway and is expected to confirm Equities as the most favoured Asset Class in the current economic environment.

Property

Property features prominently as a class facing head-winds from rising interest rates (with 'property developers', leveraged buy-outs, geared Private Equity, low equity infrastructure funds etc). With the passage of cheap capital, the risk of a 'double-dip' downturn in the US housing market cannot be over-looked.

Case-Schiller Home-Price Index (USA)



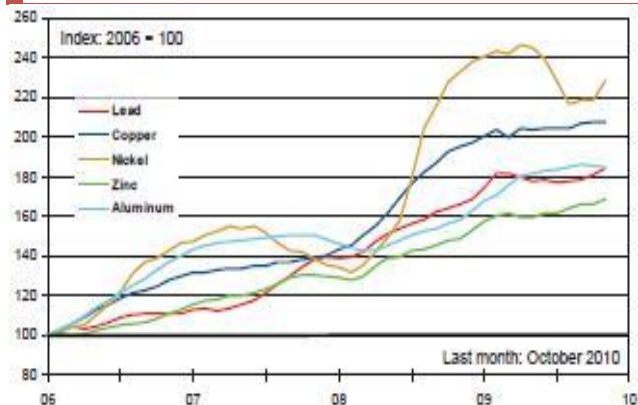
Source: Dundee Wealth Mgmt, Economic Monitor, Jan 21, 2011.

Diversified's model strategies have for some time advocated only minimal weighting to Property as an investment asset class.

Commodities – Super-cycle intact

Many Prices have risen fast and furiously, with the Commodity Super-cycle broadening steadily to envelope most materials. Looking ahead, demand is likely to remain buoyant as Developed World demand joins that of still expanding Emerging Markets. However prices are already heady and global stocks are responding.

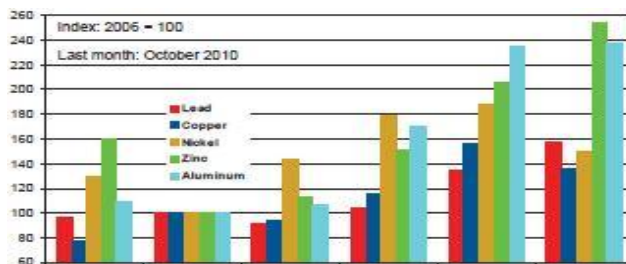
China's Demand for Industrial Metals



Source: Dundee Wealth Mgmt, Economic Monitor, Jan 21, 2011.

But supplies are keeping pace.

Selected Global Commodity Supply Response



Source: Dundee Wealth Mgmt, Economic Monitor, Jan 21, 2011.

In the absence of a supply upset, Diversified believes the greater probability is of Commodities generally, remaining in high demand supporting high prices compared to recent history. Noteworthy for investors, is that even without further price escalation, most suppliers are enjoying high margins and very good earnings.

Diversified's model strategies favour investing through Equities in producers of Energy, Metals and Hard Commodities. On balance, we gauge most commodity prices – energy, base-metals, agriculture - are most likely to be higher (perhaps by 10% to 15%), in one-year to 18 months hence. **Gold:** Clearly the original 2004 impetus on which Diversified advocated an allocation to gold bullion – the perceived threat to the global financial system – has ebbed. But concurrently, China has developed an investment appetite for gold as an asset class, generating an entirely new demand rivalling the traditional champion, India. China produced 340 tonnes of gold domestically in 2010, and imported about another 350 tonnes. The Chinese people's memory easily extends back to 1948, when hundreds of millions of its most prudent citizens were ripped off, holding worthless Nationalist banknotes, purportedly convertible into gold.

Diversified's is currently reviewing the rationale for gold and its optimal allocation as a facet of its formal strategy review.

Currency – the kiwi an awkward flyer

Buffeted by world events and price-taker of foreign-buyer's whimsies, our kiwi dollars' monthly range has been heightened over the past few months.

Notwithstanding its less-than-helpful (to portfolio valuation of offshore holdings) exchange rate at the end of last month, Diversified continues to believe that currency risk is generally best diversified. Sure, short-term returns may lag those of hedged funds during those periods when the kiwi rises precipitously, but unhedged gains are restored when our volatile domestic unit wanes – and the whole is achieved without undue NZ\$ risk.

NZ\$ Exchange Rate Forecasts - Month-end

	Mar 2011	Dec 2011	Sept 2012
US\$	0.73	0.74	0.71
A\$	0.73	0.74	0.75
Euro	0.56	0.57	0.53
GBP (£)	0.47	0.47	0.44
Japan ¥	62.1	66.6	67.5
NZ\$ TWI	66.4	67.7	65.4

Source: ANZ Market Focus, 14 February, 2011

Salient Rates, Indices, & Exchange Rates

Following are the January 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	31/01/11	3 Months	6 Months	One year ago
Prevailing Monetary Conditions Index.	+561	+396	+472	+217
Prevailing NZ Cash Rate (90-day)	3.21% pa	3.18% pa	3.28% pa	2.77% pa
Prevailing 2011 NZ Gov't Stock Yield	3.35% pa	3.53% pa	3.72% pa	3.99% pa
Prevailing 2015 NZ Gov't Stock Yield	4.53% pa	4.48% pa	4.68% pa	5.18% pa
Prevailing 2021 NZ Gov't stock Yield	5.50% pa	n.a.	n.a.	n.a.
CHANGE	Value	Gain or loss since...		
NZX NZ Gov't Stock [Bond] Index	1174.627	+0.5%	+2.1%	+7.0%
NZSE 50 (Gross)	3339.00	+1.0%	+10.0%	+5.5%
NZSCI (Gross)	21855.64	+4.9%	+10.2%	+3.2%
S&P/ASX200 (Australia) *	4754.00	+0.4%	+5.8%	+4.0%
MSCI World Index (Capital)*	1308.08	+7.0%	+16.3%	+16.8%
Dow Jones (USA) *	12040.00	+8.3%	+15.0%	+19.6%
NASDAQ*	2751.00	+9.7%	+22.0%	+28.1%
FTSE 100 (UK)	5958.00	+5.0%	+13.3%	+14.8%
Nikkei DJ (Japan) *	10238.11	+11.3%	+7.4%	.0%
Hang Seng (Hong Kong) *	23352.65	+1.1%	+11.0%	+15.6%
NZD/USD	0.77	+0.4%	+6.3%	+9.5%
NZD/AUD	0.77	-0.3%	-3.5%	-1.7%
NZD/JPY	63.33	+2.8%	+0.9%	0%
TWI	68.68	+2.6%	+1.6%	+6.2%
Gold (US\$ / oz., troy)	1,326.83	-2.4%	+12.9%	+22.2%
Crude Oil (WTI, US\$/bbl)	89.34	+9.7%	+14.1%	+21.3%

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

NORMAN W. STACEY, INVESTMENT ANALYST

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