

Diversified's View

January 2011

2012 - Year of the Water Dragon:

"Generally, there are more goodies in store for you in the year 2012 than 2011. It's a good year to improve oneself, take calculated investment risks and to build wealth." Feng Shui Horoscope Forecast. [For market timers, Chinese New Year starts Jan 23rd – Ed]

Diversified's investment strategies are available as:

- The Law Retirement Plan KiwiSaver Scheme;
- The Law Retirement Plan Superannuation Scheme;
- Diversified Wealth Management's 'Balanced' or 'Dynamic' PIE Funds;
- As Individually Managed Accounts for Private Clients.

DWM 'Balanced' Fund at 31st December was \$1.0324/ unit.

DWM 'Dynamic' Fund at 31st December was \$0.9052/ unit.

An Investment Statement is available at www.diversified.co.nz

Law Retirement KiwiSaver Scheme's Balanced Fund at 31st December was \$1.00756/unit.

Law Retirement KiwiSaver Scheme's Dynamic Fund at 31st December was \$0.96954/unit.

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

Summary

- *Diversified's* investment process has better results when financial markets are most influenced by fundamentals, than in emotional times.
- 2011 was swept by recurring fears that the world may be destined for another recession, or worse. But the USA economy did not enter a 'Double-Dip' recession and China did not suffer a 'Hard-Landing' economically.
- Sure, Europe is testing the boundaries of unlimited government, but that has been decades in the making. 'Crisis' debt levels are mostly manageable, but political will, to address the cause-excessive spending – or to tackle unfunded liabilities, is not yet evident.
- Importantly, global aggregate growth is intact, if a notch lower than was forecast one year ago.
- During 2011, Bonds blossomed while Equities eroded. We sense a reversal in 2012. There will be no shortage of Government bonds ahead.
- The NZ economy is resilient, blessed by remoteness from 2011's trouble spots. Currency is a commercial and investment hazard, jerked around by global 'risk-on' or 'risk-off' vacillation.
- Corporations are the stand-out sector with generally sound balance sheets. Strong earnings and profitability should be underpinned by reasonable economic growth ahead. Equities are the preferred asset class.
- Commodity prices pulled back sharply in 2011. Many may have 'priced in' more sluggish global growth than now seems probable. Selected commodity producers are very profitable even at current prices.
- Emotive forces overwhelmed financial markets in 2011. Fickle sentiment triggering big rallies or falls, often on successive days. *Diversified* expects fundamental forces most likely to reassert as 2012 unfolds.

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Disclaimer

Diversified's View is an economic commentary of a general nature. It is not intended to be personal investment advice and does not consider any individual's circumstances. Retail Investors contemplating an investment should consult a government Authorized Financial Adviser.

Expertise You Can Trust

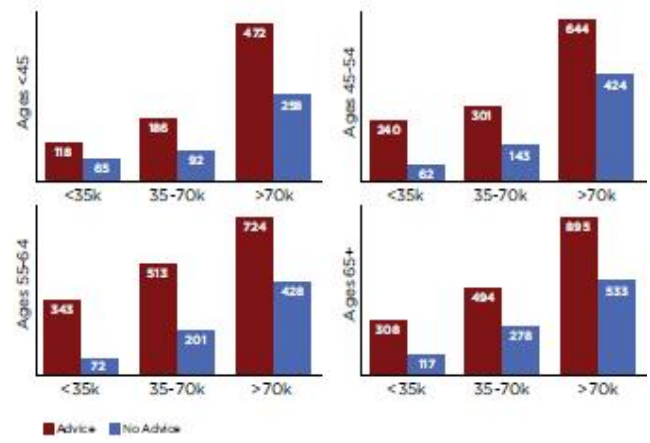
Diversified Investment Strategies Limited

www.diversified.co.nz

Advice or Wealth- which came first?

A Canadian study demonstrates convincingly that investors who work with financial advisors have more wealth and investible assets on average, than those who do not.

Household Average Net Worth - by Age Group and Income Range



Perhaps most heartening, is that Advisors are perceived by investors to have materially greater worth during more challenging years - such as was 2011.

Attitudes about the Yr 2011 (grn), 2009 and 2007 (purple)



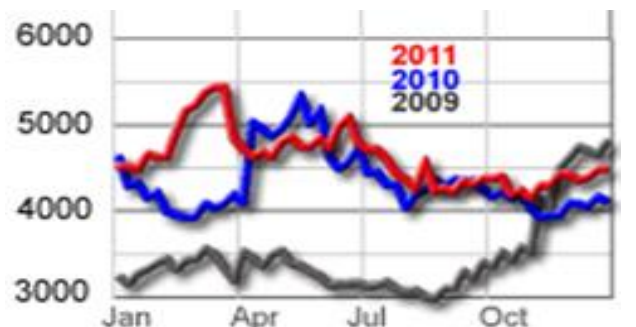
2011 Green, 2009 Mustard and 2007 Purple.

Note* 'Value of Advice Report', Nov., 2011, The Investment Funds Institute of Canada.
<https://www.ific.ca/Content/Document.aspx?id=6921>

New Zealand – Resilient

New Zealand's key dairy industry is enjoying a 'sweet spot': good prices simultaneously with high production. The La Nina weather pattern [Forecast in *Diversified's* View of Sept 2011, "For the NZ summer, La Nina augurs for warmer than normal temperatures, more northeast winds, and higher rainfall in the northeast parts of particularly the North Island, offset by drought in south and southwest South Island"], has boosted grass growth, lifting dairy production by maybe 5%. Fonterra's latest auction reversed an earlier dip with a 1.5% price-increase on good volume. The co-op is now forecasting \$6.90 to \$7.00 per kg on milksolids for the 2011/12 season gain.

Skim Milk Powder Prices – NZ\$/tonne



Source: Interest.co.nz, January 2012

Elsewhere, the NZ economy is something of a patchwork, with most sectors viable if unexciting. House prices ticked up slightly in December, business confidence flinched as the situation in Europe weighed, but electronic retail sales remained buoyant @ 7% up over one year ago.

Debt levels remain a challenge. Even with good commodity markets, NZ's Current Account Deficit only reduced - to a still uncomfortable -4.3%, from a peak of -8.9%. Households have begun deleveraging but not aggressively, trimming debt to 144% of income from a peak 154% in 2008. It is government's turn to show leadership. Spending is excessive and only half the record deficit of 9.2% of GDP is attributable to Christchurch.

But reasonable economic growth it is, and it doesn't take much to be attractive in the Developed World's current context - for now. Meanwhile, inflation pressures are moderate allowing the Official Cash Rate to remain near the current 2.5% throughout a good portion of our one-year to 18 month, tactical horizon.

Key Economic Forecasts –annualized % change

	June 2012	June 2013	Dec 2013
Growth (GDP)	+2.1%	+3.3%	+2.9%
Inflation (CPI)	+2.0%	+2.6%	+2.7%
Unemployment	+6.2	+6.1%	+6.0%
Curr. Acct (% GDP)	-4.4%	-5.4%	-5.9%

Source: ANZ Economic Forecasts, 16 January, 2012

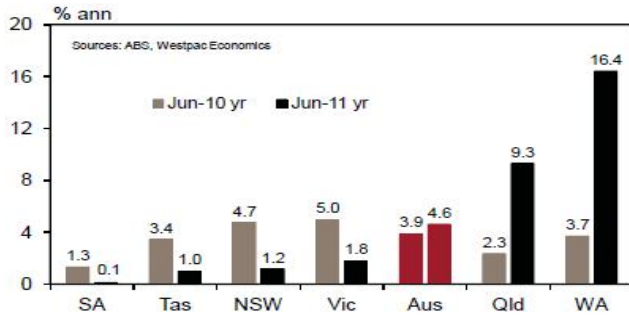
Diversified's model investment strategies currently advocate a slightly above neutral allocation to New Zealand assets.

Australia – Widely Divergent

Weak national employment post-Christmas suggest the Reserve Bank of Australia may cut its Official Cash Rate from 4.25% a couple more times - once perhaps as soon as February 7th.

There is wide disparity of economic growth between regions. The mining states – notably Queensland and Western Australia – accelerated through 2011 and continues to boom, with developments proceeding through recent resource price weakness, unabated. In contrast, economic growth in South Australia, NSW, Victoria and Tasmania slowed materially over 2011.

Growth – Regionally disparate



Source: Westpac Australia & NZ weekly, 17 Jan, 2012.

The worst may not be over in the already laggard south-eastern States. Permit activity indicates private sector construction is poised to drop by about 5% over 2012, coincident with the Federal Government's stimulative burst – which while lifting GDP by up to 1% (apparent as new school gymnasias everywhere) – is winding down. Patchy as it may be, Australia's overall economic outlook appears enviable in a Developed World context.

Key Economic Forecasts - calendar years

	2012	2013
GDP	3.0%	3.5%
CPI	3.3%	1.9%
Unemployment	5.6%	5.4%
Current Account (% GDP)	-4.5%	-3.3%

Source: Westpac Weekly Commentary, 16 Jan, 2012.

Australia's impressive economic expansionary cycle has been uninterrupted since early 1993. Their larger and more diverse economy, and access to different sectors, continues to warrant a significant allocation in model strategies.

International – Growth Pace Revised Down

Hardly of surprise to investors who experienced 2011, is that the World Bank has just revised downward its global growth outlook for 2012 – but only to a still respectable +3.4% GDP growth in 2012, and +4% in 2013 (on a Purchasing Power Parity basis). Only Europe is forecast to slip into a mild recession in 2012. Forecast Developed World growth is now 1.4% and 2.0% in 2012 and 2013 respectively, considerably out-performed by Emerging Economies' 5.7% and 6.2% expansions.

Selected Growth Forecasts - % of GDP, PPP adjusted

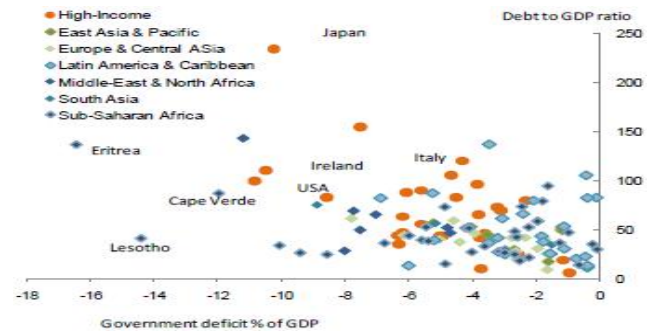
Country / Region	2012	2013
USA	+2.2%	+2.4%
Japan	+1.9%	+1.6%
Euro Area	-0.3%	+1.1%
China	+8.4%	+8.3%
Russia	+3.5%	+3.9%
India	+6.5%	+7.7%
Sub-Saharan Africa	+5.3%	+5.6%

Source: World Bank, Global Economic Prospects, January 2012

In accepting that there are downside risks, *Diversified* finds the above official expectations for regional and aggregate global growth, exceeds that which may be 'in-the-market'. Market surprises may be to the upside.

Notwithstanding the unsatisfactory investment returns in 2011, *Diversified* continues to find Emerging Economies present attractive opportunities. The region is underpinned by faster rates of growth, as well as presenting less risky national finances in many instances. Emerging Countries' generally have lower levels of accumulated debt as well as superior budget discipline. Debts and deficits generally cluster below those of many Developed World (aka 'High Income') nations.

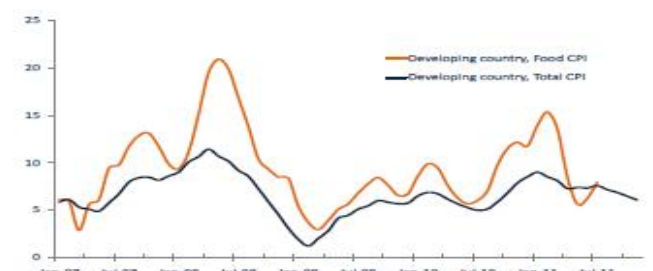
Government Debt as % of GDP



Source: World Bank, Global Economic Prospects, January 2012

Inflation has ceased to be of concern and should remain subdued most everywhere throughout our tactical horizon. A side-effect of slightly slower aggregate global pace, and of Europe's forecast recession, is that tightening measures which had begun in several Emerging Markets including China, can now be relaxed.

Total & Food Inflation (QTR over QTR annual comparison)



Source: World Bank, Global Economic Prospects, January 2012

The fundamental outlook for the global economy continues to be one of reasonable economic growth – a prospect considerably less grim than that which seemed to pervade the emotive markets of 2011. To achieve a good aggregate pace the world is heavily reliant on a dominant contribution from Emerging Economies, offset by a subdued Developed World.

Fixed Interest – Bags of Bonds available

Bond markets thrived in 2011, more than making up for their losses in 2010. Against our expectation, bonds proved to be the best asset class in 2011.

Total Return on 10-YR Gov't Bonds – in local currencies

10-Yr Bond Total Returns*	2011	2010
USA	+24.7%	-10.2%
Euro Area	+19.2%	-0.6%
UK	+25.4%	-4.8%
Japan	+6.3%	-0.7%

Source: Selected data from BCA Research January 2012

Yet a wall of bond issuance looms over 2012. In addition to US\$7.6 trillion of Government Bond issues maturing in 2012, Developed World deficits ensure a significant new supply will be sold.

G7 Government Bonds due in 2012(US\$)

Country	2012 Bond, (\$)	Coupon Payments
Japan	3,000 billion	117 billion
U.S.	2,783 billion	212 billion
Italy	428 billion	72 billion
France	367 billion	54 billion
Germany	285 billion	45 billion
Canada	221 billion	14 billion
Brazil	169 billion	31 billion
U.K.	165 billion	67 billion
China	121 billion	41 billion
India	57 billion	39 billion
Russia	13 billion	9 billion

Source: Jenkins & Worrachate, Bloomberg, Jan 4th, 2012.

Nevertheless, Funds Flow hugely favoured Bonds recently. The perceived 'safe haven' attraction of this asset class amidst the 'terrors' of 2011, was such that wealth drained from other asset classes. Using USA as example, US\$84.7 billion flowed from US Equity Funds and US\$100 billion from Money Market Funds in 2011, mostly to taxable Bond and Long-term Debt sector funds.

2011 Asset Class Fund Flow Trends – USA

Estimated Net Flows \$Mil	Dec. 2011	QTD	YTD
U.S. Stock	(17,742)	(44,409)	(84,692)
International Stock	(6,501)	(13,961)	473
Balanced	(1,101)	(9,666)	11,490
Taxable Bond	11,806	40,883	130,197
Municipal Bond	4,831	9,923	(11,984)
Alternative	(403)	1,703	12,189
Commodities	(734)	869	9,449
All Long Term	(9,844)	(14,659)	67,121
Money Market	36,182	61,893	(100,372)

Source: MorningStar Direct Fund Flow Update, January 2012

If risk-aversion fades in 2012 as we expect, this recent trend of Funds Flow to Bonds could well abate and eventually reverse. Other asset classes will be recipients.

In the normal course, one might expect heightened indebtedness and bond issuance to trigger higher yields. While that may eventually happen, bond markets are currently subject to powerful government manipulation. Official Cash Rates are being kept at extremely low rates, fostering the carry trade for banks who can capture the difference. Further, the US Federal Reserve Board's 'Operation Twist' deliberately applies that powerful institute's resources to suppressing bond yields. Central Banks in, UK and Europe are also actively manipulating bond markets. Risks inherent in bonds should now include the prospect of possible policy change, in addition to the normal ones of yield or of default.

Looking ahead, and although they have served well, the paltry yields now available from either of Cash or Sovereign Bonds, means these asset classes fail to provide adequate returns for Income Investors, and will be a drag on the long-run average rate-of-return expected from for diversified strategies.

Diversified regards Sovereign Bonds as being in a 'Bubble' entering 2012. [Professor James Tobin defines a Bubble as: "Speculations on the speculations of other speculators who are doing the same."]

Equities – Sound Value & Outlook

Across the USA, Australia, China, Europe, Japan and even NZ markets, ambitious company earnings came through largely as promised in 2011. Yet while consensus expectations were met or exceeded, market prices most everywhere nevertheless tumbled. Entering 2012, value of Equities is more compelling.

Selected Share market's Returns – in local currencies

MSCI Index Total Return	2011	2010
USA	+0.6%	+15.4%
Euro Area	-16.0%	+3.3%
UK	-4.5%	+12.2%
Japan	-19.9%	+0.7%
Emerging Asia	-19.6%	+19.4%
Latin America	-18.6%	+14.9%

Source: Selected data from BCA Research January 2012

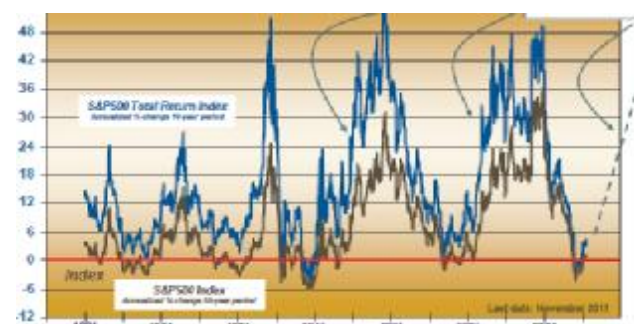
Uncomfortable as it was, and in our view more emotionally driven than fundamentally justified, the share market losses in 2011 were not of unusual magnitude by historic comparison. History demonstrates that loss years are frequently followed by years of impressive gain.

Dow 2011 Performance in Historic Context



One longer-term study finds major bull markets have commenced from similar circumstances. The study uses rolling, average 10-year returns on the bellwether US S&P 500 Index. The decade since 2001 has been pitiful for market returns. However such periods have historically been followed by very high average 10-year returns.

S&P 500 Index – Annualized % change over 10-yr periods



Diversified cautions that major turning points are almost never recognizable in advance – but the probability is favourable.

Our research finds the Equities Asset class is likely to outperform Bonds or Cash, over the course of our one-year to 18-month tactical horizon. Model strategies are arranged accordingly.

Commodities – Oversold?

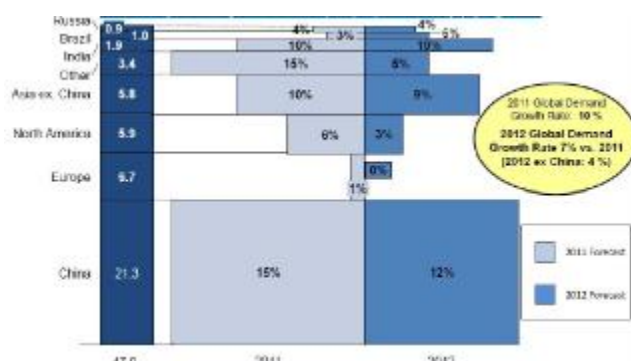
Amidst the recession fears which swept financial markets in 2011, commodities were perceived to be at great risk if global growth faltered. Commodity prices were sold off precipitously, and shares in commodity producers languished.

With official forecasts for growth now restated, and markets stabilized, the fears of 2011 appear overdone. Commodity markets may have been oversold.

A softer pace of global growth will require a more slowly rising, and increased demand for commodities – including agricultural products - rather than an absolute reduction.

Industrial Materials are an instructive market, with demand for Aluminium both readily tracked and symptomatic of broader trends. Alcoa forecast demand for primary aluminium in 2012 growing at +7%; only a slightly lesser than 2011's 10% pace. The graph below includes increased demand and contributions from most regions bar Europe.

Regional forecasts Al consumption, 2012 vs 2011



Source: Excerpted from Salman Partners Morning Note. Jan 10, 2012

Diversified concludes the grim assessment of future demand for commodities assumed during 2011 was excessively pessimistic. Model strategies retain allocations to commodity producer's shares.

Currency – NZ\$ a proxy for risk

A relationship has established in recent times whereby our NZ\$ appreciates strongly when concerns over global abate, and tumbles when global risks become topical, quite heedless of domestic parameters. Local currency forecasting is an exercise in predicting global risk sentiment.

Over 2011 as a whole, and accepting that it was very volatile over shorter periods, our NZ\$ exchange rate was surprisingly little changed overall (TWI-terms). Nevertheless, the weekly, monthly or quarterly increments can be a torrid journey.

NZ\$ Currency Change to end 2011

NZ\$ vs.	1 mth	1-yr	2-yrs	3-yrs	5yrs
A\$	-0.16%	-0.26%	-5.93%	-8.87%	-14.74%
€	+4.49%	+3.02%	+18.31%	+45.52%	+11.82%
H-K\$	+1.56%	-0.42%	+6.45%	+34.18%	+9.72%
¥	+0.56%	-5.25%	-11.03%	+14.81%	-28.55%
TWI	+0.59%	+1.18%	+6.03%	+24.50%	+0.12%
£	+2.56%	-0.08%	+11.21%	+25.98%	+39.435%
US\$	+1.79%	-0.36%	+6.27%	+33.88%	+9.83%

Source: Data modified from FundSource Data

Looking ahead, we are indebted to the heroic folks at ANZ for their forecasts of what the NZ dollar will be worth ahead:

Key Currency Forecasts

Currency	June '12	Dec '12	June '13
NZ\$/US\$	0.83	0.89	0.90
NZ\$/A\$	0.79	0.81	0.82
NZ\$/euro	0.59	0.61	0.62
NZ\$/¥	59.8	64.1	63.0
NZ\$/GB£	0.52	0.55	0.55
TWI	71.3	74.8	75.4

Sources: ANZ Market Focus, 16 January, 2012.

Coincidentally, the NZ\$ is currently on a par with the Singapore dollar.

The neutral stance for *Diversified's* model strategies is to hold unhedged positions in major world currencies arising from asset allocation. Portfolio performance reported in NZ\$ may appear volatile over from quarter-to-quarter, but even out over time. Meanwhile, investors are not excessively exposed to NZ dollar risk.

Salient Rates, Indices, & Exchange Rates

Following are the December 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	1 Mth	3 Mths Ago	6 Mths Ago	12 Mths Ago	2 Yrs Ago	3 Yrs Ago	5 Yrs Ago
Prevailing Monetary Conditions Index	515	416	532	616	543	264	-229	1052
Prevailing NZ Cash Rate (90-day) - p.a	2.68%	2.73%	2.86%	2.61%	3.18%	2.80%	5.10%	7.74%
Prevailing 2015 NZ Govt Stock Yield - p.a	2.72%	2.86%	3.35%	3.06%	4.71%	5.49%	4.51%	0.00%
Prevailing 2016 NZ Govt Inf. Ind. Yield - p.a	1.05%	1.05%	0.99%	1.67%	0.00%	0.00%	0.00%	0.00%
Prevailing 2021 NZ Govt Stock Yield - p.a	3.79%	4.05%	4.46%	5.10%	5.82%	0.00%	0.00%	0.00%

CHANGE

Salient Rates, Indices & Exch Rates	Current	1 Mth	3 Mths	6 Mths	12 Mths	2 Yrs	3 Yrs	5 Yrs
NZX NZ Govt Stock (Gross Returns Index)	1311.93	1.40%	3.76%	7.40%	13.31%	21.21%	23.22%	48.22%
NZX50 (Gross)	3274.11	0.12%	-2.07%	-5.05%	-1.06%	1.36%	20.56%	-19.27%
NZSCI (Gross)	20987.7	-0.53%	5.93%	0.58%	-4.34%	0.20%	24.64%	-17.37%
S&P/ASX200 (Australian)	4056.6	-1.53%	1.20%	-11.64%	-14.51%	-16.71%	8.98%	-28.46%
MSCI World Index (Capital)	1182.59	-0.17%	7.11%	-11.16%	-7.71%	-1.40%	28.51%	-20.29%
Dow Jones (USA)	12217.56	5.72%	11.95%	-5.40%	4.73%	17.16%	39.21%	-2.27%
NASDAQ COMP	2605	3.54%	7.87%	-6.08%	-2.54%	14.06%	65.18%	7.42%
FTSE 100 (UK)	5572.28	1.67%	8.66%	-6.28%	-5.55%	2.94%	25.67%	-10.43%
Nikkei DJ (Japan)	8455.32	0.24%	-2.82%	-13.86%	-17.34%	-19.83%	-4.56%	-50.91%
Hang Seng (Hong Kong)	18455.55	2.59%	4.39%	-17.55%	-19.88%	-15.62%	28.28%	-9.14%
NZD/USD	0.7897	2.03%	2.60%	-4.24%	2.53%	9.42%	36.72%	11.98%
NZD/AUD	0.7614	0.50%	-3.82%	-1.46%	0.61%	-5.72%	-8.79%	-14.74%
NZD/JPY	60.56	0.78%	2.45%	-9.06%	-3.54%	-9.22%	16.26%	-27.95%
TRADE WEIGHTED INDEX (TWI)	68.91	1.82%	-0.20%	-3.26%	-0.19%	3.98%	22.33%	-1.03%
Gold (US\$/f.oz., troy)	1603.8	-6.59%	-0.57%	6.49%	16.16%	47.08%	84.25%	152.05%
Crude Oil (WTI, US\$/bbl)	102.7	2.97%	25.46%	10.57%	11.93%	30.26%	157.65%	70.06%

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