

28 JULY 2009

MARKET OVERVIEW

It is part of the human condition to look on the bright side. Apparently, it makes us more fun to be around. In the investment world, it is sometimes difficult to determine whether the positive views we read and hear are salesmanship, the product of objective research or just plain old hopefulness. At present, we conclude that it must be either the former or the latter because any objective view of the facts tells us we are some way from being out of the economic mire.

To begin on a positive note, it is now widely acknowledged that the financial armageddon that the world was on the brink of in the third quarter of 2008 has been averted. We must be thankful for that. Additionally, it appears that Australasia's banking system has emerged from the crisis as one of the strongest in the world.

It has, however, been a period of enormous tumult in financial markets. Reflecting back on some of the key developments over the last year or so reminds us of the journey we have been on.

- Contraction in key global economies. Corporate profits fell almost unilaterally, unemployment increased as companies rationalised their workforces and high interest rates and debt levels beat down on property markets. With most economies slipping sharply into recession, central banks the world over cut interest rates relentlessly – in New Zealand the RBNZ cut rates from 8.25% to 2.50%. In the US and UK rates were sliced to near 0%.
- Financial markets volatility. In September 2008 the financial crisis entered its most intense phase, with the collapse of Lehman Brothers being the primary catalyst. Having lost confidence in the global banking system, investors panicked and share markets around the world fell sharply through to November 2008. Multiple financial institutions failed – some century old household names – and numerous were forced to either merge, be sold or be bailed out by their respective governments.
- A roller coaster start to 2009. After a grim 2008, and with share markets globally falling a further 25% in the first two months of 2009, the market found a floor in early March. The turning point appeared to be precipitated by Ben Bernanke, the Chairman of the US Federal Reserve, saying that the “green shoots” of an economic recovery were evident. This was “substantiated” by fractionally more upbeat economic data. Investors’ appetite for risky assets returned and share markets have rebounded strongly over the last four months, albeit only to where they began this year and still more than 30% down from the start of 2008.
- Dramatic changes in the price of oil. The price of oil peaked in 2008 at around US\$147 per barrel and consumers felt the pinch in terms of higher food and fuel prices. By March 2009 that price had fallen to around US\$30. Today it is back near US\$70.
- Monetary policy easing. With limited scope for further interest rate cuts in the US and UK, the Federal Reserve and Bank of England have embarked on what is known as quantitative easing – the process of buying large quantities of government bonds that are owned by banks. In this way the banks are provided with new money to lend which, it is hoped, will stimulate the economy. To date the banks have actually hoarded the cash rather than lent it out.
- NZ dollar extremes. Having tracked its way down from 80 cents to 50 cents against the US dollar the recent increase in the appetite for risk has seen higher-yielding currencies like the New Zealand dollar rise sharply – up around 30% in the last 4 months. This has pared the extent to which a New Zealand based unhedged investor has participated in the recovery in global share markets.

OUR PORTFOLIO STRATEGY

At NZ Funds, we applied a share hedging strategy to the majority of our growth portfolios in late 2007 in order to reduce what we believed were unattractive risks for investors at that point. This strategy has been very successful in dampening the impacts of much of what has occurred on the share components of our clients' portfolios.

In March 2009 we removed 30% of our share hedges, allowing the growth portfolios to participate in some of the recent market rally. At the beginning of June 2009 our hedging models indicated that the remaining 70% should be removed. This movement from an unhedged to a hedged position, and vice versa, may be repeated a number of times until the global share markets begin a sustained move either higher or lower.

In addition to our share hedging strategy, we have implemented a number of other measures to increase the defensiveness of our portfolios during this period. Although these strategies differ from one portfolio to the next, they include:

1. actively managing our foreign currency positions;
2. favouring quality corporate bonds over shares;
3. holding record levels of cash;
4. selling down less liquid investments; and
5. investing for the decline in New Zealand interest rates.

These are not necessarily positions that we continue to hold today. Financial markets are changing very rapidly at present and the investment strategies required to position our clients' portfolios are designed to be correspondingly nimble.

LOOKING FORWARD

The aversion of disaster aside, we see only sketchy evidence of the "green shoots" recovery which supposedly materialised over the second quarter of 2009. In our view, unemployment is likely to remain elevated and corporate profitability is likely to remain subdued for some time. It is certainly less bad than it was but major economic and corporate risks remain real and present.

We think we are seeing the beginnings of a transformation in consumer behaviour toward thrift (ie. less debt and higher savings) that, while ultimately economically good, will necessitate a long and potentially difficult restructuring period for many households and the companies that serve them.

Many will argue that New Zealand is different and will fare better than our more excessive US, UK and Continental European counterparts. That may well be the case but we are not economically independent. There is a striking resemblance in the monetary policy which drove the current situation in the developed economies and we perceive that there will also be a strong resemblance in the corrective actions and adjustments required.

OUR INVESTMENT APPROACH

In our experience, one of the keys to successful investing is being able to hold several opposing or alternate scenarios in one's mind at the same time. One of our opposing views is that we could be too optimistic and that (economic) depression looms. We try not to dwell too long on that one. Alternatively, smart government intervention and tremendous corporate and consumer resolve may accelerate a more rapid return to economic prosperity. Whatever transpires, our investment strategies need to be prepared and sufficiently adaptable to constantly accommodate new and meaningful news.

While we remain economically cautious we would stress that there is no reason why investment portfolios should not both preserve investor capital and produce positive returns in that environment. Just as we have seen recently:

1. share markets can produce strong returns in the midst of a recession;
2. government and quality investment grade bonds can produce outsize returns in negative economic environments;
3. currency and commodity markets always offer profit potential, particularly when strong trends develop;
4. one can invest for or against inflation with many different financial instruments;

5. certain investment managers can prosper in difficult environments, especially if their out performance can be captured independent of the broader markets in which they invest; and
6. portfolio diversity and flexibility are critical in this environment.

Staying in cash will offer negligible reward in the immediate future. Staying in cash indefinitely is not an investment strategy. It is not even a capital preservation strategy once inflation returns to the fray (and we believe, given time, it will).

Our investment approach is founded on the simple principle of preserving investors' capital first and seeking investment returns second. Capital preservation as we practice it is an investing strategy which seeks to capture a return in excess of cash over time but also seeks to ensure our portfolios systematically avoid producing losses unrecoverable within the time frame our clients plan to utilise their capital.

As we look to the future, we believe that caution, controlled risk taking and patience will likely prove more profitable than cash or unabashed optimism, even if the latter does seem like more fun.

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