

INTRODUCTION

“It can be easily seen that the total return on equities dominates all other assets... Bear markets, which so frighten investors, pale in the context of the upward thrust of total stock returns... One dollar invested and reinvested in stocks since 1802 would have accumulated to nearly \$8.80 million by the end of 2001. This sum can be realised by an investor holding the broadest possible portfolio of stocks.”

- Stocks for the Long Run, 3rd edition 2002 - Jeremy J. Siegel, Ph.D

“Bling is dead...”

- Karl Lagerfeld, Fashion Designer

How can a Massachusetts Institute of Technology graduate, Professor of Finance and adviser to the Federal Reserve get it so wrong? And how can a fashion designer, who is also credited with saying “Yes, some people say to me you’re too skinny, but never a skinny person says that to me, only people who could lose a few pounds”, get it so right? The ‘it’ is of course the share market and, in particular, whether everyday New Zealanders fully understand the risks associated with investing in it.

In a Daily Telegraph interview, Karl Lagerfeld – the German fashion designer and Chanel boss – declared that the age of ‘bling’ was over because of the global economic crisis. The word bling was coined by hip hop music stars to mean flashy, in a good way, but has come to be used in wider culture as a general term for an overt display of wealth – something that has more recently become the norm as opposed to the exception. Wherever you look, be it at residential or commercial property, shares or finance companies, investments have until recently only ever gone up. Bling is symptomatic of a society built on the spoils of speculation. Our generation has enjoyed an extremely long (1980–2000) and extremely large (512%) increase in wealth via one continuous upward movement in share markets. True, there has been some volatility in annual returns as experienced in 1987, and the New Zealand share market has at times deviated from global shares, but an ‘upward thrust’ has more often than not prevailed.

The question is should we expect it to continue? Jeremy J. Siegel and many New Zealand ‘experts’ would have

us believe so. But with respect to the professor and the followers of his cult, we contend that 199 years (as discussed in an extract from his abovementioned book) may not be the best time frame to use when assessing the merits of an investment in shares for your retirement. Furthermore, a buy-and-hold strategy – which worked well between 1980 and 2000 – has not always done well historically and may in fact do very poorly in the future. In contrast, an investment approach which acknowledges that New Zealanders’ time horizons are less than 199 years, and consequently protects them from significant share market volatility, should prove a rewarding investment experience irrespective of how quickly share markets recover.

A BRIEF HISTORY OF SHARE MARKET RETURNS

S&P500 INDEX AFTER ADJUSTING FOR INFLATION (January 1900 to April 2009)



Source: Robert Shiller.

“It is a capital mistake to theorise before one has data. Insensibly one begins to twist facts to suit theories, instead of theories to suit facts.”

- Sir Arthur Conan Doyle, The Adventures of Sherlock Holmes

Who can remember the Great Depression during which the US share market fell 81% peak to trough and took 56 years to permanently recover? Or the 20 years between 1960 and 1979 when the US share market delivered a return of -31% (-1.8% per annum) to investors? Well, to be fair, not many of us.

The vast majority of New Zealanders for who share market returns are of serious concern are either provisioning for

retirement or are already in retirement. Education is likely to be a financial priority for New Zealanders in their early twenties, whereas those in their thirties and forties are more likely to be preoccupied with a mortgage than an investment portfolio. It is therefore fair to assume that the average age of an investor is around 50 years. And as we shall see, for the most, part a 50-year old investor has only ever witnessed one type of market and that is a secular bull market. Or as Bill Gross, founder of PIMCO – the world’s largest bond fund management company – so aptly puts it “we are all children of the bull market”. However, the precedent of history is unequivocal. Bull markets, and in particular the period from 1980 to 2000, are not normal. In fact, they are historically quite rare.

Before examining historic share market returns a practical and important observation must be made. Twenty years is the only period of relevance for an individual assessing whether global shares represent a sound investment for their retirement. As the average New Zealand investor is around 50 to 60 years of age, a 20-year time frame would make them around 70 to 80 years of age at the end of the investment period. In other words they would be well into retirement and no doubt wanting to draw down on their invested capital in order to maintain their lifestyle. After twenty years of investing few New Zealanders would want to hear that a further twenty years of investing is needed in order to earn a return, or recoup the initial amount they invested. Many simply do not have enough years left in retirement to wait that long. Therefore, an extension of the required investment time frame is to New Zealanders in retirement as good as a loss.

It is astonishing then that most investment professionals ignore New Zealanders’ relatively short investment time frame and do not set return expectations correctly. They also do not make provision in clients’ financial plans for the possibility that global shares may not perform strongly over any given 20-year period. Instead, much of today’s investment industry has been built by promoting the myth that long-term investors (where ‘long term’ is often defined as in excess of 10 years) should expect a return from investing in global shares which is calculated by taking the share market’s average rate of return as assessed over extremely long periods of time.

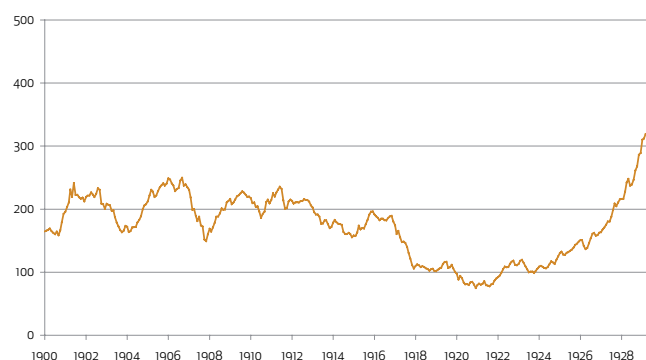
By taking a 100-year or 200-year average, savage 20-year fluctuations which wipe out all investors’ gains and leave them substantially poorer in retirement appear as mere ‘blips’. In order to accurately assess the merits of investing in global shares, the last 109 years can be broken into periods of 20 to 30 years and investors’ returns assessed over these more realistic investment time frames.

BUBBLE, BUBBLE, BUST AND TROUBLE 1900-1929

“We’d rather do without clothes than give up the car.”

- Mother of nine children c. 1924 - Jim Cullen, *The American Dream*

S&P500 INDEX AFTER ADJUSTING FOR INFLATION (January 1900 to September 1929)



Source: Robert Shiller.

Share returns over the period 1900 to 1929 can be divided into two distinct periods: 1900 to 1920 and 1921 to 1929. The period 1900 to 1920 was dominated by industrial progress, personified by Henry Ford and the establishment of the Ford Motor Company in 1903. In spite of this, the cost of the First World War between 1914 and 1918 caused US share market investors to earn a dismal return of -54% (-3.6% per annum) from shares over the twenty year period.

To make matters worse, the return of -3.6% per annum earned by patient investors came with excessive volatility. Promoters of the buy-and-hold investment strategy, using a 199-year average rate of return, would gloss over the regularity with which the market crashed and subsequently rallied during this period. The experience of owning shares from 1900 to 1920 was anything but a smooth upward thrust. Instead, investors suffered six crashes over the period (one approximately every three and a half years).

These declines ranged from a fall of 40% during the banking crisis of 1907 to a decline of 28% at the advent of the First World War.

As a result of a particularly severe fluctuation in the business cycle during 1920 to 1921 the Federal Reserve decided to set its interest rate below market levels and to lower the reserve requirements for major banks. The outcome was miraculous. Henry Ford had brought about the industrialisation of the US by perfecting mass production. Then, by setting interest rates at unsuitably low levels, the Federal Reserve created mass consumption. As consumption boomed, so too did the share market.

During the period 1921 to 1929, the US share market rose 415%. The average rate of return was a staggering 21% per annum. While there was the odd negative quarter, the capital gains were so spectacular as to captivate the nation. Much like the Jeremy Siegel of today, Edgar Lawrence Smith – a financial analyst and investment manager at the time – fuelled the public’s enthusiasm for shares with scientific studies. Smith’s book ‘Common Stocks as Long-Term Investments’ was published in 1925 and concluded “We have found that there is a force at work in our common stock holdings which tends ever towards increasing their principal value...”. The risks of investing in shares were dismissed by examining average share market returns since the Civil War of 1861 (a 64-year period) and concluding “Our hazard even in such extreme cases appears to be that of time alone”. Time alone? Time is of course the most precious commodity of all in retirement! Some years later, Fisher – like Siegel, a prominent Professor of Economics – pronounced that “stock prices have reached what looks like a permanently high plateau”². Two weeks later they crashed.

For much of the period 1921 to 1929 inflation-adjusted returns were negative. After 20 years in the share market, many buy-and-hold investors would have retired with substantially less purchasing power than they started with – a thought which is likely to shock most New Zealanders. Even if investors had held onto their share portfolio for an additional 10 years so as to enjoy the belated share market boom, and were fortunate enough to exit at the absolute high of the 30-year period, they would have earned only

2.9% per annum. This is a very different economic outcome from that promoted by today’s financial ‘experts’.

Reflecting on the unprecedented destruction of investors’ savings that occurred when the share market crashed in 1929, Benjamin Graham and David Dodd – the founding fathers of value investing – wrote “The self-deception of the mass speculator must, however, have its element of justification... In the new-era bull market, the ‘rational’ basis was the record of long-term improvement shown by diversified common-stock holdings... (which sprang from) a small and rather sketchy volume... entitled *Common Stocks as Long-Term Investments* by Edgar Lawrence Smith”.

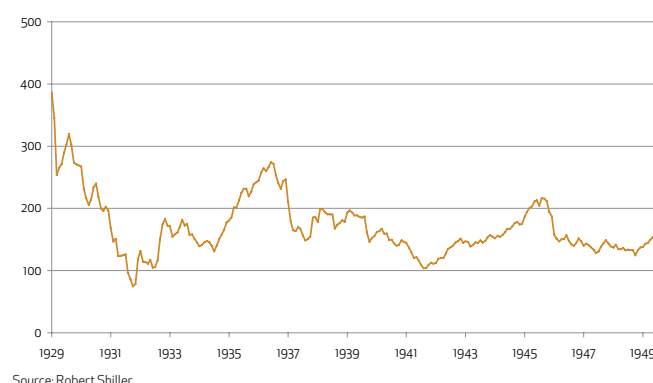
Despite the resounding failure of a buy-and-hold strategy over this period, the very same thinking was to re-emerge 50 years later with similar disastrous results.

LESSONS FROM THE GREAT DEPRESSION 1930-1950

“Those that fail to learn from history, are doomed to repeat it.”

- Winston Churchill

S&P500 INDEX AFTER ADJUSTING FOR INFLATION (September 1929 to January 1950)



Source: Robert Shiller.

There are many similarities between the lead up to the Great Depression and today. Low interest rates, easy money, excess consumption and excessive debt are but a few. But this treatise concerns share market returns and on that topic four observations can be made.

(1) Edgar L. Smith, *Common Stocks as Long-Term Investments* (New York, Macmillan, 1925) p 81.

(2) Fisher Sees Stocks Permanently High, *New York Times*, 16 October 1929, p 2.

First, the US share market did not fall overnight, nor did it fall in a straight line. It took almost three years (33 months) to reach the bottom by which time the share market had lost 81% of its value. By contrast, today's share market decline has thus far lasted 17 months and resulted in the loss of 52% of investors' capital.

Second, the decline was not linear. Similar to today, there were frequent upward rallies when it appeared the worst was over. In total there were five rebounds, the largest of which resulted in a 26% bounce. However, on each occasion the relief proved temporary and the market's subsequent collapse was to an even lower level.

Third, the 'recovery' when it did come was not of the kind we, children of the great bull market of 1980 to 2000, have come to expect. Investors who held their nerve were not rewarded a couple of years later, as was the case during the share market crash of 1987. Instead, US shares took 25 years (before adjusting for inflation) and 29 years (after adjusting for inflation) to recover.

It is of course sensationalist to take the peak of the market as a starting point, but it is not as irrational as you might think. There are numerous studies demonstrating people's propensity to invest after the market has begun to rise. A behavioural trait observed by New Zealand Funds Management Ltd (NZ Funds) over the past 20 years is that the higher an asset class climbs the more money investors tend to allocate to it. Therefore, many investors are likely to have suffered after investing near the absolute peak.

Even when the mid point of the rally from 1921 to 1929 is taken (S&P500 Index at 19 in 1928³) instead of the peak, it was not until 1950 (some 22 years later) that the share market rose and stayed above the level at which an investor would have entered the market. This begs the question, why did all these experts never say to clients "in the event of a share market collapse, you will need a spare 22 years to recover your capital"?

Expressed another way, if we put ourselves in the position of an investor lucky enough to have avoided the entire collapse and smart enough to have invested once the market stabilised in 1934, then 20 years later a buy-and-

hold strategy would have yielded a return of only 1.0% per annum. This is entirely consistent with the return delivered by shares (ie -3.6% per annum) during the 20 years prior to the roaring twenties bull market. It is interesting to note that the returns during these normal times are well below the glamorous 8-10% many investment managers assume a buy-and-hold strategy will deliver.

Finally, and most importantly for today's share market investor, even after shares stopped falling the recovery took much longer than expected and must have been an emotional roller coaster ride for true buy-and-hold investors. Between 1932 when the share market eventually bottomed and 1937, shares rallied almost 266% (32% per annum) only to fall by 40% less than 12 months later. This boom-bust behaviour which is termed 'volatility' by investment experts is consistent with the 'normal' experience of owning shares, if there is such a thing. Even during the upward thrust of the long-term secular bull market from 1980 to 2000, more than half the time annual returns were greater than +/-16% per annum before adjusting for inflation!

Irrespective of the merits of shares over the long term, few people can withstand this kind of volatility, especially when their (and their family's) livelihood is at stake. Analysis by DALBAR⁴ confirms that despite an 11.8% per annum rise in shares from 1987 to 2006 before adjusting for inflation, the average investor only enjoyed a return of 4.3% per annum. The difference is not due to fees (as some prominent commentators like to claim). In fact, it is quite the opposite. Without a professional, managed approach to investing that counters the volatility inherent in share markets, investors capitulate. Having invested near the peak, investors sell their investments at the bottom. This has been the price of being human.

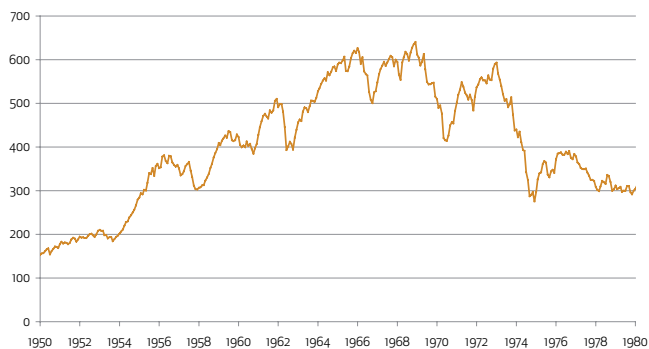
PLUS ÇA CHANGE, PLUS C'EST LA MÊME CHOSE 1950-1980

**"History never repeats,
I tell myself before I go to sleep.
Don't say the words you might regret,
I lost before, you know I can't forget."**

- Neil Finn / Split Enz
© ENZ Music

(3) S&P500 Index after adjusting for inflation. Source: Robert Shiller.
(4) 2007 DALBAR QAIB Report.

S&P500 INDEX AFTER ADJUSTING FOR INFLATION (January 1950 to January 1980)



Source: Robert Shiller.

If we have to read another comparison with the 1930s, a depression of the non-economic sort will overcome us all. Luckily, there is no need. There is as much precedent for today's share market investor in the period 1950 to 1980 as there was in the period 1900 to 1950. In fact, the lesson is almost identical but you will not hear it from financial commentators who profit from selling buy-and-hold strategies to New Zealanders.

After a long period of gyrating sideways, shares rocketed skyward at the end of 1953. Having survived from the back-to-back horrors of the Great Depression and the Second World War, excess consumption was back! Back too was man's age old quest to conquer nature. Surely this time monetary and fiscal policy would ensure the business cycle was abolished? The prominent thinking of the time was that a collection of popular large-cap shares, known as the Nifty Fifty, were one-decision shares. Their business franchises were so stable as to be able to deliver ever increasing profits for investors who used a buy-and-hold strategy over the long run. Initially, as is always the case, the share market seemed to confirm this. From 1950 to 1959 the US share market increased by 192% (12% per annum).

But as readers may begin to appreciate, history demonstrates that share markets do not constantly rise. On the contrary, it is more common that they move sideways for long periods at a time. For example, the periods 1900 to 1920 and 1930 to 1950 were both sideways movements lasting approximately 20 years during which the share market returned -3.6% per annum and -2.1% per annum respectively.

Why have share markets regularly moved sideways for 20 years at a time? Initially, shares tend to move sideways to repair the damage done during the preceding boom. Perhaps it takes 10 years to mend balance sheets and another 10 years to encourage management to start reinvesting in equipment, technology and labour? During this sideways move, earnings and profitability gradually improve until share prices, still close to where they were some 20 years earlier, no longer accurately reflect the assets and earnings power of the listed company. As a result, shares begin to rise. Unfortunately, both the 1920 to 1929 and 1950 to 1959 bull market periods only lasted for 10 years. By the time most investors had noticed that shares were going up again it is likely the market was approaching its peak. In the crash that inevitably followed, investors often gave back more than what they had earned.

The long sideways movements of 1900 to 1920 and 1930 to 1950 both culminated in a share market boom which lasted for a much shorter period of time before collapsing. Unlike the 1920s, the bull market of the 1950s did not end in a collapse of the financial system. Instead, the US share market plateaued, and not in the same sense as the word 'plateau' which is defined as a relatively level surface. By contrast, this was a 20-year period of little or no economic return which was regularly punctuated with crashes and recoveries. In total, there were six declines ranging from 12% in 1960 to 54% in 1974. The 'Teflon investor' (a chemical construct manufactured by one of the Nifty Fifty), who did not capitulate at seeing his or her lifetime savings double and then halve regularly through this time, was 'rewarded' with a return of -1.8% per annum. By relying on a buy-and-hold strategy, investors had once more been duped. They had lost 31% of their purchasing power after enduring 20 years of volatility.

THE MODERN DAY CULTING OF THE SHARE 1980-2000

"I never think that people die. They just go to department stores."

- Andy Warhol, Artist

S&P500 INDEX AFTER ADJUSTING FOR INFLATION (January 1980 to August 2000)



Source: Robert Shiller.

Having analysed the preceding 80 years one has to question why the buy-and-hold strategy is so popular with investors today?

The answer lies in the 20 years between 1980 and 2000. Starting in 1980, the US share market did a very rare thing. Put simply, it rose – compounding at 9.2% per annum for not 10 years, as had previously been the case from 1921 to 1929 and 1950 to 1959, but for almost 21 years with scarcely a pause for breath. Never before in the history of shares has so much of the long-term average return been owed to so few years.

From 1802 to 2000, shares returned 3% per annum before adjusting for inflation and 1.6% per annum after adjusting for inflation. From 1900 to 2000, shares returned 5.5% per annum before adjusting for inflation and 2.3% per annum after adjusting for inflation. But from 1980 to 2000, shares returned 13.5% per annum before adjusting for inflation and 9.2% per annum after adjusting for inflation. No wonder the cult of shares is barely questioned and investment professionals the world over studiously assume a pre-tax, pre-fees and pre-inflation rate of return of 8-10% per annum from the share market. This is significantly higher than the historical long-term average rate of return from shares. Unfortunately, it is the higher number which is often marketed as the rate of return buy-and-hold investors should expect from owning shares.

With the benefit of hindsight (or an appreciation of the history of share market returns) it should come as little

surprise that the laws of gravity and, in particular, the business cycle would reassert itself after the spectacular bull market of the 1980s and 1990s. The S&P500 share market index fell in August 2000 and during a period of only 30 months it eliminated 47% of investors' accumulated savings. But one man and his apprentice stood ready. And unlike today's dramatic everyday use of the word, their response was truly 'unprecedented'.

PURGATORY 2000-2009

"Man," I cried, "how ignorant art thou in thy pride of wisdom!"

- Mary Shelley, Frankenstein

S&P500 INDEX AFTER ADJUSTING FOR INFLATION (August 2000 to April 2009)



Source: Robert Shiller.

That man was of course Alan Greenspan, then Chairman of the Federal Reserve, assisted by today's Chairman, Benjamin Bernanke. In an experiment that rivals today's 'quantitative easing', Alan Greenspan cut interest rates not once but 12 times until the cost of borrowing, be it for capital investment in plant or equipment or to finance a new car or home loan, dropped to almost nothing. With interest rates and inflation both at 1%, consumers went mad – as they had done in the 1920s, 1950s and late 1990s. Everything became purchasable... you just had to borrow to buy. And thanks to the avarice of the banking sector and a new technology called 'securitisation' there were any number of lenders. Unfortunately, this experiment was not limited to the US. In New Zealand, for example, the Reserve Bank cut interest rates from 6.50% to 4.75%.

While tech stocks continued to fall, the resumption of consumption breathed life into the broader economy and, with a gasp, it recovered, causing the US share market to rebound from a low of 976 in 2003 to a high of 1573 in 2007⁵. In fact, with interest rates so low and the global economy awash with US liquidity, all assets – be it farms, businesses, bonds or art – rose in value.

At last it appeared as if man had indeed abolished the business cycle. But as Dr Victor Frankenstein discovered, there is often a terrible price to be paid for playing God. What price were we to pay for Greenspan's actions? Actions which resulted in the creation of excessive credit, and the subsequent loaning of money to applicants with no income, no jobs and no assets (NINJA loan anyone?). Trees do not grow to the sky and at some point those who had acted as lenders would demand repayment. When interest rates eventually began rising again, each new rate hike set off a ripple of defaults. If you default for long enough the bank forecloses your house and sells it. If enough houses are sold, property prices start falling – which is what they did nationwide in the US, creating the first ever synchronised property downturn on record. This sparked off the now infamous sub-prime loan crisis which, in turn, triggered a credit crisis among the daring NINJA lenders who turned out to be almost every large bank, investment company and a fair number of Norwegian municipalities and New Zealand-based fund managers, including NZ Funds.

NIGHTMARE ON WALL ST

We keep getting told that the market is telling us "something," usually that the recession is going to end. For some reason, people keep repeating the bromide that the market looks out about 6 months. To that I politely say, rubbish. Riddle me this, Batman. Did the market see the recession in October of 2007?

- John Mauldin, Thoughts from the Frontline Weekly Newsletter

What will global shares do for an encore having fallen 59% from the peak in August 2000 to the recent trough in March 2009 – a decline that has erased 13 years of share market returns? Are we at the bottom of the bear market? Shares are after all still one of the few asset classes capable of generating spectacular capital gains over time

even if they do so in a highly unreliable manner. As such they will continue to play an essential role in the long-term accumulation of wealth by New Zealand investors. There are no crystal balls in the share market but neither are they needed. New Zealanders should not have to gamble on a rapid and sustained rebound in global shares. The more pertinent question that we all should be asking is not whether global shares have bottomed or not but how to utilise them in a manner which makes for a rewarding investment. And the answer is not to blindly buy-and-hope for the best as many in the investment industry would have you do. Sceptical? From the peak in August 2000 to April 2009 investors have earned an average return of -8.5% per annum from global shares and have twice seen approximately 50% of their investment capital vanish. Welcome to the buy-and-hold nightmare.

TIME ALONE IS AN INSUFFICIENT CONDITION FOR INVESTMENT SUCCESS

Si vis pacem, para bellum
"If you want peace, prepare for war"

Few investors who utilise global or New Zealand shares as a means of accumulating wealth understand the risks over their investing timeframes. Put simply, the hazards associated with investing in shares are: first, the destruction of value caused by regular share market crashes, and second, long periods of up to 20 years during which inflation adjusted returns are low or negative. Consideration needs to be given to alternatives to the investment industry's dogma "its time in the market not timing that matters". As demonstrated, a careful analysis of stock market returns refutes this. But what of the alternative?

A DIFFERENT APPROACH

"Survive first, make money second"

- George Soros

As recent share market volatility has shown, it is impossible to time the market on a daily basis but we do believe it is possible to mitigate periods of excessive volatility, which result in irrecoverable losses for investors,

with a finite investment timeframe. It is the successful implementation of this philosophy that has distinguished NZ Funds since November 2007 and will continue to do so in the future.

Our strategy is relatively simple. We are long term investors in shares which we perceive have superior valuation characteristics. But we recognise that, during some periods, all shares will suffer as part of a wide market malaise. We aim to identify these periods, as they begin and end, and seek to preserve our investors' capital during these stages of the cycle.

Should today's 'unprecedented' fiscal and monetary stimulus rekindle a global share market boom as occurred in 2002, clients' share market protection is removed in stages, enabling them to become fully exposed to a share market recovery. In such an environment all boats will rise with the incoming tide and, as before, there will be little to distinguish the foolish from the wise or the reckless from the conservative. Such is the nature of a bull market. However, should shares at any stage resume their downward trajectory the share market protection strategy will be automatically reapplied.

We are equally prepared for a long period of consolidation, repair and recuperation during which returns are low or negative. As illustrated in this paper, such periods were very difficult times for buy-and-hold share market investors. Most would have earned returns that were low

or negative. By contrast, those investors who were able to successfully capture the booms, and have their capital protected during the subsequent declines, experienced positive returns which over a 20-year period compounded into a significantly higher result. In back-testing, NZ Funds' share market protection strategy achieved just that, as illustrated below by selecting two particularly poor periods for buy-and-hold investors.

S&P500 INDEX BEFORE ADJUSTING FOR INFLATION

Investment strategy	1930 - 1950		1960 - 1980	
	Annual return	Total return	Annual return	Total return
Buy-and-hold index returns	-1.2%	-21.7%	3.0%	80.2%
NZ Funds' strategy	3.4%	96.5%	5.1%	170.8%

Source: Bloomberg.

When asked by Barron's on 13 October 2008 if anything would be learnt from the ongoing crisis, Jeremy Grantham – the Chairman and co-founder of the investment firm Grantham, Mayo, Van Otterloo Company (GMO) – responded "We will learn an enormous amount in a very short time, quite a bit in the medium term, and absolutely nothing in the long term. That would be the historical precedent. Don't become another victim of history and allow yourself to be fooled into a buy-and-hope investment strategy. Utilise an investment approach which has been designed to harness global share market returns irrespective of the investment environment.

NOTE: ALL RETURNS IN THIS DOCUMENT ARE AFTER ADJUSTING FOR INFLATION, UNLESS STATED OTHERWISE. ALL RETURN DATA IS SOURCED FROM ROBERT SHILLER, UNLESS STATED OTHERWISE.

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