ARCUS™

active investment management

Arcus Investment Management

Quarterly Investment Strategy Update

September 2007

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Portfolio strategy summary

This table summarises our key portfolio strategies. For a full explanation of the thinking behind these views, see the individual reviews of asset class valuations.

Asset Class	Target DAA Weighting	Description
Australasian Property	Underweight	Valuations have improved following a significant correction, but we remain cautious in the current high interest rate environment.
Australasian Infrastructure	Overweight	High interest rates and increased leverage have triggered some concerns among investors. Nevertheless, infrastructure remains an attractive defensive sector in the current, uncertain economic environment. Income streams are less correlated to the economic cycle.
Australasian Shares	Neutral	The risks surrounding the local sharemarket have increased. Relative valuations, earnings and economic performance tend to favour Australian companies.
International Shares	Neutral	Earnings growth remains strong and valuations are at reasonable levels. We expect the rally to continue, but it will be difficult for returns to continue at the pace of recent years. Volatility is likely to remain higher than has been the case for some years.
Emerging Market Shares	Overweight	Although economic fundamentals remain favourable, the discount relative to developed markets has narrowed significantly during recent years. We will be trimming our overweight position during coming weeks.
New Zealand Bonds	Underweight	Government bond yields have followed the recent US rally, but have now reached unsustainably low levels given the outlook for inflation and the OCR.
International Bonds	Underweight	The Federal Reserve recently stepped in to cut the discount rate and fed funds rate in an attempt to boost liquidity. At this stage, the inflation outlook limits the scope for further significant interest rate cuts in the US, but the start of the easing cycle is not far away. However, it is unlikely that other major countries will follow the US lead.
New Zealand Cash	Overweight	The RBNZ is forecasting the first cut in the Official Cash Rate in 2009, but markets have started to look for a cut in early 2008. An early cut would require a harsh slowdown in domestic spending and the housing sector.

TOPICAL ISSUES

The 2007 year will be one that goes down in history for the impact that it had on the growth of financial savings and the managed funds industry in New Zealand. On April 1 2007, the new investment tax regime came into effect. This was followed by the July 1 introduction of KiwiSaver. The final part to the government's three pronged savings strategy is the October 1 introduction of the PIE regime. Local fund managers have poured significant resources into issues such as product compliance and accounting systems - resources that are akin to the period leading up to Y2K. This quarter we look at the likely implications, both positive and negative, of these policy changes on strategic asset allocations among local fund managers, the likely asset allocation decisions of households and the wider financial sector.

We also take a closer look at the recent volatility in credit markets. For some years, critics have stated that because gearing levels in the consumer sector are not excessive i.e. balance sheets are healthy, the sharp rise in debt levels is of little concern. Recent events in the US show, however, that leverage can be a dangerous thing. Rather than revisiting leverage in the household sector, this quarter we shift our attention to the corporate sector.

Taxes, KiwiSaver and PIEs

Christmas has come early for the funds management industry. The introduction of the new tax regime, the PIE regime and KiwiSaver will go a long way towards reducing the significant dis-incentive that has existed for investors in managed funds relative to DIY investments, particularly residential property. While the new tax regime is not the level playing field that most in the industry would have preferred, we are hardly in a position to complain. It's a shame that it took KiwiSaver to force the change, as simple fairness considerations should have driven a change long ago.

Local fund managers have taken the opportunity to re-optimise their strategic asset allocations based on the new tax assumptions. Although the results of this re-optimisation were in line with what one would intuitively expect, they may not be completely in line with the government's expectations:

- As expected, the strategic allocation of many fund managers to local equities will increase, reflecting their tax advantage (no capital gains tax). This urge to increase allocations could be balanced, however, by the heavy local home bias that already exists and by the increase in after-tax volatility.
- Although Australian tax domiciled companies appear to have the same tax treatment as New Zealand companies, local companies do, in fact, have an advantage in the new tax environment. This is because local investors are able to benefit from imputation credits on local equities, but are unable to benefit from franking credits on Australian tax domiciled companies.
- The strategic allocation to New Zealand's listed property sector has tended to increase, reflecting the government's decision late last year to allow companies in the sector to benefit from the PIE regime. However, the lack of breadth in the local market is likely to cap any increase in allocation.
- The final implication of the new environment is that it strongly favours global fixed interest over local fixed interest. In theory, a fully hedged global bond portfolio should deliver the same return as a domestic bond portfolio, but this is not the case in practice. New Zealand's consistently high relative interest rates mean that currency hedging is not a zero sum game - there is a persistent gain to be made. This gain is small, but nevertheless makes it difficult to justify a benchmark allocation to domestic bonds without imposing a minimum allocation as a forced assumption. Whether or not this was an intended or unintended outcome of the changes to the investment tax regime is unclear.

Does it really matter? After all, Australia has encountered a similar situation and it doesn't appear to have caused any significant negative flow-on effects. Furthermore, the government is financially sound and apart from capital spending requirements, there is no real need for the supply of sovereign bonds to increase. Of course, there are other sides to the argument:

- Liquidity is important - lack of liquidity in our bond market can impact on New Zealand's country risk premium.
- The government is not the only issuer of bonds. Reduced demand for corporate bonds could restrict opportunities for corporates to raise debt to finance growth.
- If the local bond market is not able to grow and develop, it will restrict the development of both consumer and corporate debt products. Lack of depth and breadth in the bond market is a key reason why fixed mortgage rates beyond 5 years are not readily available in New Zealand.

Given the likely changes to strategic asset allocations by local managers as already mentioned, will we experience a sudden increase in the local equity market or fall in allocations to the local fixed interest sector? In fact, the adjustments to asset allocations are likely to be small and any changes will be implemented gradually.

As far as the domestic fixed interest sector goes, the impact will be tempered by the fact that around 70 percent of government bonds are offshore owned i.e. domestic institutions own a minority proportion. Also, tactical allocations are likely to act as a headwind, reflecting the inflation outlook - local managers tend to be underweight this sector. Lastly, there is the influx of managed fund flows that will accompany the growth of KiwiSaver, although this will be a longer term consideration rather than an immediate one.

In terms of local equities, which is the most obvious beneficiary of the policy changes, cyclical factors will mean that most local managers that actively manage asset allocations will tend to be underweight the New Zealand market. Earnings growth is weak, local interest rates are very high, and the economy is fragile. This will temper the near term shift into this sector. Reflecting its bigger allocation, the potential medium to longer term benefits of KiwiSaver for the local sharemarket will be considerably greater than for the fixed interest sector.

One of the more significant effects of the new regime is that DIY investing will no longer be tax effective relative to managed funds. For many investors, managed funds will now offer a tax saving. If the DIY approach is more time consuming *and* incurs an additional net cost, then why not take the easier option - one which also provides the benefits of external expertise and advice. Of course, tearing New Zealanders away from residential property won't be easy. The gap between residential property and other forms of investment will be narrower, but the playing field still won't be level. Only time will tell whether the managed funds industry can have its PIE and eat it too.

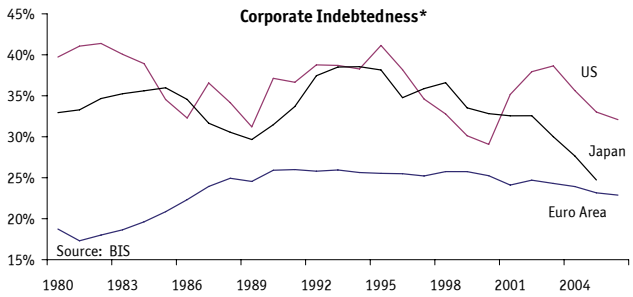
The consequences of excess leverage

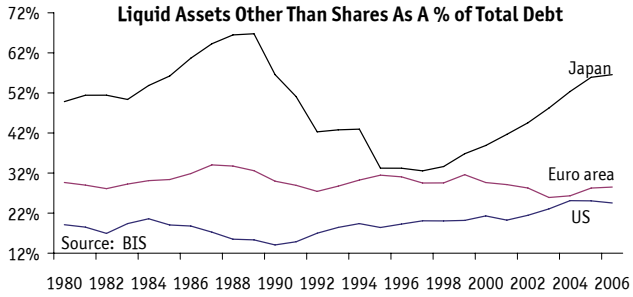
Deliquencies among sub-prime and Alt-A (largely low doc) loans have been steadily rising since late last year. However, it was only in late July as signs emerged that the fall-out was spreading outside the US, that equity markets and wider credit markets suddenly started to take notice. In fact, the time-line of events that led to the late July sell-off started with news that Moody's had cut the credit rating on 131 securities backed by sub-prime mortgages and announced that another 250 were up for review with a view to downgrade. In July, both Moody's and Standard & Poor's announced another substantial round of rating downgrades. The announcement on July 24 by Countrywide Financial of a sharp drop in earnings was just the straw that broke the camel's back.

We have been expecting a re-pricing of risk for some time - tighter credit underwriting standards and an increase in spreads for higher risk debt instruments have been long overdue. What has been surprising is the magnitude

of the flow-on effects onto wider credit markets. The level of volatility and illiquidity over recent months has been unprecedented. Even institutions that believed that they had been prudent and taken measures to minimise their exposure to sub-prime debt were caught up in the turmoil. The domino effect was exacerbated as a sharp fall in the price of Mortgage Backed Securities (MBSs) and Collateralised Debt Obligations (CDOs) triggered forced selling due to margin calls on leveraged investors. The credit rating downgrades also resulted in forced selling due to the restrictions that some institutions place on the ratings of securities that they are permitted to hold. Given a severe lack of buyers, these liquidations pushed prices down even more - the usual market conditions of a willing buyer and a willing seller were no longer in place.

It could be argued that recent events are just the beginning - spreads could widen further as the corporate sector follows households down the road of default, triggered by the combination of higher interest rates, a restricted availability of credit and an economic slowdown. We believe that credit conditions will settle. The main reason for our optimism is the financial health of the corporate sector. As shown in the graph below, corporate sector leverage has reduced during the last five years in both the US and Japan, and remains well below the highs seen during the dotcom boom. Leverage levels are not an issue in the Euro area either. Furthermore, companies have ample cash available to fund capital spending while they wait for credit conditions to settle.





* Debt of non-financial corporations, excluding shares, as a % of total assets

The trend towards sharply lower levels of leverage in the US appears at odds with increasing volumes of leveraged buy-out (LBO) activity. This is because the risks associated with the LBO boom are concentrated in individual companies and not the wider corporate sector. The total value of takeover activity has remained modest relative to the size of the overall market. We expect corporates in the US and other major countries to continue to have access to credit.

The Reserve Bank of New Zealand faces problems that are, in many ways, similar to those being experienced by the Federal Reserve. Like the US, we have a nation of highly indebted consumers. Like the US, there are signs that some consumers are starting to experience significant financial stress. However, in New Zealand's case, this stress is manifesting itself through finance companies and the problem has now escalated from one of consumer defaults to liquidity problems. Already, anecdotal evidence has surfaced of reduced lending for property development and cuts to existing funding from the banking sector. If the housing market continues to weaken as expected, another round of finance company collapses relating to exposure to the housing sector could eventuate.

While some increase in mortgage defaults would not come as a surprise, the household sector should avoid a significant increase in defaults even if the housing market continues to slow. Local banks hold most mortgages on their balance sheets rather than on-selling them onto investors as in the US, so credit underwriting standards tend to be more prudent.

A key area of concern is households' low holdings of liquid financial assets i.e. their reliance on housing assets,

which are relatively illiquid. Furthermore, a significant proportion of these housing assets don't earn any income - according to Spicers' Household Savings Indicators, almost 90% of housing wealth is tied up in owner occupied homes. In comparison, American households have larger holdings of financial assets that they can sell if they become strapped for cash. The US experience shows just how severe losses can be if a cash shortfall forces you to sell your home in an illiquid market. Hedge funds that have recently suffered losses due to sub-prime exposure are facing the same dilemma - waiting for conditions to settle is preferable in most cases to selling securities at "firesale" prices. However, many hedge funds haven't had that option - they have been forced to liquidate assets to meet margin calls.

EQUITIES

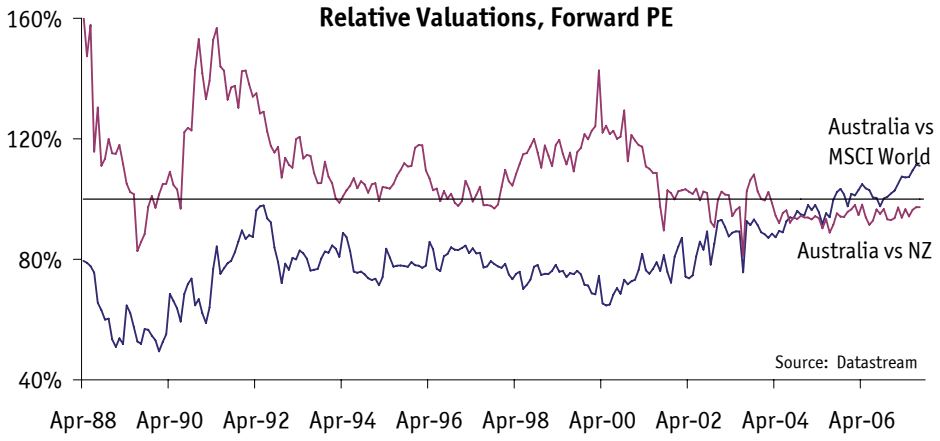
Australasian Equities

For some time now, we have been expecting the local sharemarket to under-perform that of Australia. Our concerns have been centred around the local market's reliance on private equity and takeover activity as a means of support and the absence of positive fundamentals to keep it going if that takeover activity disappeared - company earnings growth has been weak, the local economy is in a vulnerable position due to the high interest rate environment, and valuations have become expensive on a historical basis.

Relative performance data during the last 12 months show that our concerns were justified. Although both the New Zealand and Australian sharemarkets were caught up in the global volatility that started in late July, the Australian market has clearly outperformed. As at the end of August, the ASX All Ords Index was showing a year-to-date return of 13.5 percent. In comparison, the NZX50 rose just 1.6 percent. For the year ended August, the NZX50 recorded a healthy return of 17 percent, but the All Ords Index easily out-paced it with a 28 percent return. Going forward, we believe that relative risk-return relationship between the two markets remains unchanged. Australia continues to offer a broader range of opportunities with fewer risks attached.

Private equity and leverged buy-out (LBO) activity has remained strong in both countries. While some of the more leveraged private equity deals are likely to be put on hold due to funding constraints, this is not expected to have a significant impact. The majority of pending deals have relatively low gearing. Even if LBO activity does reduce significantly, Australia has the benefit of stronger fundamentals to provide support.

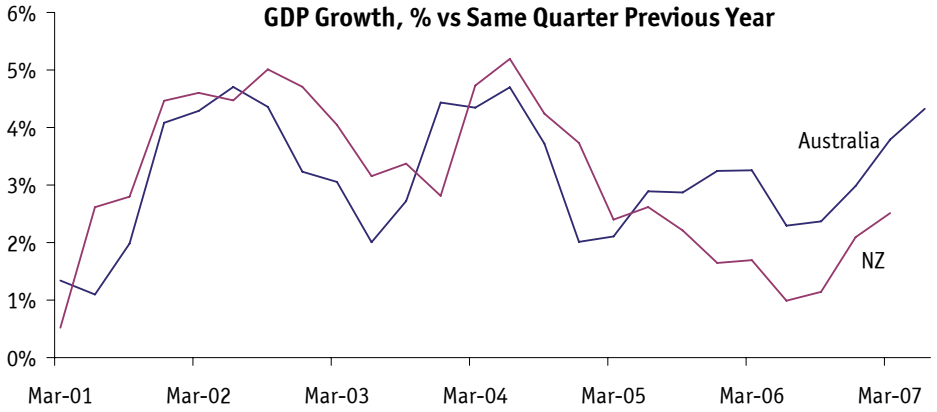
From a valuation perspective, the Australian market is no longer cheap, but it is not particularly expensive either - valuations are only slightly above the long run average. Relative to other major markets, the story is less clear. As at the end of August, the Australian market was trading at a small premium above the MSCI developed countries index (around 14.6 times forward earnings vs 13.6 respectively). As shown in the graph below, Australia has historically traded at a discount. However, Australia continues to offer value relative to the New Zealand market. Although our PE ratio has moved down from its recent historical highs to 15.4 times forward earnings as at the end of August, Australia's PE ratio has also declined. The Australian sharemarket has been trading at a small discount to the New Zealand market for over three years, which is unusual in a longer term context. A comparison of relative economic growth and earnings performance tilts the arguments even further in Australia's favour.



The risks of a hard landing in the domestic side of the economy have increased. The benefits of high commodity prices, and the booming dairy sector in particular, are expected to provide a boon for parts of rural New Zealand, but the benefits will not spread wide enough to cushion much of the household sector from very high interest rates and high levels of indebtedness. The housing sector's resilience last winter does not reassure us that the slowdown that is currently under way will once again be temporary. In fact, we are more concerned about the outlook than we were a year ago. Debt servicing costs have continued to climb during the last year, and housing valuations have become even more stretched relative to both incomes and rents.

Local companies are finding it difficult to maintain healthy profit growth. High inflation and higher interest rates have pushed up costs, but competitive pressures are limiting the ability of companies to pass these higher costs onto customers. Achieving volume growth has also been difficult. Median June year earnings growth for companies that had reported their results by late August was a mediocre 3 percent.

As shown in the graph below, the Australian economy is stronger than New Zealand's and significantly more robust. The Australian economy grew 0.9 percent in seasonally adjusted terms in the June quarter and 4.3 percent during the year. Although the New Zealand economy grew a healthy 1.0 percent in the March quarter, the annual growth rate was only 2.5 percent. Furthermore, Australia's annual growth rate underestimates the underlying strength of their economy, as it includes a significant negative impact from the drought. The annual growth rate in non-farm GDP in the year ended June was 5.2 percent, the highest since December 1994.



Source: Statistics NZ

Stock selection in both markets has become a much more difficult task than it has been for some time. However, the challenge in the New Zealand market goes one step further - the difference between the winners and losers is no longer the difference between a huge gain and a more modest one. Separating the winners from the losers has become the difference between a gain and a loss. Increasingly, picking the winners has meant being able to successfully identify potential takeover targets. While the new tax environment will see many local fund managers increase their strategic asset allocation towards the New Zealand market, the near term effect is likely to be largely offset by cyclical concerns.

Of course, just because the Australian market is more attractive than New Zealand's at this point of the cycle, it doesn't, by definition, imply that Australia stands out as an attractive proposition in its own right. In fact, there is a growing body of opinion that the Australian equity market is vulnerable, largely for valuation reasons i.e. as shown earlier, Australia has become expensive relative to the rest of the world.

Supporters of the Australian market argue that the PE discount that has traditionally existed relative to other major developed markets is no longer relevant. Australia has stable and low inflation, a sound fiscal and monetary policy environment and a large and liquid equity market that is no more volatile than most other major global markets. Furthermore, earnings growth among Australian listed companies exceeds that for the wider global market and dividend payout ratios are higher. Analysts in this camp argue that the premium on the Australian market is justified. What is more difficult to explain is its discount relative to the New Zealand market, which has persisted for around three years.

The issue, of course, is how long the factors mentioned above can continue to act in Australia's favour i.e. has Australia benefited from a structural change or is it purely a cylical argument? Earnings growth has not only been running at above trend, but it has been running at historical highs - return on equity based on earnings for the last 12 months is currently running at around 20 percent, the top end of the range for the last 30 years. This momentum will be difficult to sustain. Nevertheless, there is room for earnings growth to slow but still leave scope for shareprices to record reasonable gains without significant upward pressure on earnings multiples.

A key factor underpinning Australia's continued attractiveness is its ability to take advantage of the China/India boom, in particular through its resource sector. Although the resource sector as a whole is no longer cheap relative to the market, key mining stocks such as Rio Tinto and BHP Billiton are still trading at a reasonable discount based on forward earnings estimates. At this stage, we are comfortable being underweight the local market in favour of Australia.

Global Equities - Developed Markets

Problems in the US sub-prime mortgage market triggered a widespread correction in global equities during late July as investors succumbed to profit-taking and wound back levels of risk in their portfolios. The depth and magnitude of the fall-out has exceeded expectations and as a result, the risks surrounding the US economy and the potential for a flow-on effect onto wider consumer spending have increased.

The bad news from the US housing sector is not yet over. The 2 year teaser rates that are the main source of sub-prime delinquencies continued to be issued into the first half of 2006 and the last of these loans will not expire until well into 2008. The wider real estate market and home prices are therefore likely to remain under downward pressure for some time. The odds of a downturn in consumer spending would further increase if the equity market were to suffer a prolonged downturn due to the significant weighting of financial assets in household balance sheets.

Global equity markets will remain vulnerable to further periods of volatility as more bad news relating to the sub-prime crisis emerges. However, we expect the positive fundamentals that continue to support equities to eventually prevail. The Federal Reserve's recent moves to add liquidity to the financial system and its willingness to cut both the discount and fed funds rate suggest that while the inflation outlook is a concern, it is willing to take action if necessary. The inflation problem is not big enough to supersede the threat of financial instability and recession. Furthermore, the pace of earnings growth in the US has continued to surprise analysts, who have been expecting a slowing for some time. Recent growth rates will prove difficult to sustain, but are not expected to slow dramatically.

A market that has been particularly prone to an over-reaction during recent times is Japan. Their sharemarket was a significant under-performer during the July-August period of market volatility, largely reflecting a perceived

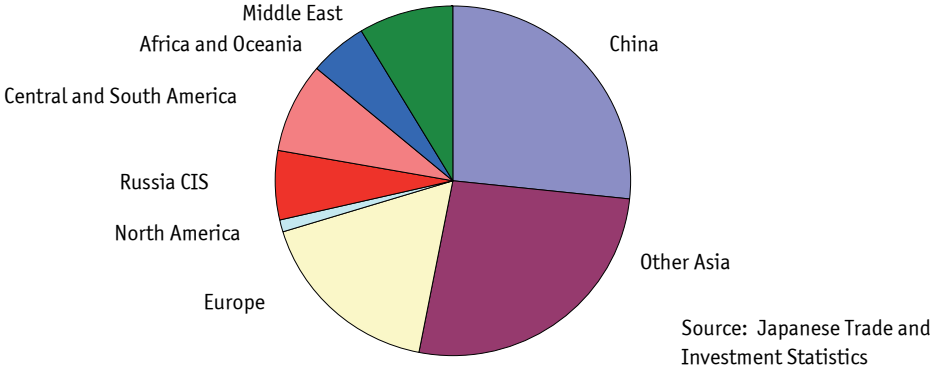
reliance on US exports. These concerns were exacerbated by the release of June quarter GDP, which was up only 0.1 percent. Furthermore, net exports failed to make a positive contribution to growth, and exports to the US were flat. While we are cautious regarding the outlook for the Japanese economy, we believe that the market's recent reaction was overdone for the following reasons:

- Although exports to the US account for just over 20 percent of the total nominal value, the US has not been a driving force behind Japan's recent export performance. In the four months to April, nominal exports were up a healthy 9.5 percent on the levels of the same period in 2006 and as shown in the graph below, more than half of this was attributable to the growing Asian market. Exports to Asia were up 10.6 percent, while exports to China were up 18.5 percent. Exports to Europe were also strong.

- The failure of net exports to make a bigger, positive contribution to June quarter GDP was partly due to the strength of imports. Imports have risen at a solid pace of 0.8-0.9 percent for the last two quarters, suggesting that domestic demand is not, in fact, dormant.

- Exchange rate effects alone are not expected to be enough to stop exports to China and other rapidly growing Asian economies from increasing - demand is expected to be underpinned by strong economic growth.

Contribution to Japanese Export Growth, YTD, April 07 vs Same Period Previous Year



For Europe and other major economies, the arguments for an economic slowdown in response to a weaker US economy are even more tenuous. The global economy is currently in its fifth consecutive year of above average growth, and recent events are unlikely to stop this from continuing. Balancing the softer outlook for the US economy is a stronger performance from Australia and non-Japan Asia. Growth in China, in particular, has continued to exceed expectations, despite the government's attempts to take the heat out of activity - their economy grew at an annual pace of almost 12 percent in the June quarter.

The relationship between the US and the world has not just de-coupled, but has to some extent switched direction. Major global economies are no longer heavily reliant on the US, as other countries have taken its place as the driving force behind global demand. In fact, the US is continuing to benefit from its own exports to the rest of the world. Nevertheless, there are risks to their growth outlook and these risks have recently increased. Our views are based on an assumption that current liquidity issues will be resolved. We will be monitoring the situation closely.

While the outlook for global equities generally remains positive and we believe that recent events merely triggered a short-term correction within an upward trend, the returns of recent years will be difficult to repeat. Despite the European market's out-performance over the last year, it still stands out as offering reasonable value. In comparison, the US market is no longer cheap, but it is not expensive either. The resilience of earnings growth

among US companies has been very encouraging, but it will be difficult to sustain going forward, implying only a modest increase in equity prices or a increase in the price-earnings ratio. In the current economic environment, we favour the former i.e. only modest share price gains.

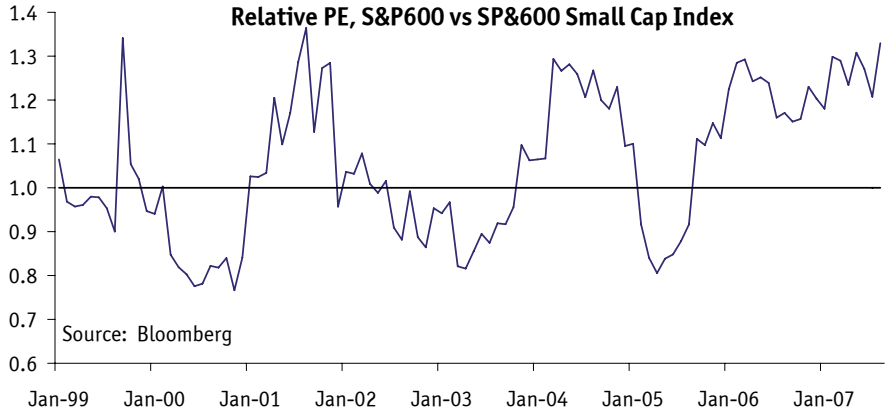
Another influence that has been positive in the past but is expected to play a smaller role going forward is private equity activity and LBOs. The cost of obtaining credit has increased and the financial sector is more cautious about funding deals. In fact, the higher cost of credit among companies that have been the target of leveraged buy-outs places some of the more highly geared companies at increased risk of default.

Potential sources of opportunities in this asset class going foward include:

- Emerging markets and Europe continue to offer the combination of reasonable valuations and a generally positive economic environment. Our view on emerging markets is discussed in the next section.
- A potential change in the relative performance of growth stocks vs value stocks.
- A potential change in the relative performance of small cap vs large cap stocks.

Value stocks have outperformed growth stocks largely since the dotcom bubble burst and 2006 was no different - the Russell 1000 value index returned 22.2 percent last year compared to a 9.1 percent return for the growth index. Year to date to the end of August, however, it is growth stocks that outperformed (6.9 vs 2.0 percent respectively). Has the trend finally turned?

During the last 28 years, growth stocks have traded at an average premium of around 1.55 relative to value stocks based on the price-to-earnings ratio of the Russell 1000 growth and value indices. During the tech bubble, the premium attached to growth stocks reached extreme highs of almost 3.5. Despite the shift in relative performance over recent months, as at the end of August, the discount attached to value stocks remained below the long term average at 1.43.



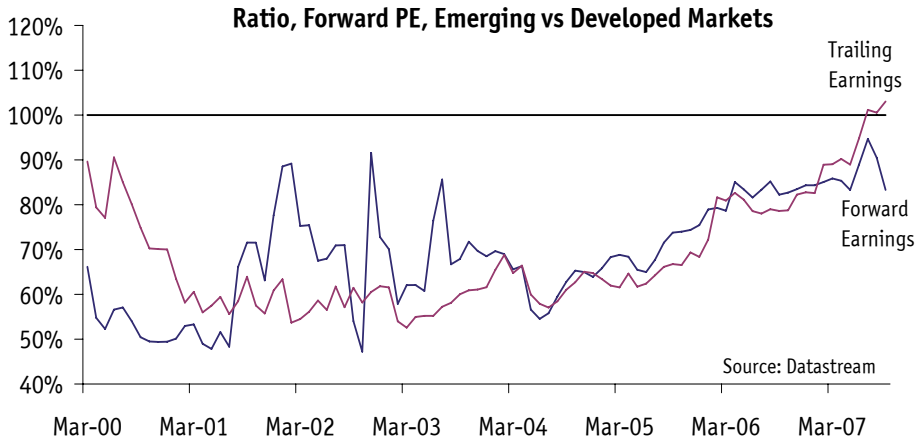
Like value stocks, small cap stocks have also out-performed since the bursting of the tech bubble in 2000 - the S&P600 Small Cap Index rose 118 percent during the period compared to 76 percent for the large-cap S&P500 Index. During the last few months, however, the S&P500 (large caps) has out-performed. Intuitively, one would expect small caps tend to out-perform during a period of strong economic growth, but under-perform during an economic downturn. This is because large companies tend to have more diversified income streams. Small caps also tend to be inherently more volatile. Consequently, it would be logical to expect that small caps would, on average, trade at a lower multiple than large caps to compensate for this extra risk. As shown in the graph above, during the last 2

years the premium on small cap stocks has been rising. We believe that this trend is unsustainable.

Global Equities - Emerging Markets

Emerging markets were caught up in the derisking of investor portfolios of late July/August. While some similarities exist with pre-1997 crisis conditions e.g. easy money, a trend towards currency appreciation and higher asset prices, there are also several important differences.

- Economic growth in 2007 is expected to be slightly slower than the 7.4 percent recorded in 2006, but still stronger than the year before. However, there is an inflation risk attached to this sustained, strong growth performance.
- Many countries have accumulated significant foreign reserves. In contrast to the 1990s, the source of currency inflows has been current account surpluses rather than capital flows. This reduces vulnerability to shocks and to a sudden outflow of foreign capital.
- There has been a general trend towards a structural improvement in fiscal policy management. The median debt/GDP ratio for all EMEs fell around 14 percentage points to 33 percent between 2003 and 2006, with Brazil, Chile, Colombia, Peru, the Philippines, Russia, Thailand, Turkey and Venezuela all recording an improvement in excess of 10 percent of GDP. A number of countries have developed stabilisation funds that will allow a smoothing of government spending during bad times, using revenue that was accumulated during the good times. Some countries have also started up wealth funds to support future generations in case resource stocks start to run out.
- A number of countries have undertaken debt management operations in order to reduce reliance on foreign currency debt (and hence exposure to currency risk), improve the terms of financing, extend maturities and reduce currency mismatches.
- The allocation of large funds and institutional investors to this sector has gradually been increasing for diversification reasons.



While we believe that this sector continues to offer potential, it is no longer cheap on a valuation basis. As shown in the graph above, the discount relative to developed markets is now reasonably narrow based on forward earnings.

Based on trailing earnings, emerging markets now trade at a small premium. Consequently, we will be trimming our overweight position in this sector.

BONDS

Government bond yields in many parts of the world have benefited from a flight to safety over recent months. An escalation of problems in the US sub-prime mortgage market during late July triggered a sharp and sudden global de-risking of portfolios that had ripple effects across the globe. The threat of a global credit crunch prompted the major global central banks to take action during August, injecting liquidity into markets in an attempt to restore confidence. When this failed to impact, the Federal Reserve went one step further and cut the discount rate and then the fed funds rate.

In New Zealand, long dated bond yields followed the US rally, while bank bill rates rose sharply in response to liquidity concerns. The Reserve Bank of New Zealand followed the lead of other central banks in easing liquidity conditions - the Bank announced that it would accept bank bills in its overnight repurchase facility.

We believe that the upward trend in mortgage delinquencies in the US is not yet over. The 2/28 loans that were issued during the housing boom continued into 2006 and are therefore not scheduled to expire until the first half of 2008. Delinquency rates for loans issued in 2005 have been higher than those issued in 2004, and it is likely that this trend will continue.

We do not expect a credit crunch to occur. Markets have a tendency to over-react in times of extreme uncertainty, and the recent past has been no exception. The conditions that resulted in a rise in delinquencies in the sub-prime mortgage market were unique to those borrowers and the flow-on effects have been significantly disproportionate to the underlying magnitude of the problem. As explained earlier in this report, corporates in most parts of the world have strong earnings growth and healthy balance sheets and most should continue to have access to credit. We expect that for creditworthy borrowers, much of the recent tightening in credit conditions will be reversed.

Nevertheless, due to the fragile nature of market sentiment, we are wary of the possibility of a full-blown credit crunch. A sustained loss of confidence that results in a permanent credit squeeze could threaten macroeconomic stability, resulting in an increase in corporate defaults and a further destabilising of credit markets. While we are monitoring this risk, we do not believe that it is the most likely scenario. The restoration of "normal" market conditions will depend to a significant extent on the Federal Reserve's determination to do what it takes to ensure that this happens and we believe that it will come to the party. While the Fed is concerned about inflation and would prefer not to bail out irresponsible behaviour, it will do what it takes to restore stability, including cutting interest rates further. There is no reason why otherwise financially sound businesses should be dragged down with the irresponsible ones.

The liquidity squeeze is not unique to the US - many other countries face the same issue. While central banks have generally responded by injecting liquidity, their efforts have had limited success. There is a general perception that because the problem stems from the US, the Federal Reserve must take primary responsibility for fixing the problem, and the Reserve Bank of New Zealand appears to follow this line of thinking. However, domestic financial market participants generally believe that this reliance on the Federal Reserve is too great and a stronger domestic response is needed. While the cut in the fed funds rate helped liquidity conditions to improve in many parts of the world, including New Zealand, it is still a little early to gauge the extent of the improvement.

Unfortunately, New Zealand faces a more difficult situation than many other parts of the world. Due to the fragility of the finance company sector and vulnerability of the domestic economy to a downturn, there are additional pressures other than just global ones that are weighing on liquidity and access to credit. Furthermore, the inflation outlook is sufficiently worrisome to make the Reserve Bank strongly resist a near term cut in the OCR just in case it reignites the housing market. If liquidity conditions do, in fact settle, it would be faced with having to later reverse the cut. With tradables inflation expected to rise in response to the currency and higher commodity prices, the Bank desperately needs domestic sourced inflation pressures to slow i.e. it needs the housing sector to continue along its current weakening path. Clearly, there is no scope for the housing market to find its fourth wind. We believe that the Reserve Bank will focus on non-OCR measures to improve liquidity conditions.

In its recent Monetary Policy Statement, the Reserve Bank was projecting the Official Cash Rate to remain at its current high levels until 2009. The best chance of an earlier cut is if the domestic economy and housing market weaken significantly, and unfortunately, this is starting to look like much more than an outside chance. We expect a struggling domestic economy to result in a cut by around the middle of next year.

Given the very high level of domestic short term interest rates, there is little incentive to be taking on either credit risk or duration risk. We believe that the scope for further, near term falls in domestic bond rates is limited, and government bond yields are vulnerable to a sharp retracement if liquidity conditions improve. Sharply lower bond yields are clearly not justified by the inflation outlook.

The recent cut in the fed funds rate should be interpreted, at this stage, as a measure to improve liquidity and not as the start of the easing cycle. Nevertheless, given the risks surrounding the US economy, their easing cycle is likely to commence by late 2007/early 2008. However, this does not imply that other countries will follow suit, although further rate rises could be delayed. We will continue to monitor the risk of a credit crunch, as this could threaten macroeconomic stability and force a global trend towards lower bond rates.

PROPERTY

The domestic listed property sector has generally under-performed the wider sharemarket since April. After an initial surge in response to the Government's decision in late 2006 to extend the benefits of the new investment tax regime to this sector, sentiment has deteriorated. Local property companies are enjoying high occupancy rates, rental increases and asset revaluations, but high valuations and rising interest rates have weighed on sentiment.

Gearing levels in the sector have increased over recent years and high interest rates are impacting on debt servicing costs. New development projects are likely to be affected by the collapse of several finance companies through the reduced availability of credit, but the impact should fall mainly on the highly geared projects of developers that rely on mezzanine funding and subordinated debt from this sector. Listed property companies have lower levels of gearing and are more heavily reliant on bank and investor equity funding.

Like the local property sector, Australian listed property trusts have also come under selling pressure over recent months. A higher than expected June quarter inflation out-turn, another interest rate rise in late July and the sell-off in global REITS added to existing valuation concerns. Australian property giant Westfield reported recently that subprime issues had impacted negatively on sales in its US shopping malls, which initially weighed on the stock.

The surge in capital raisings that occurred during the June quarter is unlikely to continue while market conditions remain nervous and volatile. In the June quarter, a total of $A6.1 billion in equity was raised, the highest quarterly

total ever recorded.

More recently, sentiment in Australia has improved with the help of a recovery in global REITs and a fall in bond rates. Investors have also responded to the improvement in valuations following the sharp sell-off of recent months. The Australian market recovered strongly towards the latter part of August, led by market heavyweight Westfield. The ASX300 Property Index finished the month up 7.8 percent. In comparison, the NZX Property Index posted a 1.3 percent decline.

Locally, the new tax environment will see many fund managers increase allocations to the sector, but cyclical issues are likely to minimise the initial impact. This sector remains vulnerable to any further weakness in global markets and concerns about a credit squeeze. We continue to favour infrastructure due to its defensive qualities.

INFRASTRUCTURE

As with property stocks, infrastructure companies were also negatively affected by the environment of high interest rates during the June-July period. Analysts' concerns have been centred around the rise in gearing levels over recent years.

While the impact of rising interest rates on existing debt will be minimal due to significant levels of hedging, some companies re-gear to fund distributions. Macquarie Infrastructure Group, the biggest player in the sector, has been negatively affected by such concerns over recent months. Higher interest rates also impact negatively on the cost of future expansion. These interest rate concerns have overshadowed the sector's otherwise defensive qualities.

Despite recent volatility and weakness, this sector remains attractive for cyclical reasons. In an uncertain economic environment where many New Zealand companies are finding it difficult to maintain earnings growth, this sector offers stable cash flows and monopoly or near monopoly conditions. Valuations have also become more attractive due to the sector's weak performance over recent months. While the rise in interest rates will impact on debt repayment costs and the cost of investing in new projects, the higher inflation environment effectively provides some hedging on the revenue side as cashflows are often CPI-linked.

This sector has expanded over recent years. Infrastructure and utility stocks now account for 5.2 percent of the ASX/S&P200 index compared to only 1.1 percent five years ago and compulsory superannuation has played a significant role in this growth. More recently, the Australian market has also started to experience the development of retail products. We expect New Zealand to experience similar benefits as the pool of KiwiSaver funds grows and the private sector becomes more involved. While there is likely to be some political and public resistance to private/public partnerships, we believe that this will be gradually overcome by the necessity of a severe backlog of required infrastructure investment. Nevertheless, the government will continue to play a significant role - both the Australian and New Zealand governments remain committed to significant increases in infrastructure spending.

CURRENCY

Up until late July, the New Zealand dollar was in a strong, upward trend. Four consecutive rises in the Official Cash Rate and an environment where yen carry trades were very popular saw the New Zealand dollar soar to post-float highs of more than 80 cents against the US dollar. Several bouts of intervention by the Reserve Bank, the first since the currency was floated, struggled to slow the rise. It was a reassessment of risk appetites due to the US sub-prime

crisis that finally reversed the upward trend in a dramatic fashion. Hedge funds scrambled to unwind yen carry trades and over the next few weeks, the New Zealand dollar fell by more than 10 cents against the US dollar to lows of around 67 cents. The decline in the crossrate against the yen was even larger.

A record $3.5 billion in Uridashi and Eurokiwi bonds matured in August, around $2 billion of this on one day (the 20th). Concerns about the likely impact weighed on the currency in the days leading up to the 20th, however, the actual day passed without fuss. While new issues haven't kept up with the surge in maturities, a significant proportion of the funds didn't leave the country either. The funds that weren't reinvested have tended to remain in New Zealand, but have remained invested in liquid assets and are therefore vulnerable to another deterioration in sentiment.

The New Zealand dollar continues to face conflicting pressures. Positive influences include very high terms of trade and a wide interest rate differential. Demand for yen carry trades has recovered since the unwinding of late July/early August, and if confidence in these trades continues to improve, the New Zealand dollar would struggle to resist the global trend. However, we remain very cautious in this regard. Significant leveraged carry trade positions continue to exist, particularly among hedge funds, and any shock that triggers a sharp rise in the yen could prompt a further rapid unwinding. These leveraged carry trade positions pose a risk to stability in currency markets in the same way that leveraged holdings of CDOs and MBSs were a risk to stability in credit markets. We have seen over recent times just how significant the implications can be if leveraged trades start to incur significant losses.

The New Zealand dollar also faces the growing risks associated with a deteriorating local economy. Economic data over coming months are expected to show a further slowing in the housing market and ongoing stress in the household sector. Also arguing in favour of a continued currency decline is the fact that the current nervous tone in markets and deterioration in the economic outlook is coinciding with record levels of maturities of Uridashi and Eurokiwi bonds. The $3.5 billion in bonds that matured in August were just the start of a trend that will continue into year end - approximately another $8.0 billion in bonds will mature between September and December. The next peak will be in October, when $3.9 billion in bonds will mature, a new monthly record. It will be difficult to match the surge in maturing bonds with new issues.

We continue to run hedging levels that are at the lower end of benchmark ranges as we believe that the currency is still overvalued and fundamentals will eventually prevail.

Asset allocation: Conclusion

CONCLUSION

Recent events in investment markets highlight the importance of diversification and sound investment strategy. At times, the temptation to blindly chase returns without fully considering the risk implications can be powerful. Playing it safe and investing in a diversified portfolio may mean that returns are sometimes disappointing relative to other "flavour of the month" opportunities, but at times like these, those diversified investors should take heart. Higher risk strategies can play a useful role in an investment portfolio, but the allocation to such assets should be a small one. Diversified investors have also benefited over recent months from the natural hedging qualities of the New Zealand dollar - its recent decline has largely offset the negative impact of the recent weakness in equity markets.

The other concern at times of extreme volatility is that investors get so caught up in the day-to-day drama that they lose sight of fundamentals. While the rise in mortgage defaults in the US has been sharp, the wider reaction within credit markets has far exceeded what one would normally expect given the circumstances, even if one takes into account the tendency of markets to over-react. The total amount of at-risk mortgages is only a small part of the total mortgage pool in the US and the risk is concentrated within a small group of borrowers and a small part of the financial sector. The wider financial and corporate sector is fundamentally sound and the wider household sector is reasonably secure also.

Despite the recent volatility in equity markets, the outlook remains fundamentally sound. The global growth outlook is strong and no longer heavily reliant on the US, companies in many parts of the world are enjoying robust earnings growth and valuations are not extreme. Although the returns of recent years will be difficult to match going forward, New Zealand investors should keep in mind the potential for currency effects to contribute positively to returns.

It is tempting to get caught up in the recent rally in bond markets and the negative sentiment surrounding the US economy. At this stage, however, the interest rate cuts that we have seen are due to liquidity issues and not an improvement in the inflation outlook i.e. they should be treated as a one-off event rather than the start of a cyclical shift. Nevertheless, the start of the US easing cycle is getting nearer.

In New Zealand, the Reserve Bank will continue to strongly resist a cut in the Official Cash Rate, but the domestic economy is looking vulnerable and we expect a significant slowing to result in the first rate cut by around the middle of 2008. Given the current level of cash rates and with the yield curve so steeply inverse, the incentive to take on extra risk by increasing exposure to the fixed interest sector isn't compelling. Government bond yields could rise sharply as liquidity issues are resolved.