

ECONOMIC OVERVIEW

OCTOBER 2008

The purpose of this latest Economic Overview is to outline where our managers have been positioned, how this impacts on overall exposure within client portfolios, and to attempt to put some perspective on the economic and market outlook. Communicating this is crucial at times like this, when there is so little clarity and far too much noise and uncertainty. It also gives us the opportunity to reiterate our investment philosophy and strategy - to protect capital when market conditions become very risky, so that capital remains intact and we can take advantage of opportunities when the eventual recovery occurs.

We believe that our strategy is always a low risk approach to investing. When market conditions are not risky, for instance when valuations are attractive and economic growth and profitability is recovering, we look for managers to have a very high exposure to the markets, expecting them to be 100% net invested. Conversely, when market conditions become riskier; when valuations are stretched or economic growth is about to contract, we look for them to reduce exposure to take away the risk of the markets. Taking this approach ensures that the overall risk profile across client portfolios is low most of the time. We firmly believe that it is easy to make returns when markets are going up but the real long-term outperformance comes by not losing money when markets fall. This is why over the last 17 years of managing clients' capital we have outperformed the markets by 2.5 times. Consequently, this explains why we have had a very low net exposure to markets for all of 2008.

September's exposure was 13% net invested.....

When we last wrote to you in July, the net exposure in clients' portfolios to the markets had been reduced from around 34% in May to 28% net in July. At the time we said that we believed that a 28% net exposure to the markets was suggesting that the fund managers were taking a very cautious and defensive stance. With the month of August seeing further deleveraging in global credit markets leading to increasingly unpredictable falls in equities, managers saw this volatility as rationale to reduce their exposure further. Consequently, by the end of August the net exposure had been reduced to 18%. The continuing uncertainty within the first week of September saw them cut exposure even further to 13% net.

We were relieved to see that managers had moved to this defensive position before the severe volatility occurred in the middle of September when markets fell sharply in response to the demise of investment bank Lehman Bros and the bailing out of Merrill Lynch and AIG. Such a low net exposure has allowed managers to navigate more safely through the worst of the September market turmoil with much less impact to overall portfolio performance than we would have expected considering the size of falls in markets and the severity of the volatility.

We have continued to speak to the fund managers on a regular basis to assess how they are approaching the volatility and to gauge their reaction and expectations going forward. It is continually reiterated to us that if equity valuations were fairly valued before the credit crisis came to head in August last year, then after 20 – 30% falls in major markets this year alone, stocks are now very, very oversold and valuations

have become cheap - even allowing for downgrades to earnings to reflect what is becoming apparent, a slowing world economy. In a letter 6 months ago we showed a chart that plotted global price earnings ratios (P/E) going back to the late 1980s. This showed that the P/Es for global stocks were at their lowest level since the last major global recession in 1990. Since then the fall in share prices over the last 6 months has pushed P/Es far below the levels that we saw in 1990, suggesting that markets are more oversold and cheaper than at any time over the last 30 years. The issue for fund managers is when to deploy the cash that they have built up to capitalise on these opportunities?

Looking forward – possums in the headlights.....

Sentiment is certainly being determined by what we read and hear in the media. Right now airplay seems to go to those commentators who can sound the most bearish! Maybe this is an indication that we have already reached the bottom!

This makes it very hard for investors to see much further ahead than the hand that is in front of their face. Panic and fear does that. This crisis is very different from 1929, or Japan in the 1990s. Yet sitting watching the news you get far too many comparisons. Ill guided and ill informed? Yes, this is very different! Back then there was either no policy response or it was totally the wrong response in the case of Japan where the Bank of Japan actually raised interest rates – twice! This time, the policy response all around the world has been swift, none more so than in the US. Certainly there will be debate whether all the actions have been the right ones, and whether it has been enough, but at least there is action.

The potential for significant interest rate cuts is building as inflation disappears

Central Banks are also shifting their bias from raising rates to cutting rates. The continuing noise from some Central Bankers about inflation concerns is just too hard to understand. Commodity prices have fallen sharply, and not just oil; manufacturers will find it increasingly harder to pass on price increases to a less healthy consumer; and as economic growth slows unemployment will rise. Couple that with the strong deflationary impact that comes from falling asset prices and the world may well be facing a deflationary shock rather than any lingering concerns about inflation. This should in turn see interest rates tumble around the world. This is ultimately very stimulatory for global growth once the current credit crisis is resolved.

Just how much the credit crisis in the global financial system impacts on global growth is still being debated? It is impacting – the economic data makes that clear, but the issue is whether the credit markets can be freed up quickly enough to reduce the impact on the broader economy. That will be played out in the weeks and months ahead, but it is interesting that the debate is still focused on whether the US economy is in recession or not and if so how severe. That is the debate that has been going on since the end of last year and still there is no clear answer!! This tends to suggest that if the credit and banking markets can begin to function more normally again, then the economic impact may not be too great to the broader economy which up until very recently has been performing well. If the US weathers this storm well then that would suggest that the global economy goes through a slowdown or very mild recession rather than a deep recession that seems to be already reflected in asset prices.

Moving through the credit crisis.....

To help put a perspective on where we are in the credit cycle, one of the research houses that we subscribe to, Bank Credit Analyst, has put together a very useful checklist of events that need to occur to see a way out of this crisis.

Required Actions

- | | |
|--|-----|
| 1. Aggressive Fed easing accompanied by an open-minded commitment to ease further if necessary | yes |
| 2. Non-conventional policy support | yes |
| 3. A steeper yield curve | yes |
| 4. Fiscal stimulus | yes |
| 5. A major fiscal bailout | yes |
| 6. Coordinated easing by global Central Banks | no |
| 7. A moderation in the decline in housing prices | no |
| 8. Increased transparency and recognised losses in the financial sector | no |

Responses to date

1. So far 1 has been achieved with The US Federal Reserve having cut interest rates quickly and aggressively to 2%. With the Federal Reserve showing that they are prepared to do whatever is necessary to shore up the US financial system, there is now a growing expectation that interest rates will be cut even further.
2. Non-conventional policy support – we have witnessed that the US Treasury has been prepared to inject capital into “at risk” financial institutions that has resulted in the bailout of Bear Sterns and the effective nationalization of Fannie Mae, Freddie Mac and AIG.
3. A steeper yield curve was initially achieved with the sharp cuts in interest rates that is necessary to allow banks to recover profits through borrowing at lower rates and lending at higher rates. The events of September have unwound this with the yield curve flattening and therefore further rate cuts are required.
4. Fiscal stimulus – the major Central Banks have injected billions of US\$ to the inter-bank market in an attempt to improve liquidity.
5. The passing by Congress on Friday of the US\$700bn rescue package is a step in the right direction and will go some way to restoring sentiment and confidence. However, this may only be the first of a number of bailout packages that may be required before the credit markets begin to function normally.
6. We have yet to see coordinated easing of monetary policy from Central Bankers around the world. It has started with the US, China, Australia and New Zealand all in easing mode. While the European Central Bank has shifted its position, it has still to begin cutting rates. Much the same applies to the UK. However, we may not be too far away from the coordinated policy response required.
7. House prices are continuing to fall though there are some tentative signs that the market may be getting close to a bottom.
8. Still some way to go.

How far through this crisis we are is still a very difficult question to answer. However, we have found the table above useful to give some sort of perspective on the steps required to get closer to a resolution and what steps are being covered. Certainly the events in September have been important in forcing appropriate policy responses from politicians and central banks around the world. The sharp selloff in markets following the Lehman Bros collapse and bailout of AIG has led to far more rapid and appropriate responses to bailing out a number of financial institutions in the US and Europe. And it is in Europe where we are seeing surprisingly swift and positive action though it is yet to be coordinated. The bailout of Fortis by the governments of Belgium, the Netherlands and Luxemburg, the nationalizing of Bradford and Bingley in the UK and in the last few days, Ireland and Germany moving to guarantee bank depositors' funds.

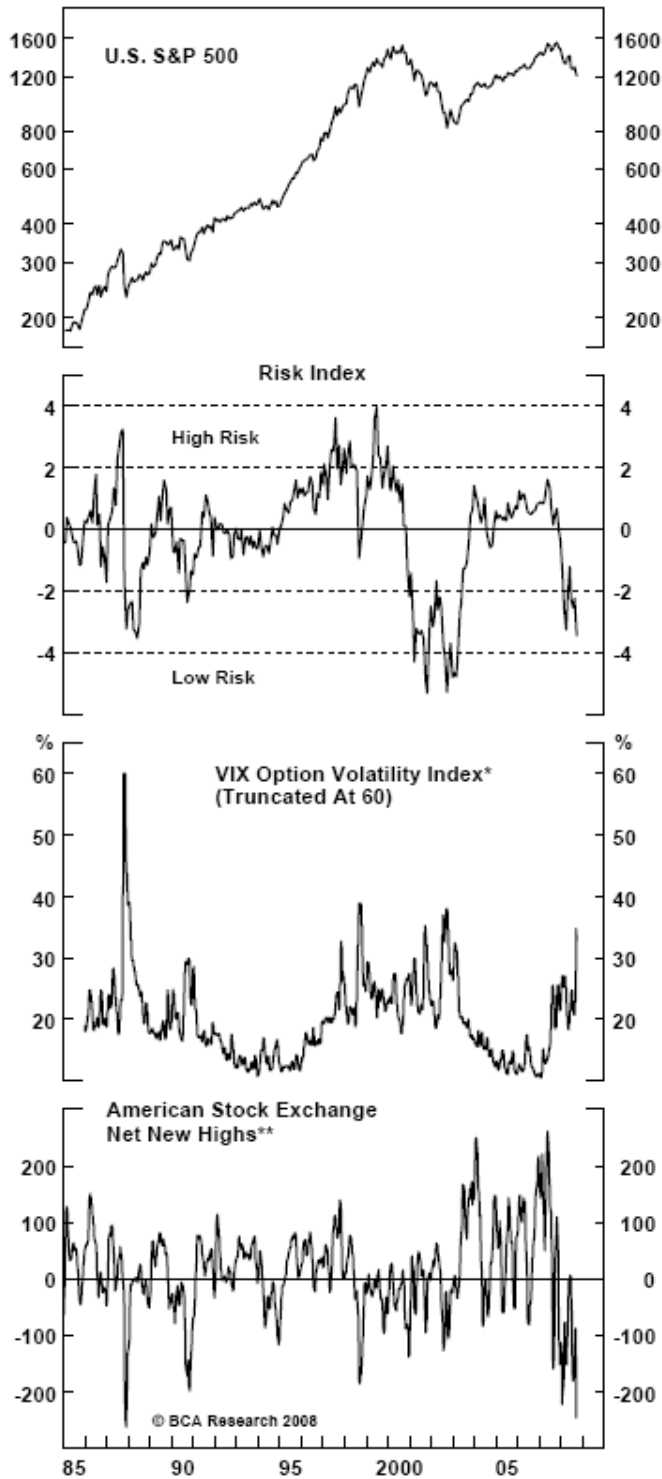
Trying to pick a bottom

Clearly, the second half of September has seen a riot point for markets as it appears that if there were any bullish investors left, they just capitulated. This riot point has been positive from a policy response perspective, as it has forced authorities around the world to begin acting to deal with the credit issues. The passing of the US\$700bn package in itself may not be enough to solve the problems but ultimately it should begin the process that reduces the fear and panic in the markets.

There are, however, a number of indicators that tend to suggest over the last few weeks we may be getting a little closer to a bottom in the markets. It is always very difficult to pick the bottom in share prices especially when there is so much fear in the market, yet there are a number of indicators that we can look at that in the past have shown the way forward in previous bear markets.

Chart 1 shows BCA's Risk index. Equities are now clearly in the "low risk" zone; anything over the -2 standard deviation mark suggests a reversal is imminent as it was in 1987, 1991 and 2002. At these levels the Risk Index also signals that the bear market is mature. The last time it approached these levels was in 2002 when the catalyst for the fall in share markets was extreme overvaluations. In 2000, the MSCI Global Index was trading on a P/E of 36 times compared to the start of this bear market in August 2007 when the P/E ratio was 17 times.

Chart 1



* Source: Chicago Board of Options Exchange, shown smoothed except for latest datapoint. VXO prior to 1990.
 ** 52-week new highs minus new lows, smoothed.

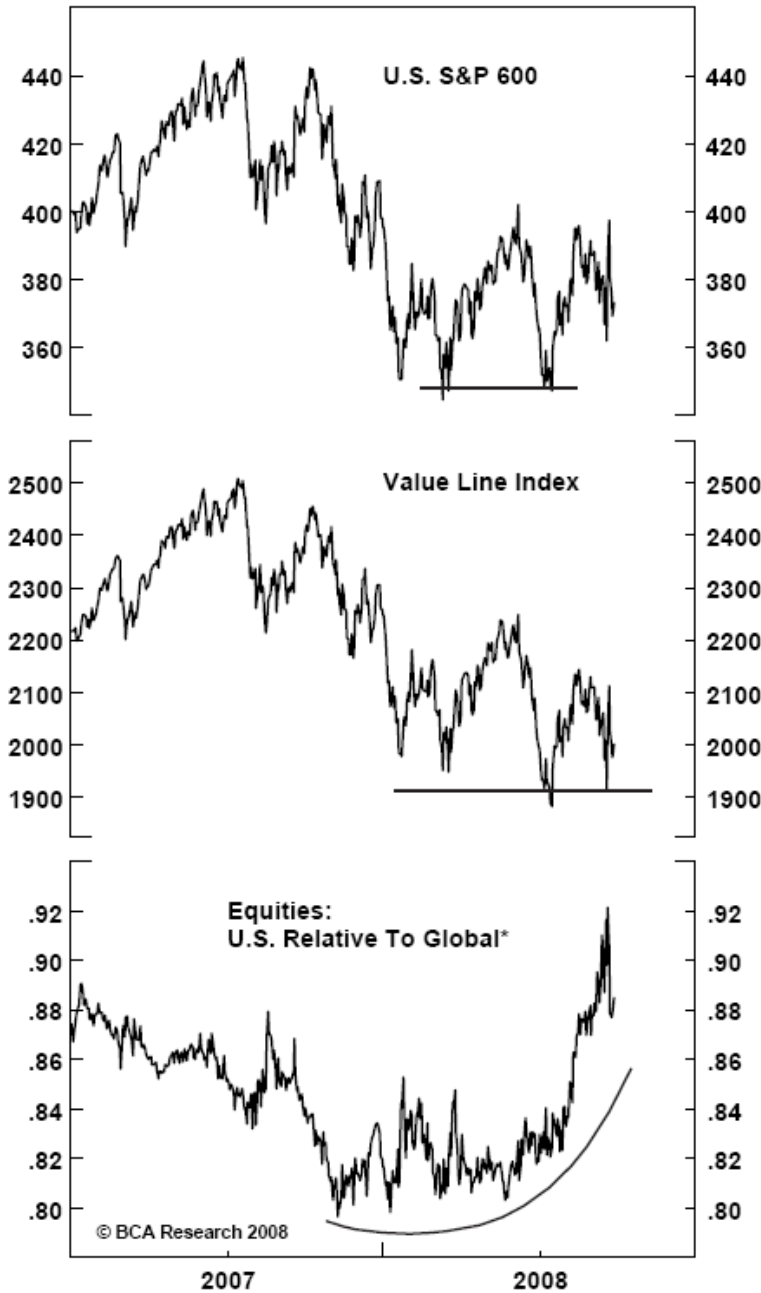
Another important indicator is the volume and breadth of activity in the US market. While markets have gone up and down markedly in September, it has been on small volumes and across the full breadth of the market; a sign that investors are dumping shares indiscriminately rather than on any particular objective view of a share's value.

The sharp rise in the volatility of the market as represented by the VIX index (**Chart 1**) is also an accurate indicator of a mature bear market. As you can see from the chart, the last time the VIX reading was above 40%, as it did after the "no vote" last week (this chart was dated 26 September 2008), was back in 1987. It is viewed that a very high VIX index suggests that the stock market is over-discounting risk.

Finally, the bottom panel in **Chart 1** suggests that the US stock market is very oversold. The last time this index reached these current levels was in 1987.

Trying to take a read from these indicators is very difficult, but it may be suggesting that through all the noise surrounding the credit markets, the equity markets may have sold off too far and a bottom maybe developing from which a rebound can begin.

Chart 2



* Thomson/Reuters data.

Unusual US stock market behavior.....

Contrary to perceptions we are also seeing some interesting and unusual US stock market behavior. There has been a strong perception that the credit crisis has had a significant impact on the broader US economy leading to a contraction in domestic activity. Therefore, the small cap index, the S&P600, which reflects stocks with a very strong domestic focus, should have fallen sharply along with its bigger brothers the Dow Jones and the S&P500. Yet, as the following **chart 2** shows, the US small cap index is still way above its lows that were reached earlier in the year and have been actually recovering in the midst of this latest crisis. This would suggest that to date the credit crisis hasn't fed into a downturn in the domestic economy.

The Value Line Index, "which is the arithmetic average of all listed stocks in the US", has also recovered off its lows. This is despite the sharp fall in the S&P500 index though this is due to the large banking/finance component to the index. This also suggests that the broader market is trying to find a bottom.

These US market indicators, while suggesting that a bottom to the market is forming, also tell us that that the US economy has not fallen into the severe recession that so many seem to believe. It is also possibly reflective that the US corporate sector is also underleveraged and the impact of the credit crisis is not impacting balance sheets and profits. In fact the corporate sector globally is underleveraged, which should help businesses weather the storm far better than in 1990 when the debt was in the corporate sector. This

again stresses why it is important that the housing market stabilises soon as it is the household sector that carry all the debt, not businesses.

Finally, stocks prices tend to reflect prospects 18 months out. Considering the incredible stimulation that the global economy is and will continue to get from much lower interest rates plus the flow-on benefits of ongoing rescue packages, then one may see more positive economic conditions towards the end of 2009 than we have today. The question is do today's equity prices reflect that?

Finally the most important bottoming indicator – Warren Buffett is buying...

Finally, Warren Buffett is buying. The world's wealthiest man and one of the most successful investors has started to invest. His US\$ 5bn investment into Goldman Sachs and the US\$ 3bn into GE over the last few weeks can't be ignored as he clearly sees some value in the companies that he has poured substantial cash into.

Short selling ban.....

We have received a number of calls from clients asking about the impact of the short selling ban in some markets on the ability of managers to continue to operate normally. There has been a short-selling ban in varying degrees in the US, UK and Australian markets. This effectively stops investors from putting on new short positions in certain stocks and sectors. In the US it is limited to a defined list of financial stocks while in Australia it was a blanket ban. Firstly, the impact has been absolutely minimal on managers. There is no exposure to Australia and in the US, managers found the extreme volatility in financial stocks too difficult to trade either long or short. While managers can still short a wide array of stocks outside of the "list", they are still able to use shorts on the various equity market indexes as a way of offering some market downside protection. However, it would already appear that the ban has had little impact and it is questionable about whether it will be retained past the short period that it was initially brought in for.

Conclusion

While markets continue to be buffeted by fear and uncertainty, portfolios have been well positioned so as to let the crisis pass. With only a 13% net exposure to the markets, the sharp selloffs and increased volatility are largely passing us by. Adding further to the protection of clients' portfolios is the weakness in the NZ dollar versus the US dollar.

Sentiment is driving markets and until that sentiment improves markets will remain volatile and vulnerable. As we highlighted earlier in the letter, a coordinated policy response from global Central Bankers in the form of interest rate cuts is required as one of the prerequisites before the crisis in the credit markets can be resolved. Rhetoric in the last few days would suggest that we are getting closer to that point. Certainly the continuing falls in global equity markets are acting as the catalyst to provoke that coordinated policy response.