NEW ZEALAND ASSETS MANAGEMENT MARKET COMMENTARY
FEBRUARY 2009

In recent weeks the global equity markets have attempted to retest the market lows seen back in November 2008. This retest is an important psychological test of investor sentiment and behaviour – if the markets continue to tumble lower then there will be real questions asked as to just how low these markets could tumble. If the markets pull back from decisively breaking the November lows then it may suggest that investor sentiment is not quite as bearish as it seemed. Time will tell, but for the market, this may be a crucial turning point.

Through the market turmoil of 2008 and early 2009, never before has the preservation of capital been more important. Keeping capital intact through periods such as this allows one the opportunity to take advantage of what are usually very attractive investment opportunities rather than be faced with trying to recoup losses. As our letter highlights, our absolute return investment approach has again, much like it did in 2000 – 2002, been able to protect clients' capital over the last 10 months when markets have been under the greatest duress and at the same time been able to produce attractive positive returns.

Market performance in 2009 has carried on from where 2008 left off……

Equity markets in 2009 have carried on from where 2008 left off, continuing to remain volatile and soft with little respite from the ongoing negative sentiment that has dominated markets for most of the last year. This is disappointing as it appeared that investor sentiment was finally beginning to recover in the belief that at least the economic recession was becoming understood and that there was a positive way forward on the back of the aggressive and unprecedented stimulus packages and aggressive interest rate cuts by all the world's governments and Central Banks. This shift in sentiment was reflected in December and early January's better market performance. Unfortunately this was proved short lived as firstly, the much anticipated President Obama's Financial Stability Plan was announced but the lack of concrete detail left investors with the distinct impression that the new Administration had no better idea of how to sort out the US economy's problems than did the previous team under Bush. Secondly, there has been a marked deterioration in economic events in Eastern Europe that has the potential to unfold into a major Emerging Market crisis with ramifications for Western European banks. And finally, the US banking sector is going through yet another weak phase as further government financial support is required for Citibank and AIG and speculation, now refuted, that many of the large banks will be nationalized. The market has been spooked by each of these events reminding investors that we are still not out of the woods yet.

This reversal of fortunes in the first few months of the New Year has seen the MSCI World Share market index shed 18% since January 1st 2009. This follows on from a dismal performance in 2008 that saw markets fall 40.71% for the calendar year. No country or region has been spared, with falls in the region of 40 to 50% being the norm and in the case of some of the markets which had performed better in 2006 and 2007 where the risk appetite was generally greater, the falls last year were even more severe.

Portfolio positioning……

This raises the question as to how NZAM has manoeuvered through what has been the most difficult investment period in memory. As we have outlined in letters over the last year, since mid-2008 our underlying fund managers have been aggressively reducing their net exposure to the markets in response to increasing turmoil and a lack of clarity about the health and direction of the global economy. In July last year managers cut their net exposure to what we thought at the time was a very defensive net position of 28%. In the following months as the news and sentiment became gloomier managers continued to become even more defensive to be 18% net at the end of August, 13% in September and October and then by the end of December to be just 9% net exposed. By the end of January managers had retained their defensive stance having marginally increased exposure to 11%. The realization that preserving capital in this type of environment was above all else paramount, and could only be achieved by having less exposure to the direction of the market and by holding large amounts of cash.

This defensive stance by the underlying fund managers has ensured that we have managed to avoid most of the carnage in the markets, and certainly all of the damage since the Lehman Bros collapse in September last year that has been especially devastating.

Portfolio performance……

In the 2008 calendar year portfolios made a return of -3.8%. This result was frustrating as all of that loss and then some occurred in the first quarter of 2008 and particularly in January, as the fund managers were taken by surprise by the speed and severity of the market decline as investors scrambled to raise cash to reduce debt and meet margin calls. At that point managers' exposure to the market was still high relative to the levels in the second half of the year and at the time was justified on what they still perceived to be very attractive valuations at the time.

However, since the start of the current financial year from 1st April, portfolio performance has been positive despite the dreadful performance of markets. The more defensive manager stance coupled with a much better understanding of what has been driving the market has produced a positive return of 8.07% for the ten months to the end of January 2009. This is against a fall in the MSCI World Share Index of 40% or an unhedged return in NZ dollars of -7.48%.

Portfolios benefiting from managers' defensive positioning……

Since January 1st 2009 portfolios have continued to benefit from the managers' defensive positioning and their stock picking skills, posting an attractive positive return of 3.02% versus the global markets that have generated a return of -18%. This markedly contrasting return versus the MSCI world Index has not only been by benefit of the falling NZ dollar as 75% of our offshore currency exposure has been hedged for most of the period and 100% hedged against all currencies since late January. For NZAM, it has been gratifying that the overall manager selection has allowed us to escape relatively unscathed from the wealth destruction of the last 12 months.

Since the start of 2009 managers have been able to protect capital even though the broader markets were still in sharp decline. Being able to produce a positive return with such low overall market exposure suggests that the managers' stock selection is paying off even with the low exposure that they have to the market. This latter point suggests that the markets are beginning to behave more rationally and are being driven by fundamental factors rather than liquidity. This should in turn allow managers to gradually increase their ownership of selected stocks on the basis that good companies' share prices have been massively oversold in the bear market.

We may be nearing the end of the deleveraging cycle……

The stock picking performance suggests that we may be nearing the end of the deleveraging process that was the main driver of market performance in 2008 as investors were desperate to raise cash to repay debt, meet margin calls on borrowings, have cash in hand for fear of having it anywhere else; or in the case of the fund management industry, to meet redemptions, And as investors quickly found out, the most liquid of all assets were equities where cash could be received in days as opposed to fixed interest bonds, property or private equity that was difficult to sell if saleable at all. Unfortunately this ensured that global shares bore the brunt of the forced selling.

Because of the sheer scale of the deleveraging all of the “normal” investment text books were thrown out the window. The shares that declined the most were those that were the easiest to sell, i.e. the most liquid and the most widely owned. These were also invariably the better companies while those shares that were less attractive, less owned and less liquid, performed relatively better.

From our managers’ view point, it took them a while to work out that they were operating in a totally new and different market than they had ever experienced before which rendered their stock picking skills largely redundant. Applying “value” or “growth” parameters to shares was largely irrelevant and as the deleveraging cycle became even more vicious it eventually became apparent that to have too much exposure to the market only opened the door to further losses. That explains why many of them performed poorly in the first half of 2008 as they struggled in a market where they continued to own and buy very good companies at very compelling prices only to see these same companies become cheaper. It is also why by the middle of the year they began to cut their market positions aggressively, realizing that the safest place to be was with a low market exposure and holding plenty of cash.

2008 could possibly be broken down into two distinct phases. The first three quarters of the year were driven by the credit crisis; by the need to deleverage investment balance sheets as investors were required to meet margin calls and reduce debt. In the final quarter, while deleveraging continued, the overriding driver appeared to be the awareness that the world was sliding into a global recession of an unknown scale not seen for a long time that manifested itself into retail investor panic. This led to panic selling of individual holdings and massive redemptions from managed funds creating another wave of significant forced selling.

An abundance of cash……

When we look around the market place today our observations would suggest that there is now plenty of cash sitting on the sidelines. The fear of not having cash has become so overriding that it may have gone too far. Not only do we observe our own managers holding abnormally large amounts of cash (thankfully in their case) but so too is the broader investment community; either as a defensive strategy by managed funds; cashed up retail investors, or by fund managers making provisions in case the level of redemptions as seen at the end of December continues. The market being so cashed up and the low trading volumes also supports our observation that the forced selling has largely run its course and the market is now being driven more by fundamental valuation reasons.

Even if the markets continue to decline we would expect the performance from the underlying managers to continue to be positive such is their positioning. That said, even though the markets appear to be behaving in a more rational way, managers are comfortable to remain very defensively positioned with ammunition dry in the form of cash. While they are encouraged by the opportunities they are seeing they also realise that it is not yet time to be taking more risk until sentiment improves and the risk reward ratio is more favourable. We are not at that point yet.

Participating when markets do recover…….

Occasionally there has been a perception that while the underlying managers are very good at protecting capital in down markets their defensive bias means they miss out on the eventual market recovery when it occurs. Yet in the past the fund managers have shown in the past that they are agile enough to increase their exposure to the markets when they feel that the risk/reward ratio justifies it. Not only do they participate in the bounce, their stock picking ability tends to ensure that they outperform the market indices by being able to buy quality companies that have been massively oversold rather than just having to buy the index. This is highlighted in 2003 when markets recovered following on from a three year bear market that finally ended in March of that year and after markets had tumbled a total of 45%. NZAM's portfolios made a return of 18% for the 2003 year versus the MSCI World Index that was up 6.33% in NZ dollars. Even in the following year portfolios continued to outperform in the 2004 year with NZAM portfolios up 8% versus the markets 4.62%, less attractive in real terms but reflective of a sharply appreciating NZ dollar where NZAM was 100% unhedged.

On a long-term view equity markets are the most attractive since 1986……

We shouldn't lose track of where market valuations currently reside. There is a lot of debate as to whether markets are cheap or not. Clearly the visibility regarding short-term earnings through 2009 is nigh impossible such is the uncertainty due to the underlying economic conditions. On a short-term basis, i.e. on 2009 earnings estimates markets are not cheap, rather closer to fair value. But if we take a longer-term view, as we should, and look at the average earnings over the last ten years so that we smooth out short-term earnings fluctuations, then the current markets are the cheapest they have been since 1986. That is a perspective, but it does support our view that on a long-term basis stocks are attractive from a broad index basis. Individually, there are many, many oversold stocks that offer unbelievably attractive buying opportunities now. The issue is timing the entry point into these individual stocks.

Currency hedging……

The fall in the New Zealand dollar to the low US$0.50 region prompted our currency model to hedge the final 25% of the unhedged US dollar exposure. This means that portfolios are now fully hedged against all the currency exposures in portfolios; US dollars, Euro and Australian dollars. We are extremely comfortable holding a 100% hedged currency exposure as the NZ dollar is now trading towards the lower end of its long-term trading ranges, especially against the Euro. While it would be hugely advantageous to be able to know in advance where currencies will trade and where the ultimate bottom lies, we know only too well from past experience that it is impossible even for those who are expert currency traders to pick a bottom or even a near bottom.

While the currency may go lower, it would now appear that the greater risk lies with a rise in the value of NZ dollar against the basket of currencies in portfolios. It is no longer a question of "if" the world recovers but "when". Once risk appetite is rekindled then New Zealand's attractive higher interest rate yield advantage over those on offer in other countries may see renewed interest in owning NZ denominated debt as a way of generating much needed income in a very low global interest rate environment. As in the past, our attractive interest rate differential has been NZ dollar supportive.

It is also worth noting that much of the recent strength in the US dollar and the corresponding weakness in the NZ dollar has been attributable to risk aversion with investors choosing to own US dollar fixed interest assets, as the US dollar remains the world's "safe haven" currency. However, when risk aversion lessens, the relatively unattractive yield on US dollar denominated debt will likely see money flows out of US dollars to "riskier" assets where returns are higher. Under this scenario the NZ dollar should benefit.

The global economy……

Trying to put some clear and realistic perspective on the outlook for the global economy at present is difficult as the picture continues to remain murky. One only has to pick up the local paper or watch the news to be bombarded with a litany of un-nerving economic commentary. And again the media seems to be competing as to who can be the most bearish and pessimistic which is unfortunately so self-defeating and unnecessary. Yet the list of uncertainties is both long and impressive – Eastern Europe's woes and the impact that this may have on other Emerging Markets, European growth and the stability of the Euro; the ongoing need to recapitalize the US banks; the perceived disorganization of the new Obama administration - the latter issue is really rattling the markets; collapsing global growth; possible protectionism; tax increases to fund government bailouts; weak political leadership.

Despite the gloom market conditions are actually far better than late last year……

Given the news since the start of the year it is quite surprising that global equity markets aren't substantially lower than the previous lows hit in November last year. Compared to November last year market conditions are far better rather than worse. Firstly, credit markets have stopped deteriorating and inter-bank credit spreads have narrowed substantially though they are not yet "normal". Secondly, monetary policy is much further advanced and continues to be incredibly accommodative everywhere around the world with interest rates in many countries sitting at generational lows with the probability of even more rate cuts to come. Thirdly, the massive fall in the oil price and consequently petrol prices is acting like a tax cut for consumers all around the world. Fourthly, there is a growing list of technical indicators that are turning up. Finally, equity valuations have reached extremely attractive levels for those investors prepared to take a long-term view. All of these suggest that that the bear phase is maturing.

In past real estate and banking crises, markets do not tend to recover until two policy conditions are met: monetary policy is eased aggressively including flooding the banking system with liquidity; the requirement of policy measures to remove toxic assets from the balance sheets of financial institutions and induce banks to start lending. The US has certainly passed the first hurdle of flooding the system with liquidity. On the second precondition, the Obama administration's Capital Assistance Program (CAP), while greeted by the market with skepticism due to the lack of detail when it was announced and implementation delays since, does however offer a workable and clear bailout plan. The CAP program has a reasonable chance of success though it will take several months for various conditions such as stress testing banks' balance sheets to be completed before the plan can move to full action. This delay may cause further market uncertainty – but it is a positive step in the right direction despite the market's reaction to it.

Recessions do end eventually……

Despite all this gloom the one thing we do know is that recessions do end – eventually. The question at the moment is when and where do we look for leadership? While markets all around the world are retesting the lows seen in November last year, the one region that has not is Asia, and more specifically China.

The Western world has a view that it is the US that will lead the rest of the world out of this recession and hence much of the behaviour of markets is in response to what is occurring in the US. Certainly the response by the US authorities has been far earlier and far more aggressive than other developed regions of the world so one would rightly assume that the US will recover sooner than any other Western economy. However, there is growing evidence that it may be China, not the US that leads the world out of this despite the Western world's perception that China's economy is in dire straits because of its low cost manufacturing base and its dependence on the developed world's consumers. This is merely a distraction from the true picture. "The Chinese economy may not save the world, but China can save itself" and in doing so will play an important part in the recovery in global confidence.

Such a simplistic view of China by the West shows a lack of understanding of China's real exposure to the global economy, the state of its domestic markets and the government's fiscal strength and ability to manage the economy through this period. While China may have enjoyed growth in the region of 12% for many years on the back of its manufacturing base, Western economists have been quick to mark down their estimates of GDP growth to around 4%, (which to the Chinese would feel like a recession), when in fact GDP growth may actually surprise in 2009 in the region of 8% - according to China and Hong Kong based economists as well as by the government itself, as announced recently at Davos by the Chinese Premier Wen.

Why? Because the Chinese leadership is resourceful and has at its disposal the enormous financial resources to provide the stimulus to the economy as and when needed. In order to maintain growth, the Chinese authorities are undertaking a number of massive stimulation programmes targeted at the domestic market, designed to replace the export-led growth with domestic-led consumption. This is being aided by measures to boost consumption through tax cuts, bank lending criteria and issuing "consumption" coupons.

To date it would appear that these stimulus measures are working. Credit lending by the Chinese banks has increased. Manufacturing production has recovered in each of the last three months. Retail sales are growing and the Chinese equity market is the only market in the world that has posted positive returns in 2009 with the "A" share market up an impressive 14% year to date. Couple this with a banking sector that has none of the toxic exposure that Western banks are trying to deal with and it is understandable why China is a beacon in an otherwise dark landscape.

Inflation is better than Deflation……

One final issue we would like to cover is the question surrounding inflation versus deflation as a number of clients have raised this with us. There has been much speculation about the heightened risks of a surge in inflation due to the incredibly stimulatory low interest rate environment, the massive injections of liquidity into the global financial system and the debt being incurred by governments to do this, and in the US where the Federal Reserve is literally printing money to increase the money supply.

At present the biggest risk facing the world is an intensifying and deepening deflationary spiral. Deflation manifests itself in ever falling prices resulting in little incentive to spend because the price of goods tomorrow will be cheaper than the price today. This ultimately encourages households to save and repay debt rather than spend. While this may seem preferable in light of the high level of household debt today, it would have a severe negative impact on economic activity. One only has to look at the Japanese economy over the last 20 years where deflation is firmly entrenched, ensuring falling consumer goods and asset prices that have led to Japanese households having the highest savings rate in the world and as a consequence, the Japanese economy has been in and out of recession over the same period.

Hence the threat of entrenched deflation is a primary driver behind most Central Banks' aggressive cutting of interest rates to or below long-term historical lows in a bid to reflate their economies. This is a bid to get more money into the pockets of consumers through lower borrowing costs; lower the cost of borrowing for households and businesses and by default, make saving a less attractive option through low interest rates before investors have a deflationary mindset much like the Japanese.

Encouraging inflation also helps reduce the debt burden on over indebted home owners – which will be an issue in the years to come for many households globally. A dose of inflation will inflate the value of the asset that the debt is leveraged against thereby reducing the real level of the debt as a percentage of the underlying asset. This effectively inflates away the debt over time especially if loans can be locked in at today's low interest rates. While it will ultimately reflate asset prices again, one would hope that Central Banks have learnt some painful lessons in the last twelve months and will be far more diligent in managing the level of longer-term inflation. Whatever way you turn it, a dose of inflation right now would be a relief for Central Bankers, borrowers and the broader economies.

Conclusion

Picking a bottom in these markets as we have explained in the body of this letter is particularly difficult. Clearly steps are continuing to be made in the right direction especially when it comes to those that relate to reflating the global economy through very low interest rates and fiscal stimulation packages. Fiscal stimulation can only do so much – at the end of the day investor sentiment determines the direction of markets.

Yet markets in the past have a tendency to recover when the news seems to be at its worse. Or as we have said previously, "when the news is bad but not as bad as the market has been expecting". Certainly from a valuation perspective, global equities are more attractive today than they have been at any stage since 1986 and that ultimately will create very exciting opportunities. In the meantime, we will continue to expect our underlying fund managers to be cautious, remain focused on capital preservation, retain market exposures that are relevant to the current sentiment, and hold onto their hard earned cash until the time is appropriate to begin deploying it into the markets.