

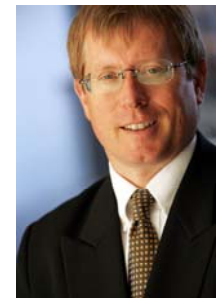
Outlook for 2009

Clearly, the world economy is in a poor state at present and despite our reputation for being less than cheery, even we have been surprised by the extent of the weakness that now afflicts the global economy. At the centre of this co-ordinated collapse in global activity lies the slump that occurred in the middle part of last year in international capital flows. During the boom years of the mid 2000s, surging international capital flows had allowed many countries – and certainly the vast majority of the OECD – to grow rapidly on the back of easy credit conditions, falling savings rates and rising asset prices. Countries as diverse as Denmark, Spain, New Zealand, the UK and of course the US each borrowed heavily from abroad in order to augment their low savings rates and so finance huge increases in consumption, property investment and in some cases even productive investment. Unfortunately, now that these capital flows have abated or even reversed, this spend-thrift behaviour has been obliged to come to an end, most notably in those countries (and this covers three-quarters of the OECD) that possess significant current account deficits in their trade accounts, since without an easy supply of international capital, it is no longer possible to fund these deficits.

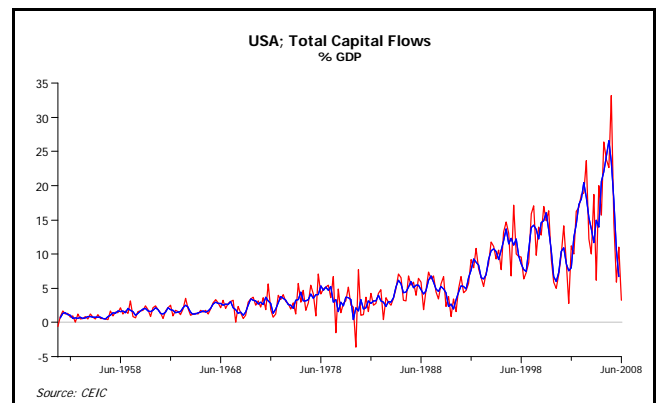
Unfortunately, with so many large rich countries trying to, in effect, save more, spend less and close their trade gaps, global trade activity has naturally been weak and export growth has been hard to come by, whatever the level of one's currency. Consequently, the onus of the necessary trade adjustments is increasingly falling on the need to cut imports, which of course has been hugely detrimental to world trade trends. Consequently, with global import growth now collapsing, even the surplus countries are finding downward pressure on their export revenues and this is imposing an income loss on them, as the recent collapse in Japanese and Chinese economic growth rates has revealed.

Indeed, global demand is now so weak that despite what have already been savage production cuts in many countries, inventories of unsold goods are continuing to rise around the world, most notably in the US, Japan and China. This in turn suggests

that we can expect further sharp production cuts in the early part of next year and hence employment can be expected to decline sharply. Consequently, although weak demand may be producing remarkably negative GDP figures in 2008Q4, production weakness will likely cause continued severe economic weakness in 2009Q1. Clearly, the next six months are going to be a very unhappy time for many of the participants in the global economic system but fortunately we do suspect that the situation may improve a little, at least temporarily, in 2009H2.



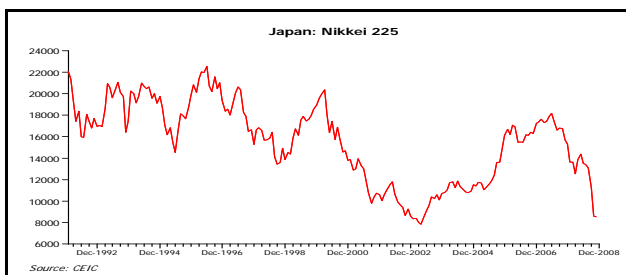
Andrew Hunt
International Economist



We do not expect a sharp recovery in the global economy in late 2009 but we do nevertheless believe that the ongoing easing of monetary policy in the major economies will begin to restore some semblance of stability to the global credit system, although we suspect that growth will remain anaemic at best. At the same time, the size of fiscal responses now being 'leaked' in the US and mooted in Europe should be sufficient to provide the world's highly indebted consumers with sufficient new cash flow that will allow the sector to pay off at least some of its debts without the need for further dramatic cutbacks in its own expenditure. For the corporate sector, such an end to the nominal income deflation would clearly go a long way to easing the financial strains in that sector.

Therefore, while we do not believe that the fiscal policies will be enough to *rekindle global growth*, we do believe that by mid 2009 the size of the public injections could be sufficient to stop the negative cycle and produce a degree of stability in the real economy. It is therefore our view that the massive monetary response of recent weeks, and the proposed fiscal response in early 2009, will be enough to bring stability back to the global economy in mid-late 2009. Presumably, equity markets have begun to sense this and they have naturally rallied, since even stability will mark a dramatic improvement on where we are today. However, we do wonder whether 'travelling will be better than arriving' for the markets.

During the 1990s and early 2000s, Japan's equity market enjoyed frequent and often quite long bull market phases as belief spread that the latest recovery package or rate cut would deliver growth to the economy and, although these packages did succeed in preventing Japan's economy from entering the type of depression seen in the 1930s or in Asia in the late 1990s, when the markets realised that the effect of a hugely expensive 15-16% of GDP budget deficit or zero interest rates was merely economic stagnation and a 'disaster avoided outcome', the equity markets usually sank back to new lows fearing (correctly) that the authorities would not be able to remain expansionary *ad infinitum*.



Consequently, we do wonder whether at some point in 2009 or even early 2010, financial markets may look at the results of Obama's \$3 trillion spending splurge, the effects of the Fed's monetary policy actions and the similar events in Europe and

conclude that despite the effort and the long term costs to the public purse, the results were unimpressive and probably not sustainable. We suspect that it could well be that at this point the ultimate lows for the equity markets are reached, as they were in Japan.

As for timing such a potential reversal in equity markets, we would suggest that it is unlikely to be before March 2009 (barring unforeseen circumstances) and probably not until the second half of the year, although we shall simply have to watch the speed of the fiscal expansion and monitor its effects as time unfolds. But, until then, it is possible that the recent rally may continue a while longer, although clearly markets have already come a long way and, as the chart of Japan's equity market above shows, the period of 'maximum positive gains' within the rallies were usually heavily front loaded in the bull market phases.

“We do not expect a sharp recovery in the global economy”

Andrew Hunt, London

A note for your diary:

Andrew will be visiting New Zealand in March:

Presentation invitations will be sent in due course once timings have been confirmed:

Thursday, 19th March at Philanthropy New Zealand Conference – 11am Workshop for conference attendees in Wellington

Thursday, 19th March Tyndall **Wellington** Presentation at the Wellington Club, 4pm (timing depends on conference timetable)

Friday, 20th March Tyndall Breakfast in **Auckland** at the Auckland Club from 7.30am

Monday, 23rd March, Tyndall presentation in **Christchurch**, probably 11am or 12pm start (to be confirmed)

Bernie's No Longer Ponzing Around

One of the most amazing stories of a pretty amazing 2008 came right at the end. It was the revelation that a USD50b Ponzi (or pyramid) scheme had been operating in the US for possibly decades. In addition, it attracted several big names to invest large portions of their net wealth and, even more unbelievably, several major institutions had significant sums invested in it.

Ponzi schemes, for the uninitiated, are simply investment funds that pay out the early investors from the investments of later investors. Hence, it pays to get in early to a Ponzi scheme and then get out. These schemes are required to subscribe to Newtonian physics – eventually they must fall down to Earth, as there will not be enough new investors to keep paying out current investors. They are also illegal, of course.

Their success lies in the ability of a promoter to keep attracting new funds into it. Take a trustworthy former NASDAQ chairman named Bernard Madhoff, who was very well known amongst the US financial community, the Jewish community, as well as at elite golf clubs in New York and Florida, and you have someone that “high net worth individuals” will happily invest their money with. But for a scheme to go for so long and attract the interest of institutions, you need to put up some strong numbers. This, Bernie Madhoff did exceptionally well. His results were so consistently strong that investors felt he almost had some magic attached to him.

I see a lot of fund managers in my job and receive lots of return series from them, for a range of asset classes and hedge funds. One of the most interesting ones I received last year was the following (from an international manager I will not name):

Performance Graph



This graph plots the performance of this “single strategy hedge fund” (after fees) against the S&P 500 Index over the past 12 or so years. The performance of the fund is almost a perfect straight line, which would make sense if the investment was in cash.



Peter Lynn, CFA
Head of Strategy

But it wasn't. It is invested in what the document refers to as a “split-strike strategy”. And, if you can read the graph legend, the fund climbs from \$1000 to over \$3,500 over this period. That is a return of around 11% p.a. over the time period. The actual annual returns (after fees) range from around 8% to 16%, including during the bear market years of 2001-2003. Of the more than 150 monthly returns, only seven are negative (in the -0.01% to -0.20% range). If I were making up returns, I think I would put a little bit more volatility into it than this.

I paid little attention to this fund at the time I first came across it (in March) and the later updates, despite its unbelievable return profile. However, in the wake of the Bernie Madoff scandal, I did some investigating and found out that the fund whose performance is represented in the column on the

left was invested purely in one Bernard L. Madhoff Investment Securities LLC.

I relate this story to you because it shows the need to do solid due diligence on any investment you get involved with. How was it that so many intelligent people were duped by Madhoff? Even some of his employees had almost all of their net wealth invested in his fabrication, but it wasn't until he admitted the lie to his sons that the game was up. Anyone viewing that performance record would have to ask how is it that a fund can do so consistently well through all types of market. What is a “split-strike strategy” anyway? Are the funds audited? Do the regulators check them?

Sometimes this due diligence can take a long time and involve a lot of work trying to understand what is involved. Maybe opportunities get missed because the length of time taken to perform the necessary diligence bypasses the time that the window of opportunity is actually open. However, I



Fund Manager of the Year
New Zealand

would rather miss out on an opportunity than rush into a Madhoff special.

The same sort of due diligence would have also prevented a lot of the individual losses some people in New Zealand have suffered over the past couple of years from investing in finance companies that became insolvent. Even a quick read of the offering statements, prospectuses or financial accounts would show that there were not sufficient assets to cover interest payments with any sort of "safety margin". It makes me angry when people are put into "diversified" investments consisting of a number of failed finance companies. I assume that the 'advisor' failed to perform any serious due diligence on any of them.

The Madhoff scandal still has a lot to reveal before we know all its details – indeed, some we may never know. However, a very tragic footnote is that at least one investor has committed suicide as a result of losing a huge amount of money in it. I hope Madhoff gets put away for a very long time.

Finally, an update on how markets fared during 2008. We know the answer is "not well" and I highlighted last month how almost all asset classes were heading to some sort of record annual performance. The December month actually turned out all right at the end, with the market seeming to appreciate President-Elect Obama's fiscal stimulus plan, leading to some consistently strong up days on the US (and hence the world) markets. Here is the table of annual index returns:

Asset Class	Index	12 month Return (%)
Domestic shares	NZX 50	-31.6%
Global shares (unhdgd)	MSCI World	-21.9%
Global shares (hedged)	MSCI World	-39.5%
Global property	GPR HiHi	-44.0%
NZ Government bonds	NZX NZGS	15.8%
NZ "A" corporate bonds	NZX Corp A	15.4%
Global bonds	LBGAI	11.2%
Cash	NZX 90d BB	8.8%
Funds of hedge funds	HFR FoHF	-15.7%*

* For 11 months only

Peter Lynn, CFA
Head of Strategy
7 January 2009



Fund Manager of the Year
New Zealand