

FROM THE
undergrowth

OCTOBER 10



Last month's newsletter was dedicated to positivity, and it just shows, optimism can indeed be catchy. World share markets had a great month, shrugging off the "September is always a bad month" hex. Now we've just got to get through the "All the worst market falls happen in October" curse and we should be able to glide positively into year end!



Our Portfolios

What has been going on since we last spoke?

At a glance

As at 30 September 2010

Unit Prices (\$)

NZ Growth Fund	2.9107
Australian Growth Fund	2.3408
International Growth Fund	1.1859
Fledgling Fund	1.0496
KiwiSaver Growth	1.0938
Infrastructure Fund	1.2541

Performance (September 2010)

NZ Growth Fund	5.4%
Australian Growth Fund	7.9%
International Growth Fund	4.3%
Fledgling Fund	5.3%
KiwiSaver Growth	5.3%
Infrastructure Fund	2.5%
NZ50 Gross index	4.7%
S&P/ASX 300 (\$NZ)	8.3%
MSCI Global Small Cap Index	6.1%

After a pretty horrible August, many investors could have been forgiven for thinking that September 2010 was a lost cause. Historically September has been a bad month for investors, the worst in fact. Excluding 2010, the Dow Jones index over its entire history has averaged a 1.2% drop in September and has fallen 58% of the time. But this year September surprised investors lifting 7.7% making it the second strongest September performance since 1926. This is the second year in a row (and the fifth out of the last six) in which September has seen positive returns – maybe the September curse has finally been broken.

While we're talking statistics, it is also good to know that the fourth quarter of the year is historically the quarter with the highest return on average, and the highest frequency of positive returns (up 77.4% of the time). It's official then – there is no reason that the rest of the year can't follow in September's footsteps!

What is more important though is the reason that world share markets have had better than expected performance of late. In the US at least, the outsized gains have been attributed to improving economic data, a lift in merger and acquisition activity, and confirmation that the US Federal Reserve is prepared to provide additional stimulus measures if need be. Similar expectations around further stimulus (if needed) in the UK and Europe has improved sentiment, and as for Asia, well markets there have been positive for a long time and with

good reason. The Australian share market was strong during September in spite of the inconclusive Federal election outcome and the subsequent negotiations required to form a Government. Sentiment in Australia was no doubt helped by a better than expected GDP performance, strong employment numbers and strong oil, gold and base metal prices.

"The key to making money out of stocks is not to get scared out of them."

Peter Lynch

The New Zealand market put in a solid performance for September though lagged its international peers, as it tends to do in particularly strong months. The flip side of course is that New Zealand doesn't tend to fall as sharply when world markets have negative periods.

Your portfolios had a good September for largely the same reasons that the market overall did. Indeed, the positive factors driving economies and markets right now are proving even strong drivers of individual company performance. Economies are growing as is business activity and with every lift in revenue our companies are enjoying a lift in profitability. Merger and acquisition activity is resulting in higher share prices for target companies, and we have had more than our share of takeover targets that we have

Have you joined KiwiSaver yet?*

Your Portfolios (cont.)

ultimately been willing to relinquish, once the takeover price has reflected what we believe to be fair value. The willingness of Governments around the world to use stimulus and other measures to maintain economic momentum is helping our businesses by creating a buoyant (well at least, more buoyant than we've had) environment in which to operate.

This really does feel like a good time to be a share market investor. Bonds and fixed interest investments have had a good run and have provided stability and safety for investors during the most volatile of the past eighteen months. But bonds don't have something that shares offer – the opportunity to profit from earnings growth. That is why periods of shares underperforming bonds are historically rare, and don't tend to last long. When economic growth occurs, leading to profit growth, you need to be invested in shares in order to catch the uplift. Your decision does not need to be complicated by questioning which shares or which geographic regions to invest in – you just need to make sure you are invested, and that you have sufficient of your assets invested for growth.

New Zealand

The gross portfolio return of 5.6% for September was ahead of the market and made up for last month's underperformance. All stocks with the exception of **Tower** made positive contributions, with a number of the large underperformers in previous months having a rebound in share price performances (**NZX**, **Delegat's**, **Metlifecare**). The Tower share price was impacted by its insurance exposure to the Christchurch earthquake, although its exposure is capped at \$5m pre-tax.

The September portfolio performance relative to the NZ50G Index is particularly pleasing considering that Fletcher Building (the largest weighting in NZ50G) rose 9% for the month.

Abano announced that it is selling its 6.5% stake in National Hearing Care for NZ\$26m, representing a gain of \$11m on the \$15m investment it made late last year – equivalent to 53c per Abano share. Abano will have net cash (~\$5m) on settlement in December and is looking to do a capital repayment and share buy-back early next year. The **Kathmandu** result was in line with guidance following last month's trading update where the company indicated that it will miss its prospectus earnings forecasts (it missed by around 5%). **Pumpkin Patch** announced net profit up 76%, but profitability is still below levels achieved in 2006. This shows just how costly its expansion into the UK and USA has been. In common with other clothing retailers, Pumpkin Patch's second half was tough although the company is now well financed and has appropriate stock levels.

During the month we reduced our holdings in **Delegat's** and **NZX** and purchased more **Infratil** and **Fisher & Paykel Healthcare**.

Australia

Back to back strong months meant a gain for the quarter of 21.9% with September up 7.9%. On a relative basis we lagged the index for the month although this is typical of the performance pattern we would expect and has historically been the case – matching the index or underperforming in really strong months and adding alpha in weaker or flat markets.

Leading the portfolio on the positive side were two of our newer positions as well as an old hand that is getting a new lease (pun intended) on life. The number one contributor for the month was **McMillan Shakespeare** (+26.8%) which is getting a massive rerating on the back of its Interleasing acquisition as the market gets more comfortable with the metrics of this

transaction. **Dart Energy** (+49.4%), child of Arrow Energy, rallied massively as it launched a takeover for Apollo Energy and further expanded on its global coal seam methane plans. Last but not least **Nanosonics** (+27.4%) rose on the back of a US distribution agreement. The key negative performer for the month, as it was last month, was the currency hedge that we have in place which reduced returns by around 0.9% as the kiwi dollar slipped against the Aussie. With the currency continuing to fall we increased the size of hedge.

International

Our International fund had a positive month though the New Zealand dollar rallied 5% against the US dollar acting as a drag on returns. The NZ dollar is now more than 20% above its long term average and fair value level of 0.60 and is considered in the price extreme range from a statistical perspective. Since floating in the mid 1980's the NZ dollar has spent less than 10% of the time above 0.71 and this has historically been a good time to move assets offshore.

Corporate activity continues to be a positive driver in our international fund. **Wellstream** announced it had received "a number of preliminary approaches regarding a possible offer for the Company". Since this announcement it has been reported that General Electric and National Oilwell Varco have made bids for the company. Shares rallied 45% in September.

Actelion announced that one of its potential new drug candidates Clazosentan has failed its primary endpoint in the first of its phase III trials. While this is disappointing we considered it an upside option to shares. The company remains undervalued and there are still multiple catalysts over the next few years to drive the share price higher. The shares sold off 8% on this announcement.

We sold our shares in **F5 Networks** as price performance has been strong and the valuation more than reflects the positive company outlook. We remain disciplined to our investment process and are rotating those proceeds into what we believe will be tomorrow's winners.

We added **Travelsky** to the fund. Based in Beijing and listed in Hong Kong, Travelsky is the leading information technology provider for China's air travel and tourism industry. They essentially make money every time an electronic airline ticket is issued and also provide other software and services like departure processing, reservation and inventory control and ticket settlements. In addition, they have been expanding into other travel related areas like hotel, rail and cargo.

Infrastructure

The infrastructure fund was a relative under-performer during the month though still finished September up 2.4% including the distribution paid during the month. In the eighteen months since we launched the Infrastructure fund it has behaved just as we hoped – less volatile than share markets, lagging equity markets in strong months and falling less in negative months. The Morrison & Co team added a new bond position to the Infrastructure fund in **Auckland Healthcare Services**, which is rated AAA and pays a fixed coupon of 7.75% maturing in 2015. The bond is the first social infrastructure position we have included in the portfolio.

A bird's eye view

We share the comments of other kindred souls, investment specialists who share our optimism for the future.

Warren Buffett leads a herd of prominent names stampeding through a wall of worry. They sometimes seem like an endangered species these days on Wall Street. With all the talk about deflation, double-dip recession, housing troubles and unemployment, it has increasingly become difficult to find Wall Street bulls.

The lack of stock market optimism may itself be a contrarian signal to purchase equities. But there are genuine bulls still roaming around who have been advocating broad stock-market exposure for months.

Robert Doll is chief equity strategist for BlackRock, one of the most powerful money management firms on Wall Street. He has been one of the most prominent bulls for a long time. He is dismissive of the likelihood of a double-dip recession and currently sees the Standard & Poor's 500 index increasing on average by close to 8% annually for next 10 years. "We think the likelihood of two disastrous decades in a row is extremely low," he wrote in August.

In *The Wall Street Journal* Doll wrote that, while the U.S. recovery is U-shaped, corporate profits were rebounding with a definitive V shape. He has said recent weak economic data indicated a slowdown in the pace of recovery and not that the economy is headed down the tubes. The stock market environment, Doll believes, is friendly.

He is not completely alone. Billionaire money manager and *Forbes* columnist **Kenneth Fisher** put his readers on notice in a recent column: "Get ready for this bull market's second leg," he wrote. Fisher

says a double-dip U.S. recession is not in the cards since it would require a global double dip, something he claims has pretty much never happened. Fisher believes irrational fears often grab hold early in a big bull market.

We'll leave the last word to Warren Buffett. "I am a huge bull on this country. We are not going to have a double-dip recession at all. I see our businesses coming back almost across the board."



Your questions

This month we've had several questions from investors along similar lines:

Q: Given that Australian shares have done so well, should I move all my funds into the Australian fund? Or, Australia has had a great run so do you think it's time to move into the International fund because it might be next?

A: You probably won't be surprised to learn that we are not fans of chasing markets, or chasing yesterday's winners in the hope that they will also be tomorrow's winners. Investment performance is random and if you happen to have a large exposure to the best performing market or stock for a particular period, good on you, but be careful to attribute at least some of your good fortune to luck. The best way to ensure that you benefit from strong performance in a market is to diversify your assets across a number of sectors and geographies.

It is very tempting to chase last month's winners and it is also easy to keep holding on to winners even when they run so far that they become

overvalued and therefore likely to underperform. For this reason, we establish target weightings in your portfolios. We decide at the outset how much of your portfolios we want to allocate to certain stocks and certain geographies and we then manage the portfolios to these targets. If we find we have a higher exposure to Australian equities or to a particular stock than we have targeted, we will sell some and replenish those holdings that are languishing beneath our target weight. This allows us to be disciplined and remove some of the emotion that inevitably accompanies strong performance.

Fund facts

Fund Performance

Fund Net Returns	1 Year	2 Years	3 Years	5 Years	Since Fund Inception
NZ Growth Fund	2.3%	-0.6%	-13.5%	-0.7%	9.2%
Australian Growth Fund	22.4%	23.4%	-3.4%	7.5%	8.8%
International Growth Fund	6.9%	13.8%	na	na	6.1%
Infrastructure Fund	10.4%	na	na	na	17.0%
KiwiSaver Growth Fund	10.8%	15.4%	na	na	3.0%

NB... annualised returns, after tax and fees.

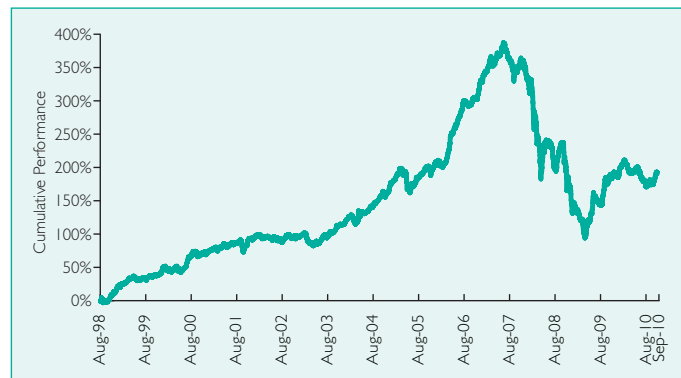
Fund Pre-tax Returns	1 Year	2 Years	3 Years	5 Years	Since Fund Inception
NZ Growth Fund	3.5%	0.5%	-12.5%	1.8%	11.8%
Australian Growth Fund	22.5%	23.8%	-3.2%	na	10.6%
International Growth Fund	6.9%	13.8%	na	na	6.1%
Infrastructure Fund	10.4%	na	na	na	17.0%
KiwiSaver Growth Fund	10.8%	15.4%	na	na	3.0%

NB... annualised returns before tax and after fees. They differ from actual returns experienced during these periods.

Market Indices	1 Year	2 Years	3 Years	5 Years
NZ50G	0.5%	1.4%	-9.4%	-1.6%
90day bank bill	2.9%	3.8%	5.5%	6.5%
S&P/ASX300 (Calculated in \$NZ)	8.6%	10.3%	-3.6%	8.0%
MSCI Global Small Cap Index (in \$NZ)	11.7%	4.3%	-4.4%	0.2%

September's Biggest Movers	
New Zealand	
Kathmandu	20%
Delegats	14%
NZX	12%
Opus International	12%
Australia	
Dart Energy	49%
Nanosonics	27%
McMillan Shakespeare	27%
WHK Group	12%
International	
Wellstream	41%
Brembo	29%
China Automation	28%
ZhuZhou CSR	23%

New Zealand Growth Fund



Fund Inception August 1998

Portfolio Holdings – Abano Healthcare, Delegats, Fisher & Paykel Healthcare, Freightways, Infratil, Kathmandu, Mainfreight, Metlifecare, Michael Hill, NZX, Opus International, Pumpkin Patch, Ryman Healthcare, Tower Limited, Wakefield Health.

Australian Growth Fund



Fund Inception June 2005

Portfolio Holdings – Aevum, Austbrokers, Bravura, Centrebet, Credit Corp, Dart Energy, DWS Solutions, McMillan Shakespeare, Nanosonics, Nick Scali, Oakton, Pharmaxis, Reckon, Taxfree, Treasury Group, Universal Biosensors, Vision Group, WHK Group.

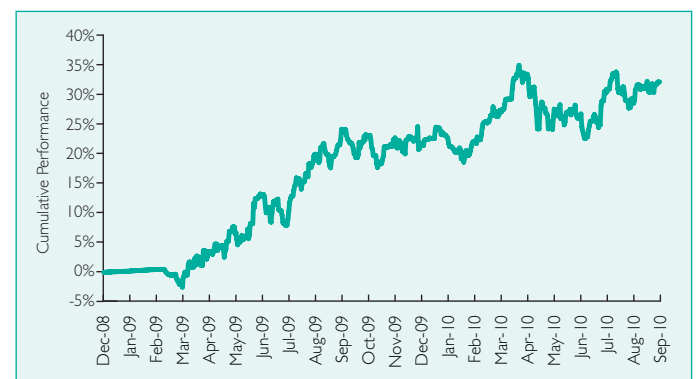
International Growth Fund



Fund Inception October 2007

Portfolio Holdings – Actelion, Advent Software, Autodesk, Bawang International, Biotest, Brembo, China Automation, City Telecom, Conceptus, Equinix, Gameloft, Hanger Orthopedic, Hansens Natural, Hsu Fu Chi International, Hyflux Limited, Icon PLC, Interactive Intelligence, Jumbo, Midas, Nokia Renkaat, O2 Micro, Okano Valve Manufacturing, Ports Design, Prestige International, Qiagen, Raffles Education, Sarin Technologies, Shinko Plantech, Stratec Biomed, Telvent, Travelsky, Wasion Holdings, Wellstream, Wirecard, Zhuzhou CSR Times Electric.

Infrastructure Fund



Fund Inception December 2008

Portfolio Holdings – Flughafen Wien AG, Fraport AG, Norfolk Southern Corp, TNT N.V., Flughafen Zuerich AG, Asciano Group, Union Pacific, Auckland Airport Bonds, Contact Bonds, Genesis Bonds, Meridian Energy Bonds, NZ Post Bonds, Vector Bonds, Wellington International Airport.

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