



SEPTEMBER 2010

Our Thoughts

Investing through a recession

Yes, it has been a long winter ... but let's put that behind us!

Share market investing is not the most exciting topic to talk about right now. Any mention of share markets in the media tends to be negative, and we're all sick of being reminded about a global recession. Many people are just 'over it'. This is completely understandable. We've lived through the awful times of 2008, we've had a rally which restored some of our confidence, but the past eight months of up one, down two, up two, down three, has tested the resolve of even the most ardent share market investors. Even a positive round of profit results has failed to spark investor enthusiasm. What will it take to convince investors that the best strategy for today is to invest in companies that will grow their profits tomorrow?

We know that investor confidence will return, and we know from previous recessions what will happen when it does. We know what sort of businesses will benefit first, we know the reasons why some stocks will be the better performers at the beginning of a new economic cycle, and we know the importance of being positioned with a well constructed portfolio ready for the market turning point, which will surprise everyone when it comes, and catch out a lot of underinvested investors. By talking to the real economic experts – the management teams of our companies who are operating in the real economy and who know what their customers are doing and how well their businesses are performing relative to their competition – we think we are sitting in a good vantage point.

Making the most of the opportunity

The various reasons given for the markets' negative mood and behaviour have been well and truly canvassed – European growth is slowing and risks exist in the peripheral economies, the Chinese government has successfully engineered a slowdown which some perceive as being negative (we don't) and US consumers continue to keep their wallets firmly shut. Whilst we acknowledge the impact of all these factors on the global economic recovery, we have always known that this recovery was going to be slow and faltering. The saying that 'the hangover must be proportional to the party' has never been more true.

On the face of it, everything is going as it should – company profit results have generally been better than last year, numerous economic indicators are showing improvement, and the long-awaited economic recovery does seem to be unfolding. But a couple of critical factors are missing – consumer confidence and investor confidence – and the two are linked. The normal pattern of things would see investors respond to positive corporate performance by buying shares, but for every encouraging signal they see on Wall Street, there is a negative reminder on Main Street, in the form of unemployed friends and family, and people who can't pay their mortgage or sell their home. This is not just a US issue either – Europe has more than its share of problems, New Zealand's economic recovery is fragile and even the performance of the lucky country is patchy.

Think long-term

Despite all of the above we believe it is time for investors to start thinking about the longer-term, 2-3 years out from today. Nobody really knows what will happen in the short term but we remain confident for those in the market right now there is potential for strong growth over this timeframe.

There is a tendency for retail investors to wait for evidence of a global market recovery before they add to their growth portfolios. How many times have you heard people say "I knew I should have invested in XYZ at the time, I would have made a killing". But it's hard to make that decision in volatile times. These are the times to think carefully and clearly, making sure your portfolio is well positioned for the future and then have confidence that you have made the right decision.

What are we seeing out there in the real world?

Ken Applegate is our International Portfolio Manager and he gets to travel a lot. It is great having him in the office as he brings a real global perspective and provides real insight to the international markets. Ken recently spent 10 days in China and also a week at two Asia focused investment conferences (Deutsche Bank and CLSA) in Singapore. In addition to travelling to Hong Kong and Dongguan in coastal China he also ventured inland to Chongqing (30 million people), through Chengdu and finished in a small city (only 300,000 people) in the northwest of the Sichuan Province.

China - growth for years to come

The overall growth in China last year was strong, in fact it was too strong and the Chinese government has been putting the brakes on economic growth to slow things down. We rang the warning bell in the third quarter last year that growth in China would slow in 2010.

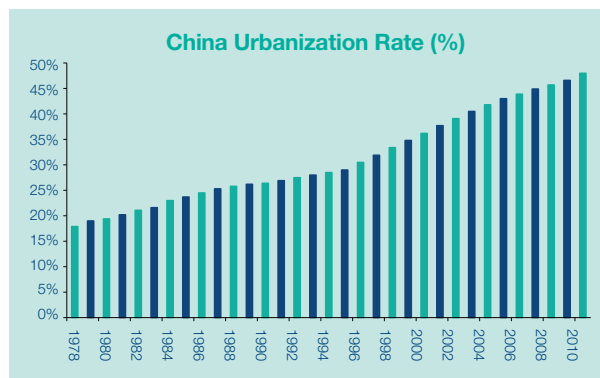
If you remember one thing from this note it's that the Chinese government induced this slowdown. They did so to support a more sustainable and high quality growth. It is unrealistic to assume that China can grow its GDP at 11-12% for an extended period of time and they would

prefer to see GDP growth of 8-9%, which is around the long term annual average for the past 20+ years. So when you hear all the hype about how China is slowing and all those bears proclaim that the China growth story is over just remember these six words; **the Chinese government induced this slowdown**. Just like they boosted the economy in 2008 when the global financial crisis hit, they can just as easily reaccelerate growth again through government spending, if required. Our research indicates they will not need to as private domestic demand is strong.

Today just 25% of the population is considered middle class in China. In 7-8 years not only will the entire economy in China have doubled in size but the percentage of people in the middle class will also have doubled to 50% of the population. As employment, income and wealth increase so does consumer discretionary spending which will benefit many of the companies we own in the International fund. We have, during the last month, begun to increase our allocation to China and Asia again and anticipate this will continue in months to come. While the headlines regarding a slowdown are likely to persist in the short term this is creating one of the best long term buying opportunities since the market lows in 2008.

Australia - requires more than just luck

In Australia, our portfolio companies are being snapped up by savvy industry players recognising that the market has undervalued them. Takeovers provide an ability for the purchaser to fast-track its own growth which is a sign of optimism in the medium term. We are happy to sell our companies for the right price, and you can take comfort that we work hard behind the scenes to generate what we feel is a fair price when any of our companies receive takeover interest. We know that in accepting a takeover offer, we are giving up the opportunity to benefit from future growth, so we want to be compensated. In the recent activity around Aevum, we took a firm stance with



The trend continues.

Stockland after they made a takeover offer. As the largest institutional investor in the company we were happy to appear in the Australian media, talking through the offer and explaining our calculation of what a fair price was for investors. It was therefore pleasing to see the share price of Aevum head north of the offer price, meaning Stockland will need to lift their offer to be successful.

NZ - form is temporary, class is permanent

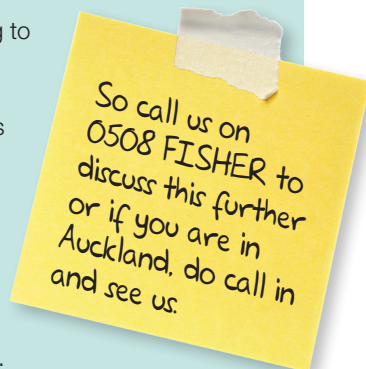
A lot of people think of the New Zealand share market as being tired and lacking any exciting investment opportunities. Call us old-fashioned but we get very excited about companies that have grown their earnings by close to 20%pa over the past five years, like our two largest portfolio holdings, Mainfreight and Ryman Healthcare. We also like the fact that New Zealand businesses generally know how to 'cut their coat according to their cloth'. While the New Zealand economy might only grow slowly, our companies have maintained lean corporate structures so that they achieve economic leverage at the first sign of growth, and others have enhanced their domestic growth profile by establishing businesses offshore. There is nothing tired or unexciting about this next phase of the economic cycle for our New Zealand portfolio companies.

Where to now?

There is no right answer to that question. There is no crystal ball which can tell us with any certainty which fund is going to be the best performer today, tomorrow, next week, let alone this month or this year. However, we are investing in great businesses that are capable of performing strongly in this environment and we see this as an opportunity for the long term investor.

The most frustrating thing for investors in these choppy markets is that we can't do anything to stop it. While it is natural to want to take action – move our investments around, switch from underperformers and move to the few assets that are heading in the right direction – active trading in choppy markets is often precisely the wrong thing to do. As long as your portfolios have been constructed sensibly and on the basis of long-term fundamentals, which they have been, the most successful investment strategy is to sit and wait for the choppiness to abate. Our mothers always told us that patience is a virtue – let's hope that we can all start feeling virtuous soon, because feeling frustrated and hopeless is not a good feeling!

If you are worried you'll miss out on the next surge, you might want to consider a regular investment to remove the risk of getting the timing of your investment wrong. Remember, as an existing investor there are no fees to add to your existing funds or to invest in a new fund.



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