Portfolio

Investment commentary from TOWER Investments

US Real Estate Roots of the Global Credit Crunch: How Main Street Hijacked Wall Street

Most commentators trace the source of today's global financial woes back to the uncontrolled expansion of credit in the United States following September 11, when US interest rates were cut sharply.

US economic growth in subsequent years was largely debt funded with the most obvious debt excesses associated with the residential housing market ("Main Street"). While lenders were initially prudent, excess liquidity together with very low interest rates saw investors looking for higher returns and being prepared to take on increasingly more risk. This opened the door for structured products such as Collateralised Debt Obligations (CDO), with "asset backed" CDOs seen as particularly attractive due to the underlying mortgage backing for such securities ("Wall Street").

Lending practices became increasingly lax as investment demand continued, culminating in the "sub-prime" debacle where the lending proposition was not based on the ability of the borrower to repay, but on the basis that house price inflation would overwhelm any mortgage servicing and repayment concerns.

We have a story, courtesy of your global bond advisor PIMCO, which demonstrates the cavalier attitude to extending credit that prevailed.

Back in January 2005 a couple purchased a luxury property in Turtle Ridge, California, for US$1,157,000; the property was 100% financed.

In April 2005 the owners refinanced through Countrywide (a lending business that went bust and was purchased by Bank of America earlier this year) using an Option Adjustable Rate Mortgage (ARM). An Option ARM entices borrowers with an initial "teaser" interest rate, in this case 1%, substantially lower than the prevailing market rate, which ratchets-up to a more onerous interest rate after the initial honey-moon period.

To make up the short fall between the original mortgage of US$1,157,000 and Countrywide's new home loan of US$999,999, the home owners raised a second mortgage of US$215,000. This left an excess of US$57,999 (US$1,157,000 less US$999,999 plus US$215,000) which the couple were able to pocket.

In August 2005 the couple replaced the second mortgage with a with US$ 293,000 revolving line of credit which was later extended in April 2007 to US$ 491,000. Less out- goings, this permitted the couple to siphon off another US$275,000.

Not long after, unable to secure any further credit and unable or not prepared to service the mortgage obligations, the home owners simply vacated the house and "passed" the property back to the lenders. Sure the couple's credit history is bad, but they lived for three years in a new house in a nice suburb whilst paying themselves US$333,000!

This US phenomenon of "jingle mail", where financially distressed home owners post the keys back to the credit providers, thereby terminating any further financial obligation, is unheard of in New Zealand.

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September 2008

Highlights

- **Lending policies based on rising property values**
- **The ultimate result is "jingle mail"**
- **US residential property may have further to fall**

Contents

In America, State laws mean home loans are registered against the property and not against the borrower, unlike New Zealand where home loans are a personal loan to the borrower and the property mortgaged as security for the loan.

Given the well documented overhang of US housing stock and the number of distressed housing assets available for immediate sale, how far can residential property prices fall?

In our opinion, one of the best common- sense pieces of research on the US housing market is by Credit Suisse's Economics Research Unit (US Economics Digest, 2 September 2008). A simple indicator of the fair value of homes is the ratio of median existing single-family home price to median family income.

Throughout 1981 to 2000, the price of a single-family home approximated 2.9 times the median family income. Peaking in October 2005 at 4.1, this ratio fell to 3.7 in July 2007 as the liquidity/credit crisis began, and is anticipated to fall to its long term trend ratio of 2.9 in early 2010.

This is a very simple metric that does not take into account a decline in household incomes (what of weakened salary and wage bargaining power in a recession ?) and that asset prices tend to undershoot fair value once bubbles burst, but it is a valid indication that US residential property values have the potential to fall further.

Asset Allocation and Currency

Sean Newman

Market Review

When historians look back at the September quarter of 2008 they will have a lot to write about. We have seen panic in share price movements, experienced a complete crash in investor sentiment and have recently seen the authorities globally take the big first steps in the resolution process. A massive support package has been announced.

The shocks from financial failures have been relentless and seemingly occurring at warp speed. In the space of two weeks we saw the bail out of US mortgage suppliers Fannie Mae and Freddie Mac, and the failure of US investment bank Lehman Brothers, and the shotgun marriage of Merrill Lynch to Bank of America.

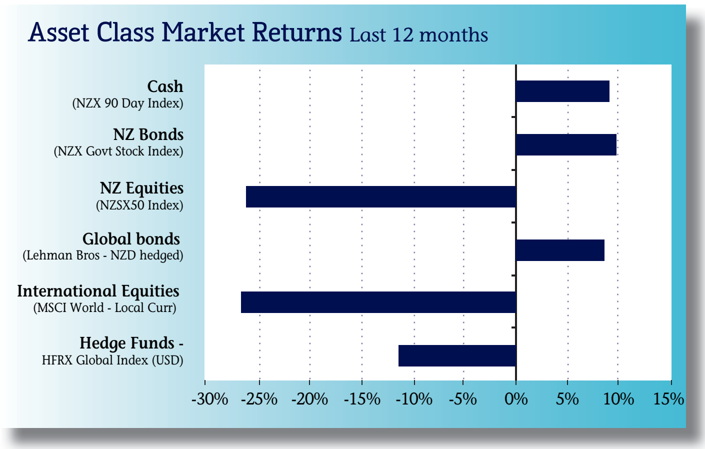
With this backdrop it is not surprising equity markets performed poorly. In local currency terms the global sharemarket fell by 12% over the quarter. In New Zealand dollar terms the fall was more modest due to the impact of a falling New Zealand dollar. The New Zealand sharemarket also declined over the quarter, but by much less than the global sharemarket.

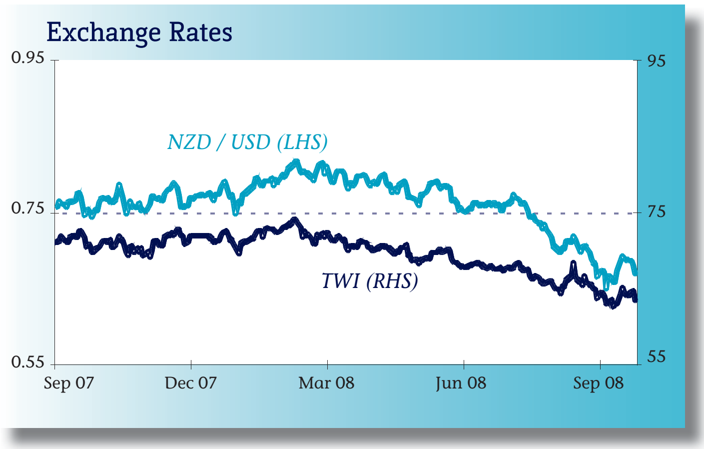
The environment of slowing global growth contributed to commodity prices weakening significantly. Oil prices fell, which helped reduce concerns about inflation. The combination of increased risk aversion and slower growth helped government yields rally around the globe.

Lower government bond yields did not pull corporate bond yields lower; conversely, they increased as banks became wary of lending money to each other. The fear was at such a level that nothing was taken on trust and credit markets became dysfunctional.

Locally, surveys have shown a surprisingly strong improvement in consumer and business sentiment in the past couple of months, with lower interest rates, a lower New Zealand dollar and lower oil prices all helping to boost confidence. The Reserve Bank of New Zealand cut the official cash rate to 7.50% in the quarter, in what commentators believe is the start of a potentially aggressive easing cycle.

The broadening of the global economic slowdown resulted in a turnaround for the US dollar, which rose





against most major currencies. The New Zealand dollar fell sharply versus the US dollar and Japanese yen over the quarter, but rose versus the Australian dollar. The rise against the Australian dollar was a reflection of Australian dollar weakness rather than New Zealand dollar strength.

Market Outlook

Overall, our funds have slightly less invested in shares than usual. Within the allocation to growth assets, they are positioned to hold more global shares than usual and less New Zealand shares than usual because we believe the global sharemarket represents better value than the local market.

Funds are also positioned to benefit from continued New Zealand dollar weakness.

Fixed Interest

Tony Dickson

Craig Alexander

Market Review

Global credit concerns escalated further during the September quarter with the markets virtually pleading for greater regulatory intervention by the end of the period.

And it was no wonder with iconic businesses failing, some of which had been part of the financial scene for over a century; Lehman Brothers can trace it roots back to 1851 but it became the first major bank forced to file for bankruptcy protection since the beginning of the credit crisis.

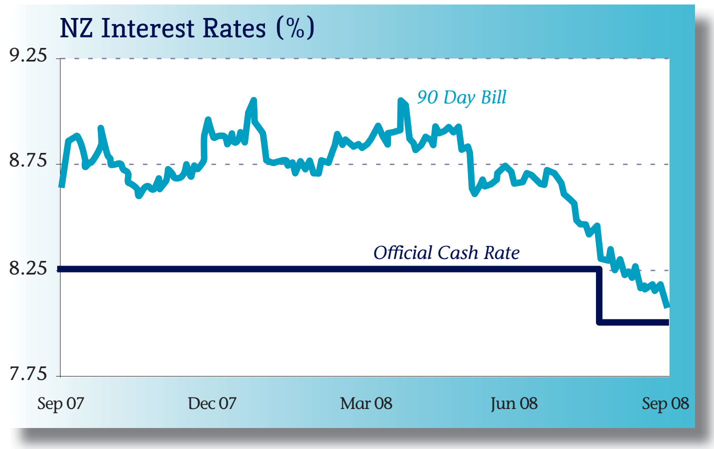
Moreover the financial meltdown was not confined to the US. The UK government assisted Lloyds TSB to purchase HBOS and nationalised the building society Bradford and Bingley. Major European financial institutions Fortis NV, Dexia and Hypo Real Estate where rescued by concerted action from a number of European central banks.

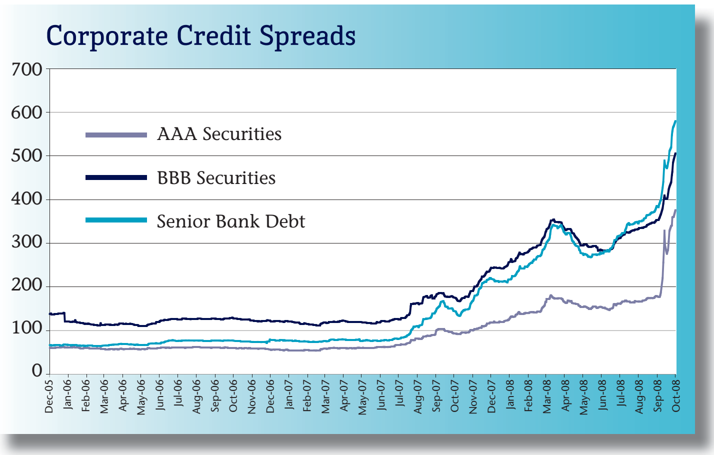
In addition, the US administration worked tirelessly; placing Fannie Mae and Freddie Mac under "conservatorship", assuming control of the insurance giant AIG, encouraging Morgan Stanley and Goldman Sachs to become bank holding companies, extending federal insurance to money market funds and officiating at a "forced marriage" as Merrill Lynch consummated its betrothal to Bank of America.

Finally, coordinated central bank activity attempted to hydrate depleted markets with more official liquidity, while US lawmakers laboured over drafting and passing legislation that was finally enacted in early October. The Emergency Economic Stabilisation Programme Act 2008 set up the Troubled Assets Relief Programme (TARP) with the promise of US$700 billion available to purchase illiquid securities from the market.

Longer- dated government yields were sidelined, as the markets considered fiscal (use of Government balance sheets) rather than a monetary response (increasing/ decreasing interest rates). The global composite 10 year government bond remained unchanged over September at 3.38%.

However, shorter dated yields anticipated a monetary response to complement the current fiscal action and moved lower. Indeed, US Government 2 year bond rates dropped 0.41% to 1.96% while equivalent UK and Australian yields fell 0.49% and 0.60% respectively to close at 4.02% and 5.11%





In contrast, credit spreads rose but this was to be expected given the markets' concerns over liquidity and solvency. Hardest hit was bank debt, or loans to banks.

The Reserve Bank of New Zealand surprised most commentators by cutting its official cash rate by 0.50% to 7.50%. Accordingly New Zealand Government bonds moved lower over the month, the 3 year bond closing down 0.53% to 5.53% and the 10 year down 0.31% to finish at 5.68%. Another significant reduction is anticipated later this month.

Looking forward, credit spreads are at compelling levels by historical standards. Both our global bond and New Zealand fixed income portfolios are positioned for a generalised credit spread contraction. Markets were somewhat relieved by the first round of global interest rates cuts, which began with the Reserve Bank of Australia's 1.00% cash rate cut in early October, followed by most of the world's major central banks. Further concerted action is expected in the weeks ahead.

International Equities

Dan Mead

Simon Brodie

Market Review

Global equities finished lower over the past quarter as markets tumbled during an eventful September.

The majority of developed markets finished in positive territory over the first two months of the quarter as prices stabilised after falling in June. At the time, the markets seemed to be volatile during July and August, but it was nothing compared to what was about to unfold during the month of September. September was a landmark month and will go down in history as one of the most eventful months on record as the US and global authorities began their attempts to stabilise the financial markets as the credit crisis deepened.

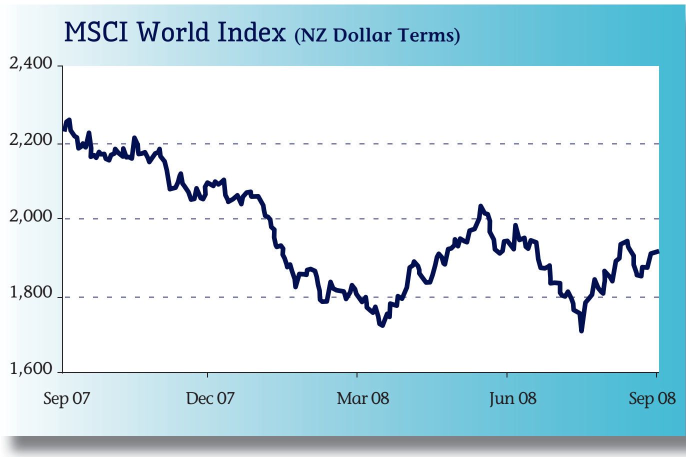
September started with the bailout of Fannie Mae and Freddie Mac. The US Treasury took control of the two government sponsored enterprises saying the move would increase the availability of credit for home buyers. The markets rallied on the news as investors speculated the takeover would stabilise the global financial economy. Shares in Fannie Mae and Freddie Mac however plunged (90.2% and 82.7% respectively) as the bailout could effectively wiped out the companies' common shareholder.

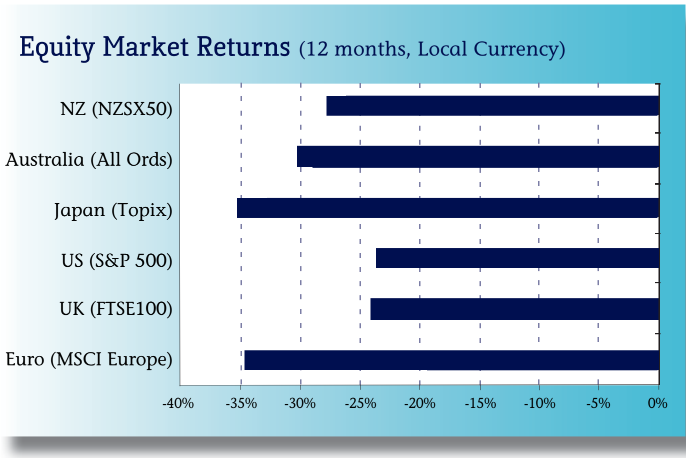
A week later Lehman Brothers, the fourth largest investment bank, filed for bankruptcy after the US government refused to provide a financial backstop. The market fell 4.7%. Around the same time Bank of America struck a deal to buy Merrill Lynch. A few days later the US government seized control of AIG, one of the world's biggest insurers. This was an historic development, as it puts the government in control of a private insurer that was not directly regulated by the government. This helped push the market 8.5% higher over a two-day period.

Government intervention was not confined to the US. The UK government brokered the sale of HBOS, the UK's biggest mortgage lender, to Lloyds TSB and then followed up by bringing Bradford & Bingley under the government's wing. Bank rescue deals also emerged in Iceland, Russia and Denmark.

Other developments during the month included a temporary ban on short-selling financial stocks by several global regulators, in an attempt to prevent further instability in the financial sector.

But the news which really shook the market over this landmark month came as the House of Representatives unexpectedly rejected the Bush administration's financial rescue plan. The plan was to buy US $700 billion of distressed assets from US institutions and foreign institutions which have a considerable presence in the United States. The rejection sent shock waves through the global market, with many markets experiencing their worst trading day since 1987. The S&P500 fell 8.8% in one day, wiping out US $1.2 trillion in market value. Markets did rebound strongly the following day as expectations grew that lawmakers would salvage the rescue package, but to an extent, the damage to sentiment had already been done.

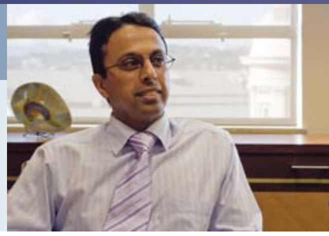




US equities were among the best performers in what was a dreadful quarter for global equities. The S&P500 ended down 8.9% while the Dow Jones only dropped 4.4%. European markets were hit harder than their US counterparts, with the UK FTSE down 12.9% while the German market finished 9.2% in the red. However the biggest declines were felt in Japan and Asia/Emerging markets with the Nikkei and the Shanghai off 16.5% and 16.0% respectively.

NZ Equities

Paul Robertshawe



Manher Sukha

Market Review

New Zealand equity markets followed the global lead with solid results in July and August, but a significant fall in September to end the quarter down 2.6%. The still intensifying credit crisis is now flowing through into lower global growth. As previously noted, many large financial institutions have failed, merged or been nationalised in an attempt to preserve the financial system. On a slightly positive note, weaker global demand should see lower inflation and commodity prices.

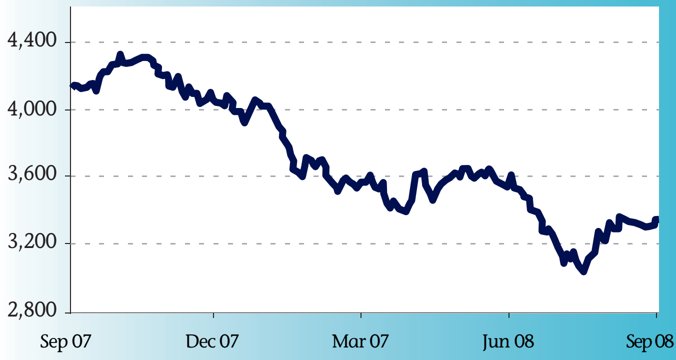
The June quarter GDP data confirmed a technical recession in the first half of 2008. The Reserve Bank has cut interest rates more aggressively than expected as a result of slowing growth and inflation forecasts. Late in the quarter, lower interest rates, oil prices and pending tax cuts saw a recovery in business and consumer confidence. Employment and incomes remain robust, but some weakness is expected as corporate profitability is squeezed. The New Zealand dollar drifted lower on falling interest rates and commodity prices, and a stubbornly high current account deficit.

The key reporting season for periods to June was broadly in line with already lowered expectations, with expectations for 2009 lowered again. The consumer and construction sectors in particular remain under pressure.

Key corporate actions revolved around the ongoing attempts to purchase the Warehouse, GPG acquiring another 15% of Tower, Onesteel making a takeover offer for Steel and Tube and PGG Wrightsons attempting to enter the meat processing industry.

The best performing sectors were those that offered defensive earnings – healthcare, utilities and food and beverage exposed companies. At the other end of the table were stocks exposed to falling commodity prices (which outweighed the fall in the New Zealand dollar) and telecommunications due to a very subdued earnings outlook for the next two years.

NZSX50 Index (Gross - including Imputation Credits)



NZ Equity Performance – September quarter 2008

Best Performers		Worst Performers	
Steel & Tube	12%	PGG Wrightsons	-36%
ANZ Bank	10%	Rakon	-21%
AMP Office Trust	9%	Tower	-21%
GMT Property	6%	Tourism Holdings	-21%
Sky City Entertainment	6%	Michael Hill	-20%
Kiwi Income Property	5%	Farming Systems Uruguay	-20%
Lion Nathan	3%	Methven	-19%
APN Media	2%	Pumpkin Patch	-19%
Skellerup	0%	Pike River Coal	-15%
Freightways	-1%	NZ Oil & Gas	-14%
NZSX50	-3%		

Outlook

With an earlier and more aggressive monetary easing, a weaker New Zealand dollar and tax cuts in train we are nearing the bottom of the current economic cycle. Slower growth has replaced cost inflation as the key risk to earnings. Over the next quarter we are likely to move some of our overweight in defensive sectors to more cyclically exposed sectors, but only where prices fully discount earnings and balance sheet risks.

Alternative Assets


Michael Coote

Market Review

September saw a continuation of negative price trends for commodities. The Dow Jones-AIG Commodity Index Total Return was off -11.53% for the month and -8.01% for the year in US dollar terms.

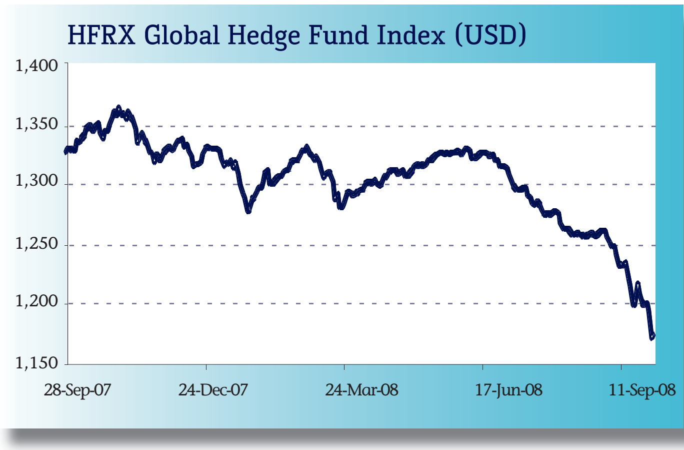
Of the 19 leading commodities tracked by the Dow Jones-AIG commodity indices, 18 fell in price, with only gold showing a positive return for the month at 5.46%. Commodity prices were affected by a combination of extreme fears over the systemic soundness of the global financial system and increasing doubts about the outlook for economic growth. Money markets and interbank lending markets froze up, credit contagion swept across banks in many countries, and perceptions of counterparty risk rocketed. The US dollar – the currency in which most commodities are traded – was extremely volatile.

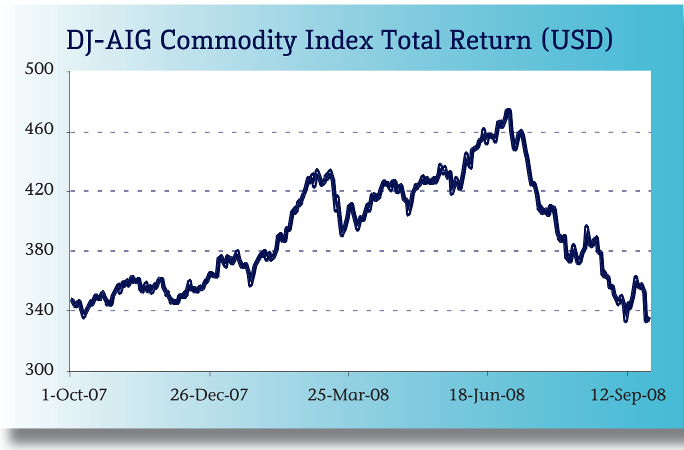
US Federal Reserve chairman Ben Bernanke testified to the American Congress, "Economic activity appears to have decelerated broadly. Stabilization of our financial system is an essential precondition for economic recovery." Emergency rescue plan legislation proposed by the US Federal Administration to enable the Treasury access to $US700 billion with which to bail out US-registered banks blighted in their balance sheets by holding impaired mortgage-backed securities looked uncertain to overcome resistance in Congress. Heightened risk aversion saw investors exiting commodities and seeking instead safe haven holdings of cash and US Treasuries.

Crude oil was highly volatile over the month, which it ended down after a huge upward spike on September 22 when there was sudden sharp loss of confidence in the US dollar. Gold was seen as a safe haven and accordingly rose in price.

September was also a tough month for hedge funds generally, particularly when the SEC and other stockmarket regulatory authorities around the world placed prohibitive restrictions on the short-selling of financial sector securities. The short-selling restrictions affected many types of hedge funds, but most notably stockmarket-exposed funds as managers were forced to close out and forego positions to comply with the new rules.

The HFRX Global Hedge Fund Index ended September down -6.90%. Big losers in its component sub-indices were convertible arbitrage at -16.55%, relative value arbitrage at -9.37%, and equity hedge at -8.59%. As might be expected, these were the sorts of strategies most likely to be affected by the clamp-down on short-selling.





Outlook

In the shorter run, commodities are likely to continue to be buffeted by fluctuating concerns around systemic instability of the global financial sector as investors cut their exposure to risk and look for safe haven investments. In the medium term the greater influence on prices would appear to be expected slowdown in economic growth across many countries because it is within the real economy that commodities are produced and consumed. The IMF continues to project, however, that commodity prices will remain at elevated levels over 2009, albeit below the sorts of peaks that have been observed over 2008.

Hedge fund managers such as GAM are predicting that the worst is past for many hedge fund strategies now that deleveraging and rationalisation of the number of prime brokers their managers deal with has largely been completed. Opportunities for investment into many asset types at reduced or even distressed prices have opened up avenues to above average returns expected over 2009. It expected that emergency regulatory bans on short-selling certain kinds of shares and related securities will start to be lifted from mid-October.

Market Movements to 30 September 2008

	Closing Positions	Changes over: 1 Mth	3 Mths	6 Mths	12 Mths
Stock Markets *	%	%	%	%	
MSCI World - (Local Curr)	859	-11.0	-11.8	-13.4	-26.7
World - MSCI ($NZ)	N/A	-7.2	-3.4	-1.9	-16.3
All World - MSCI ($NZ)	N/A	-7.8	-4.9	-3.3	-17.5
USA - S & P 500	1166	-9.1	-8.9	-11.8	-23.6
USA - Nasdaq	2082	-12.0	-9.2	-8.6	-22.9
Japan - Topix	1087	-13.3	-17.6	-10.4	-32.7
UK - FTSE100	4902	-13.0	-12.9	-14.0	-24.2
Germany - DAX	5831	-9.2	-9.2	-10.8	-25.8
France - CAC40	4032	-10.0	-9.1	-14.3	-29.5
HK - Hang Seng	18016	-15.3	-18.5	-21.2	-33.6
Australia - S & P 300	4591	-10.5	-12.0	-14.3	-30.2
NZ-NZSX50 Gross(inc imp credits)	3273	-7.2	-2.6	-10.1	-26.2
NZ-NZSX50 Gross(exc imp credits)	3090	-7.8	-3.3	-11.0	-27.6
Ten Year Bonds	%	Yield Changes			
USA	3.79	-0.01	-0.18	0.36	-0.78
Japan	1.47	0.05	-0.14	0.18	-0.21
United Kingdom	4.44	-0.03	-0.69	0.09	-0.56
Australia	5.40	-0.35	-1.05	-0.64	-0.75
New Zealand	5.67	-0.32	-0.67	-0.73	-0.58
NZX Government Stock Index	1004	2.1	4.2	6.2	9.8
NZ Inflation Linked Bonds Index	267	4.7	6.4	8.8	11.7
Lehman Bros Global Aggregate (Hedged NZD)	NA	-0.5	2.3	2.1	8.6
90 Day Bills	%	Yield Changes			
USA	4.05	1.24	1.27	1.36	-1.18
Japan	1.02	0.13	0.09	0.10	-0.01
United Kingdom	6.30	0.55	0.35	0.29	0.00
Australia	7.80	0.51	-0.01	-0.07	0.93
New Zealand	7.97	-0.22	-0.71	-0.90	-0.85
NZX 90 Day Index	535	0.7	2.1	4.4	9.1
Currencies	% %	%	%		
NZD / USD	0.6679	-5.1	-12.2	-15.0	-11.6
NZD / EUR	0.4732	-1.3	-2.1	-5.1	-10.6
NZD / GBP	0.3747	-2.8	-2.0	-5.3	1.0
NZD / AUD	0.8467	3.7	6.8	-1.7	-0.8
NZD / YEN	70.91	-7.1	-12.1	-9.4	-18.4
Trade Weighted Index	63.23	-3.7	-6.7	-10.1	-10.9
Hedge Funds & Commodities	% %	%	%		
HFRX Global Hedge Fund Index (USD)	1175	-6.90	-10.68	-9.08	-11.43
DJ-AIG Commodity Index Total Return	336	-11.53	-27.70	-16.07	-3.66
Gold (US$/ounce)	877.60	5.2	-4.9	-5.9	18.0
Oil (US$/barrel)	93.69	-17.2	-32.4	-8.8	15.7

* Capital indices except for MSCI World ($NZ), MSCI All World ($NZ), NZSX50 Gross & Australian Top 20 Leaders

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