REDE ADVISERS
PROFESSIONAL FINANCIAL ADVICE

Client Update

Market & Portfolio Update – May 2015

Global Shares

For New Zealand investors, global share markets gave further strong gains during May. The main driver of this though was a fall in the New Zealand Dollar, as share markets rose at a more modest pace in their home currency terms. The New Zealand Dollar's fall from 76c to 71c against the US Dollar increased a 1% underlying market rise to 7% once converted into NZD. On each measure, returns have been very strong over the past few years, particularly reflecting the substantial level of support from central banks. Looking forward, this pace of returns has been higher than we would usually expect, particularly in US shares. Pleasingly, although data continues to suggest that underlying US economic momentum has moderated somewhat so far this year, jobs growth is still running at a solid pace. This is supportive of the economy's ability to continue to grow under its own steam, giving room for central bank support to be gradually removed over time.

New Zealand Shares

Dairy prices continued to decline in May, which is having a short-term negative impact on the farming sector. However, for New Zealand the long term agricultural opportunities remain, driven by the growing Asian demand for quality food products. While a weaker dairy sector has flow on effects for the wider economy, the NZ share market still added 1% for the month and remains well supported by strong migration, healthy construction activity and historically low interest rates. Contact Energy had a strong month as they announced they would be returning excess cash to shareholders, while Nuplex was up over 20% as they reported strong sales growth across all of their major global markets (Europe, Asia and the US), predominantly driven by lower oil prices, a key input, but also by recovering volumes in global auto sales.

Australian Shares

The Australian economy remains an interesting mix of weaker commodity prices and slowing household income growth, offset by historically low interest rates and continued growth in house prices. This blend of forces led to a flat return for the wider Australian market for the month, as a strong construction sector was offset by continued pressure on banking sector shares despite their attractive yields. Building approvals remain high thanks to low interest rates and this aided James Hardie to strong full year results, which saw their shares rise 20% during the month. The energy sector also performed well, as Origin Energy was a key beneficiary of Contact Energy's higher dividend payout. Overall however, all these factors were outshone by the falling NZ dollar against the Australian dollar, with the currency movement giving NZ-based investors a 4% boost to returns.

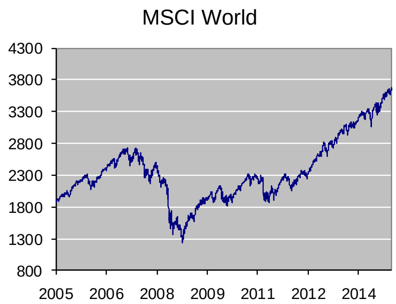
Interest Rates

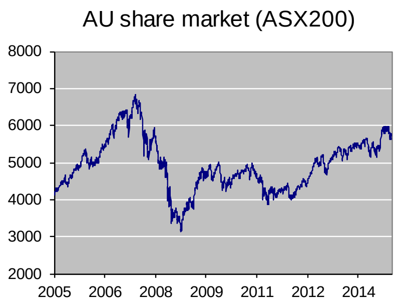
Global bond rates rose further during the month from recent lows, with expectations for the United States Federal Reserve to lift its Federal Funds Rate later this year. In New Zealand, the Reserve Bank (RBNZ) and NZ Government introduced housing and loan policies targeting the Auckland region and overseas property investors, to help slow down rising Auckland house prices. This gives the RBNZ more flexibility to potentially cut interest rates, and they are keeping a careful watch on the upcoming economic data to see if domestic demand slows or inflation expectations fall further, which could prompt a decrease to the Official Cash Rate (OCR). The market is current expecting the RBNZ to decrease the OCR by at least 0.25% by the end of the year *(which subsequently did occur with a drop in the OCR to 3.25% on 11th June).*

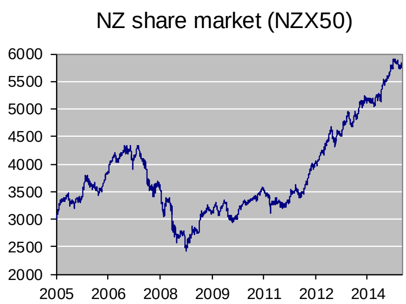
Summary of Market Movements as at 31 May 2015

Share Markets	31/05	30/04	1 Month Return	3 Month Return	12 Month Return	3 Year Return (p.a.)	5 Year Return (p.a.)
NZX50	5,845	5,791	0.9%	-0.6%	12.9%	18.8%	13.8%
ASX 200 (local)	51,325	51,121	0.4%	-1.4%	9.9%	17.4%	10.3%
ASX 200 (NZD)	55,230	52,958	4.3%	2.6%	7.9%	10.5%	7.1%
MSCI (local)	3,636	3,589	1.3%	2.0%	13.4%	19.9%	13.6%
MSCI (NZD)	6,738	6,270	7.5%	7.7%	26.8%	19.5%	11.8%
Fixed Interest Markets	**31/05**	**30/04**	**1 Month Change**	**3 Month Change**	**12 Month Change**	**3 Year Change (p.a.)**	**5 Year Change (p.a.)**
NZ 10-Yr	3.63	3.45	0.18	0.34	-0.61	0.21	-1.93
US 10-Yr	2.12	2.03	0.09	0.13	-0.35	0.56	-1.16
NZ OCR	3.50	3.50	0.00	0.00	0.50	1.00	1.00
Currencies	**31/05**	**30/04**	**1 Month Change**	**3 Month Change**	**12 Month Change**	**3 Year Change (p.a.)**	**5 Year Change (p.a.)**
NZD vs. USD	0.7115	0.7613	-7.0%	-6.4%	-19.4%	-1.8%	1.1%
NZD vs. AUD	0.9293	0.9653	-3.9%	-4.0%	1.8%	5.9%	2.8%
MSCI Weighted NZD			-6.2%	-5.7%	-13.4%	0.4%	1.8%
Commodities	**31/05**	**30/04**	**1 Month Change**	**3 Month Change**	**12 Month Change**	**3 Year Change (p.a.)**	**5 Year Change (p.a.)**
CRB Index	223.2	229.5	-2.7%	-0.4%	-26.9%	-6.5%	-2.6%
Oil	65.6	66.8	-1.8%	4.8%	-40.1%	-13.7%	-2.6%
Gold	1,189	1,182	0.6%	-2.0%	-4.5%	-8.7%	-0.4%

Summary of Market Indices as at 31 May 2015







GROSVENOR
INVESTMENT SERVICES LIMITED

Initial Public Offerings in the Spotlight

Regular followers of investment markets will probably be aware of the publicity received by new businesses listing on the stock exchange. Following a strong run of returns and generally buoyant market conditions, the New Zealand share market has seen its share of new listings in recent times (typically known as "Initial Public Offerings" or "IPOs" for short) with the opportunity to buy shares typically well promoted via share brokers and in the media.

What are Initial Public Offerings?

An IPO is a partial or full sale of shares in a business to the public on the local stock exchange. The capital raised is usually used in two ways; new capital to facilitate growth with the issue of new shares, or the sale of existing shares from current owners to new shareholders. Not all IPOs are created equal: a sell-down of existing shares by an earlier shareholder (such as a Private Equity investor) does not typically set up a company for future growth as well as raising new capital. However, much depends on the circumstances.

Over the past year, twelve new companies have joined the New Zealand Stock Exchange, covering a wide range of areas from industrial businesses to agriculture, smartphone technology and healthcare. While some have performed well (the top performer has doubled in price since listing) good outcomes have been far from assured. Half of the past year's new listings have delivered negative returns, despite the overall market rising strongly.

Grosvenor's philosophy – take a selective approach

The mixed results are reminiscent of the views of Benjamin Graham, a professional investor and considered by many to be the father of value investing. He opined, in his book, *The Intelligent Investor*, that investors should be wary of Initial Public Offerings. Graham believed that as new issues were often exclusive; promoters were incentivised to make them bright and shiny, while glossing over the inherent risks associated with the issue. This is highlighted by the current experience in the United States, where almost 80% of IPOs during the past six months have been for companies that are not making profits.

Another key advantage of a new issuer when bringing a company to market is the ability to choose the optimal timing. A company will typically be most attractive and suitable for sale when the near-term growth outlook can justify a good price, and the usual ups and downs of the business cycle for the company's industry are at a relatively smooth point. Conversely, there are not typically a large number of new IPO opportunities when share markets are at bargain basement levels.

Accordingly, Grosvenor's philosophy for investing in new IPOs places a strong emphasis on understanding the strengths, weaknesses, future prospects and risks of a new listing. This typically means being very selective, and has resulted in a tendency to participate in more strongly positioned, larger businesses.

Philosophy in action

A good example is Meridian Energy, New Zealand's largest electricity generator. While the Meridian IPO offered investors the opportunity to invest in a defensive utility with a strong yield, Meridian had significant known risks as an equity investment. These included the potential for adverse hydrological conditions through low rainfall and/ or inadequate snowmelt; and the potential closure of the Tiwai Point smelter, which takes 40% of Meridian's electricity production. Other risks included the Maori Council's continued case on water rights, and lastly the Labour party's policy to break up the electricity industry and replace it with a single buyer model. Despite an average valuation at the issue price the instalment structure of the offer, with $1 paid upfront at the IPO in 2013 and the balance paid just last month, made the valuation compelling, and Grosvenor's purchase has rewarded investors with a near 100% gain in less than two years.

An opposite example is Mighty River Power, where we did not purchase shares in the initial offer, as we did not consider the shares more attractive than either Contact Energy or TrustPower at the time. This analysis was borne out with the price of Mighty River Power receding below the issue in the months after listing, giving the opportunity to add a holding at 10% below the IPO price. In the case of Genesis Energy, while we were comfortable to purchase shares in last year's IPO, after an initial 20% rise in the share price our assessment became that the shares were less attractive, leading to a subsequent reallocation into other portfolio holdings.

Conclusion

IPO's bring an array of new and diverse companies to the market. However, they should each be assessed by the same valuation methodology used to determine your current portfolio. As Benjamin Graham puts it, "Even the intelligent investor is likely to need considerable willpower to keep from following the crowd."

Summary of Key Portfolio Monitoring Decisions

New Zealand Shares Portfolio

- The instalment payment for the Meridian Energy instalment receipts was made during the month of May, increasing the portfolio's weight from 3.5% to 5%. This was predominantly offset by a reduction to the portfolio cash weighting.

New Zealand Income Shares Portfolio

- Meridian Energy was increased 1% to 6.5% of the portfolio, following the instalment receipt payment, offset by a reduction in Vector, following a strong run over the past 12 months.

Australian Shares Portfolio

- During the month BHP's portfolio weight was reduced by 1% as the company demerged a selection of non-core assets, now trading as South32, which will allow BHP to focus on its four core divisions of iron ore, oil, coal, and base metals.
- South32 has a strong balance sheet with minimal debt, and should provide robust single digit growth driven by cost reduction expansions of current facilities. South32's asset base is dominated by three areas, Bauxite mining and refining (Aluminium), Manganese mining and refining (stainless steel) and coal mining. The remainder of its assets are in silver, lead, nickel and zinc mines. The portfolio has maintained its holding and will target a 1% weight in the portfolio.

Global Specialist Managers Portfolio

- As global share markets have risen, both of the managers in your Global Specialist Managers Portfolio (Platinum and Magellan) have continued to have a sharp focus on valuations of the holdings within their funds. This has led to some portfolio changes for each manager, but we have also taken the opportunity to rebalance back to a 50/50 allocation between the two funds. For the past few years the Global Specialist Managers Portfolio has been tilted towards Magellan, whose concentrated approach in stable global businesses has supported returns. While this approach remains very valid, in our view Platinum's broader approach of looking for value in unloved parts of world markets has now become equally timely, given that share markets have favoured perceived certainty over the past few years. This now supports a more equal weighting, while we remain very comfortable with each manager's ability to support portfolio returns over the long haul.

Corporate Bond Portfolio

- ANZ issued a new May 2020 senior bond which we allocated at a 4.0% weight to the portfolio, replacing a 4.0% allocation in the shorter dated ANZ February 2016 senior bond.
- The Warehouse also issued a June 2020 bond which we added to the portfolio at a 3.5%, replacing the soon to mature Powerco June 2015 bond.