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Investment Directions

24 February, 2009

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1. Overview

Further to our comments last month, the TED Spread has managed to keep on a downward slope, just, with the 13 February close of 95 indicating interbank lending continues to thaw. Sharemarkets though, remain nervous over corporate prospects as outlined during the current reporting rounds. While defensive health, energy, and infrastructure companies show some resilience, retail sector weakness spreads to consumer manufacturing as unemployment, debt reduction and lower house values depress discretionary spending. Indices remain vulnerable to bouts of high volatility although the extreme gyrations of November and December 2008 have eased. US leading economic indicators turned mildly positive in December but remain negative virtually everywhere else.

The US Fed has run out of room to decrease the Federal Funds Rate any further, leaving the target at 0 – 0.25%, and is now likely to support targeted lending to businesses. Despite Obama's US\$787B fiscal stimulus package plus \$350B yet to be spent from Bush's TARP package, more US bank failures are forecast. Another US\$1000B could be needed to recapitalize vulnerable banks with the Obama administration hoping to lure private capital into the plan through incentives.

US home mortgage foreclosures slowed significantly in January, down 25% from last December, indicating banking and industry efforts to save the US housing market are having an effect, but widespread availability of "bailout funding" to banks could see large numbers of mortgagors withholding payments in the hope of renegotiating loans on more favourable terms.

The Bank of England lowered its official rate to 1% on 5 February while the Euro zone retained its base rate at 2%. Markets expect more reductions from both banks in future but scope is now limited.

Regionally, Australia cut its official rate to 3.25% on 3 February, regaining the lower ground briefly held by New Zealand on 3.50%. The Rudd Government announced another A\$42B economic package. Australian full time jobs jumped a surprising 33,700 in January even as the jobless rate rose to 4.8%, placing doubts on further RBA rate cuts in the medium term.

In New Zealand the Key Government will fund \$500m infrastructure spending plus \$480m tax and regulatory assistance to small and medium sized businesses in addition to a three year income tax reduction. Essential reform, hopefully, will at last prevent blatant use of the Resource Management Act as an anti-competitive weapon (e.g. Wairau Road Pak'n'Save delayed 20 years), assist upgrade of vital infrastructure (e.g. electricity grid literally "falling apart") and require appeals of a pure anti-development or even extortionist nature to succeed on merit rather than on the impost of costs and delays.

According to Deputy RBNZ Governor Grant Spencer, the New Zealand economy should bottom in the second half of 2009, with its future dependant on the economies of Australia and China. There is still room for more OCR cuts but these would be less than the last two of 1.5% each.

In summary, while the global financial crisis shows some tentative signs of recovery or at least more stability, the broader economic impact on jobs, businesses and real asset values looks set to get worse before it gets better.

2. Equities

Share markets are now revisiting or exceeding last November's lows as concern over banks lingers and the world awaits more tangible benefits from the unprecedented series of bailouts and stimulus packages. Effects of the latest US\$787B Obama package will take time to emerge.

Locally, bold attempts by a few major companies to shore up confidence through maintaining dividends on the back of reasonable results have been sidelined by some second tier stocks presenting shocker results during the current reporting round.

As always, adversity brings opportunity.

Two major NZX-listed companies, Fisher and Paykel Appliances and PGG Wrightson have been in the news for all the wrong reasons. Both have announced problems related to falling profits and increased debt. Both appear to have made fundamental management errors and one would expect both to be equally deserving(or undeserving) of the John Key lifeline call. Fisher and Paykel Appliances reportedly funded major offshore expansion projects in Mexico and Thailand with grossly inadequate (if any) currency hedging while PGG Wrightson signed up to purchase Silver Fern Farms without having tied down funding beforehand. Plunging share prices now limit the ability of either company to raise significant new capital through pro-rata share issues but, nevertheless, this avenue could still be squeezed by the stressed duo.

At least the Government should demand this source be fully tapped before considering taxpayer assistance.

With a market price around 60 cents, F&P Appliances would need to discount any new issue by 50% to attract a good uptake at, say, 1 for 2 or 1 for 4. \$122m is needed to make up for increased debt due to currency losses alone. With 290 million existing shares, a fully subscribed 1:4 rights at 30 cents

would raise only \$22m, leaving at least \$100m to be sought from an elusive “cornerstone” shareholder – maybe even the Government. Either way, existing shareholders can expect to see their investment heavily diluted and recovery begin from a lower level than prevails at present. However, the Company is nearing completion of a major international restructuring that should bring rewards, even if current depressed international conditions persist. Subsidiary finance company, F&P Finance, continues to make satisfactory progress.

Excessive share price weakness from coincident capital raising issues and attendant bad press could produce an extraordinary opportunity to invest in the iconic brand.

PGW has recently completed a successful capital notes issue but this is now not a realistic option for FPA.

Top tier listed companies such as Leighton Holdings, BHP Billiton and Fletcher Building, having maintained dividends despite profit falls, seem to have arrested share price declines for now. Attention now turns to the next quarter where potential benefits from increased Government infrastructure spending may start to appear.

Contact Energy has maintained its 11 cps interim payout despite an after tax profit down 31% to 13.85 cps for the six months to 31 December 2008. Technically the dividend is replaced with a distribution of bonus shares which the shareholder can request the Company to repurchase. As usual in today’s market, the result a little to the downside of expectations, saw the share price immediately punished. To stabilize the share price Contact needed to provide positive guidance on profitability to date and a full year distribution forecast. It failed on both counts. Unusually though, not all the profit decline is attributable to current economic conditions, with national power distribution grid decrepitude and weather compounding closedown of the economically-hit Tiwai Point Aluminium Smelter. While weather has improved, national power grid deficiencies have become painfully obvious to all and should enjoy early benefits from the Government stimulation package. Mid term, profitability and dividend expectations during the current six months will determine share price. Further market-led weakness could create a prime opportunity to acquire one of New Zealand’s top stocks at multi-year lows.

3. Fixed Interest

Discontinuity in the debenture stock yield curve between 18 and 24 months, as shown at <http://www.debentures.co.nz/YieldCurve.pdf> , reflects investor preoccupation with the Government Deposit Guarantee, scheduled to expire on 12 October, 2010.

Both financial institutions and investors need to know at least 12 months in advance whether the Government Deposit Guarantee will be maintained in some form or eliminated altogether. Leaving the market uninformed on such a vital issue brings the possibility of more chaos as maturing deposits head back to banks (or Australia) and non-bank lenders face difficulties balancing maturity profiles. Already, lack of certainty sees the non-bank sector hoarding Government-protected cash rather than resume large scale lending.

Valid arguments support speculation that the Government Deposit Guarantee Scheme may be extended or retained:

- Australia’s scheme is scheduled to outlast New Zealand’s by 12 months. Maturing NZD funds could easily be lost by transfer into AUD deposits.

- Sheer volume of deposits seeking the Guarantee has seen short term non-bank deposit rates fall dramatically while mid term and longer rates reflect a continuing need for funds out further. Non-bank deposit takers need certainty for planning purposes.
- Finance companies, in particular, will continue to restrict their vital roles in consumer, development and business financing while the uncertainty remains. Emergence from recession depends on all sectors contributing.
- US investors enjoy the confidence an ongoing Government-backed deposit guarantee – why not in New Zealand?
- Government gains handsomely from fees paid by guaranteed institutions and can do with the money as other revenues fall.

Further official rate cuts are not a sure thing in Australia although the New Zealand market still expects another 1% cut or so at the next review on 12 March.

Highly-sought after Auckland City Council Secured Bonds appear to have been very unfairly allocated by the lead managers, resulting in many investors (including those of Canopus) receiving none at all. Although quite common in regard to the rare good quality equity floats, extension of the practice to bonds was unexpected.

Investors may be able to purchase the bonds later, after listing on the secondary market, but should expect to pay a premium plus brokerage.

More bond issues are expected. Hopefully lead managers other than those appointed by Auckland City Council will manage future issues. Issues carrying a local authority or implied central government guarantee will receive strong support. Requesting a firm allocation still offers the best possibility of participating in the initial issue. Time to request a firm allocation is usually very short but making a request does not commit the investor to accepting any bonds that may be allocated. As always, applications will only be accepted when made on the application form which accompanies the investment statement or prospectus.

Current or upcoming bond issues include Tower, Contact Energy and NZ Post.

Contact me if you would like to request a firm allocation in any of these issues alan@canopus.co.nz

4. Current Issues

- 4.1. Man OM-IP AHL
- 4.2. GoldmanSachs JBWere Trans Tasman Equity Unit Trust
- 4.3. Marac Cash PIE

4.1. **Man OM-IP AHL** is now open for subscription.

Performance potential



The Man OM-IP series of hedge funds has shown a remarkable ability to genuinely hedge and contribute to a diversified investment portfolio during the three major sharemarket downturns over the past eleven years. Based on the AHL Diversified Program which actively trades a broad range of financial markets not easily accessible to the private investor, the Man OM-IP funds have recorded mid and long term compound returns ranging from 10% to 17% p.a. - in each case backed by the security of a rising capital guarantee provided by a major Australian bank. The hedging function has been achieved through returns being uncorrelated to sharemarket gains or losses.

During the year 1 January to 31 December 2008, the underlying Man AHL Diversified program achieved an outstanding 35.1% return as sharemarkets crashed.

While the well known OM-IP 220 funds feature exposure to a second trading program aimed at providing reduced volatility, the current fund, OM-IP AHL, presents pure access to the AHL Diversified Program only, backed by a similar capital guarantee structure.

Visit the OM-IP website for full details of the issue including the Prospectus and application form:

<http://www.maninvestments.com.au/manomipahl/adv/canopus>

Alternatively, request a hard copy of the documents by emailing info@canopus.co.nz, or telephone, (09) 444 8055 or fax (09) 444 8059.

Investors pay no fees or brokerage on Man OM-IP investments made through Canopus.

4.2. **GoldmanSachs JBWere Trans Tasman Equity Unit Trust**

A fund with an excellent track record and well placed to achieve strong gains from a sharemarket recovery. Managed by Goldman Sachs JBWere Asset Management (NZ) Limited, based in Auckland, the Trust invests in listed companies or companies that intend to list in Australia and New Zealand with the intention of achieving capital growth in rising share markets and protecting capital in flat or falling markets. The Fund is actively managed (not an index fund) and provides access to a portfolio of carefully selected Australian and New Zealand shares which may include some of the larger listed companies such as Contact Energy, Fletcher Building and BHP Billiton.. For a copy of the latest report contact Canopus.

Key Features of the GS JB Were Trans Tasman Equity Unit Trust:

- Established September 1998
- Low minimum initial investment NZ\$2000
- Low minimum additional investment NZ\$1000 or NZ\$250 with regular savings plan
- Entry fee discounted from 3% to 1.0% by Canopus Investments Limited
- Management fee 1.0% per annum
- Fund size NZ\$30.5 million
- Fund rating, Fundsourc 5 star
- Registered as Portfolio Investment Entity (PIE)
- New Zealand dollar denominated – not currency hedged

- New Zealand domiciled – no foreign investment tax complications

For an investment statement and application form contact Canopus info@canopus.co.nz or download from http://www.debentures.co.nz/TTEUT_IS.pdf

4.3. Marac Cash PIE Fund

Two investment products utilising the PIE structure to provide investors with a competitive cash return and significant potential tax savings, depending on the individual's tax rate:

Key features:

- Marac Call PIE, 6.00% p.a. on call. Income earned daily and compounded monthly.
- Marac Term Deposit PIE, fixed 6.25% p.a. for 12 months, interest paid or compounded quarterly.
- Marac PIE fund has no fees.
- Minimum investment \$1000.
- No guarantee under NZ Government Deposit Guarantee Scheme, but the Marac PIE Fund invests exclusively in Marac Finance Limited Debenture Stock.
- No brokerage or entry fee charged on applications made through Canopus.

Contact Canopus info@canopus.co.nz for an investment statement and application form.

5. Kiwisaver

Unrivalled benefits of the Kiwisaver scheme make this an essential starting point for new investors and an important diversification for all others meeting eligibility criteria.

Opening a KiwiSaver account for children is of vital importance and may well determine their ability to purchase a home later in life. Even babies are eligible. Act now, the sooner a fund starts, the greater the benefits.

Canopus is an accredited agent for Huljich KiwiSaver, one of the top performing KiwiSaver schemes and one which incorporates the full range of options such as mortgage diversion. It costs nothing to open an account and each new account receives the \$1000 "kick start" government contribution.

Most Kiwisaver funds, particularly "balanced" and the more aggressive "growth" funds, have a large exposure to equities resulting in lower valuations over the past year but which should see investor value rise again quite rapidly in a general share market recovery. With shares so low at present, now is a good time to open a Kiwisaver account or contribute any outstanding amount needed to make up the \$1042 investor contribution eligible for the Government "tax credit" subsidy.

Contact Canopus: info@canopus.co.nz or telephone (09) 444 8055 for more information plus the investment statement and application form.

6. Commodities

Commodities including crude oil, copper and aluminium now sell at massive discounts to prices

ruling just a few months ago as demand falls and stockpiles rise. Exploration and production are being wound down or closed worldwide. The supply taps cannot be turned on again easily once demand starts to increase, meaning a whole new price cycle is likely to commence.

Investors interested in adding these cyclical commodities to a portfolio have a number of investment avenues available including exchange traded funds. Contact me to discuss.

7. Strategy

Despite signs of an easing international credit squeeze, share markets have failed to gain confidence from the presentation of stimulus packages to date. Concern over US and some European banks remains at red alert level with more specific bailouts likely. Liontamer Fallen Angels Series 1 Index, heavily weighted towards financials, was originally set at 100 in July 2008. The first recalculation date in November 2008 saw the index down about 35% with the final “lock in” starting point on 2 February 2009 coming in at approximately just 50% of the original value. My calculations to date show a further loss of about 4% since then.

American markets seem to have entered new uncharted territory on the downside, dragging others with them.

Under these conditions even careful, selective buying looks risky. Any purchases should be limited to major companies with the potential to maintain high dividend yields on the back of government stimulation spending.

Income seeking investors should be considering a broader range of investments than they may have in the past. Local authority, SOE and major corporate bonds offer good security and returns. Finance company debenture stock still offers reasonable returns outside the Government Deposit Guarantee term, generally the 2 year (and over) rates for now, see http://www.debentures.co.nz/debenture_stock.html .

Extension of the Government Deposit Guarantee is possible but no official comment has been made to date. Blue chip companies with high dividend yields at today’s prices now represent a real alternative for income portfolios. Likewise, listed property trusts offer good yields at current prices, but may be impacted further by property valuation writedowns and falling tenancies as the recession bites.

As always, diversification remains paramount – and remember to top up your KiwiSaver to receive the maximum \$1042 Government subsidy before 30 June. Spread over a year, for those not receiving an employer contribution, that’s about \$87 per month.

For all expressions of interest, investment statements and application forms, contact Canopus info@canopus.co.nz

Regards,
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Financial Adviser Disclosure Statement available on request, free of charge.

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