

Welcome to the third issue of the Scheme newsletter for 2008. This newsletter focuses on recent events in financial markets and in particular, their implications for the Scheme and its members.

What has happened in financial markets?

The July 2008 Scheme newsletter featured an article on the recent volatility in global sharemarkets. This volatility has now expanded in a new and dramatic direction.

Background

After the tech-stock boom and crash and the events of 11 September 2001, the US Federal Reserve dropped interest rates to stimulate the economy.

Some US mortgage brokers, in an effort to increase their business, offered mortgages to less credit-worthy borrowers for a very high percentage of the home value (in some cases actually above the home value). These mortgages are referred to as 'sub-prime' mortgages.

Banks and other financial institutions bundled up these mortgages with other good-quality assets and on-sold them to other financial institutions and investors.

The Federal Reserve then lifted US market interest rates dramatically (from 1% in 2004 to 5% in 2006) to try and control inflation and many borrowers could no longer meet their interest payments. In addition, after a number of years of strong gains, US housing prices fell in the first half of 2007. This led to a large fall in the value of the securities backed by the sub-prime mortgages.

What's happened now?

The sub-prime mortgage crisis led to a credit crisis which then became a solvency crisis for many financial institutions within the US and beyond.

In early September 2008, the US Treasury announced that it had taken over two very large government-sponsored home loan banks, FNMA ("Fannie Mae") and FHLMC ("Freddie Mac") in an attempt to help them recover from massive losses.

The announcement of the takeover of Fannie Mae and Freddie Mac put severe pressure on Lehman Brothers, one of the most prestigious players on Wall Street and a major player in the mortgage market. After the US Treasury made it clear that no bailout would be forthcoming, and efforts to sell to other financial institutions failed, Lehman Brothers filed for bankruptcy.

In a separate development, Merrill Lynch, a leading US sharebroker, which had also invested heavily in relatively high-risk, high-return securities backed by sub-prime mortgages, was taken over by Bank of America.

Two days later, insurance giant AIG was assisted in the form of a US\$85bn government loan after suffering enormous losses on bond insurance products.

The common factor of all these events was the extent to which weak collateral (the sub-prime mortgages) had been packaged into products which were perceived to offer high collateral and security of repayment. The extent was such as to threaten the financial system itself. As financial institutions began to realise that they had loaned money to institutions that may not be able to repay, they attempted to sell these loans, and to adopt a very conservative approach to granting new loans. This drove down the value of these loans (typically packaged in mortgage-backed securities) in what became a self-reinforcing cycle. The more the loan prices fell, the more the banks and financial institutions needed to sell.

The Trustees' response

The Trustees are continuing to closely monitor the situation in conjunction with reports received from the Scheme's advisers and investment managers. In mid August the Trustees met to review global financial market valuations, and to receive reports on the outlooks for the global and local economies.

At this stage, the Trustees believe that the current benchmark (or target) asset allocations continue to be appropriate for the investment timeframes of each of the investment options. Focus on longer-term investment timeframes can generally be expected to provide higher returns in exchange for the 'risk' of shorter-term volatility. The Trustees accept that it is difficult to avoid risk and at the same time achieve high returns.

In the event that the Trustees were to alter investment strategies, members would be advised well ahead of any planned changes.

Latest events

In late September it was announced that Lloyds TSB was buying out HBOS, Britain's largest home lender. HBOS has come under mounting pressure as it is more reliant on wholesale markets to fund its business than other UK banks, and the cost of borrowing funds continues to rise.

The news for the US economy continues to worsen. Unemployment is at a seven year high and automotive production is at its lowest monthly level since 1993. After the shock rejection of the first rescue package intended to prop up the US economy, which wiped US\$1.2 trillion off US share values in a day, at the date this newsletter was prepared a revised US\$700 billion bail-out plan had just been approved by the House of Representatives. The aim of the latest package is to

take the bad debts off the books of banks, thus freeing up credit markets. The US Treasury Secretary wants to use the money to buy up many of the dubious mortgage investments. In return, US taxpayers will gain a non-voting stake in the banks they rescue. If the banks recover, taxpayers make a profit. If taxpayers make a loss, then the rest of the financial services industry will be forced to carry some of the costs.

Acceptance of the second rescue plan has seen major markets in Europe, Asia and Latin America fall as traders focused on Europe's growing financial crisis. The catalyst for the selling has been investors' concerns that the spreading credit crisis will take a heavy toll around the world. Investors have come to the realisation that the rescue plan and steps taken by other governments won't work quickly to unfreeze the credit markets.

Selected fixed interest investments such as corporate bonds have also produced low returns as nervous investors try to gauge the strength of the corporate sector, especially the financial sector, and weigh up the relative attractiveness in today's environment of US Treasury bonds and other sovereign bonds.

This financial crisis has raised the likelihood that the US economy may struggle to regain a positive growth path and that this could damage global growth as a whole. Sharemarket volatility, therefore, has not been confined to the US.

The implications for the Scheme

The Scheme's investment options include different proportions of growth assets such as shares and property. Recently returns from the Growth and Balanced options, which invest in a higher percentage of growth assets have been lower than the more conservative options. As one would expect, the options with a higher percentage of growth assets are designed to achieve higher returns over long periods and the more conservative options will perform better during shorter-term periods of market volatility.

For most people, superannuation is for long-term savings and members are encouraged to consider the current crisis in an historical perspective. In the long term the assumption is that the global economy will improve, valuations for share markets and selected fixed interest securities are now priced at fair value or cheaper and there is a strong prospect of an imminent solution to the current crisis. As a result, members need to reflect carefully before altering their investment strategies at this time.

For background details and updates on the latest developments in the credit crisis visit:

www.Bloomberg.Com

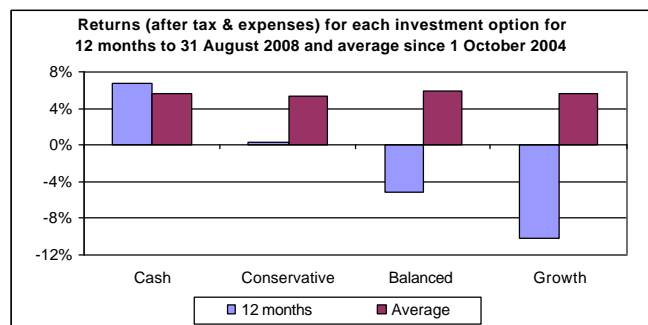
www.efinancialnews.com

www.federalreserve.gov/

www.rbnz.govt.nz/news/

<http://finance.yahoo.com/>

The following graph compares the return (after tax and expenses) for each investment option for the 12 months to 31 August 2008 and the average return since 1 October 2004 (when member investment choice commenced). It shows that despite negative returns over the last 12 months, over the longer term the Balanced and Growth options continue to provide sound returns.



Looking forward

For most people superannuation is a long-term investment, so it is important not to be distracted by short-term events.

Over the next one to three years, global economic growth is expected to be slower but still positive. While the US economy is likely to remain slow until there are signs of the financial system stabilising, this is expected to be offset to some extent by strong growth from the Asian economies and China in particular.

Looking forward 15 to 20 years, history indicates that risk will be rewarded and the current crisis will later be seen in its historical context.

What should you do?

Stay calm – history shows that volatility and low returns do occur from time to time and are part of the investment cycle.

Take a long-term view - while it is easy to forget recent sound returns and focus on the current market, maintaining a long-term view is important because your Scheme savings (particularly those in the Balanced and Growth Fund options) are invested for the long term.

Stick to your strategy – time in the market rather than timing the market is key to looking after your savings. History shows that investors who stick with a well-planned investment strategy for the long term tend to come out ahead. If you switch options to chase returns you may risk doing more harm than good over time by 'locking-in' low points in the asset price cycles.

Expert advice – if you are concerned that your current investment strategy may not meet your needs, talk to a professional investment adviser.

Get online – your Scheme website www.superfacts.co.nz has articles and tools to help you better understand your Scheme and what's happening in investments.

Looking for more information the Scheme?

- Call **0800 UNIScheme** (0800 864 724)
- Visit www.superfacts.co.nz (employer number 900106)