Canopus Investments Limited

Investment Advice Sharebroking Managed Funds Fixed Interest Property Company Formations Trade Mark Registration

P O Box 101 662
North Shore Mail Centre
Auckland
New Zealand

Phone: +64 9 444 8055
+64 9 444 8056
Fax: +64 9 444 8059
Websites: www.canopus.co.nz
www.debex.co.nz

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Investment Directions 31 May 2016

"Analysis to action; opportunities to outcomes"

In this Issue

1. **Overview** – weak equity markets during most of May turn sharply bullish at the end but data says optimism overdone. "Velocity of Money" still falling. New Zealand dollar and equities up on healthy trade data, high immigration, steadier OCR outlook and money inflow from negative interest rate zones. NZ budget focusses on debt reduction. Brexit opinion leaning towards "Stay".

2. **Equities** – results from and outlook for some of our portfolio shares: Sky City Entertainment (entitlement issue), Infratil, Macquarie Group, Westpac Bank and Woolworths. Contrary to some reports, Australia's big four banks not being shorted to any great extent.

3. **Interest rates, bonds and debentures** – Deposit rates tumble again. Deposit rates for major S&P-rated finance companies.

4. **Strategy** – Building a portfolio to cope with the unexpected as the US starts to lead the world towards economic recovery, higher interest rates and inflation. Published portfolio unit values move up again in May but surging NZD/AUD rate limits gains.

Space Exploration News

NASA releases flyby video of Pluto taken by New Horizons spacecraft during closest approach to Pluto on July 14, 2015 showing spectacular detail. http://www.nasa.gov/feature/new-horizons-best-close-up-of-plutos-surface

New Horizons is now on its way to visit another Kuiper Belt Object, 2014 MU69, which it expects to flyby on 1 January 2019.

1. Overview

May spent most of its time confirming its reputation as a miserly month for equity investors and then promptly changed course in its final days for the S&P 500 to sit at 1.65% above its starting level by Friday, 27th. Sell in May and go away didn't pay. If anything, all that was confirmed is that investment portfolios have to be

constructed as far as possible to cope with the unexpected.

US equity markets have recently see-sawed between taking a lead from crude oil price volatility and on-again, off-again expectations of further US target interest rate rises from the Federal Reserve. Rising crude prices in May, on reports of an unexpected fall in US oil reserves, were largely overshadowed by firmer Fed guidance of another rate rise looming in June. But rate rise concerns had been costed into equity indices by late in the month, with many investors choosing to view higher interest rates positively as a sign of a healthier US economy. US bond yields and the US dollar rose. Bond prices declined. The US Consumer Price Index (which the Fed doesn't target) was up 1.1%, year on year for April, the largest gain in three years.

US corporates are reportedly flush with cash, holding US$1.68T in cash now c.f. US$742B in 2007 just before the GFC. Much (72%) is held outside the US to avoid a 42% repatriation tax. Huge stockpiles of cash indicate companies generally need little further borrowing and are not investing in new projects, buildings or other facilities. Apple, Microsoft, Google, Cisco and Oracle are said to be amongst the major companies hoarding cash offshore.

Such reports appear consistent with the continuing decline in "velocity of money" – a measure of the rate at which money circulates in the US – indicating that the huge amounts of cash created during various QE programs has yet to reach the real economy, instead being channelled towards speculative ventures in housing, a few commodities and equities.

Although large amounts of unused money in the US system plus ongoing high margin trading levels on the NYSE and continuing growth in M2 money supply all hold potential for a major boost to inflation (marked by falling equity prices and sharply higher interest rates) at some time in the future, such a scenario looks unlikely in the near or even mid-term. US Treasury bonds remain in high demand as a repository of global financial reserves meaning the US Fed does not have to act as banker of last resort to the profligate US government. Foreign demand for US Treasuries and natural maturity of some securities held on the US Fed books, particularly mortgage backed securities, may even allow the Fed's balance sheet to be reduced over time with little disruption at all to the economic recovery.

In New Zealand the ASB's commodity price index rose sharply in early May as lamb prices lifted 4.5% in NZD terms, boosted by a deal to export chilled meat to China and discontinuance of a 30% premium paid to Chinese lamb producers. Dairy prices rose 2.3% in mid-May after a flat start to the month and beef gained 2.2%. Wool and forestry both lost 1% in USD terms but the NZD/USD rate declined 4.1% from .6977 at April's close to .6692 on 27 May.

The NZ dollar and NZ shares rose on news of a larger than expected trade surplus for April, $292m actual vs $232m expected. Exports were up 4% to $4.3B while imports rose only 1.5% to $4.01B.

Immigration set a new record of +68,500 in the 12 months to 30 April 2016 while tourism continued to boom with visitors up 11% over the same year to 3.27 million.

On 26 May Finance Minister Bill English presented his budget, focussing on paying down debt and generating a government revenue surplus rather than disbursing handouts and tax cuts. Standard negativity of comment followed, with the normal suspects demanding ever greater slices of government cash for themselves, but now being joined by calls for "greater government expenditure on infrastructure while interest rates are low". It seems just yesterday that barbs were being shot aplenty at the Australian government for not doing exactly what Bill English is now attempting here – paying down debt and consolidating government accounts while times are good!

Australian Treasurer Scott Morrison presented his budget on 3 May, targeting a smaller budget deficit (A$37.1B) than estimated just last year. Some personal and business tax rates have effectively been reduced – no doubt with an eye on the forthcoming 2 July Federal election. To some extent the Australian budget was overshadowed by the RBA dropping its OCR to a record low of 1.75% on the same day. Outgoing RBA Governor, Glenn Stevens, says whoever wins the election will face "years of hard repair work". Stevens also noted "growth is proceeding, it would be good if it was a bit stronger, but it's not too bad".

New Zealand and Australian equity and bond markets continue to benefit from European and Japanese

"refugee money" seeking a positive return rather than the negative returns on offer in their home markets. Chartwise the S&P 500 looks toppy on both the one and five year scales. The S&P/ASX 200 looks to have broken out of its long downward trend since January 2015 and the NZX 50 looks overbought on all scales. Unfortunately, just like the racing systems in Turf Digest, technical analysis of share markets works wonderfully during back testing but fails to predict the future – or there would be a lot of very wealthy people testifying to its success.

In the UK, annual inflation unexpectedly fell to 0.3% in April from 0.5% in March. As in NZ, inflation is well below the BoE's 2% target. A return to 2% is not expected until 2018. The forthcoming Brexit referendum on 23 June is likely to be weighing on consumer spending. As at 25 May, the Financial Times' Brexit poll tracker put "Stay" ahead of "Leave" by 46% to 41%. Economists broadly agree a "Leave" vote would hold serious consequences for the UK economy and equity markets. The only world leader showing enthusiasm for the UK/Europe split is Russia's Vladimir Putin. Success in weakening Europe would add nicely to his string of military and political achievements in Europe and the middle-east. Having retaken Crimea and carved out Russian client states in Georgia and Ukraine, Mr Putin has now expanded Russia's presence in the Mediterranean by adding the powerful Latakia air base to his Navy's Tartous facility in Assad's Syria. Western backed anti-Assad forces, having failed in their desperate pleas to President we-don't-have-a-strategy for protection under a western no fly zone, now find themselves being destroyed by joint Assad/Russian forces under cover of a Russian-imposed no fly zone instead, backed by the installation of Russia's highly sophisticated S-400 anti-aircraft missile system. The same no fly zone protects the newly declared Kurdish enclave adjoining Turkey – against which Russia is surely just itching for an excuse to retaliate for Turkey's shooting down of a Russian jet. Following failed UN-backed "peace" discussions in Geneva, Mr Putin has wrested the initiative - deciding the fate of Syria and setting a timetable for liquidation of ISIL through joint Gulf Cooperation Council and Russian discussions in Moscow to which the West is not party.

Keeping our finger on the pulse of major Leading Economic Indicators (LEI) and other leading data:

	Latest	Apr 16	Mar 16	Feb 16	Jan 16	Dec 15	Nov 15
3 month LIBOR (end of month) %	.67405	.63835	.62820	.63310	.61560	.61270	.41620
TED Spread (points)	.34	.42	.42	.30	0.29	0.45	.20
VIX equity volatility	13.12	15.70	13.95	20.55	20.20	18.21	16.13
US LEI		+0.6%	+0.0%	-0.1%	-0.2%	-0.3%	+0.5%
Japan LEI			+0.2%	-0.3%	-1.2%	-0.5%	+0.1%
Eurozone LEI		+0.1%	+0.3%	-0.2%	+0.1%	+0.2%	+0.6%
Australia LEI			+0.1%	-0.3%	-0.5%	-0.3%	+0.2%
United Kingdom LEI			+0.0%	+0.1%	+0.2%	+0.4%	+0.4%
China LEI		+0.1%	+0.3%	+0.3%	-0.2%	+0.5%	+0.4%
US Money Market Funds $T	2.733	2.709	2.765	2.807	2.756	2.759	2.741
US Gov. 10 year T-Bond (%)	1.851	1.819	1.786	1.740	1.931	2.269	2.218
US 5 yr inflation expectations %	1.65	1.82	1.75	1.61	1.63	1.77	1.88
US high yield-treasury spread 3-5yr %	6.08	6.24	7.05	7.75	7.77	6.95	6.40
Foreign holdings of US T-Bonds $B			6287.0	6236.2	6183.1	6165.8	6125.7
Margin debt, NYSE (US$ millions)			445,846	435,814	447,681	461,200	472,772
US M2 Money Stock (US$B)		12651.3	12,568.6	12,472.8	12,420.3	12,331	12,288
Velocity of Money US M2			1.459			1.482	
CNN Fear and Greed Index	78	72	64	51	17	44	53
AAII sentiment survey (% bullish)	17.8	27.4	27.2	32.0			
Insider Buy/Sell ratio (US) %	44	41	58	65	58	53	49
Forward P/E S&P 500 (12 month)	17.75	17.80	17.55	15.75	15.38	17.19	17.55
Trailing P/E S&P 500 (12 month)	24.04	24.11	23.53	21.82	20.69	22.65	23.18
Total Put/Call options ratio CBOE	0.90	1.15	1.08	1.20	0.91	1.00	1.07
S&P 500 Share Index	2099.06	2065.30	2059.74	1932.23	1940.24	2043.94	2080.41

The Leading Economic Indicator for China has been heavily revised and recalculated. Where LEI data was shown as "n/a" in previous issues of ID, our current table records the revised and recalculated values dating

back to November 2015.

Velocity of Money has set a new low since records began in 1959. This is an important factor to watch. An eventual reversal upwards in Q2 2016 – as seems likely - would serve as further evidence of higher US interest rates and inflation ahead.

US inflation expectations hit a peak of 1.83% on April 28, declining to 1.59% on 24 May. The quick jump back up to 1.65% the next day, May 25, indicates a short term reversal of sentiment which, if followed through would consolidate an outlook for higher US interest rates and inflation.

The high yield – US treasury spread, viewed by many as a harbinger of inflation, has continued to decline. The current fall is probably more representative of confidence in the improving US economy and less nervousness over mass defaults in the US high yield bond market rather than as an indicator of inflation.

Lower VIX volatility, higher insider buy/sell ratio and reduced Put/Call options ratio all point to greater short term confidence in US equity markets. However, the very low AAII bullish sentiment and "extreme greed" reading of the CNN fear and Greed Index both flag a warning that short term optimism is overdone and a sharp near term correction is probable. Movement in these factors will feed into our immediate strategy.

2. Equities

Bloomberg reports that short interest in Chinese stocks has surged on belief that the slumping Yuan will produce heavy selling of Chinese equities as rising US interest rates push up the US dollar.

Sky City Entertainment (NZX:SKC) is conducting an accelerated pro-rata 1:10 entitlement issue to eligible shareholders at NZ$4.40 per new share (A$4.05 for eligible Australian shareholders). An "accelerated offer" means the rights will not be traded on a licensed stock exchange. The new capital will be used to fund Sky City's two major growth projects in Auckland and Adelaide while aiming to preserve the company's investment grade BBB- credit rating. The two major projects are construction of the New Zealand International Convention Centre in Auckland and expansion of the Adelaide Casino. The new shares will rank equally with existing shares and should therefore participate in upcoming dividends to the same extend as existing shares.

Sky City has given no indication that future dividends will be affected by the new issue and hence, providing previous dividends can at least be maintained, the new shares would provide an initial cash yield of 4.66% on the purchase price. Should the new shares manage to attain the recent SKC market price of $4.79 over the next year, total annual gain on the new shares would be 13.52% - a good return in today's environment.

Sky City offers a relatively diverse avenue for investors to participate in New Zealand's booming tourism sector. Main risks would appear to be future regulatory risk and the risk of major cost and timing over-runs on the two big projects. Applications must be with the registrar by close of business on 2 June 2016.

Infratil (NZX:IFT) posted a strong final result to 31 March 2016 with the net parent company surplus rising to $438.3m from $383.5m (78 cps from 68 cps) and the non-GAAP measure of EBITDAF from continuing operations up to $462.1m from $450.7m in 2015. Infratil reported strong contributions from all businesses.

Highlights from the year include:

- Access to $728.6m of capital on deposit with net debt only 14% of capitalisation as at 31 March 2016.
- Trustpower will more than double its generating capacity in Australia from the current 385MW.
- Wellington Airport is part way through a $300m upgrade to facilities.
- Retire Australia and Metlifecare are both increasing construction of accommodation to meet increasing demand.
- NZ Bus is about to trial electric buses which may significantly affect New Zealand public transport.

Net debt fell to $295.9m, down from $760.8m at the start of the financial year. Final dividend has been increased 12.5%, from 8cps to 9cps, to be paid on 15 June to shareholders on the register at 2 June 2016.

Infratil will spend A$392m for a 48% share of Canberra Data Centres, in partnership with Australia's Commonwealth Superannuation Corporation. The CDC purchase provides Infratil with meaningful access to the emerging data and related telecommunications infrastructure sector.

Infratil has provided underlying EBITDAF guidance for 2017 of $475m - $515m provided business conditions remain consistent and with the other normal provisos applying.

Macquarie Group (ASX:MQG) produced the standout result amongst Australian banks reporting in May. Full year profit (NPAT) to 31 March 2016 reached A$2063m, up 29% on 2015. Operating income rose 9% to A$10,135m with international income contributing 68% of the total. Earnings per share were up 23% to A$6.19 and Return on Equity increased to 14.7% from 14% in 2015. A final dividend of A$2.40 (40% franked for Australian tax payers) brings the full year dividend to A$4.00 per share, a 21.2% increase on 2015 and represents a conservative payout ratio of 66%. Macquarie foresees a similar result for 2017.

Of the major Australian trading banks reporting interim results during May, **Westpac (ASX:WBC)** arguably edged out NAB in difficult trading conditions with ANZ further back in third. Key points of Westpac's result included:

- Cash earnings up 3% to A$3,904
- Cash earnings per share down 2% to 118.2 cents
- Cash return on equity (ROE) 14.2%, down from 15.86%
- Interim dividend up 1 cps to 94 cents (100% franked for Australian tax payers)
- Common Tier 1 capital ratio up 171 basis points to 10.5%
- Lending and customer deposit growth of 6% and 5% respectively
- Expense to income ratio 41.6%, down from 42.5%

Impairment provisions were largely as predicted with A$252m extra charges being reported in relation to four specific loans.

Westpac's share price has effectively gone nowhere in three years. After reaching highs of over A$40 in early 2015 WBC is back to where it was in January 2013. However, the dividend of over 6% cash yield is generally picked by analysts to be sustainable giving a high return irrespective of share price growth. Longer term shareholders have also benefitted from a well-priced offering of BTIM shares from the Westpac sell-down to raise capital in July 2015. The BTIM shares offered at A$8.20 now sell for A$9.87, a 20% gain, in addition to paying a 4% -5% cash dividend yield. Following various capital raising exercises involving cash issues and sale of assets, the Australian banks are solidly capitalised. The new, higher capitalisations will almost inevitably lead to somewhat lower returns on equity but that is the price to pay for a sounder financial base in the sector.

Reports of heavy shorting of the Australian banks by hedge funds "betting" on bursting of an Australian housing bubble look to be out of place. The Housing Industry of Australia reports that the Australian housing market is cooling gradually with a small decline in home sales being very mild after the record levels of home building over the past couple of years. Recently reported short positions in the big four banks are not extraordinary at all with Westpac the lowest at just .05% of issued capital on 27 May. In contrast, Macquarie Group is a much more favoured target by those happy to speculate with other people's money. The MQG share price is frequently pushed around temporarily by those hoping to sell the price down for immediate gain. Steady recovery of the Macquarie share price would indicate at least some of those shorts lose their shirts.

ANZ Bank (ASX:ANZ) turned in a significantly worse result than Westpac, with interim cash profit down 24% to A$2.78B after A$717 in charges and interim dividend cut by 7% to 80 cps. However, the market largely expected the bad news, bidding ANZ up after its release.

Exposure of the big four banks' New Zealand subsidiaries to this country's dairy farming sector has yet to be reckoned with but the Reserve Bank of New Zealand has expressed confidence that capitalisation is adequate to handle even a major round of devaluations and forced sales of highly indebted farm units. Lending to farming support businesses in rural New Zealand is said to be of much less value, largely financing working capital and some equipment purchases. The big lending has been for dairy farm land purchases although borrowing for herd aggregation also features to a significant, if lesser, degree.

Shareholders of **Woolworths (ASX:WOW)** have gained some respite after speculation that private equity giant KKR (Kohlberg Kravis Roberts) was considering a takeover bid for the struggling retailer. That the recovery from under A$21 into the A$22 – A$23 band has been so muted indicates the market has little faith that a takeover offer, if it eventuates, would command much of a premium. Private equity groups Blackstone and Carlyle were rumoured to be looking at buying Woolworths six months ago but the speculation came to nothing.

3. Interest rates, bonds and debentures

According to Bloomberg, New Zealand OCR expectations, 8 RBNZ meetings ahead, have stabilised at just under 2%. In contrast, expectations for Australia's OCR, 8 meetings ahead, have dropped suddenly to 1.5%. Harbour Asset Management believes a rising Trade Weighted Index could oblige a reluctant RBNZ to cut the New Zealand OCR again in the near future.

F&P Finance has made further heavy cuts to deposit rates, taking 0.40% off its 4 and 5 year rates with a little less off some shorter terms. Liberty Financial has dropped its 36 month rate by 0.70% (for deposits under $20k) with large cuts to other longer terms as well.

Current major S&P rated finance company deposit rates, % p.a., quarterly interest payments:

Issuer	S&P rating	$ min	Call	3m	6m	9m	12m	18m	24m	36m	48m	60m
F&P Finance	BB	1000	2.50	2.95	3.65	3.70	3.75	3.80	3.85	3.90	3.95	4.05
F&P Finance	BB	25,000	2.50	3.30	3.80	3.85	3.90	3.95	4.00	4.05	4.10	4.20
Liberty Fin	BBB-	5,000		3.40	3.85	4.10	4.40	4.80	4.95	5.15	5.40	5.65
Liberty Fin	BBB-	20,000		3.50	3.95	4.15	4.65	4.85	5.00	5.40	5.55	5.75
Liberty Fin	BBB-	100,000		3.65	4.05	4.25	4.75	5.00	5.20	5.50	5.60	5.80
UDC Finance	AA-	5,000	2.20	2.70	3.20	3.15	3.45	3.25	3.30	3.30	3.30	3.40
UDC Finance	AA-	100,000	2.70	2.75	3.25	3.20	3.45	3.30	3.35	3.35	3.35	3.45

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4. Strategy

All expectations are for low interest rates, low inflation and low investment returns to be with us for a long time – but we have to be aware of the possibility that the situation could change quite quickly, especially if large amounts of QE money eventually get out into the real US economy.

The picture we have from our economic data is one of the US starting to lead the world into an economic recovery where higher interest rates and increasing growth will gradually spread over the next two years. The overwhelming consensus that New Zealand (and Australian) interest rates will continue downwards for the next year or two could turn out to be wrong, just as commentator (and RBNZ) expectations for higher interest rates turned out to be wrong in 2014.

Portfolios have to be constructed, as far as possible, to cope with the unexpected. How we achieve this is the challenge. Aggregating a diversified portfolio of high quality equities, bonds, fixed interest securities and listed property over time has produced good results irrespective of market ups and downs. Price paid for each investment is important. Outlook for each company and ability to maintain dividends or interest with a measure of earnings growth is vital. Direct ownership of equities entitles portfolio owners to participate in special share purchase plans and entitlement issues that may not be accessible through alternative holding

arrangements. Acceptance of well-priced special offers can add useful growth to a personalised investment portfolio.

Given that our current crop of data indicates that now is not a favourable time to be buying shares “off the shelf” our recent purchases have been limited to special opportunities and specific entitlement issues. For small cap shares and international equities we utilise, where possible, fund managers or listed investment companies with proven expertise in each sector. Even here, one has to be careful. Specialist or “boutique” managed funds are growing in New Zealand offering access to those sectors where research for the individual investor is difficult to obtain and evaluate. However, some local funds have established good (even outstanding) records under skilled management – and some haven’t!

Our published portfolio unit values have made further gains during May with the diversified income portfolio unit now over $1.40 and our diversified growth unit up about 1% for the month so far to nearly $1.61. A surge in the NZD/AUD exchange rate, reflecting lower iron ore prices and diverging expectations of interest rates on either side of the Tasman, has restricted portfolio gains for May. Published returns are after fees and tax at the investor’s prescribed rate on portfolio investments.

Click this link to see charts http://www.canopus.co.nz/investment_advice.html#returns

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To discuss building a diversified, low volatility personal investment portfolio designed to produce income, growth or a combination of both, contact me by email at alan@canopus.co.nz or telephone 09 444 8055.

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Regards,

Alan King
Authorised Financial Adviser
Canopus Investments Limited
Email: alan@canopus.co.nz
Mob: 0274 718 253
Tel: +649 444 8055

Postal address:
PO Box 101662
North Shore Mail Centre
Auckland 0745
New Zealand

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