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Investors in NZ Funds' Growth Portfolios<sup>1</sup> are now capturing capital gains thanks to the recent share market rally and the full removal of the share hedges NZ Funds has had in place over the past 18 months.

The share hedges are a key component of NZ Funds' broader active management approach designed to, firstly, preserve investors' capital over time, then generate returns. The share hedging strategy was first put in place in late 2007 when we concluded that the probability of a contagion effect from credit markets across to share markets was unacceptably high. The share hedging strategy was implemented across the Growth Portfolios to minimise the impact of any pronounced decline in share markets globally. The share hedges have saved investors well over \$150 million during what has been an unprecedentedly difficult period in financial markets.

Financial markets are forward looking and, as such, prices are not so much determined by current supply and demand but more by how the future is perceived.

For the past 18 months, the market has priced in the likely impact of the financial crisis continuing. However, over the recent weeks financial markets have started to price in a possible recovery – economists everywhere are talking about the 'green shoots of recovery'.

Actual economic statistics have been less encouraging and instead are suggesting that the rate of decline in global growth is merely slowing. Nevertheless, share markets have rallied strongly and this appreciation has been reflected in the performance of all of our Growth Portfolios over the past two months.

Our share hedging strategy has been developed to be dynamic so that the share hedges come off when the markets trend upwards and kick in when markets trend downward. The share markets bottomed out on Monday 9 March and ten days later our dynamic hedging model was triggered and the share hedges were partially removed.

The benefits of this flowed through to the performance of the Growth Portfolios with approximately \$18 million earned for investors over the period 19 March to 31 May.

For example, the Wealth Appreciation Portfolio was up 3.4% over April and May bringing its return since it was launched in early March 2008 to -6.2%; the Diversified Growth Portfolio was up 2.5% with a return since launch of -3.7%; and the Balanced Growth Portfolio produced 1.6% over the two months and -1.4% since its launch. These Growth Portfolio returns are against a backdrop of a global share market which has fallen in excess of 30%<sup>2</sup> (in local currency) over a similar period.

On Wednesday 3 June the remainder of the share hedges were removed and investors are now capturing further benefits as markets continue to rally. Capital gains are likely to continue as long as the markets continue to appreciate.

Since implementing the share hedging strategy in 2007 we have undertaken extensive research to develop the dynamic hedging model. Our analysts have sourced and modelled daily data for each of the major share market indices back as far as 1927 and back-tested the data under multiple different scenarios to determine a strategy that consistently works as a hedge against material share market losses.

The back-testing proves that the dynamic hedging model has produced superior returns to a buy and hold strategy over the long run. Most importantly, the dynamic hedging model consistently moderates the impact of periods of significant negative returns in share markets, materially reducing overall volatility in investor portfolios. The key benefit of having quantitative models to assist investment decisions is that it removes a significant element of emotion and subjectivity in the process and brings greater discipline to our investment decision making.

(1) The NZ Funds' Growth Portfolios currently include a number of both AUT and PIE diversified portfolios. The share exposure for these portfolios were hedged excluding the Wealth Creation Strategy and the Principles of Wealth Fund.

(2) As per the MSCI World Index.

Any significant resumption of a share market downtrend will likely see us moving back toward a fully hedged position. In addition, while investors are now fully exposed to global share markets in the Growth Portfolios, a permanent exposure to defensive assets in each Growth Portfolio has been added to help ensure investors' capital continues to be managed in a conservative manner, whatever the uncertain future brings.

Our share hedging strategy is a continuing attribute of the NZ Funds' Growth Portfolios. The dynamic hedging model is a very comforting feature for our investors who, while seeking growth, do not wish to see their retirement capital swinging wildly in value. While they are willing to accept some volatility in pursuit of higher returns they have indicated very strongly their desire for that volatility to be managed. The share hedging strategy is not designed to prevent negative returns, rather it is designed to protect investors against a significant loss of capital from which it is often hard to recover.

The ongoing development and implementation of risk protection approaches to preserve our investors' capital will continue to be a core component of our active management approach.

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