

## Manager insight – 30 November 2009

The Portfolio returned 1.06%<sup>1</sup> for the month of November and 3.89%<sup>1</sup> for the year to date. This positive performance reflects improved prices for the Portfolio's Australasian credit holdings (both corporate bonds and mortgage-backed securities) and a strong rally (lower yields) in US long-term interest rates towards the end of November.

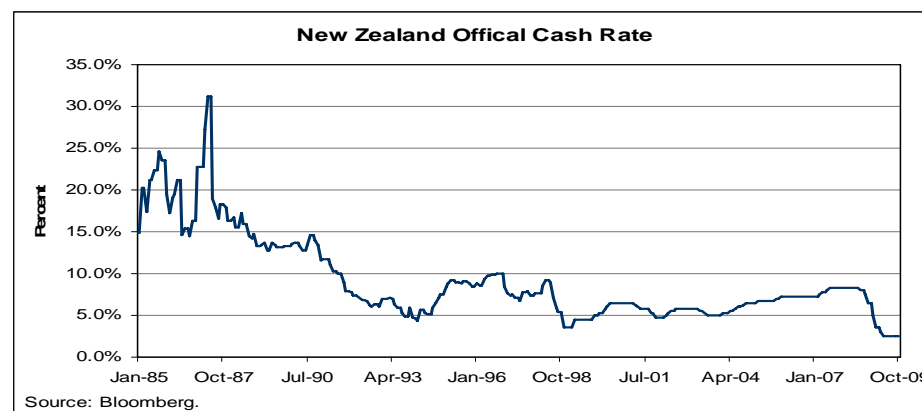
Early in November, the manager fully hedged all the Portfolio's long-term interest rate exposures. This asset allocation change was in response to NZ Funds' interest rate risk management models signalling the need to take (interest rate) risk "off the table". At different points throughout 2009 the manager has hedged the Portfolio's interest rate exposure to specific markets as separate models are run for New Zealand, Australian and US interest rates. However, November was the first time that all the interest rate risk models have signalled the need to be hedged at the same time. The hedging signal proved to be short lived. As such, New Zealand and US interest rate exposures were reintroduced towards the end of November.

### Bond insight: The scepter of 1994

The consensus view for the New Zealand economy at present is for a gradual pick up in economic activity and for interest rates to remain lower for longer. In some ways this appears similar to the outlook for the US economy at start of 1994. At the beginning of 1994 a Wall Street Journal survey of banks showed forecast bond returns of 5% to 7% and an expectation of only small rises in the cash rate (Fed funds rate). Unfortunately, the reality of 1994 was very different. The Federal Reserve embarked on a series of unanticipated interest rate rises

designed to stamp out rising inflation. This resulted in 1994 being one of the worst years for bonds on record, with US government bonds returning -3.35% (on average) for the year.

Moving forward into 2010, the unanswered question is how will central banks around the world remove the exceptionally easy monetary conditions as growth returns to the global economy? Central bankers, including the Governor of the RBNZ, Dr Bollard, are certainly very cognisant of the impact that the surprise interest rate hikes had in 1994 and the resulting pain this caused for bond investors. Consequently, interest rate increases are likely to be telegraphed long in advance. Still, the experience of 1994 shows clearly that markets can get it very wrong and that a sudden increase in growth and or inflation could prove to be the catalyst for a sharp increase in interest rates. This is a key reason why NZ Funds has an objective risk management strategy in place to determine when the Portfolio does or does not have exposure to long-term interest rates in New Zealand, Australia and the United States.



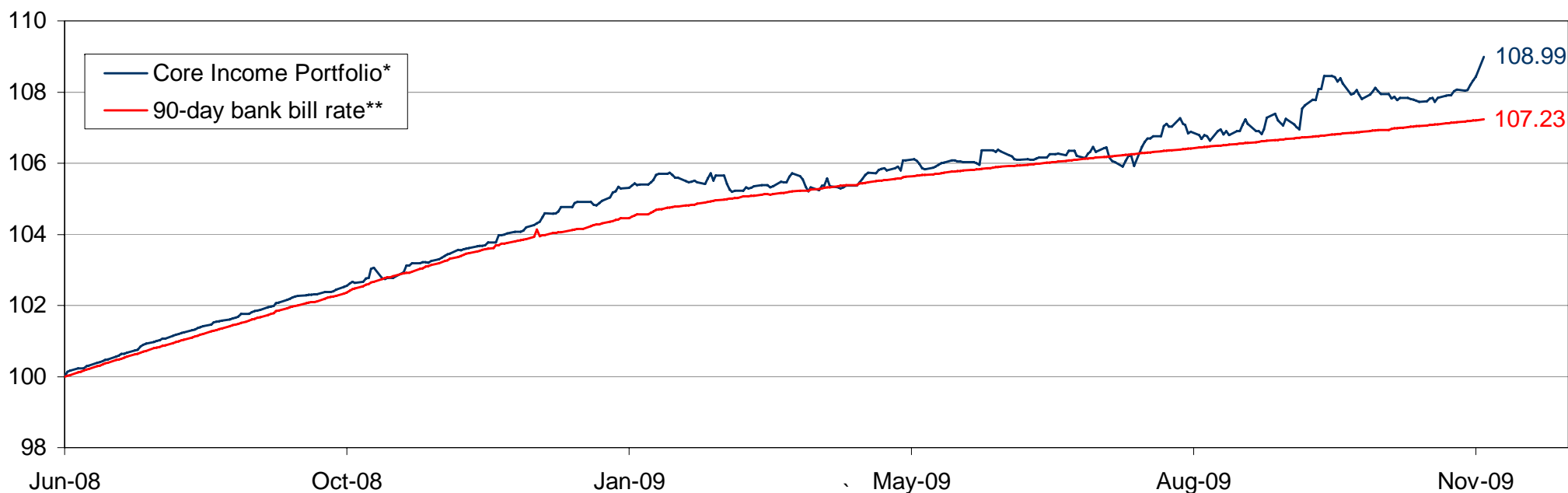
<sup>1</sup> Returns are stated after Portfolio fees and expenses, but before any advisory fees or investor tax. Past performance is not necessarily an indication of future returns.

# Core Income Portfolio



Performance since 25 June 2008 to 30 November 2009 (Part 1)

CIP performance attribution	1 month	3 month	6 month
Positive	NZ/Australian credit	Credit; interest rates	Credit
Neutral	Australian rates	Cash	Cash
Negative	Selected Australian credits	US interest rate hedges	NZ interest rate hedging



Comparison	1 month	3 month	6 month	1 year	2 year pa	5 year pa	7 year pa	Since strategy inception pa	Maximum drawdownx
Portfolio*	1.06%	1.94%	2.46%	5.02%	-	-	-	6.19%	-0.67%
90-day bank bill rate**	0.21%	0.64%	1.30%	3.48%	-	-	-	4.99%	-0.18%

**IMPORTANT:** Please refer to the slide that follows for the footnotes relating to this slide.

## Performance since 25 June 2008 to 30 November 2009 (Part 2)

### **Core Income Portfolio**

- \* Returns are stated after portfolio fees and expenses, but before any advisory fees or investor tax. Past performance is not necessarily an indication of future returns.

### **Comparative index**

- \*\* The comparative index is based on the 90-day bank bill rate (sourced from Bloomberg). A fee of 0.20% pa has been deducted from the published rate to reflect the fact that bank bills are usually accessed by retail investors through a managed fund. The returns from this index should be higher than the returns from the NZX Call Index over longer periods of time.

### **Maximum drawdown**

- x Returns should be looked at in conjunction with the level of risk associated with an investment. For this reason, we have included the 'maximum drawdown' for both the Portfolio and the comparison. Maximum drawdown is a measure of volatility and represents the largest cumulative decline experienced during the reporting period.

# Core Income Portfolio

Portfolio summary as at 26 November 2009

## Portfolio summary

Number of securities	38 <sup>1</sup>
Yield	4.8% <sup>2</sup>
Weighted average credit rating	AA-
Weighted average credit spread duration	1.8 years
Weighted average interest rate duration	3.8 years

Sector	Portfolio value	Proportion of portfolio	Expected maturity	S&P rating	Yield to maturity <sup>3</sup>
Bank deposits / Bank bills	\$5,041,799	8.6%	Nov-09	A1+	2.5%
New Zealand / Australian corporate bonds	\$12,495,401	21.2%	Oct-13	A-	6.3%
Global corporate bonds	\$4,181,986	7.1%	Oct-12	BBB+	6.6%
Government/Government-guaranteed bonds	\$30,204,898	51.3%	Oct-16	AAA	5.0%
Residential mortgages	\$5,606,840	9.5%	Jun-11	AA	10.3%
Loans	\$1,027,422	1.7%	-	NR	7.3%
Debt strategies	\$358,633	0.6%			
<b>Total economic exposure</b>	<b>\$58,916,980</b>	<b>100.0%</b>			

Interest rate swaps, notional value ~ \$18m.

<sup>1</sup> The Portfolio often holds more than one security under a given issuer. The 'number of securities' takes this into account. <sup>2</sup> The yield is stated after the deduction of management, custodial and trustee fees. The yield is not the actual return of the Portfolio, nor is it a projection or forecast. Rather, it is an estimate of the pre-tax income stream generated from investing in the Portfolio. The Portfolio return consists of yield and capital gains and losses (also calculated on a pre-tax and fees basis). Therefore, the Portfolio's return could be less than the Portfolio's yield. Details of the yield calculation are available on request from NZ Funds. <sup>3</sup> The yield to maturity is stated before the deduction of management, custodial and trustee fees. Note: Rounding may affect the subtotals and totals.

# Core Income Portfolio

## Complete portfolio as at 26 November 2009 (Part 1)

### Portfolio summary

Number of securities	38 <sup>1</sup>
Yield	4.8% <sup>2</sup>
Weighted average credit rating	AA-
Weighted average credit spread duration	1.8 years
Weighted average interest rate duration	3.8 years

Sector / Security	Portfolio value	Proportion of portfolio	Expected maturity	S&P rating	Yield to maturity <sup>3</sup>
<b>Bank deposits / Bank bills</b>		<b>8.6%</b>			<b>2.5%</b>
Westpac (Bank deposits) <sup>4</sup>	\$4,431,177	7.5%	Current	A1+	2.5%
BNZ (Bank bills)	\$155,973	0.3%	Dec-09	A1+	2.7%
Kiwibank (Bank bills)	\$155,973	0.3%	Dec-09	A1+	2.7%
ANZ (Bank bills)	\$155,701	0.3%	Dec-09	A1+	2.8%
ASB (Bank bills)	\$142,975	0.2%	Dec-09	A1+	2.7%
<b>New Zealand / Australian corporate bonds</b>		<b>21.2%</b>			<b>6.3%</b>
Fonterra	\$2,786,908	4.7%	Mar-15	A+	7.1%
Woolworths	\$2,610,979	4.4%	Nov-11	A-	5.5%
Telstra Corporation	\$2,360,373	4.0%	Nov-12	A	5.1%
Vector	\$2,204,477	3.7%	Oct-14	BBB+	7.4%
Watercare	\$1,443,589	2.5%	May-14	AA	6.8%
Bank of New Zealand	\$1,089,076	1.8%	Mar-14	AA	6.5%

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# Core Income Portfolio

## Complete portfolio as at 26 November 2009 (Part 2)

Sector / Security	Portfolio value	Proportion of portfolio	Expected maturity	S&P rating	Yield to maturity <sup>3</sup>
<b>Global corporate bonds</b>		<b>7.1%</b>			<b>6.6%</b>
Vodafone	\$2,772,722	4.7%	Jan-13	BBB+	5.5%
Citigroup	\$1,409,264	2.4%	May-12	A-	8.9%
<b>Government/Government-guaranteed bonds</b>		<b>51.3%</b>			<b>5.0%</b>
US Treasury	\$17,617,550	29.9%	Sep-19	AAA	5.5%
Westpac	\$5,189,607	8.8%	Jan-12	AAA	3.8%
Commonwealth Bank of Australia	\$3,663,148	6.2%	Dec-13	AAA	4.7%
BNZ	\$1,715,234	2.9%	Feb-14	AAA	6.1%
National Australia Bank	\$1,014,582	1.7%	Jan-12	AAA	4.4%
ANZ	\$1,004,778	1.7%	Dec-10	AAA	3.4%
<b>Residential mortgages</b>		<b>9.5%</b>			<b>10.3%</b>
AMSNZ mortgage security (various issues) <sup>5</sup>	\$4,299,504	7.3%	May-10 to Mar-11	AA- to AAA	9.2%
Sapphire mortgage security (various issues)	\$1,307,336	2.2%	Jan-12 to Jun-14	AA	13.8%
<b>Loans</b>		<b>1.7%</b>			<b>7.3%</b>
Private Loan Trust (Fidelity - 32 current loans)	\$1,027,422	1.7%	-	NR	7.3%
<b>Debt Strategies</b>		<b>0.6%</b>			
Interest rate swaps	\$358,633	0.6%			
<b>Total economic exposure</b>	<b>\$58,916,980</b>	<b>100.0%</b>			

Interest rate swaps, notional value ~ \$18m.

<sup>3</sup> The yield to maturity is stated before the deduction of management, custodial and trustee fees. <sup>5</sup> Originated and serviced by AMSNZ, a subsidiary of GE Capital. Note: Rounding may affect the subtotals and totals.

For further information or to request a copy of the relevant Investment Statement, please contact New Zealand Funds Management Limited.

Past performance is not necessarily an indication of future returns.

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