Core Income Portfolio

NZFUNDS

Manager insight – 31 May 2009

The Core Income Portfolio returned 0.27%[1] for the month of May. This takes the six-month performance to 2.50%[1]. By comparison, the Money Market Portfolio returned 1.61%[1] over the six-month period. During May the Portfolio benefited from improving (lower) corporate bond spreads. However, this was more than offset by the increase in medium-term interest rates across the world.

Beware the default cycle

There is no doubt that thanks to the global financial crisis, corporate bonds offer exceptional value. Corporate bond spreads – which measure how much more corporate bonds are yielding than cash in the bank – have not been this high since the Great Depression of the 1930s. But exceptional returns rarely travel without risk, and the primary risk associated with corporate bonds is default. During the 1930s, annualised default rates reached approximately 15% per annum as more than one in ten bonds defaulted each year. Bond defaults are on the rise again. What makes the corporate bond default cycle most damaging is that it lags the economic cycle. In fact, it is not uncommon for bond investors to be at maximum risk after the economy has already recovered!

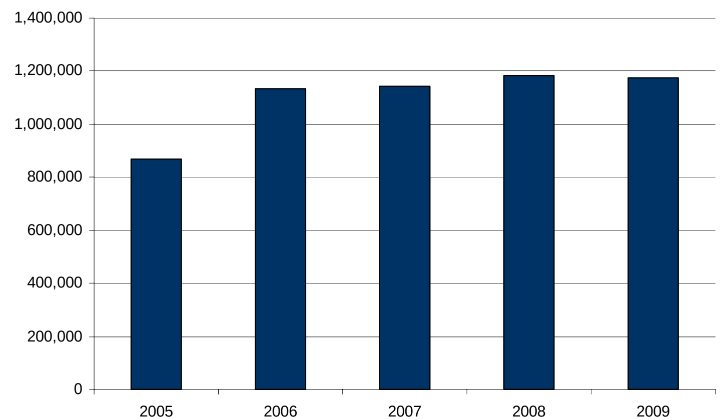
Bond insight: Vector

There are several ways to protect against the possibility of default. Focusing on the corporate bond issues of companies operating in defensive sectors is a good place to start, and bond issuers don't getmuch more defensive than Vector – its bonds were added to the Portfolio in May.

Approximately half of Vector's annual revenue – which amounts to a colossal $1.3 billion per annum – is derived from government-regulated gas and electricity transportation. In total, Vector services over 520,000 electricity customers (households), 148,000 gas customers, 23,000 LPG customers and owns and monitors 817,000 gas and electricity meters – many on behalf of other utility companies. After operating expenses, it derives $331 million in cash flow per annum – that is 2.7x the level that is needed to meet the annual interest rate of 7.80% on its bonds.

Although electricity and gas transportation may not be the most electrifying business, it is also unlikely to shock investors. In fact, should corporate bond spreads normalise before this bond's maturity date in October 2014, bond holders stand to earn an additional 9% through capital gains.

Vector revenue 2005-2009



[1] Returns are stated after fund fees and expenses, but before any advisory fees or investor tax. Past performance is not necessarily an indication of future returns.

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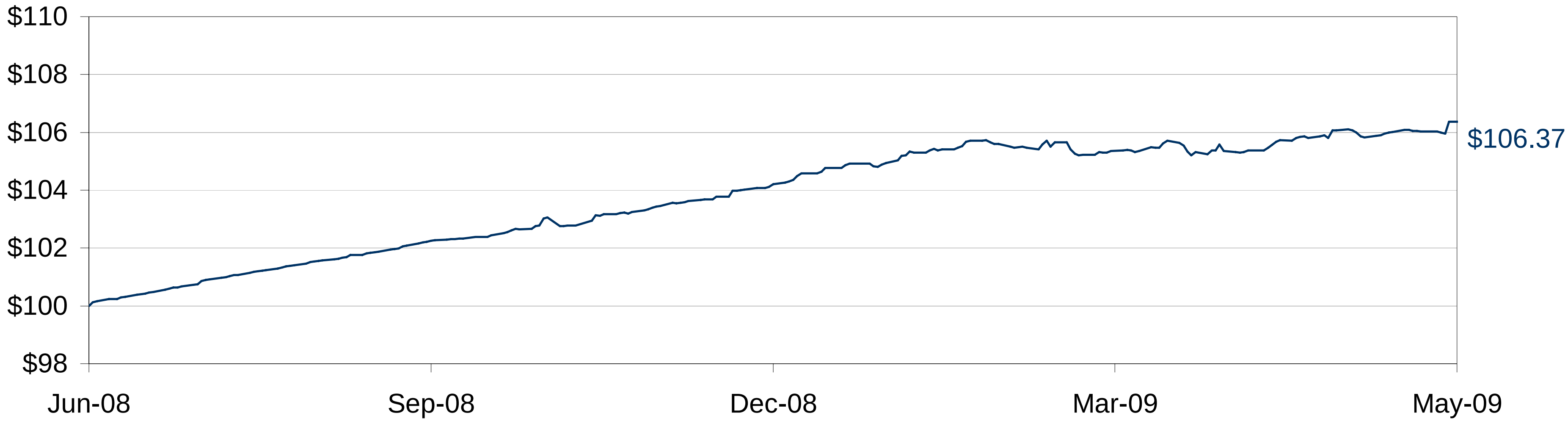
Performance since 25 June 2008 to 31 May 2009

Performance attribution	One month	Three month	Six month
Positive	Credit spreads	-	-
Neutral	n/a	-	-
Negative	Long duration exposure	-	-



One-month return	Three-month return	Six-month return	One-year return	Since inception of strategy pa
0.27%	1.08%	2.50%	-	-

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. The Portfolio was launched on 20 May 2008. As the Portfolio was only invested on 25 June 2008, performance is measured from this date.

Core Income Portfolio

Portfolio summary as at 30 May 2009

Portfolio summary

Number of securities	38*
Weighted average running yield (approximately)	5.8%**
Weighted average credit rating	AA

Sector / Security	Portfolio value	Proportion of portfolio	Maturity date / Expected average life date	S&P rating	Yield to maturity***
Bank deposits / Bank bills		**37%**			
ANZ (Bank bills)	$3,825,995	7%	Sep-09	A1+	2.8%
ANZ (Bank bills)	$4,024,071	7%	Sep-09	A1+	2.8%
BNZ (Bank bills)	$3,391,362	6%	Sep-09	A1+	2.8%
Kiwibank (Bank bills)	$4,099,318	7%	Sep-09	A1+	2.8%
Westpac (Bank deposits)****	$3,258,759	6%	Current	A1+	2.5%
Westpac (Bank bills)	$2,620,282	5%	Sep-09	A1+	2.8%
Corporate bonds		**26%**			
Telstra Corporation	$2,206,753	4%	Nov-12	A	6.9%
Citigroup	$1,254,865	2%	May-12	A-	11.8%
Vodafone	$2,527,679	4%	Jan-13	A-	8.7%
Fonterra	$2,579,634	4%	Mar-15	A+	8.3%
Woolworths	$2,770,125	5%	Nov-11	A-	7.6%
Watercare	$1,367,711	2%	May-14	AA	7.1%
Vector	$2,078,886	4%	Oct-14	BBB+	7.8%
New Zealand / Australian government guaranteed bonds		**23%**			
ANZ	$1,127,595	2%	Dec-10	AAA	3.5%
Commonwealth Bank of Australia	$3,611,044	6%	Dec-13	AAA	5.1%
National Australia Bank	$1,126,597	2%	Jan-12	AAA	4.7%
Westpac	$5,775,369	10%	May-12	AAA	4.4%
BNZ	$1,680,828	3%	Feb-14	AAA	5.8%
Residential mortgages		**9%**			
AMSNZ mortgage security (various issues)*****	$4,050,581	7%	May-10 to Mar-11	AA- to AAA	10.9%
Sapphire New Zealand mortgage security (various issues)	$1,199,146	2%	Jul-11 to Jan-12	AA	14.9%
Other debt securities		**3%**			
Titan (portfolio of Australian & US corporate loans)	$1,848,832	3%	Jun-09	AA	53.0%
Loans		**2%**			
Private Loan Trust (Fidelity - 32 current loans)	$1,391,403	2%	-	NR	7.5%
Total	**$57,816,833**	100%			

Interest rate swaps, notional value ~ $15m.

*With reference to bank bills, the Portfolio often holds more than one security under a given issuer. The 'number of securities' takes this into account. **The running yield is stated after the deduction of management, custodial and trustee fees. The running yield is not the actual return of the Portfolio, nor is it a projection or forecast. ***The yield to maturity is stated before the deduction of management, custodial and trustee fees. ****Bank deposits includes cash and FX assets. *****Originated and serviced by AMSNZ, a subsidiary of GE Capital. Note: Rounding may affect the subtotals and totals.

Notes

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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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