

MANAGER INSIGHT – 31 MAY 2010

The Portfolio returned -0.34%¹ in May, taking the year-to-date performance to 1.27%¹. The performance for the month was predominantly driven by a decline in the value of the Portfolio's global corporate bonds.

Subordinated and perpetual securities – worth the risk?

As bank deposit rates have fallen over the past couple of years, one alternative that retail investors have increasingly turned to are the subordinated capital securities and perpetual preference shares offered by financial organisations. In aggregate, more than NZ\$2.5 billion has been invested in these securities, with the majority being over the past three years.

The attraction of these securities is simple. They offer a higher yield, present a known and familiar 'name' for investors and, in particular, have achieved very strong credit ratings.

At this point, investors should be asking themselves one simple question. Why are they being paid a high yield from a familiar name with a high credit rating?

The answer is that all bonds are not created equal – in particular, the subordinated capital securities and perpetual bonds are more akin to an investment in shares than an investment in senior-ranking debt securities. Therefore, they may experience price fluctuations similar to shares.

Being deeply subordinated or perpetual means that in the case of a default by the issuer, these securities will be further down the queue when it comes to principal repayment. This is the reason these securities pay a high coupon.

During the financial crisis, there were a number of examples overseas where subordinated capital securities experienced losses, both in the form of principal writedowns and coupon suspension. Closer to home, a chilling reminder of the principal risk presented by these securities is the sorry story of the South Canterbury perpetual preference shares. These securities were issued in 2006 with a coupon of 10%. Thanks to the general decline in interest rates, the current coupon has fallen to 5.6%. However, more importantly, the highly publicised troubles of South Canterbury have resulted in the preference shares falling from the issue price of \$1 to just 26c – a decline of 74%. The key point here is that investors need to clearly understand their own needs and what they are trying to achieve from their investments. If the primary need is a return on capital, then the potential extra return available from deeply subordinated securities is not sufficient compensation.

For New Zealand Funds Management, it is critical that the portfolios target clearly defined goal categories. It is for this reason that the Portfolio, in contrast to many of our market counterparts, does not invest in deeply subordinated or perpetual securities. This ensures alignment between the active management of the Portfolio and the investment goals desired by our clients.

¹ 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.

PERFORMANCE SINCE 25 JUNE 2008 TO 31 MAY 2010 (PART 1)

CIP PERFORMANCE ATTRIBUTION	1 MONTH	3 MONTH	6 MONTH
Positive	NZ corporate bonds; interest rates	NZ & global corporate bonds; credit	NZ & global corporate bonds; credit
Neutral	Cash	US interest rate hedging	Cash
Negative	Global corporate bonds	NZ interest rate hedging	Interest rate hedging



COMPARISON	1 MONTH	3 MONTH	6 MONTH	1 YEAR	2 YEAR PA	5 YEAR PA	7 YEAR PA	SINCE INCEPTION	MAXIMUM DRAWDOWN*
Portfolio*	-0.34%	1.30%	0.62%	3.10%	-	-	-	9.67%	-1.06%
90-day bank bill rate**	0.20%	0.62%	1.27%	2.58%	-	-	-	8.58%	-0.18%

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

PERFORMANCE SINCE 25 JUNE 2008 TO 31 MAY 2010 (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

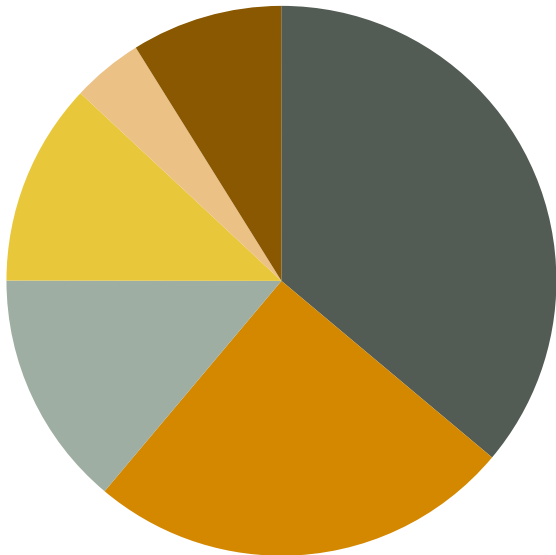
- ** The comparative index is based on the 90-day bank bill rate (sourced from Bloomberg). A fee of 0.20% pa has been deducted from the published rate to reflect the fact that bank bills are usually accessed by retail investors through a managed fund. The returns from this index should be higher than 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, the 'maximum drawdown' is included for both the Portfolio and the comparison. The maximum drawdown is a measure of volatility and represents the largest decline in value experienced during the reporting period.

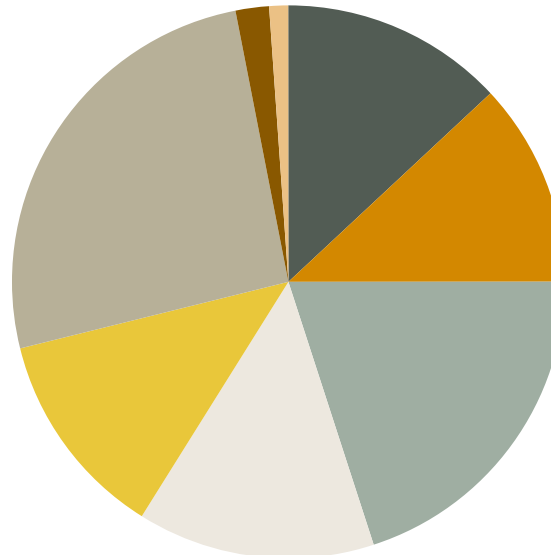
ASSET ALLOCATION (%)

January 2009



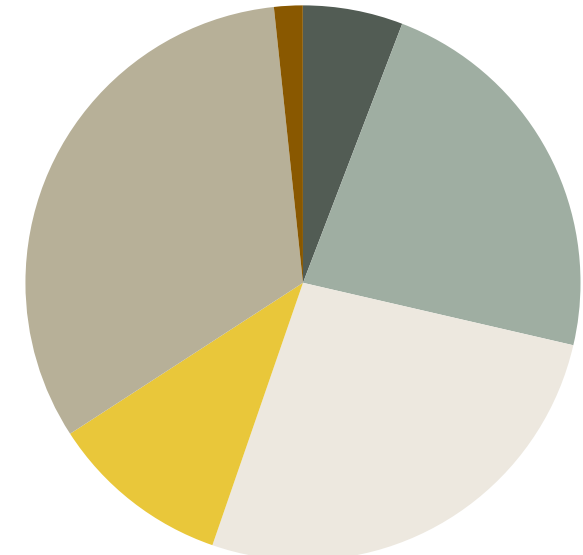
● BANK DEPOSITS & BANK BILLS	36
● GOVT-GUARANTEED BONDS	25
● CORPORATE BONDS	14
● RESIDENTIAL MORTGAGES	12
● OTHER DEBT SECURITIES	4
● LOANS	9
TOTAL	100

January 2010



● BANK DEPOSITS & BANK BILLS	13
● GOVT / GOVT-GUARANTEED BONDS	12
● NZ / AUSTRALIAN CORPORATE BONDS	20
● GLOBAL CORPORATE BONDS	14
● RESIDENTIAL MORTGAGES	12
● EXTERNALLY MANAGED FUNDS	26
● LOANS	2
● DEBT STRATEGIES	1
TOTAL	100

May 2010



● BANK DEPOSITS & BANK BILLS	6
● NZ / AUSTRALIAN CORPORATE BONDS	23
● GLOBAL CORPORATE BONDS	27
● RESIDENTIAL MORTGAGES	11
● EXTERNALLY MANAGED FUNDS	31
● LOANS	2
TOTAL	100

COMPLETE PORTFOLIO AS AT 31 MAY 2010 (PART 1)

PORTFOLIO SUMMARY

Number of securities	43 ¹
Yield	5.8% ²
Weighted average credit rating	BBB ³
Weighted average credit spread duration	5.7 years
Weighted average interest rate duration	4.5 years

SECTOR / SECURITY	PORTFOLIO VALUE	PORTFOLIO ALLOCATION	EXPECTED MATURITY	S&P RATING	YIELD TO MATURITY ⁴
BANK DEPOSITS / BANK BILLS		5.8%			2.5%
Westpac (Bank deposits) ⁵	\$3,532,119	5.8%	Current	A1+	2.5%
NEW ZEALAND / AUSTRALIAN CORPORATE BONDS		22.9%			6.9%
University of Canterbury 7.25% 15/12/2019	\$1,780,360	2.9%	Dec-19	NR	7.1%
Fonterra 7.57%10/03/2015	\$1,733,905	2.9%	Mar-15	A+	6.5%
Vector 7.8% 15/10/2014	\$1,516,209	2.5%	Oct-14	BBB+	6.9%
Watercare 6.785% 15/05/2014	\$1,491,036	2.5%	May-14	AA	6.3%
Transpower Inflation Linked Note 4.115% 15/05/2020	\$1,484,284	2.5%	May-20	AA+	7.1%
Contact Energy 7.855% 13/04/2017	\$1,475,378	2.4%	Apr-17	BBB	7.7%
Works Finance NZ 9.65% 15/09/2012	\$1,454,147	2.4%	Sep-12	BBB	6.8%
Westfield 5.75% 02/09/2015	\$1,142,282	1.9%	Sep-15	A	6.8%
Mighty River Power 7.55% 12/10/2016	\$743,483	1.2%	Oct-16	BBB+	7.3%
The Warehouse 7.3% 15/06/2015	\$736,931	1.2%	Jun-15	NR	7.2%
Meridian Energy 7.15% 16/03/2015	\$300,395	0.5%	Mar-15	BBB+	6.6%
GLOBAL CORPORATE BONDS		26.6%			7.5%
Citigroup 7.825% 18/05/2012	\$1,763,784	2.9%	May-12	A-	7.0%
Rio Tinto 9% 01/05/2019	\$1,331,531	2.2%	May-19	BBB+	8.0%
BHP Finance 6.5% 01/04/2019	\$1,249,199	2.1%	Apr-19	A+	6.7%
Comcast 5.7% 01/07/2019	\$1,156,829	1.9%	Jul-19	BBB+	7.1%
Mosaic 7.375% 01/12/2014	\$1,138,095	1.9%	Dec-14	BBB	8.3%
Goldman Sachs 6.15% 01/04/2018	\$1,097,331	1.8%	Apr-18	A+	8.2%
Barrick Australia 4.95% 15/01/2020	\$1,088,120	1.8%	Jan-20	BBB+	7.2%

¹ The Portfolio often holds more than one security under a given issuer. The 'number of securities' represents the total securities held by the Portfolio. However, in the table all securities from a given issuer are treated as one security. ² 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. The Portfolio's return could be less than the Portfolio's yield. Details of the yield calculation are available on request from New Zealand Funds Management. ³ The weighted average credit rating is calculated excluding the University of Canterbury and The Warehouse bonds. The University of Canterbury and The Warehouse bonds have not been rated by a ratings agency. Our internal analysis suggests that if the bonds were to be rated, they would each receive an investment-grade rating. ⁴ The yield to maturity is stated before the deduction of management, custodial and trustee fees. ⁵ Bank deposits includes cash and FX assets. Note: Rounding may affect the subtotals and totals.

COMPLETE PORTFOLIO AS AT 31 MAY 2010 (PART 2)

SECTOR / SECURITY	PORTFOLIO VALUE	PORTFOLIO ALLOCATION	EXPECTED MATURITY	S&P RATING	YIELD TO MATURITY ⁴
GLOBAL CORPORATE BONDS		26.6%			7.5%
AT&T 5.8% 15/02/19	\$1,072,500	1.8%	Feb-19	A	6.7%
JP Morgan Chase 6% 01/10/17	\$1,030,015	1.7%	Oct-17	AA	7.4%
General Mills 5.65% 15/02//19	\$1,004,183	1.7%	Feb-19	BBB+	6.7%
Altria Group 9.25% 06/08/19	\$955,636	1.6%	Aug-19	BBB+	9.0%
Simon Property Group 5.65% 01/02/2020	\$759,610	1.3%	Feb-20	A-	8.3%
Pepsico 7.9% 01/11/2018	\$676,351	1.1%	Nov-18	AA-	6.6%
Oracle 6.5% 15/04/2038	\$611,883	1.0%	Apr-38	A	8.0%
Oracle 6.125% 08/07/2039	\$602,870	1.0%	Jul-39	A	7.6%
IBM 5.875% 29/11/2032	\$579,204	1.0%	Nov-32	A+	7.7%
RESIDENTIAL MORTGAGES		10.6%			6.2%
Westpac 2009-1 A mortgage security 21/01/2041	\$1,618,685	2.7%	Aug-12	AAA	4.5%
AMSNZ V 3 mortgage security 15/03/2032 ⁶	\$1,434,571	2.4%	Mar-11	AA-	6.7%
AMSNZ IV 3 mortgage security 15/10/2031 ⁶	\$1,087,137	1.8%	Dec-10	AA-	5.7%
Sapphire III NZ 2006 MA mortgage security 13/07/2037	\$681,921	1.1%	Oct-11	AA	9.8%
Sapphire 2007-1 MA mortgage security 13/05/2041	\$558,216	0.9%	Oct-14	AA	9.5%
AMSNZ IV 2 mortgage security 15/10/2031 ⁶	\$544,169	0.9%	Dec-10	AAA	4.5%
AMSNZ V 2 mortgage security 15/03/2032 ⁶	\$462,343	0.8%	Feb-11	AAA	5.0%
EXTERNALLY MANAGED FUNDS		32.4%			7.2%
iShares iBoxx Investment Grade US Corporate Bond Fund	\$15,078,122	24.9%	May-22	BBB+	7.2%
iShares Great Britain Corporate Bond Fund	\$2,740,802	4.5%	Dec-25	A-	8.2%
iShares European Corporate Bond Fund	\$1,769,763	2.9%	May-15	A-	5.3%
LOANS		1.7%			7.6%
Private Loan Trust (Fidelity - 29 current loans)	\$1,027,820	1.7%	n/a	NR	7.6%
DEBT STRATEGIES		0.0%			
New Zealand/Australia interest rate hedges	\$6,745,905	11.1%	n/a	n/a	n/a
International interest rate hedges - cash	\$4,773,148	7.9%	n/a	n/a	n/a
International interest rate hedges	-\$4,773,148	-7.9%	n/a	n/a	n/a
New Zealand/Australia interest rate hedges - cash	-\$6,745,905	-11.1%	n/a	n/a	n/a
TOTAL ECONOMIC EXPOSURE⁷	\$60,511,222	100.0%			

⁴ The yield to maturity is stated before the deduction of management, custodial and trustee fees. ⁶ Originated and serviced by AMSNZ, a subsidiary of GE Capital. ⁷ Total economic exposure represents the total economic value of a Portfolio, which is the gross asset value of the Portfolio adjusted for the effect of direct or indirect derivative positions taken by the Portfolio. Note: Rounding may affect the subtotals and totals.

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

Past performance is not necessarily an indication of future returns.

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