Credit Opportunities Portfolio

NZFUNDS

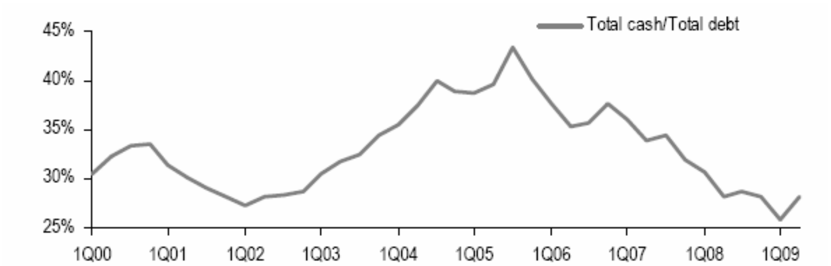
Manager insight – 30 September 2009

One of the consequences of the freezing of world financial markets during the second half of 2008 was that it translated into a very sudden and sharp decline in revenue for many US corporations. During the 4th quarter of 2008 investment-grade companies, on average, saw their revenue decline by 10%. During the 1st quarter of 2009 revenues fell by a further 12%.

With such an extreme decline in revenue it is natural to expect an equally sudden decline in the credit quality of US investment-grade companies. Initially, this was the case. However, the recent 2nd quarter earning reports have shown that on average companies have been able to grow their profit margins back to levels enjoyed before the crisis began. The average EBITDA margin for US investment-grade companies is a robust 23%, which is above the average for the past ten years. Importantly, this means that companies have, in aggregate, been able to fully adjust their cost structure to the lower revenue environment. This is a very positive result as it means that in general companies are very well positioned to benefit from any increase in revenue, which should occur as the United States economy rebounds.

While companies are well positioned to increase earnings with an improving economy, the process of restoring balance sheets back to full health with take longer. However, it is a process that has begun.

One sign of this is that companies have also been increasing their cash holdings. Over the past year US investment-grade companies have increased their cash holdings by 30%. However, much of this increase in cash reflects new debt that has been issued to the markets. The chart below shows that although the total cash/total debt ratio has begun to improve, it remains similar to the low point following the 2001/2002 recession.



Source: JP Morgan

This suggests that companies will look to use any increase in profits to reduce debt and improve measures such as the one above.

*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.

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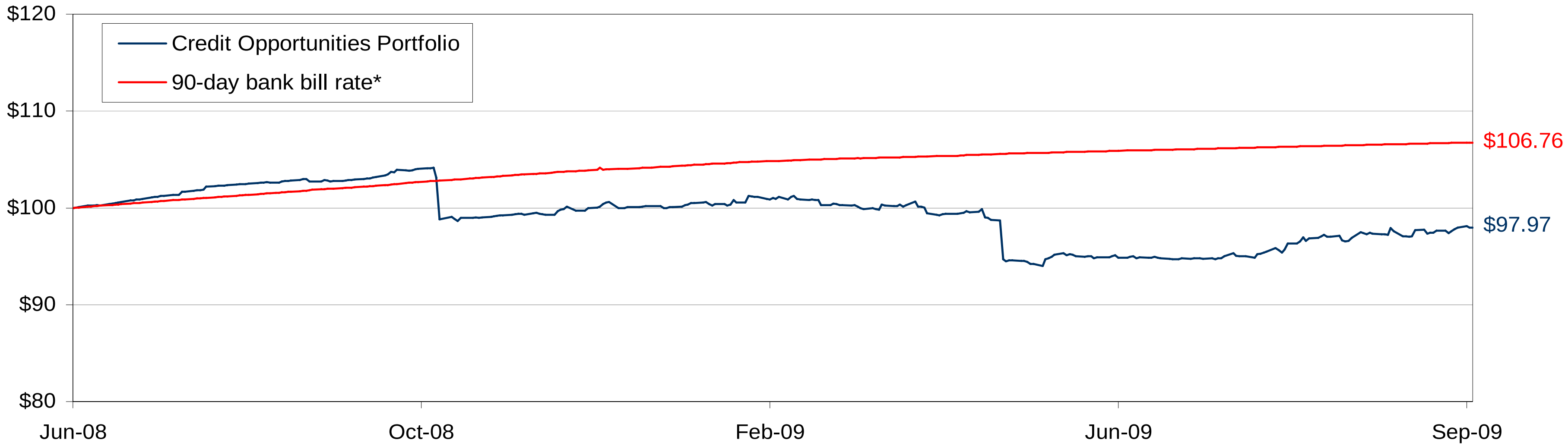
Performance since 25 June 2008 to 30 September 2009

Performance attribution	1 month	3 month	6 month
Positive	Interest rates and credit	Cash; inv. grade credit	Cash
Neutral	n/a	n/a	n/a
Negative	n/a	Distressed credit	Distressed credit



Period	1 month	3 month	6 month	1 year	2 year pa	Since inception pa
Portfolio	0.72%	3.24%	-2.17%	-4.91%	-	-1.61%

*Source: Bloomberg. 90-day bank bill rate adjusted for assumed portfolio management fees of 0.20% pa. 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. Strategy implemented on 25 June 2008.

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Portfolio summary as at 30 September 2009

Portfolio summary

Number of securities	17*
Weighted average credit spread duration (yrs)	3.6
Weighted average interest rate duration (yrs)	3.8
Weighted average running yield (approximately)	4.8%**
Weighted average credit rating	BBB+

Sector / Security	Portfolio value	Proportion of portfolio	Maturity date / Expected average life date	S&P rating	Yield to maturity***
Bank deposits / Bank bills		**34.4%**			
Westpac (Bank deposits)	$3,073,639	27.3%	Current	A1+	2.5%
FX Asset	$581,211	5.2%	n/a	A1+	n/a
ANZ (Bank bills)	$54,297	0.5%	Oct-09	A1+	2.7%
Westpac (Bank bills)	$44,116	0.4%	Oct-09	A1+	2.7%
Kiwibank (Bank bills)	$44,116	0.4%	Oct-09	A1+	2.7%
ASB Bank (Bank bills)	$38,687	0.3%	Oct-09	A1+	2.7%
BNZ (Bank bills)	$37,329	0.3%	Oct-09	A1+	2.7%
Corporate bonds		**36.0%**			
Works Finance NZ	$1,600,034	14.2%	Sep-12	BBB-	8.0%
Altria Group Inc	$982,236	8.7%	Aug-19	BBB+	8.9%
Telecom Italia SA	$911,571	8.1%	Jul-36	BBB	8.8%
Woolworths	$561,981	5.0%	Nov-11	A-	5.8%
Government / Government-guaranteed bonds		**25.6%**			
US Treasury	$2,891,417	25.6%	Aug-19	AAA	5.8%
Residential mortgages		**3.3%**			
Sapphire New Zealand mortgage security	$366,958	3.3%	Jul-37	BB	20.0%
Stressed assets		**0.8%**			
CLO equity (4 securities)	$88,495	0.8%	Dec-10	NR	0%
Total	**$11,276,087**	**100.0%**			

*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 fund, nor is it a projection or forecast. ***The yield to maturity is stated before the deduction of management, custodial and trustee fees. 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.