Credit Opportunities Portfolio

NZFUNDS

Manager insight – 31 August 2009

The Portfolio returned 0.95%[1] for the month of August and -2.89%[1] for the year to date. During August the largest contribution to performance came from the Portfolios' US dollar corporate bond holdings.

The Portfolio aims to meet the needs of the Future Growth needs category by taking on credit risk to generate return. Credit risk however is just one of the risks that NZ Funds considers when evaluating potential investments for the Portfolio. Even seemingly 'plain vanilla' corporate bonds have many moving parts that require a detailed and ongoing analysis process. To paraphrase the movie Shrek:

Corporate bonds are like onions – onions have layers, corporate bonds have layers.

The layers are the different forms of risk that are embedded in corporate bonds. There are three primary layers to corporate bonds that investors need to understand. The first is the most obvious layer, ie credit risk. This is the key risk as it determines whether investors get their principal back. Unfortunately, many investors look no further than the credit risk that they are taking on.

The next layer is the embedded interest rate risk. The maturity of a bond is set by the issuer, and in a low interest rate environment where banks are limiting the term of their loans to two years, corporations are extending their corporate bond maturities as long as possible. This exposes investors to the risk of capital loss if interest rates rise in the future. This risk is amply apparent in the scenario where interest rates revert to historical levels of around 8%. This would implying, all other things being equal, a loss of approximately 12%. This is calculated (roughly) by multiplying the change in interest rates (2.6%) by the period to maturity (4.6 years).

The last and by no means the least of the layers is structural risk. Unlike shares, corporate bonds are customised securities, each with a unique combination of features set out in their legal documents. Two recent examples of this are the Deutsche Bank subordinated bond issued in July 2004 and the Rabobank Capital Securities bond issued in October 2007. The Deutsche Bank bond was marketed to investors as a five-year bond. However, this relied on Deutsche Bank opting to redeem the bond in July 2009. As they did not choose to redeem at that time, this delayed the return of investors' capital until the bond's legal maturity in 2014 – ten years from issue. In the case of the Rabobank bond, the feature was not the anticipated maturity changing but rather the coupon. After an initial two-year period, the security's coupon resets annually at a spread above the one-year interest rate. When this security was issued, one-year interest rates were 8.8%. However, now one-year interest rates are 3.1% – which is a far less attractive proposition.

Both of these cases highlight the need for rigorous analysis and active ongoing portfolio management. Simply passively holding positions may lead to poor outcomes.

[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.

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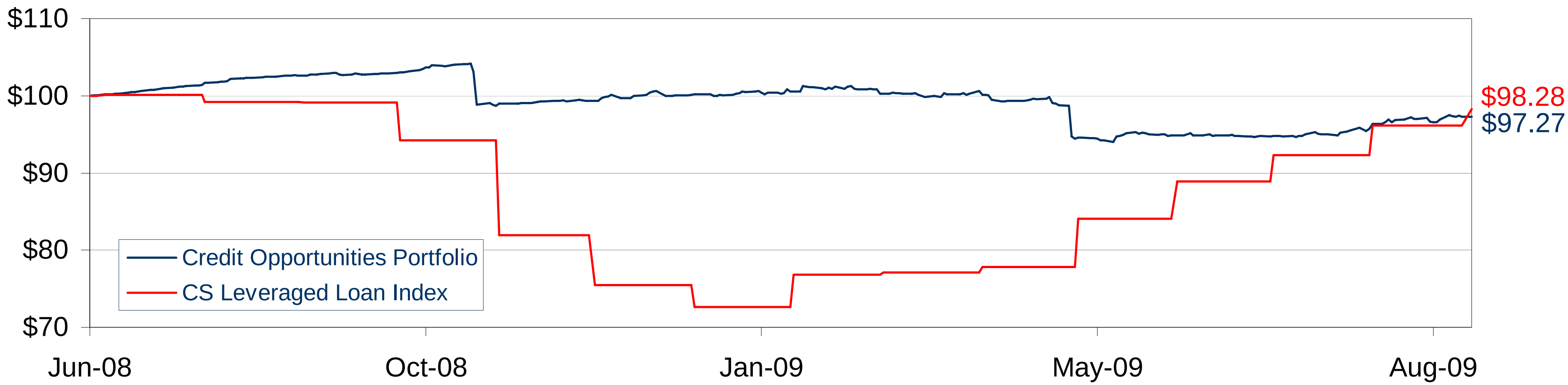
Performance since 25 June 2008 to 31 August 2009

Performance attribution	One month	Three month	Six month
Positive	Corporate credit spreads	Cash; inv. grade credit	Cash
Neutral	Cash; interest rates	n/a	n/a
Negative	US interest rate hedging	Distressed credit	Distressed credit



One-month return	Three-month return	Six-month return	One-year return	Since inception return pa
0.95%	2.52%	-2.99%	-5.21%	-0.44%

Source: Bloomberg. 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 27 August 2009

Portfolio summary

Number of securities	24*
Weighted average running yield (approximately)	6.2%**
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		**19%**			
Westpac (Bank deposits)	$1,517,582	14%	Current	A1+	2.5%
FX Asset	$372,138	3%	n/a	A1+	n/a
ANZ (Bank bills)	$37,040	0%	Oct-09	A1+	2.7%
Westpac (Bank bills)	$37,010	0%	Oct-09	A1+	2.8%
ASB Bank (Bank bills)	$30,010	0%	Oct-09	A1+	2.8%
BNZ (Bank bills)	$26,538	0%	Sep-09	A1+	2.7%
Kiwibank (Bank bills)	$33,172	0%	Sep-09	A1+	2.7%
Corporate bonds		**61%**			
Works Finance NZ	$1,754,273	16%	Sep-12	BBB-	8.2%
Altria Group Inc	$1,028,027	9%	Aug-19	BBB+	8.8%
Telecom Italia SA	$941,119	8%	Jul-36	BBB	8.8%
Arcelor Mittal	$646,028	6%	Jun-19	BBB-	10.2%
Citigroup	$617,269	6%	May-19	A-	9.6%
Mosaic	$595,990	5%	Dec-16	BBB	9.1%
Woolworths	$581,097	5%	Nov-11	A-	6.4%
Simon Property Group	$579,187	5%	Mar-12	A-	6.5%
Government-guaranteed bonds		**17%**			
US Treasury	$1,839,198		Aug-19	AAA	5.8%
Residential mortgages		**3%**			
Sapphire New Zealand mortgage security	$366,845	3%	May-12	BB	20.0%
Stressed assets		**1%**			
CLO equity (4 securities)	$92,382	1%	Dec-10	NR	0%
Total	**$11,094,905**	**100%**			

*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. Note: Rounding may affect the subtotals and totals.

Notes

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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