

Manager insight – 31 October 2009

The Portfolio returned -0.90%¹ for the month of October and -3.07%¹ for the year to date. The slightly negative performance during the month is primarily due to US 10-year interest rates moving higher during October.

Bond Insight: Sapphire III

This month we turn the spotlight on one of the ‘opportunity positions’ held by the Portfolio – a New Zealand residential mortgage-backed (RMBS) security called Sapphire III.

The Portfolio has a small holding (just a 3% weighting) in a junior tranche (class BZ) of the Sapphire III transaction. ‘Junior tranche’ means that this position ranks behind an number of more senior tranches with respect to the repayment of principal. As a result, this debt security has a risk profile more akin to that of a growth investment such as shares. The Core Income Portfolio also has a holding in Sapphire III. However, it holds a more senior tranche (class MA) of this transaction, which has lower risk and a more stable profile.

The manager of the Portfolio defines ‘opportunity positions’ as investments that have the potential to generate a return that is a significant multiple of the initial investment amount. NZ Funds believes the Sapphire III security has this potential because our proprietary, internal research indicates that the value of this position may be significantly more than the deeply discounted price (less than 20% of its original issue price) at which it was purchased.

NZ Funds’ research process

In order to assess the value of the junior tranche, NZ Funds analysed each of the 500 mortgages in the mortgage pool for this deal. By comparing the individual amount borrowed against the lender’s property valuation and then ‘reality checking’ the lender’s valuations against the council valuations for each property, we were able to model how the security performs under various scenarios. Specifically, we were able to model the impact of falling property prices to determine the level of property price declines and mortgage defaults that would be required to sustain a loss on the investment.

The results of the modelling showed that even in a situation where property prices declined across the country by 30%, it would still require 300 of the 500 mortgages in the pool (60%) to default before the Portfolio suffered a loss on its investment. Indeed, if New Zealand property prices experienced a more moderate decline or remained stable, then we would expect the investment to be worth significantly more than its initial purchase price. Given this dependence on the future path of New Zealand property prices, the realisation of value from the Sapphire investment, as with other ‘opportunity positions’ will not be immediate. Instead, the value is likely to emerge over a period of one to two years.

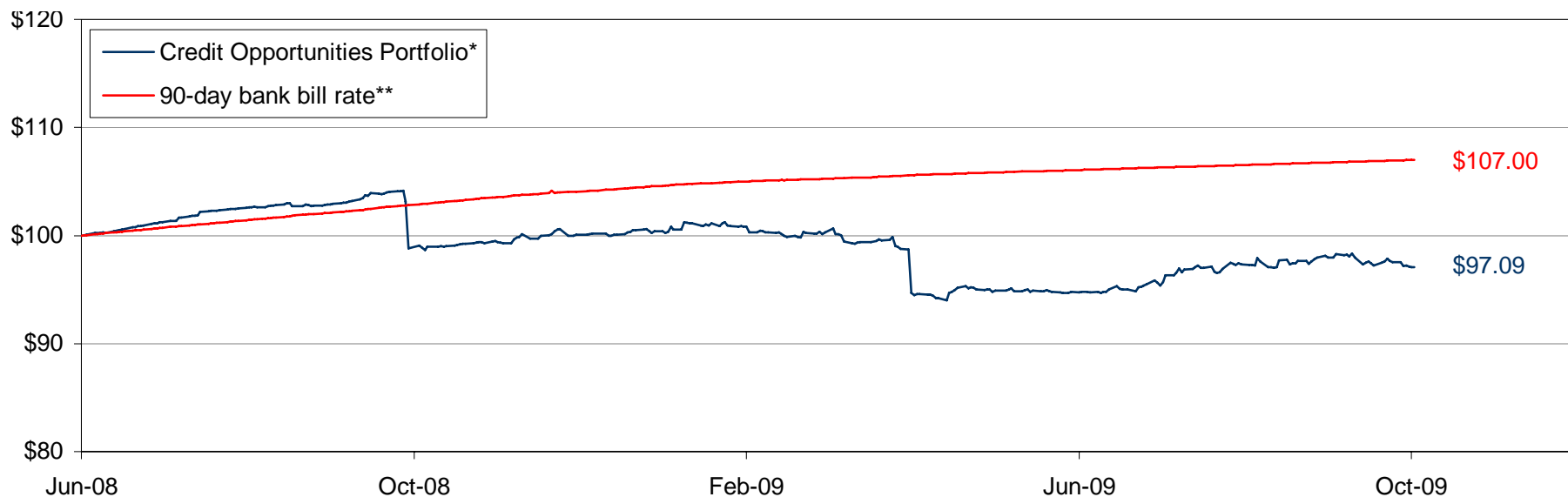
¹ Returns are stated after Portfolio fees and expenses, but before any advisory fees or investor tax. Past performance is not necessarily an indication of future returns.

Credit Opportunities Portfolio



Performance since 25 June 2008 to 31 October 2009 (Part 1)

Performance attribution	1 month	3 month	6 month
Positive	Opportunity positions	Cash; inv. grade credit	Cash
Neutral	Credit	Opportunity positions	Interest rates
Negative	Interest rates	Credit hedging	Opportunity positions



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*	-0.90%	0.77%	2.63%	-1.90%	-	-	-	-2.16%	-9.76%
90-day bank bill rate**	0.22%	0.65%	1.32%	3.94%	-	-	-	5.14%	-0.18%

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

Performance since 25 June 2008 to 31 October 2009 (Part 2)

Credit Opportunities 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. Due to the 'absolute return' nature of this Portfolio, cash is the most appropriate comparison.

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.

Credit Opportunities Portfolio

Portfolio summary as at 31 October 2009

Portfolio summary

Number of securities	18 ¹
Weighted average credit spread duration (yrs)	0.6
Weighted average interest rate duration (yrs)	5.2
Yield (approximately)	5.0% ²
Weighted average credit rating	A-

Sector / Security	Portfolio value	Proportion of portfolio	Maturity date / Expected average life date	S&P rating	Yield to maturity ³
Bank deposits / Bank bills		20.0%			
Westpac (Bank deposits)	\$2,266,059	20.1%	Current	A1+	2.5%
FX Asset	-\$261,036	-2.3%	n/a	A1+	n/a
ANZ (Bank bills)	\$69,248	0.6%	Nov-09	A1+	2.9%
Kiwibank (Bank bills)	\$60,691	0.5%	Nov-09	A1+	2.8%
ASB Bank (Bank bills)	\$60,691	0.5%	Nov-09	A1+	2.8%
BNZ (Bank bills)	\$52,021	0.5%	Nov-09	A1+	2.8%
Corporate bonds		19.2%			
Works Finance NZ	\$1,603,110	14.2%	Sep-12	BBB-	7.9%
Woolworths	\$559,307	5.0%	Nov-11	A-	5.7%
Government / Government-guaranteed bonds		57.5%			
US Treasury	\$6,478,428	57.5%	Jul-21	AAA	6.0%
Residential mortgages		2.9%			
Sapphire New Zealand mortgage security	\$324,108	2.9%	Jul-37	BB	20.0%
Stressed assets		0.8%			
CLO equity (4 securities)	\$88,306	0.8%	Dec-10	NR	0%
Debt Strategies		-0.4%			
Interest rate swaps	\$3,384	0.0%			
Futures	-\$43,127	-0.4%			
Total	\$11,261,190	100.0%			

¹ The Portfolio often holds more than one security under a given issuer. The 'number of securities' takes this into account. 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. 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. ³ The yield to maturity is stated before the deduction of management, custodial and trustee fees. 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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