

Manager insight – 31 December 2009

The Portfolio returned 0.55%¹ for the month of December and -3.29%¹ for the year. The performance during the month reflects the Portfolio being fully hedged to US interest rates (which moved higher) and good performance from the corporate credit positions held in the Portfolio.

2010: The outlook for credit

Given where we started 2009, the financial markets have returned to 'normality' remarkably quickly. The question that will be debated over the summer break is will this normality continue into and throughout 2010 or will the rebound of 2009 prove to be just that.

Among the financial community there are two broad camps. The first is the view discussed in last month's insight which questions the degree of leverage in the banking system/government sector and concludes that a sustained period of austerity and hence lower growth is required to remove the mountain of debt that has been created. The other camp has focused on the work (1970–1990) of the business cycle economist Victor Zarnowitz who observed that deep recessions are generally followed by equally strong recoveries.

The answer may well be that both camps, in time, will be correct. Given the suddenness and degree of the 2008 recession, and the stimulus provided by governments around the world, the rebound that began in 2009 has the potential to continue to surprise us in 2010 with its strength.

However, this does not remove the longer-term issue that in time the government stimulus will need to be removed and banks and consumers need to reduce debt. This will mean lower growth.

So what does this mean for credit investors? If there is a continued rebound in the near term this will be a positive for credit markets. Thanks to the aggressive cost cutting/debt reduction that has taken place during 2008/2009 a continued rebound will translate into strong corporate profits. Higher profits are likely to lower the risk that companies default. One of the 'value' measures we use to assess whether credit spreads are cheap or expensive – rock bottom spreads – suggests that if default rates continue to fall, then credit remains cheap. The rock bottom spread measure looks to assess the minimum spread that an investor needs in order to be compensated for the uncertainty of default risk. Currently, this measure suggests that credit spreads are much wider than necessary and as a result could tighten by up to 50% during 2010.

What about the removal of stimulus? Clearly one of the largest risks that markets face in 2010 is the risk of a policy mistake by governments/central banks – basically, that the stimulus is removed too rapidly or too soon. If this does happen it should not initially be detrimental for credit. Past cycles show that typically credit is not impacted by the early stages of the tightening cycle – when central banks take their foot off the accelerator. It is only when central banks truly begin to apply the break that credit spreads begin to move wider. This suggests that the outlook for credit remains positive at least for the first half of 2010.

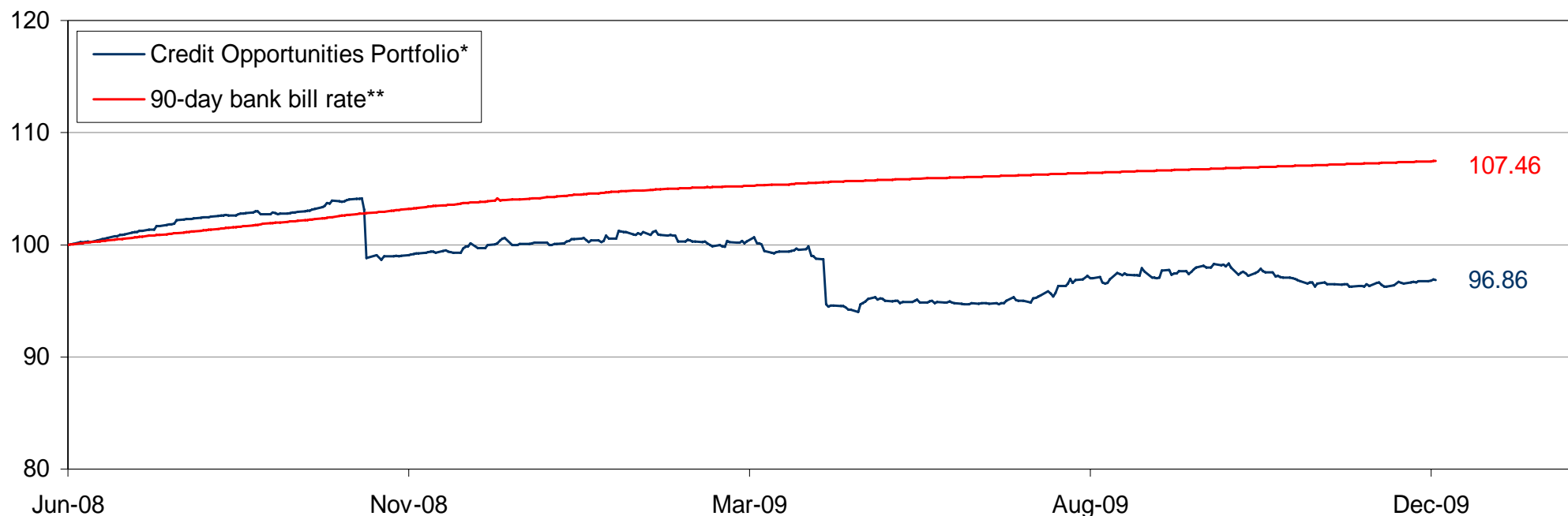
¹ Returns are stated after Portfolio fees and expenses, but before any advisory fees or investor tax. Past performance is not necessarily an indication of future returns.

Credit Opportunities Portfolio



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

COP performance attribution	1 month	3 month	6 month
Positive	Interest rate hedging; credit	Inv. grade credit; interest rate hedging	Distressed credit; inv. grade credit
Neutral	Cash; currency	Cash	Cash
Negative	US interest rates	Interest rates	Interest rate hedging



Comparison	1 month	3 month	6 month	1 year	2 year pa	5 year pa	7 year pa	Since strategy inception pa	Maximum drawdown*
Portfolio*	0.55%	-1.13%	2.17%	-3.29%	-	-	-	-2.08%	-9.76%
90-day bank bill rate**	0.22%	0.66%	1.31%	3.19%	-	-	-	4.86%	-0.18%

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

Performance since 25 June 2008 to 31 December 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



Complete portfolio as at 30 November 2009

Portfolio summary

Number of securities	15 ¹
Yield	5.2% ²
Weighted average credit rating	A-
Weighted average credit spread duration	0.6 years
Weighted average interest rate duration	5.9 years

Sector / Security	Portfolio value	Proportion of portfolio	Expected maturity	S&P rating	Yield to maturity ³
Bank deposits / Bank bills		13.2%			
Westpac (Bank deposits)	\$1,506,433	14.1%	Current	A1+	2.5%
BNZ (Bank bills)	\$4,286	0.0%	Dec-09	A1+	2.7%
Kiwibank (Bank bills)	\$4,286	0.0%	Dec-09	A1+	2.7%
ANZ (Bank bills)	\$4,279	0.0%	Dec-09	A1+	2.8%
ASB Bank (Bank bills)	\$3,929	0.0%	Dec-09	A1+	2.7%
FX Asset	-\$110,700	-1.0%	n/a	A1+	n/a
Corporate bonds		20.0%			
Works Finance NZ	\$1,561,906	14.6%	Sep-12	BBB	7.9%
Woolworths	\$578,007	5.4%	Nov-11	A-	5.5%
Government/Government-guaranteed bonds		63.0%			
US Treasury	\$6,739,449	63.0%	Jul-21	AAA	5.9%
Residential mortgages		3.1%			
Sapphire New Zealand mortgage security	\$332,970	3.1%	Jul-37	BB	20.0%
Stressed assets		0.9%			
CLO equity (4 securities)	\$91,481	0.9%	Dec-10	NR	0.0%
Debt Strategies		-0.3%			
Interest rate swaps	-\$26,828	-0.3%			
Total economic exposure	\$10,689,497	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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