

## PORTFOLIO OVERVIEW – 31 JANUARY 2010

### Needs category objective

- > To provide clients with an allocation of funds to grow their capital and, in doing so, provide for their future needs.

### Investment objective

- > To invest in a mix of income-producing and growth assets made up of shares of companies displaying high dividend yields, utilising active investment management.

### Key features

- > A diversified selection of high-dividend-paying New Zealand and Australian shares, combined with cash and capital notes.
- > Actively managed to ensure each share held remains a high-dividend-yielding share. Should the dividend yield fall due to price appreciation or a cut in the dividend, the share is sold in a timely manner and the proceeds reinvested in an alternative high-dividend-yielding share. This ensures that dividends are at all times a strong component of the Portfolio's investment returns.

### Risk management

- > Portfolio risk is controlled in three ways. First, after screening the Australasian markets for high-yielding shares, detailed fundamental security analysis is used to separate high quality, sustainable companies from more speculative or highly leveraged companies. Second, portfolio construction dictates that exposure to any one share is limited and the proportion of the Portfolio allocated to cyclical companies remains below 35% of all shares held. Finally, the Portfolio utilises New Zealand Funds Management's risk management strategy to manage volatility associated with the share market. New Zealand Funds Management's risk management strategy may result in the Portfolio's share exposure being partially hedged.

### Return enhancement

- > Uses a two-stage process whereby New Zealand and Australian share markets are screened for high-yielding shares. The resulting securities are then subjected to detailed fundamental analysis. The manager seeks to invest in shares of a high quality with sustainable franchises where the intrinsic value is substantially higher than the current market price.

## MANAGER INSIGHT

The Portfolio returned -2.49%<sup>1</sup> in January, while the NZX50 Index was down 1.38%<sup>2</sup>.

### Share insight: Air New Zealand

A company that has recently made a reappearance in the Portfolio is Air New Zealand. The national airline is a very high-profile company and one that is no doubt familiar to all clients from a customer-experience perspective. However, while its business activities are well known, less well understood is its business worth.

Airlines in general have often been investment graveyards. They are extremely cyclical businesses and are heavily impacted by factors that are largely beyond their control – principally global economic cycles and their impact on travel demand, and the price of oil. The companies have relatively low margins with large fixed costs, so if demand collapses, they can lose large amounts of money very quickly. However, the reverse is also true – if demand picks up, profitability can soar. Over history, the value of airline shares has fluctuated as investors have moved from forecasting one scenario to another. As we know all too well, however, forecasting the future is fraught with difficulty. In the face of uncertainty, how do we decide whether Air New Zealand's current value is appropriate, too high or too low?

There are a number of ways we can approach the problem. The first is to accept that while our ability to exactly predict passenger trends in the future is very limited, we can nevertheless make some assumptions about what the

standard level is. From there, we can assess the normalised earnings number and what that means for the company's valuation and compare it to the current value. Another way of looking at airlines is to look at a variation of the price-to-book ratio. Often, the price-to-book ratio is an unrealistic valuation tool, either because the book value of the assets is highly inaccurate or the assets are not practically liquid. Airlines assets are mainly their planes and these can easily be sold so an appropriate measure is the value of the company compared to the sale value of its fleet of aircraft. And finally, we can overlay an assessment of the very near-term cycle and see if that offers a catalyst for the share's performance in the near future.

In the case of Air New Zealand, a combination of these three approaches suggests it presents significant value at these levels. The present enterprise value of around NZ\$1.1 billion is only around 5x an EBIT of NZ\$230 million, which is a reasonable mid-cycle figure. At current prices, the airline is approximately only 0.8x the estimated value of its airline fleet. And recent trends in global and domestic passenger growth suggest that demand is returning. If the market was to re-rate Air New Zealand so that it is priced in line with Qantas, which is priced on an EV/EBIT of around 10x, then it would be valued at double today's price of NZ\$1.30. While the manager does not necessarily expect the share to double in the short term, Air New Zealand's share price clearly has potential to climb to a higher altitude.

<sup>1</sup> 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. <sup>2</sup> Source: Bloomberg.

## TAX-ADJUSTED PERFORMANCE TO 31 JANUARY 2010 FOR EIT/DYF/DYP COMPOSITE STRATEGY\* (PART 1)

DYP PERFORMANCE ATTRIBUTION	1 MONTH	3 MONTH	6 MONTH
Positive	Hallenstein Glasson	Fisher & Paykel Healthcare	Restaurant Brands
Neutral	Fletcher Building	Port of Tauranga	Freightways
Negative	The Warehouse	Kiwi Income Property	Trustpower



COMPARISON	DYP 1 MONTH	DYP 3 MONTH	DYP 6 MONTH	DYP 1 YEAR	COMPOSITE 2 YEAR PA	COMPOSITE 5 YEAR PA	COMPOSITE 7 YEAR PA	COMPOSITE SINCE INCEPTION <sup>1</sup>	COMPOSITE MAXIMUM DRAWDOWN <sup>x</sup>
EIT/DYF/DYP (tax adjusted)*	-2.49%	-2.04%	1.63%	5.33%	-4.74%	2.57%	9.08%	363.15%	-36.26%
Comparative index**	-1.39%	-1.00%	3.66%	10.33%	-3.60%	2.17%	6.65%	249.49%	-31.30%

<sup>1</sup> Pre-tax equivalent gross return. IMPORTANT: Please refer to the slide that follows for the footnotes relating to this slide

## TAX-ADJUSTED PERFORMANCE TO 31 JANUARY 2010 FOR EIT/DYF/DYP COMPOSITE STRATEGY\* (PART 2)

**Tax-adjusted Performance**

- \* Tax-adjusted composite strategy is stated after portfolio fees and expenses, but before any advisory fees or investor tax. Past performance is not necessarily an indication of future returns.

The composite covers New Zealand Equity Trust (EIT) data from 2 December 1992 to 5 June 2003, Dividend Yield Fund (DYF) data from 6 June 2003 to 27 February 2008, and Dividend Yield Portfolio (DYP) data from 28 February 2008 onwards.

The tax-adjusted composite strategy is designed to remove, as much as possible, the impact of the different tax regimes that applied during the calculation period. By doing so it enables the returns from EIT, DYF and DYP to be represented in a substantially consistent manner.

EIT was a New Zealand Unit Trust. The returns from this fund, which have previously been reported net of tax, have been grossed up by 33% (being the tax rate applicable to New Zealand Unit Trusts) to reflect the pre-tax position.

DYF was an Australian Unit Trust. For DYF the return has also been 'grossed up' by 33% (being the tax rate applicable to New Zealand Unit Trusts) to reflect the fact that the return was generally not taxable to an investor.

No adjustment has been made to DYP as the returns for PIEs are reported before investor tax.

The tax-adjusted composite strategy covers three different tax regimes, and accordingly three different calculation methods are applied over the course of the strategy. The three calculation periods are:

- i) the period pre 31 March 2007 (being the period prior to the introduction of the Fair Dividend Regime);
- ii) the period from 1 April 2007 to 28 February 2008 (being the period that a New Zealand investor in DYF was subject to the Fair Dividend regime);
- iii) the period post 1 March 2008 (establishment date of DYP under the PIE regime).

This calculation is undertaken for comparative purposes only, and should not be confused with the portfolio returns generated from EIT, DYF or DYP.

More details on these calculations, together with the formulae used, are available on request from New Zealand Funds Management.

## TAX-ADJUSTED PERFORMANCE TO 31 JANUARY 2010 FOR EIT/DYF/DYP COMPOSITE STRATEGY\* (PART 3)

**Comparative Index**

\*\* The comparative index is made up of 70% NZX50 Index and 30% 90-day bank bill rate. All index figures are sourced from Bloomberg. A fee of 0.60% pa has been deducted from the NZX50 Index to reflect the cost of obtaining a passive New Zealand share market exposure using an Exchange Traded Fund and the brokerage associated with purchasing it. A fee of 0.20% pa has been deducted from the 90-day bank bill rate as bank bills are usually accessed by retail investors through a managed fund. The 90-day bank bill rate has been included in the comparison because the mandate allows the manager to invest up to 30% of the Portfolio in cash and capital notes. The comparative index is stated on a pre-tax basis.

**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 strategy and the comparison. The maximum drawdown is a measure of volatility and represents the largest decline in value experienced during the reporting period.

\* The EIT/DYF/DYP Composite Strategy is a tax-adjusted composite strategy stated after portfolio fees and expenses, but before any advisory fees or investor tax. Past performance is not necessarily an indication of future returns.

## COMPLETE PORTFOLIO AS AT 31 JANUARY 2010

### PORTFOLIO SUMMARY

Number of securities	30
Yield <sup>1</sup>	6.9%
Weighted average market cap (share holdings)	\$2.2b
Cash, capital notes & other	17%
Shares	83%
Total economic exposure	100%

SECTOR / SECURITY	COUNTRY	PORTFOLIO VALUE	PORTFOLIO ALLOCATION	MARKET CAP (NZ\$M)	PRICE/ EARNINGS	PRICE/ BOOK	PAYOUT RATIO	YIELD
<b>CASH</b>			<b>9.3%</b>					
Cash	New Zealand	\$1,539,818	9.3%	n/a	n/a	n/a	n/a	2.8%
<b>CYCLICALS</b>			<b>27.0%</b>					
Freightways	New Zealand	\$1,182,672	7.2%	\$515	16.7	3.4	79.0%	6.8%
The Warehouse	New Zealand	\$1,149,103	7.0%	\$1,198	13.6	3.7	78.0%	8.2%
Fletcher Building	New Zealand	\$703,981	4.3%	\$4,758	16.1	1.6	58.0%	5.1%
Restaurant Brands	New Zealand	\$551,656	3.3%	\$172	9.5	3.9	56.0%	6.9%
Mainfreight	New Zealand	\$401,001	2.4%	\$581	16.6	2.0	51.0%	4.5%
Hallenstein Glasson	New Zealand	\$337,415	2.0%	\$221	14.0	3.9	95.0%	9.3%
Air New Zealand	New Zealand	\$139,256	0.8%	\$1,406	12.8	0.9	60.0%	7.1%
<b>NON CYCLICALS</b>			<b>56.0%</b>					
Goodman Fielder	New Zealand	\$1,190,423	7.2%	\$2,719	11.3	1.3	80.0%	6.4%
Trustpower	New Zealand	\$1,153,492	7.0%	\$2,314	18.0	1.6	92.0%	7.4%
Fisher & Paykel Healthcare	New Zealand	\$790,978	4.8%	\$1,737	25.7	8.5	95.0%	5.2%
Kiwi Income Property	New Zealand	\$762,499	4.6%	\$831	13.0	0.7	97.0%	10.4%
Goodman Property	New Zealand	\$759,514	4.6%	\$873	11.5	1.0	93.0%	12.0%
Corporate Express	Australia	\$500,965	3.0%	\$855	12.4	3.9	66.0%	4.5%
Foster's Group	Australia	\$495,149	3.0%	\$12,967	14.5	2.8	73.0%	4.3%
Coca Cola Amatil	Australia	\$490,980	3.0%	\$10,025	17.7	5.8	70.0%	3.4%
Metcash	Australia	\$486,471	2.9%	\$4,076	13.5	2.7	79.0%	5.0%
Spotless Group	New Zealand	\$461,087	2.8%	\$906	12.7	1.6	54.0%	4.3%
Sigma Pharmaceuticals	Australia	\$456,302	2.8%	\$1,349	9.9	0.6	72.0%	7.3%
Port of Tauranga	New Zealand	\$393,806	2.4%	\$964	20.8	1.5	81.0%	5.6%
Contact Energy	New Zealand	\$363,534	2.2%	\$3,486	19.3	1.2	96.0%	6.9%
AMP New Zealand Office Trust	New Zealand	\$343,484	2.1%	\$728	11.6	0.8	97.0%	11.8%
STW Communications	Australia	\$224,935	1.4%	\$358	7.3	0.7	32.0%	4.4%
UXC	Australia	\$201,864	1.2%	\$210	6.8	0.9	57.0%	8.3%
Photon Group	Australia	\$168,522	1.0%	\$251	5.2	0.5	46.0%	8.9%
Energy Developments	Australia	\$9,097	0.1%	\$526	12.1	1.4	59.6%	4.9%
<b>CAPITAL NOTES &amp; OTHER</b>			<b>7.7%</b>					
Kiwi Income MCN 8% 30 Jun 2010	New Zealand	\$692,884	4.2%	n/a	n/a	n/a	n/a	9.0%
Sky City 8% 15 May 2010	New Zealand	\$265,192	1.6%	n/a	n/a	n/a	n/a	8.0%
Infratil 8.5% 15 Sep 2013	New Zealand	\$140,045	0.8%	n/a	n/a	n/a	n/a	9.5%
Trustpower 8.5% 15 Mar 2014	New Zealand	\$94,195	0.6%	n/a	n/a	n/a	n/a	8.3%
Fletcher Building 7.5% 15 Mar 2012	New Zealand	\$80,253	0.5%	n/a	n/a	n/a	n/a	8.2%
<b>TOTAL ECONOMIC EXPOSURE</b>		<b>\$16,530,577</b>	<b>100.0%</b>					

<sup>1</sup> The yield calculation represents an estimate of the yield on the Portfolio, calculated using yields forecast by NZ Funds for each company's current financial year. Where applicable, the security's yield reflects the benefit derived from imputation credits received. The yield is not the return on the Portfolio, nor is it a projection or forecast. Rather, it is an estimate of the pre-tax and fees 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 New Zealand Funds Management. 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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