

Core Income Portfolio

September 2009

NZFUND\$

Positioning of Portfolios within the advice framework

Needs category	Portfolio	Core / Tilt
Cash Needs	Money Market Portfolio	Core
Near Term Spending Needs	Core Income Portfolio	Core
Maintaining Capital	Mid Term Growth Portfolio	Core
Future Growth	Balanced Growth Portfolio	Core
	Diversified Growth Portfolio	Core
	Wealth Appreciation Portfolio	Core
	Dividend Yield Portfolio	Tilt
	Credit Opportunities Portfolio	Tilt

Portfolio overview

Investment objectives

- The Core Income Portfolio is explicitly designed to meet the needs of the Near Term Spending category of a diversified financial plan.
- The objective of the Near Term Spending needs category is to provide for anticipated income and expenditure items over the medium term (2–5 years).

How is this achieved?

- Investing in a portfolio of income assets which includes cash, government/government-guaranteed bonds, corporate bonds and mortgages.
- Selecting investments from a wider universe.
- Placing equal emphasis on risk management (downside protection) and generating returns.

Portfolio overview

Differentiating factors

- Customised investment objective
 - The Portfolio is unique in that it has been designed to meet the requirements of a specific investment category.
 - It is client focused rather than investment focused.
 - The Portfolio is not designed to track an index.

- Active risk management
 - As managers, we recognise that during some periods all investments can suffer as part of a wider market malaise. NZ Funds' risk management strategy aims to identify these periods and actively manage market exposures to seek to preserve clients' capital during these stages of the cycle.
 - This downside protection is controlled by structured, objective management of both interest rate risk and credit market risk.

How do we differ from the typical fund?

Feature	Typical fund	Core Income Portfolio
Design rationale	To replicate an index or sector exposure	Specifically designed as a component of a goal-based financial plan
Investment focus	Usually favour one asset type or an index allocation	A portfolio of income assets to enhance the stability of client returns
Investment universe	Typically New Zealand focused	Ability to select from a global universe
Return focus	To outperform an index	Total return with emphasis on capital preservation
Capital protection strategies	None	Proprietary active risk management overlay, designed to mitigate downside risk
Management style	Buy-and-hold or index orientated	Active sector allocation and security selection

New Zealand corporate bonds – A limited universe

- Portfolios solely focused on New Zealand corporate bonds suffer from limited choice and are highly dependent on the timing of purchase (vintage).

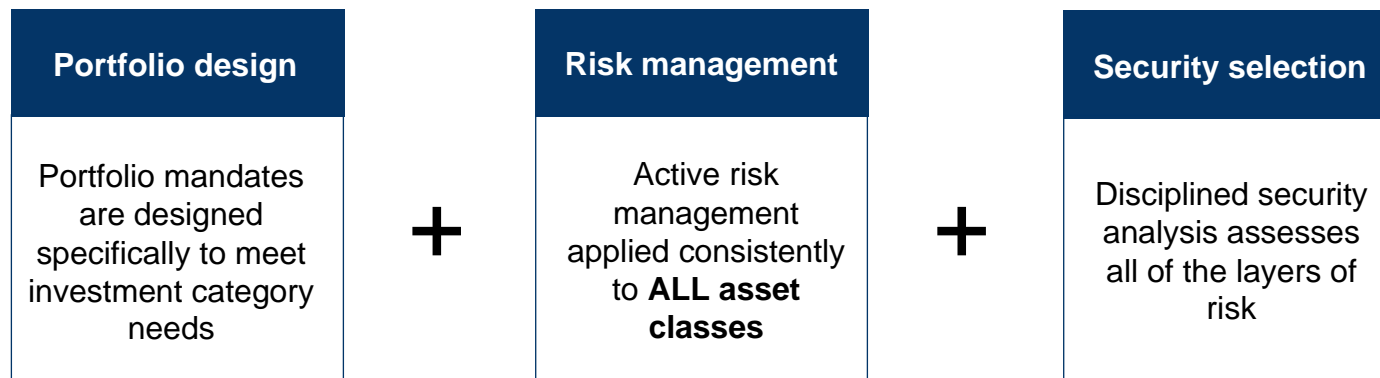
Bond issues	2006	2007	2008	2009
Total number	24	29	38	34
Banking/Financial	11	14	20	13
Semi government	4	8	7	13
Subordinated/Perpetual	8	10	8	6
Average maturity	9 years	10 years	4 years	6 years

Senior bond issuers	2006	2007	2008	2009
Distinct issuers	12	11	16	12
Banking/Financial issuers	4	5	9	4
Rated BBB+ or less	5	2	4	4
Rated A- or better	7	9	12	8

Source: Austraclear.

Investment process

The NZ Funds' investment process has three distinct steps



Aim: to generate consistent returns appropriate for the goal category

Risk management – Overview

Aim

- Preserve clients' capital during negative markets to:
 - Improve investor confidence.
 - Increase the likelihood of clients' goals being achieved.

How

- NZ Funds has developed a proprietary risk management strategy that determines when to **seek** or **avoid** asset market risk.
 - This strategy covers all asset markets – shares, interest rates, credit and currency.
 - Results in meaningful asset allocation changes – for example, the Portfolio may switch from being 100% hedged to 100% unhedged.

Risk management – Methodology

- The downside protection strategy is structured and objective.
- Different models have been developed for each asset market – shares, currency, interest rates and credit spreads.
- Models are generally based on a combination of moving averages (of prices) to identify market trends.
 - If the short-term moving average is trading above the longer-term moving average, it is considered to be in an uptrend and the signal is to 'seek' market risk.
 - If the short-term moving average is trading below the longer-term moving average, it is considered to be in a downtrend and the signal is to 'avoid' market risk.
- Actions following a signal may involve buying/selling physical securities or it may be implemented using derivative contracts to achieve the same 'economic effect'.

Risk management – Interest rate case study

Portfolio exposure

In December 2008 the Portfolio purchased A\$4.25 million of the Vodafone 6.75% 1/10/2013 bond.

This created an exposure to four-year Australian interest rates.

Action

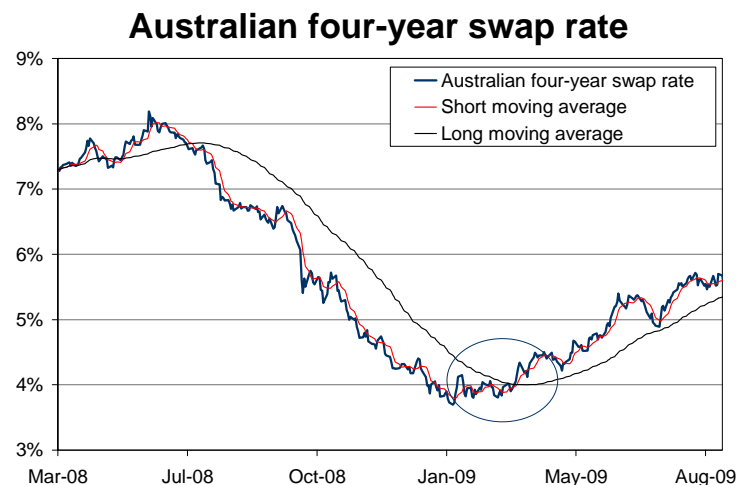
In late February 2009, NZ Funds' active risk management strategy (the circled area in the chart opposite) signalled the need to protect the Portfolio against an increase in interest rates.

The interest rate exposure was hedged on 26 February 2009 at 4.1%. Since then interest rates have risen by 1.5% to 5.6%.

Result

Hedging the interest rate component of the Vodafone bond has avoided interest rates detracting 4.4% from the value of the position.

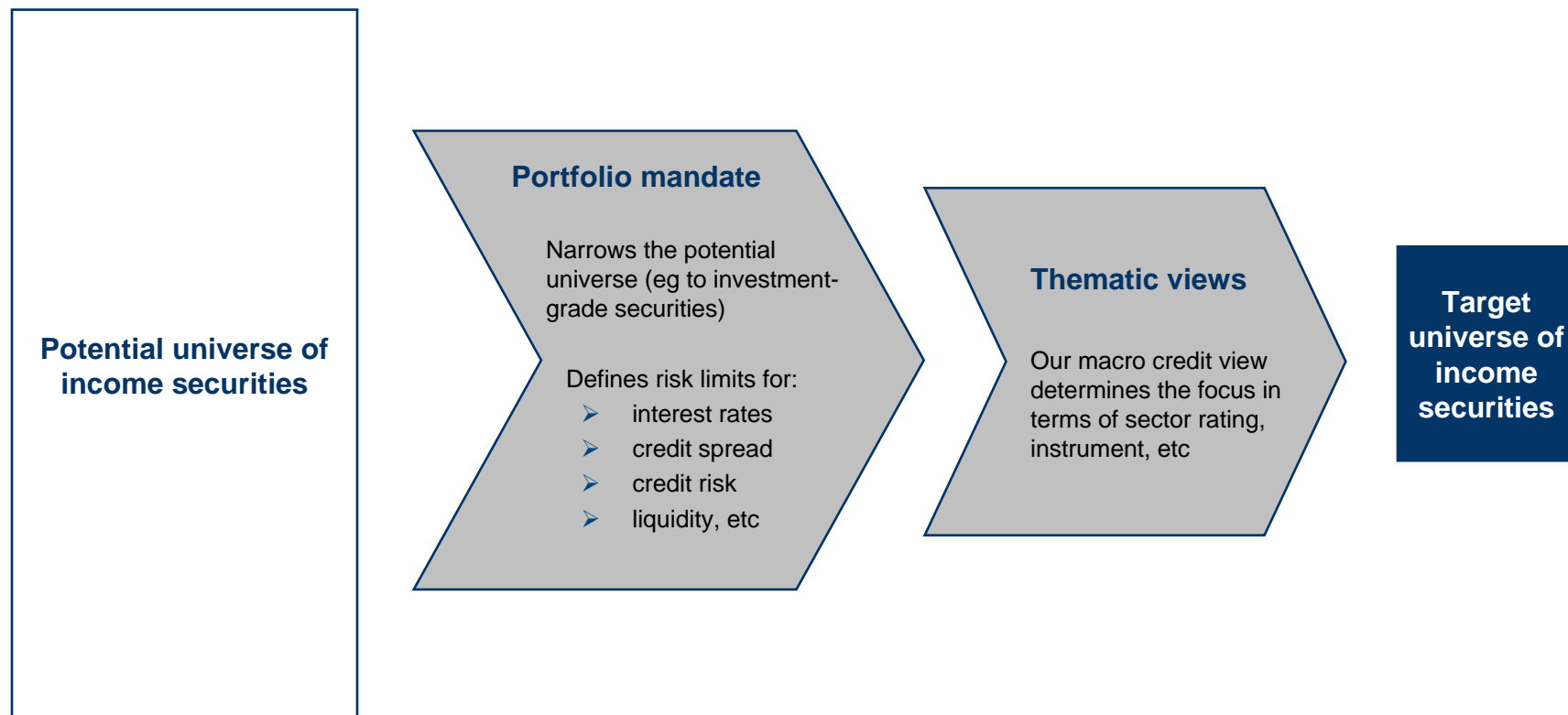
Had the position not been hedged, the interest rate move would have nullified the benefit of tighter credit spreads during the period.



Source: Bloomberg.

Security selection process – Narrowing the universe

- Mandate design and thematic economic views, in combination, generate a target universe.



Security selection process – Sector case study

Investment universe

The New Zealand debt market is small, which increases risk as investments may not fit the investment category.

Having access to global markets means that we can tailor the Portfolio to meet the goal objectives.

The technology sector

We can access very large, financially secure business such as IBM, Oracle and Microsoft.

These companies are characterised by:

- Diversified and defensive revenue streams.
- Exceptionally low debt levels.
- Very strong cash generation.

Company	IBM	Oracle	Microsoft
(US\$ billions)			
Rating	A1/A+	A2/A	AAA/AAA
Revenue	97,269	23,252	60,420
Earnings	22,956	9,202	22,492
Free Cash Flow	12,173	7,473	15,918
Gross Margin	45%	80%	79%
Cash	12,526	12,624	31,447
Total Debt	29,372	10,239	6,269
Net Debt	16,846	(2,385)	(25,178)

Free Cash Flow / Total Debt	41%	73%	254%
Free Cash Flow / Net Debt	72%	-313%	-63%

Source: IBM, Oracle, Microsoft.

Security selection process – Layers of risk

- Security analysis is about understanding the **layers of risk**.

- There are three primary layers:
 - **Credit risk** – the risk that a borrower defaults on its repayment obligations.
 - **Maturity risk** – the sensitivity to changes of interest rates and credit spreads.
 - **Structural risks** – the impact of the unique features of each security.



Credit analysis is about asking the simple question:

“How will a company meet its debt repayment obligations?”



Security selection process – Woolworths case study

Can Woolworths repay its debt?

- Cash flow positive – YES
 - Approximately A\$1b per year in free cash flow after anticipated capital expenditure.

- Liquidity hurdles – NO
 - Next debt repayment is A\$700m during 2011.
 - The company can meet this repayment using either cash on hand or earnings.

Sources	
	(A\$ millions)
Cash	763
Undrawn bank facilities	3,382
Forecast free cash flow	978
Total	5,122

Uses	
	(A\$ millions)
Current borrowings	189
Forecast dividends	1,395
Acquisitions	88
Share buy-backs	0
Total	1,671

Source: Woolworths.

Security selection process – Maturity risks

- The term to maturity of a bond determines its sensitivity to:
 - Interest rate risk.
 - Credit spread risk.

- The rule of thumb to estimate sensitivity to interest rate or credit spread changes is:
 - Duration x change in spread.

- The table opposite shows the impact of a 1% increase in interest rates on different maturities.

Bond maturity (years)	Interest rate duration (years)	Price change (%)
1	0.95	-0.95%
3	2.90	-2.90%
5	4.70	-4.70%
10	8.50	-8.50%

Security selection process – Structural risks case study

- Debt securities are customised securities each with a unique combination of features.
- These features can include:
 - Structural subordination.
 - Call features.
 - Coupon resets.
 - Principal and interest payment rules.
 - Change of control provisions.
- Individually or in combination they can have a very significant impact on value – both positive and negative.

Security selection process – Structural risks case study

Rabobank Capital

A recent example of the potential negative impact is the Rabobank Capital Securities bond issued in October 2007.

Relevant feature

The security's coupon resets annually at a spread above the one-year interest rate.

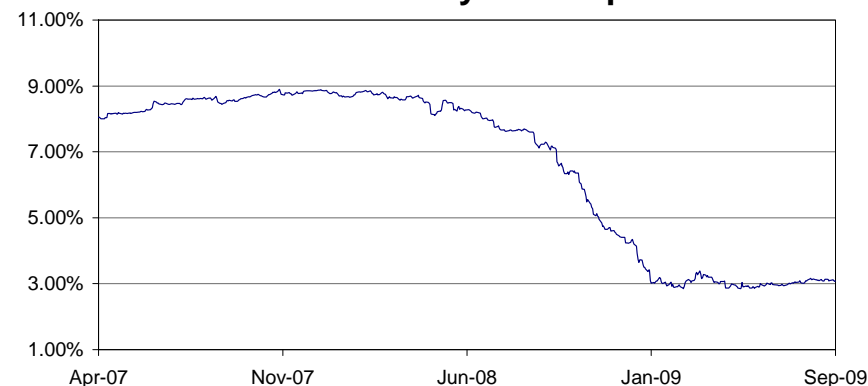
Impact

When this security was issued, one-year interest rates were 8.8%.

Now one-year interest rates are 3.1%.

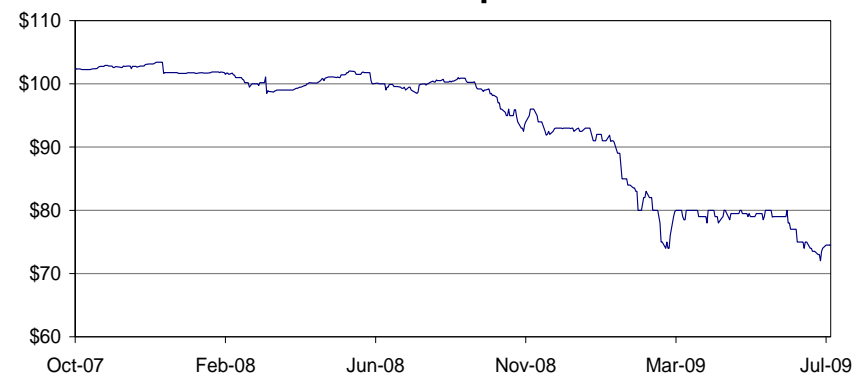
This is a far less attractive proposition and as a result the bond's price has declined by approximately 25%.

New Zealand one-year swap rate



Source: Bloomberg.

Rabobank 7.449% Capital Securities



Source: Bloomberg.

Security selection process – Mortgage-backed security case study

Market view

Residential mortgage-backed securities (RMBS) have a bad name around the globe as a result of the housing market problems in the USA.

NZ Funds' view

Consider the Australasian mortgage market to be significantly different and hence RMBS offer significant value.

Research process

Analysed each individual mortgage in these deals, often over 500 mortgages. By comparing the individual mortgage values against the council valuations of each property we were able to model how the deals perform under various mortgage default rate/loss rate scenarios. Core Income Portfolio owns approximately \$600,000 of the Sapphire III AA rated bond.

Result

To sustain a loss on this bond the analysis showed it would need to have all the mortgages default and a 40% loss on every one of these mortgages, as shown in the table below. This makes the bonds an attractive proposition from a risk/reward perspective.

		Residential property market value decline											
		90%	80%	70%	60%	50%	40%	30%	20%	10%	0%		
Mortgage Default Rate	10%											●	
	20%												
	30%												
	40%												
	50%												
	60%												
	70%												
	80%												
	90%												
	100%												

Key	
No loss on investment	
Partial loss on investment	
Full loss on investment	
Current loss experience by mortgage pool	●

Appendix – Biographies

Mark Brooks (MCom)

Principal / Head of Income

Mark is responsible for the overall management of the cash and credit portfolios. He has recently rejoined NZ Funds after four years in the United Kingdom. During this time he was a senior portfolio manager at Credaris, a London-based credit hedge fund with over NZ\$2.6b in assets under management. Prior to this Mark spent eight years at NZ Funds where he was involved in the management of the cash and credit portfolios and was responsible for the development of the currency overlay program. He graduated from the University of Auckland in 1993.

Mark de Nooij (MSc, CFA)

Portfolio Manager

Mark's primary task is the day-to-day management of the NZ Fixed Income Portfolio. Furthermore, he assists with the Tactical Asset Allocation for the Growth Portfolios and employs his analytical skills building investment models. Prior to joining NZ Funds, Mark was working at Mn Services – a Dutch Pension Fund – as an investment analyst in the Investment Strategy Team. Mark graduated at Nyenrode Business University (Master of General Management) after he completed his Masters degree in Engineering at the Technical University of Delft.

Michelle Hancock (BMS, CFA)

Senior Investment Analyst

Michelle's responsibilities include analysing and monitoring fixed income securities and assessing structured credit investments. Before joining NZ Funds, Michelle worked as a senior banking analyst in the finance team of the Bank of New Zealand. Michelle graduated from the University of Waikato in 2000.

Michael Eyre (BCom, BSc, DipGrad)

Investment Analyst

Michael's current areas of responsibility involve assisting with the day to day management of the Income Portfolios. Prior to joining NZ Funds, Michael spent two years working as a financial analyst with Vodafone in Auckland. Michael graduated from the University of Otago in 2004.

For further information or to request a copy of the relevant Investment Statement, please contact New Zealand Funds Management Limited.

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