

# Mid Term Growth Portfolio

August 2009

NZFUNDŞ

## 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	<b>Mid Term Growth Portfolio</b>	Core
Future Growth	Balanced Growth Portfolio	Core
	Diversified Growth Portfolio	Core
	Wealth Appreciation Portfolio	Core
	Dividend Yield Portfolio	Tilt
	Credit Opportunities Portfolio	Tilt

## Introduction

### **Goal objective**

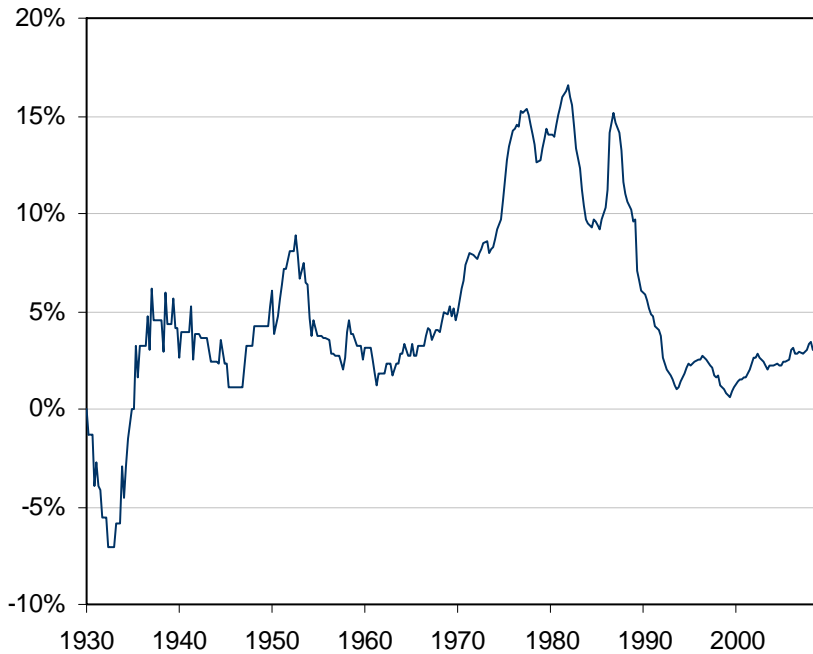
- The Mid Term Growth Portfolio is in the Maintaining Capital needs category.
- The objective of the Maintaining Capital needs category is to protect investors' purchasing power from inflation.

### **How is this achieved?**

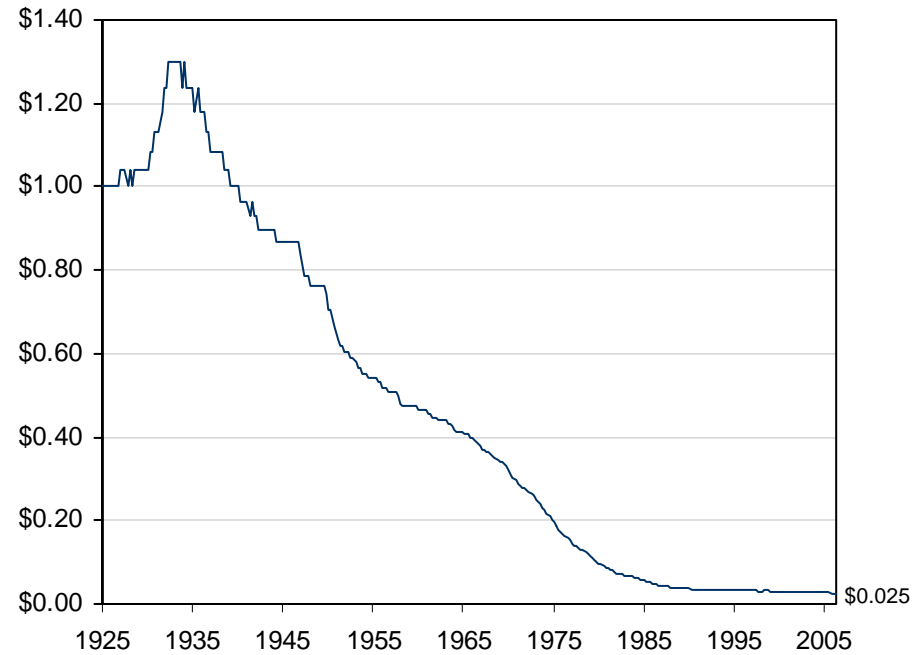
- The Mid Term Growth Portfolio achieves this objective by investing in a defensive blend of income and growth assets designed to perform well in periods of inflation.
- Risk is minimised by:
  - Maximising the benefits of diversification by:
    - Using a number of different managers;
    - With differing investment styles;
    - Accessing a variety of markets.
  - Having a low exposure to global share market risk.

## The danger of inflation

### New Zealand inflation: three-year rolling annualised inflation rates

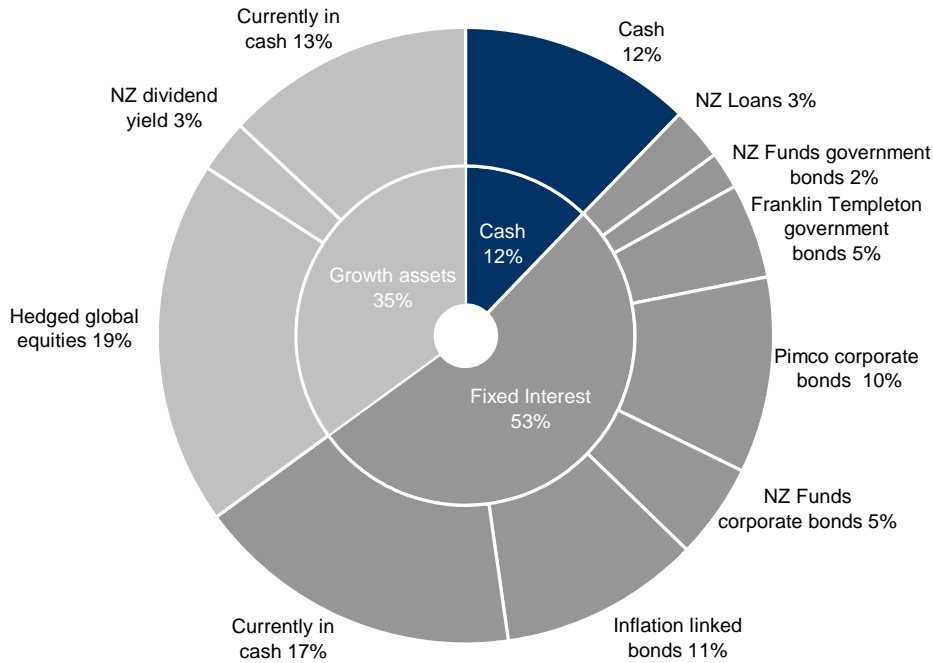


### New Zealand inflation: the decline in the purchasing power of a dollar

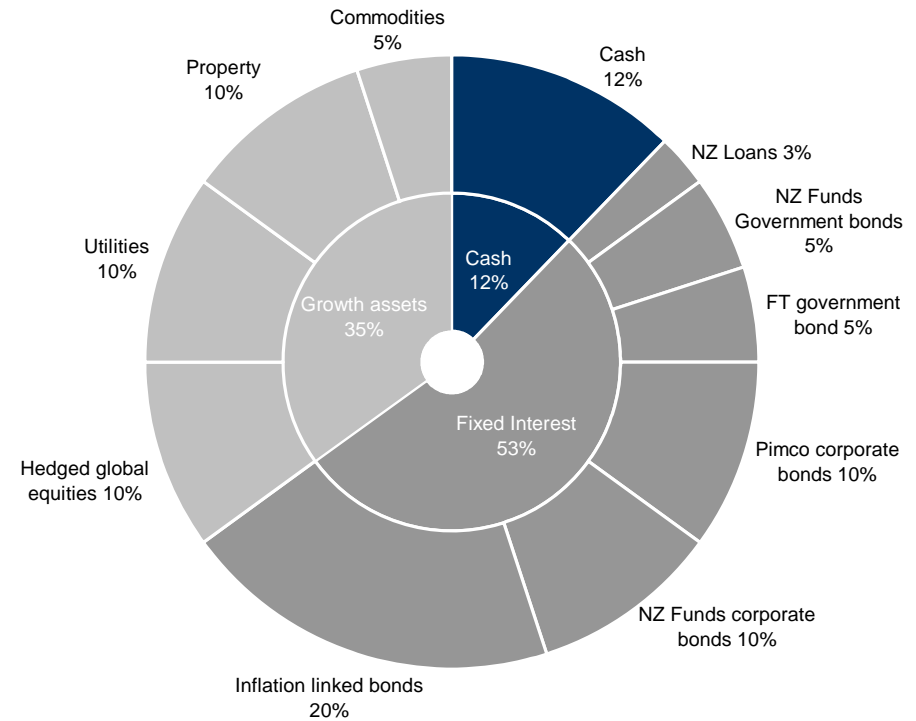


## Current and target asset allocations of Mid Term Growth Portfolio

21 August 2009



Target allocations



# Mid Term Growth Portfolio

## Target asset allocations of Mid Term Growth Portfolio

Investment	Style	Manager	Allocation
<b>Cash</b>			<b>12%</b>
Cash	Active	NZ Funds	12%
<b>Income assets protected against inflation</b>			<b>53%</b>
Inflation linked bonds	Active	NZ Funds	20%
NZFM corporate bonds	Smart index	NZ Funds	10%
Pimco corporate bonds	Active	PIMCO	10%
FT government bond	Active	Franklin Templeton	5%
NZFM government bonds	Smart index	NZ Funds	5%
NZ Loans	Active	Fidelity	3%
<b>Growth assets driven by inflation</b>			<b>35%</b>
Hedged global equities	Active	Various	10%
Utilities	Smart index	NZ Funds	10%
Property	Active	Various	10%
Commodities	Smart index	NZ Funds	5%
<b>Total</b>			<b>100%</b>

## Utilities strategy

### Utilities

- These companies own and operate essential infrastructure – for instance they distribute gas, water and electricity to households and businesses.
- The prices at which they can sell their products are typically regulated because they tend to have a monopoly.
- Utilities have two attractive characteristics for the Mid Term Growth Portfolio:
  - The level of demand for their products is relatively stable in good times and bad because they sell essential products;
  - As the prices they charge are regulated, this provides stability and inbuilt inflation protection.

### Investment approach

- A smart index approach is used to efficiently access this sector:
  - Each utility in the Portfolio has the same weight. This avoids some large utilities having a disproportionate impact on the performance of the strategy;
  - Screens are used to remove riskier utilities such as those that have excessive debt.

## Performance of utilities during periods of high inflation

Period	Inflation	Utilities		NZ Funds Strategy	
		Above/below inflation	Value	Above/below inflation	Value
August 1940 - July 1943	7.8%	Above	14.8%	Above	19.3%
July 1945 - October 1948	9.6%	Above	14.5%	Below	8.8%
January 1950 - November 1951	6.6%	Above	22.9%	Above	11%
December 1968 - June 1970	6.1%	Below	-14.6%	Below	0.6%
August 1972 - July 1982	8.9%	Above	10.3%	Above	10.8%
September 1989 - December 1990	5.6%	Above	5.7%	Below	0.3%
<b>Total</b>	<b>219.9%</b>		<b>301.1%</b>		<b>297.9%</b>

## Key characteristics of the Portfolio's utilities strategy

	United States	Europe	Combined
<b>Portfolio allocations</b>			
Number of utilities	26	20	46
Allocation	1.9%	2.5%	2.2%
<b>Financial metrics of the utilities</b>			
Market capitalisation (US\$ millions)	9,677	20,645	15,161
Average daily turnover (US\$ millions)	24.8	73.3	49.1
Dividend yield (Hedged in NZ\$)	7.0%	7.6%	7.3%
Price-to-book ratio	1.4	2.0	1.7
Price earnings ratio	12.6	13.0	12.8

## Case study for utilities: Terna Rete Elettrica Nazionale SpA

Terna Rete Elettrica Nazionale SpA (Terna) is a good example of a utility that would be included in the utilities allocation. It is the primary owner and operator of Italy's high-voltage electricity transmission grid (similar to New Zealand's Transpower). This grid is a network of high capacity power lines that transmit electricity from where the power is generated to areas where it is consumed. As operator of the grid, Terna is also responsible for dispatching electricity and keeping the grid in balance – ensuring the electricity supplied to the grid equals that used.

As owner and operator of Italy's high-voltage electricity transmission grid Terna is in a monopolistic position. To avoid Terna exploiting this position and charging excessive tariffs it faces price regulation. The regulator charged with setting prices introduced a new incentive regime to encourage companies to invest in the aging electricity grid at the end of 2007. It set up a structure whereby Terna would earn an additional 2-3% on new investments for a period of 12 years. This is a significant premium over the 6.9% real return that utilities are typically allowed to earn. Terna is taking advantage of this incentive regime by undergoing an extensive capital expenditure program. Over the next five years Terna intends spending €3.4 billion on the network. This capital expenditure will increase Terna's regulated asset base from €6.3 billion to almost €10 billion in five years – a 9% annual average increase. These plans suggest that in a few years time Terna's profit will be boosted by an additional €85 million as a result of this incentive program (assuming that Terna receives an average of 2.5% pa on the €3.4 billion of network

spend). To put this increase into perspective this is approximately 15% of Terna's pre-tax profits.

Perhaps the strongest argument for investment in Terna is its valuation. Terna is forecast to pay a dividend of approximately 18.2 cents in their next financial year which translates into a dividend yield of 7.3% at the current market price. When this is hedged back into New Zealand dollars the Portfolio will earn a yield of 9.3%. This is attractive particularly considering the 5% plus expected growth of Terna over the next five years. Assuming that the dividend yield remains constant, this suggests a return of almost 15% pa.



## Case study for utilities: American Electric Power

American Electric Power (AEP) is another example of a utility that will be included in the Portfolio as part of the utilities allocation. In a number of ways AEP is an industry leader and has been since 1917 when it built America's first power station located at the mouth of a coal mine. To transmit the electricity from this power station to the steel mills and other customers, AEP also constructed America's first high-voltage power line. Nowadays, it owns the largest fleet of high-efficiency, supercritical coal generation units in the United States. These units produce 17,000mW – which is approximately half of AEP's generating capacity.

The technology used by AEP improves the efficiency of power generation and thus reduces emissions. AEP's generation units use extreme pressures and temperatures to take water to its critical point. When liquids approach their critical point, the distinction between the liquid and gas phases diminishes until there is a continuous transition between liquid and gas. In simple terms, under sufficient pressure and temperatures water turns into steam without boiling. The advantage of these extreme temperatures and pressures is that the water is more efficiently turned into steam. The reduction in the energy required to heat the water and the efficiencies gained in the turbine allow these plants to utilise significantly less coal. Reducing coal usage not only decreases the cost of generation but minimises carbon taxes which have to be paid in the future.

Efficient generation is certainly not AEP's only attractive attribute. It has in excess of five million customers across eleven states, making it one of the largest utilities in the United States. Not only does this large customer base provide AEP with a stable base of earnings, but because the tariffs that AEP is allowed to charge rise with inflation, so will its profits.

AEP is forecast to pay a dividend of US\$1.65 per share which translates into a yield of 5.3%. When hedged back to New Zealand dollars, this yield rises to 7.7%. Analysts expect AEP to increase its earnings by 5% per annum in the long term. Assuming AEP retains its current payout and the dividend yield of AEP does not change, this investment is likely to produce returns of 12-13% pa in New Zealand dollars.



## Inflation-linked bonds strategy

### **Inflation-linked bonds**

- These bonds are issued by a number of governments.
- They are similar to normal bonds with one exception: their coupon payments and principal repayment increase with inflation.
- This inflation linking protects investors against the risk of high inflation.

### **Investment strategy**

- Invest in inflation-linked bonds issued by highest-quality governments.
- Where possible invest in bonds with a deflation floor as this provides protection against deflation.
- Ensure that the Portfolio is well diversified by investing in bonds issued by a number of governments (including United States, Europe and New Zealand).

### **Example of a Portfolio holding**

- United States Treasury Inflation Protected Security maturing in July 2018:
  - Bought with a real yield of 1.78%. This is equivalent to a nominal yield of 6.3% when hedged back to New Zealand dollars.
  - Deflation CPI floor of 215.6 versus the current CPI of 213.3 – protects against deflation.

## Inflation-linked bonds scenario analysis (returns in New Zealand dollars)

Inflation assumptions	Deflation	No inflation	Moderate inflation	High inflation
Inflation	-5.0%	0.0%	5.0%	10.0%
<b>Hold to maturity – Returns of inflation-protected bonds increase as inflation increases if held to maturity</b>				
Normal government bond	6.3%	6.3%	6.3%	6.3%
Inflation-linked government bond	4.3%	4.3%	9.3%	14.3%
<b>Returns if held for one year – Returns over one year can be volatile unless the interest rate is hedged</b>				
Normal government bond	27.2%	27.2%	-14.4%	-56.1%
Inflation-linked government bond	18.1%	18.1%	2.2%	-13.7%
NZ Funds' strategy	4.7%	4.7%	9.7%	14.6%

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

**DISCLAIMER:** This document has been provided for information purposes only. The content of this document is not intended as a substitute for specific professional advice on investments, financial planning or any other matter.

While the information provided in this document is stated accurately to the best of our knowledge and belief, New Zealand Funds Management Limited, its directors, employees and related parties accept no liability or responsibility for any loss, damage, claim or expense suffered or incurred by any party as a result of reliance on the information provided and opinions expressed in this document except as required by law. This document, or any part of it, may not be reproduced without the written permission of New Zealand Funds Management Limited.