

## Manager insight – 30 June 2009

The Mid Term Growth Portfolio returned 0.03%<sup>1</sup> for the month of June, taking the year-to-date performance to 0.97%<sup>1</sup>. Over the next few months the Portfolio is going to build a 20% position in inflation-linked bonds that are issued by highly-rated governments. Inflation-linked bonds are very similar to plain vanilla fixed-rate bonds (normal bonds). In fact, the only difference is that the payments made to investors increase with inflation. This inbuilt inflation protection makes them an ideal investment for this Portfolio.

To best understand inflation-linked bonds it is useful to briefly review normal bonds. Normal bonds pay a fixed interest rate until maturity, at which point the face value is returned to investors. Once issued, the value of these bonds varies depending on the current interest rate investors require for the time to maturity of the bond. As the rate of interest increases, the value of the bond declines. There are two reasons why investors require a higher rate of interest: either their inflation expectations have increased, or they demand a higher real rate of interest.

Now turning our attention to inflation-linked bonds, instead of promising to pay a fixed interest rate and then the initial investment back at maturity, issuers promise to pay a real interest rate and the real value of the initial investment back at maturity (ie the principal repayment is the initial investment increased by inflation over the life of the bond). Therefore, the value of the bond only changes if the real

interest rate demanded by investors changes. This difference only becomes important when inflation is unexpectedly high. When this occurs a normal bond will plummet in value while the inflation-linked bond's response will be muted. While inflation has not been a significant issue for investors for the last few decades, the intervention of central banks and governments to help stabilise the economy in the fallout from the global financial crisis could result in runaway inflation.

One downside risk of inflation-linked bonds is deflation. Instead of interest payments being increased and principal growing, the reverse occurs whereby interest and principal repayments are reduced because of the inflation link. While investors receive the real return promised at issue, the interest and principal repayment is less than that of a normal bond. Given the potential for deflation, this is a very real risk.

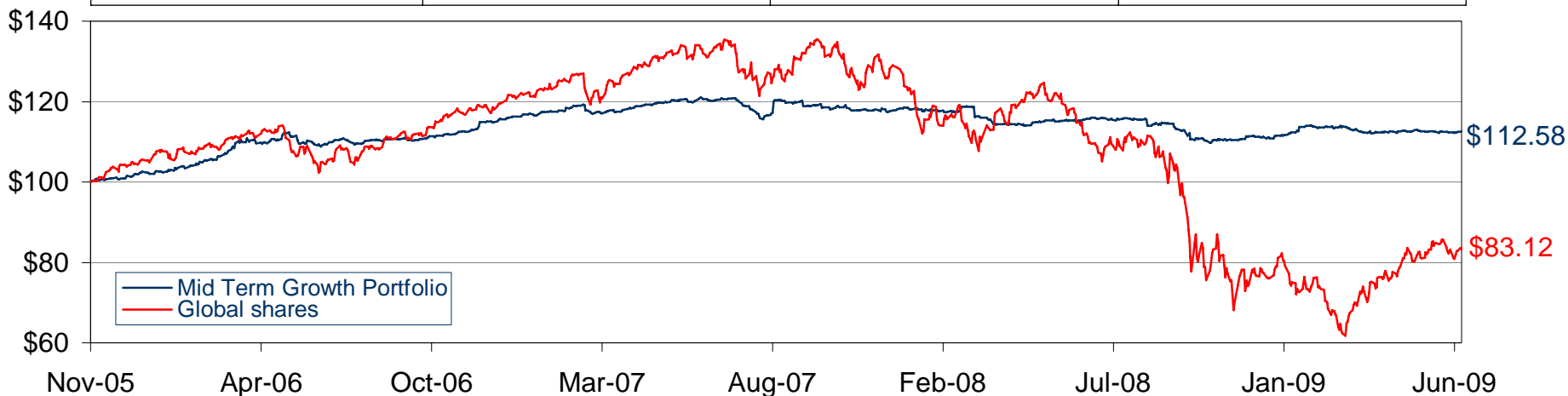
The good news is that some inflation-linked securities limit the impact of this risk by having a deflation floor. In this instance, the principal repaid on maturity cannot be less than that invested when the bond was issued. Investors in bonds with deflation floors have the best of both worlds – they are protected against inflation, but have deflation protection. As a result, bonds with deflationary floors (that are close to the current level) will dominate the Portfolio's exposure to this sector.

<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.

# Mid Term Growth Portfolio

Performance since last mandate change (3 November 2005) to 30 June 2009

Performance attribution	One month	Three month	Six month
Positive	Cash; managers	Cash; bonds	Cash; bonds
Neutral	Bonds	n/a	n/a
Negative	Global shares	Global shares	Global shares



One-month return	Three-month return	Six-month return	One-year return	Since mandate change return pa
0.03%	0.16%	0.97%	-2.72%	3.29%

Source: Bloomberg. 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. Last mandate change was in November 2005. Global shares represented by MSCI World Index in local currency. The asset class index in the chart (MSCI World Index) is not for benchmarking purposes but rather to demonstrate the performance of the largest asset class allocation in the Portfolio.

# Mid Term Growth Portfolio

## Portfolio summary as at 30 June 2009

### Portfolio summary

Yield/Interest	3.1%
Income strategies (before share hedge)	85%
Growth strategies (before share hedge)	15%

Sector / Security	Manager	Portfolio value	Proportion of portfolio	Yield / Interest rate
<b>Income strategies</b>			<b>94%</b>	
Cash - Bank deposits	NZ Funds	\$16,848,879	33%	2.5%
Cash - Bank bills	NZ Funds	\$14,323,838	28%	2.8%
Loans (via Private Loan Trust)	NZ Funds	\$1,481,114	3%	7.6%
Inflation-linked government bonds	NZ Funds	\$2,288,678	4%	5.7%
NZ government bonds	NZ Funds	\$1,198,014	2%	5.4%
Global government bonds	Franklin Templeton	\$2,168,567	4%	7.8%
Corporate bonds	PIMCO	\$2,193,981	4%	9.3%
Share hedge*	NZ Funds	\$7,622,654	15%	2.5%
<b>Growth strategies</b>			<b>6%</b>	
Australasian shares - High dividend yield	NZ Funds	\$810,627	2%	8.4%
Global shares - Core	Lazard	\$3,825,757	7%	3.5%
Global shares - Growth	T Rowe Price	\$3,832,172	7%	1.8%
Global shares - High dividend yield	Tweedy Browne	\$2,358,350	5%	5.0%
Share hedge**	NZ Funds	-\$7,622,654	-15%	2.5%
<b>Total</b>		<b>\$51,329,978</b>	<b>100%</b>	<b>4%</b>
<b>Currency</b>				
Foreign currency exposure	NZ Funds	Fully hedged	0%	

\*The effect of the share hedge is to reduce the impact of changes in global shares on the Portfolio. Actual performance will depend on whether the respective manager under or outperforms the global share benchmark. In addition to this manager outperformance, the Portfolio receives a cash return on the hedged assets.\*\*The share hedge applies to global shares, however, at times it may also apply to a portion of the Australasian shares due to the size of the hedge contracts being purchased.  
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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