Mid Term Growth Portfolio

NZFUNDS

Manager insight – 31 July 2009

This 'Manager insight' summarises an article written by Marc Faber which reviews the inflation/deflation debate. It is worth keeping in mind that the article appears in Faber's Gloom, Boom and Doom Report[1]. As the name suggests, this publication highlights potential extreme events. Opinion pieces like this are useful to ensure that extreme, and arguably less probable, risks are understood and considered.

Faber contends that the economy follows a very long-term cycle that is known as the Kondratieff cycle. This cycle bottomed in the 1930s and 1940s (a period of low inflation) and peaked in the 1970s (a period of high inflation). It bottomed again during the past decade, implying that it is due to climb and that inflation may reassert itself.

He concedes that those arguing there are deflationary risks have a strong case – in the short term the economy is very weak and this weakness will more than offset government spending and money printing. A good example of this weakness is the staggering 33.8 million food stamps that were issued in April. To put this into perspective, approximately 200 million Americans are in the age bracket that is eligible to receive these stamps. This is consistent with estimates of broad unemployment of around 16.5%.

While this weakness is likely to overwhelm the efforts by the US government to spend their way out of the problem, Faber argues that the spending should not be ignored. To make his point Faber uses research authored by Richard Berner, the Chief US Economist at Morgan Stanley. Berner contends that the massive spending and associated deficits will increase US government debt to 82% of GDP in 2019. The interest bill from this debt will create pressure on the fiscal deficit.

Faber argues that the weakness in the labour market will most probably have another important implication – when the recovery occurs it will be fragile. If this is the case, the Fed is likely to have a similar approach to that of early this decade when it applied an accommodative policy for an extended period. This loose monetary policy combined with the growing fiscal deficits may lead to inflation.

While Faber is not overly concerned at this prospect, inflation has important implications for savers. In the words of Ronald Regan, the 40th President of the US:

"Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man."

In summary, Faber's article highlights short-term deflationary risks and longer-term inflationary risks. The Mid Term Growth Portfolio is constructed with these dual risks in mind. A good example of this is the allocation to Treasury Inflation Protected Securities with deflationary floors described in the previous month's Manager insight.

[1] Faber, M. (26 July 2009). The Gloom, Boom & Doom Report.

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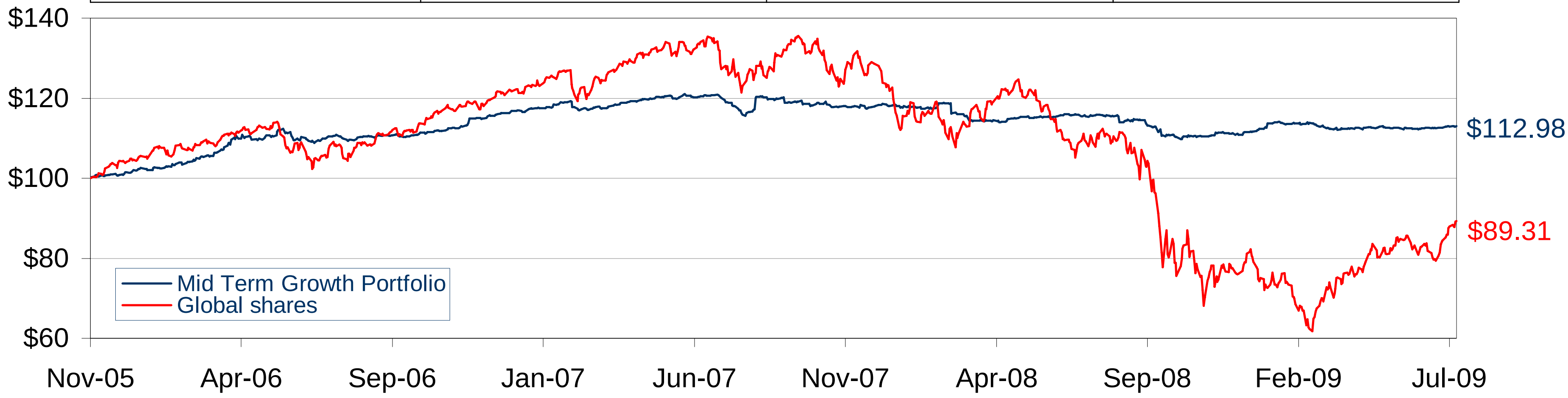
Performance since last mandate change (3 November 2005) to 31 July 2009

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



One-month return	Three-month return	Six-month return	One-year return	Since mandate change return pa
0.35%	0.38%	-0.87%	-2.31%	3.31%

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.

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Portfolio summary as at 31 July 2009

Portfolio summary

Yield/Interest	3.1%
Income strategies (before share hedge)	78%
Growth strategies (before share hedge)	22%
Currency strategies	0%
Combined economic exposure	100%

Strategy	Manager	Asset class	Portfolio value	Proportion of portfolio	Yield / Interest rate
Income strategies				**94%**	
Bank deposits	NZ Funds	Cash	$16,704,748	31%	2.5%
Bank bills	NZ Funds	Cash	$14,356,874	27%	2.8%
Inflation-linked government bonds	NZ Funds	Government bonds	$3,476,807	7%	5.7%
Global government bonds	Franklin Templeton	Government bonds	$2,216,087	4%	8.8%
Investment-grade corporate bonds	PIMCO	Corporate bonds	$2,175,269	4%	8.7%
Loans (via Private Loan Trust)	NZ Funds	New Zealand direct loans	$1,490,133	3%	7.6%
New Zealand government bonds	NZ Funds	Government bonds	$1,221,885	2%	5.3%
Share hedge*	NZ Funds	Cash	$8,084,764	15%	0.0%
Growth strategies				**6%**	
Global shares - Growth	T Rowe Price	Global shares	$4,051,648	8%	1.8%
Global shares - Core	Lazard	Global shares	$4,043,838	8%	3.5%
Global shares - High dividend yield	Tweedy Browne	Global shares	$2,476,630	5%	4.8%
Australasian shares - High dividend yield	NZ Funds	Australasian shares	$862,827	2%	8.1%
Share hedge**	NZ Funds	Global shares	-$8,084,764	-15%	2.5%
Currency strategies					
Foreign currency exposure	NZ Funds	Fully hedged		0%	
Total			**$53,076,745**	**100%**	**3.1%**

*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.

Notes

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.