

Investment BULLETIN

What's inside...

- Pg 01 - **INTRODUCTION & WELCOME** *By RICHARD JAMES*
- Pg 03 - **INVESTMENT MARKET OUTLOOK** *By MICHAEL LANG*
- Pg 10 - **IMPROVING THE RELIABILITY OF ACHIEVING GROWTH** *By DAVE WILSON*
- Pg 15 - **LONSEC: NZ FUNDS KIWISAVER SCHEME FIRST**
- Pg 16 - **INDICATIVE ASSET ALLOCATION BENCHMARKS FOR PERSONALISED RETIREMENT PLANS**

Dear Client,

Welcome to the NZ Funds Management Investment Bulletin – June 2011

One of our primary aims is to ensure that those who entrust their investments to us have the information available to answer the simple but important questions: *Where is my money being invested? How is it being managed? How is it performing? How does that performance compare with the alternatives such as term deposits? How does my portfolio connect to my financial plan?*

To help answer these questions, two years ago we began publishing a monthly document called **Portfolio Insights**. This document details each and every investment manager used, and securities owned, in all PIE portfolios we oversee. Together, these portfolios comprise each client's personalised investment portfolio. The Portfolio Insights document also contains detailed analysis of each portfolio's investment performance and combines the performances of the various portfolios to give three indicative client experiences. These experiences are then tracked against the after tax returns from the most common investment alternative, term deposits (which we track via the 90-day bank bill index). Your financial adviser can provide you with a copy of the Portfolio Insights or you can read it on the front page of our website at www.nzfunds.co.nz.

Each of our clients, and his or her financial objectives, are unique. However, all our clients share two lifelong financial objectives: first, the accumulation of wealth during the first two-thirds of their life, to fund the lifestyle they wish to have maintained in retirement and, second, to have their wealth managed in retirement in a manner that provides a stable and reliable source of income and protects their capital from being eroded by inflation.

AS A SPECIALIST WEALTH MANAGEMENT FIRM, OUR SOLE FOCUS IS TO MANAGE CLIENTS' INVESTMENT PORTFOLIOS IN A MANNER THAT MAXIMISES THE RELIABILITY WITH WHICH WE ACHIEVE THESE TWO LIFELONG FINANCIAL OBJECTIVES.

Continued overleaf »



RICHARD JAMES
CHIEF EXECUTIVE
OFFICER

Continued from page one »

Achieving these objectives is what our organisation has focused on for more than 20 years. We have achieved consistently in certain environments but, disappointingly, we have not always been successful. Improving the reliability of our clients' investing outcomes is the objective that dominates our ongoing research commitment.

The investment landscape is ever changing and always challenging, no more so than over the past decade. Just as in other research-based fields such as medicine, the tools and approaches used in wealth management must evolve over time. However, our principle of seeking to maintain a balance between preserving our clients' hard-earned retirement capital and growing clients' wealth remains constant. The practical application of this principle requires continual research on the particular combination of assets, investment managers and portfolio construction that will most reliably meet the objectives our clients seek from their portfolios.

THIS INVESTMENT BULLETIN IS DESIGNED TO PROVIDE YOU WITH INSIGHT INTO OUR THINKING, THE RESEARCH THAT UNDERLIES THAT THINKING, AND HOW THAT IS BEING APPLIED TO YOUR PORTFOLIO.

Your financial adviser is critical, not just in designing your personalised retirement plan but also in ensuring a clear connection between what you are seeking to achieve and how your portfolio is being managed. If you have questions as you read this Bulletin, your financial adviser will be only too happy to help.

Yours sincerely

A stylized, handwritten signature in black ink, consisting of a large loop and a trailing flourish.

Richard James
Chief Executive Officer



MICHAEL LANG
PRINCIPAL AND CHIEF
INVESTMENT OFFICER

Investment Market Outlook

By Michael Lang

IN TODAY'S WORLD WE ARE CONSTANTLY BOMBARDED WITH INVESTMENT INFORMATION. GONE ARE THE DAYS WHEN COMPANIES REPORTED ANNUALLY AND THERE WAS A COMPETITIVE ADVANTAGE TO BE GAINED FROM LIVING IN AUCKLAND, WHERE ANNUAL REPORTS ARRIVED A DAY EARLIER IN THE MAIL. TODAY THE NEW ZEALAND PUBLIC IS ALMOST OVERWHELMED BY DAILY INVESTMENT NEWS ON NUMEROUS TELEVISION CHANNELS, NOT TO MENTION THE MANY ONLINE WEBSITES, NEWSPAPER SECTIONS, COLUMNISTS AND INVESTMENT FOCUSED ADVERTISEMENTS – MANY OF WHICH HAVE ONLY ONE POINT OF VIEW, OR FOCUS ONLY ON A SELECTIVE PERIOD OF TIME.

THE YEAR THAT WAS: 2010

When operating in an environment of excessive information, the basic and unchanging principles behind investment management are more important than ever. Nothing is more constant than the certainty that financial markets move in cycles. The Global Financial Crisis has not changed this certainty. This crisis was simply the most recent in a series of cyclical economic downturns, which in recent times have included the global share market crash in 1987, the Asian Crisis in 1997, and the global technology collapse in 2001. Just as the sun rises each morning, each of these events has been followed by an economic upturn.

We ended 2010 with both the New Zealand economy and global economy in a slow but steady recovery mode. It is easy to become overwhelmed by news of natural disasters, civil unrest, sovereign debt crises, radiation leaks, and the United States' 14 trillion dollar national debt. It all makes for attention grabbing headlines. It is therefore more important than ever to focus on the basics. Economic downturns are followed by economic recoveries and nothing that has occurred year to date has changed this.

THE YEAR THAT IS: 2011

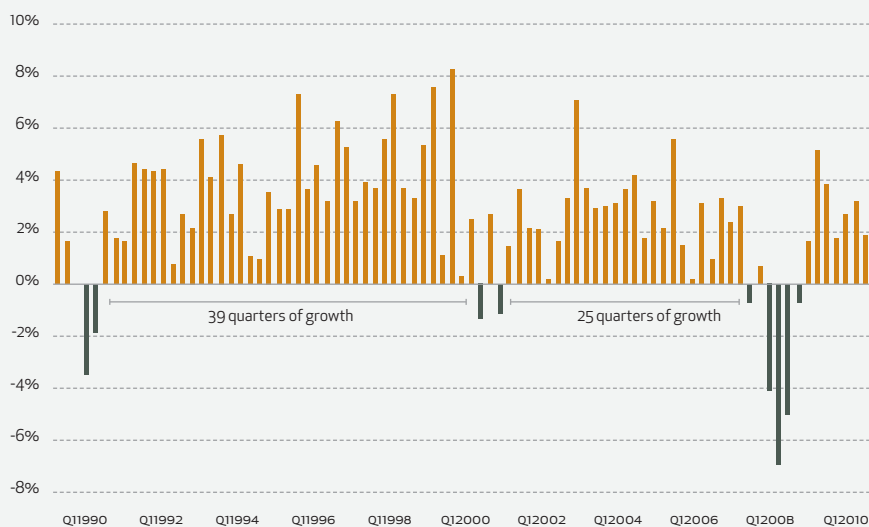
Having managed clients' wealth through multiple cyclical downturns, we have been (and remain) more concerned about declines and more wary of bounces than some of our investment management peers. Having said this, we are optimistic about the outlook for growth assets, especially when compared with term deposits.

“It is therefore more important than ever to focus on the basics. Economic downturns are followed by economic recoveries and nothing that has occurred year to date has changed this.”

Our optimism is greatly assisted by the United States Federal Reserve. The Federal Reserve's Quantitative Easing (or electronic money printing) has led to a 220% increase in the supply of money since the beginning of the Global Financial Crisis. The Federal Reserve has also been instrumental in setting interest rates at the lowest level ever recorded. As a result of the combination of zero interest rates and an expanding monetary base, the United States economy (which is three times bigger than the world's next largest economy – China) has once more begun to grow and is forecast to accelerate its growth to approximately 4% per annum by 2012.

When we add China's phenomenal economic growth rate of approximately 10% last year and the observation that even Europe looks to be eking out a positive return, we believe we have the ingredients for sustained growth in the global economy and, correspondingly, the potential for continued growth in the value of the global share market.

UNITED STATES ECONOMIC GROWTH 1990 TO 31 MARCH 2011



SOURCE: BLOOMBERG, NZ FUNDS MANAGEMENT CALCULATIONS.

While global shares are by no means cheap, valuation alone does not deter us from holding a significant allocation of global shares in the Growth component of our clients' portfolios. Over the long-run, global shares have historically proven to be a better store of value than term deposits on an after tax basis. Furthermore, some of the most spectacular share market gains have occurred as global shares have moved from fairly valued to significantly overvalued. And that situation has frequently occurred during periods of negative real interest rates such as that which prevails now.

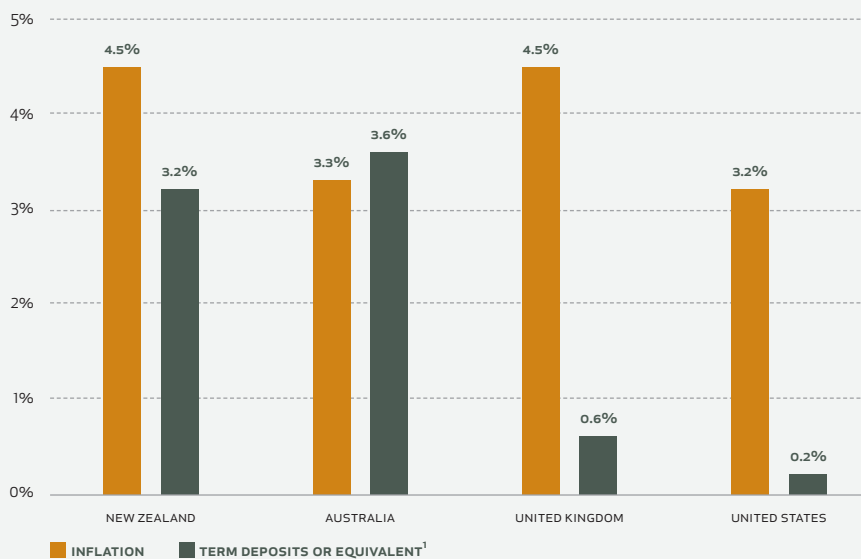
Nevertheless, we cannot rely solely on global shares to achieve real growth in clients' portfolios. Just as importantly, there are risks associated with share ownership. Therefore the management of risk in client portfolios must be approached systematically, rather than by relying on the perception that turning points can be identified at the time they occur and not with the benefit of hindsight.

In contrast to shares, commodities remain significantly undervalued. The year began with copper at 129% below its previous inflation adjusted high, corn at 44% and oil at 22%. Out of all the asset classes our view is that the value proposition for commodities is by far the most compelling. However, commodities (along with currencies) also offer the highest levels of volatility and require the investment manager to be as focused on the downside as on the upside. In today's monetary fuelled recovery, commodities have both value and momentum in their favour and we have been progressively adding oil and gas, industrial metals, agricultural commodities and gold to the longer term growth components of clients' portfolios.

(AVOIDING) GOING BROKE SLOWLY

Interest rates set below the rate of inflation (referred to as "negative real interest rates") are, in our opinion, the most insidious force undermining retirement savings today. The United States Federal Reserve is not alone in its adoption of negative real interest rates. In the first quarter of this year the Reserve Bank of New Zealand continued to hold wholesale interest rates at 2.5% despite annualised inflation hitting 4.5%. This practice, once regarded as exceptional, has now become the norm in both developed and emerging economies. The implication for investments held in cash is as follows:

COMPARISON BETWEEN CURRENT TERM DEPOSITS (OR EQUIVALENT) AND INFLATION RATES



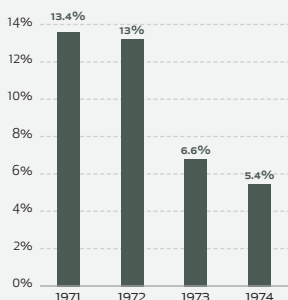
SOURCE: BLOOMBERG, NZ FUNDS MANAGEMENT CALCULATIONS.

Only a small amount of negative real returns (currently negative 1.3% in New Zealand) can cause real damage for a term deposit saver over time. Over twenty years it would mean that \$30,000 of retirement spending dollars held in term deposits would buy you just \$23,170 worth of goods at the end of that period. Think about how hard it would be to live on two thirds of what you do today – what would you not spend money on?

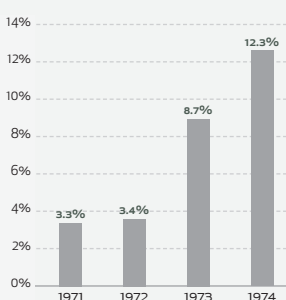
There are no free lunches in finance and eventually we must all collectively pay a price for having a central bank-induced economic recovery through negative real interest rates. In time the current stimulus will lead to higher inflation – with an expected lag of between two and three years – as occurred in New Zealand and the United States during the 1970s.

Please note: (1) Term deposit returns are estimates only based on 3-month term deposits in New Zealand and 3-month cash returns in Australia, the United Kingdom and the United States. Returns are shown after tax, assuming a PIE tax rate of 28%.

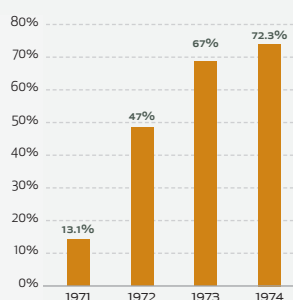
US MONEY SUPPLY GROWTH



US INFLATION RATE



GOLD PRICE APPRECIATION



SOURCE: BLOOMBERG, NZ FUNDS MANAGEMENT CALCULATIONS.

How can we be so sure of this inflationary risk in the face of central bankers' assurances that inflation remains under control? In a word – gold. Since the advent of the Global Financial Crisis, gold has risen 100%. Significantly, 34% of this gain has occurred since the global economy began to recover. This is not a risk aversion trade. Financial markets are forward looking and gold's continued appreciation is our inflationary canary in the coal mine. Gold's appreciating value signals the increasing risk of inflation in the future.

As noted above, negative real interest rates are a phenomenon that has occurred in a number of economies historically including Japan, China and the United States. These rates generally led to the erosion of wealth held in cash, and in some cases a corresponding boom in shares and related asset classes such as property and commodities. These booms are frequently characterised by much higher levels of volatility, including sharp declines of 20%, 30% or even 50%. It is unlikely to be any different this time. Five of the most dangerous words in finance are "this time it is different".

Eight to ten times more New Zealand wealth is held in term deposits than was held in finance companies. We are fearful that the real wealth erosion resulting from the combination of term deposits and higher inflation may be much greater than the wealth erosion caused by the finance company sector during the past decade, unless corrective measures are taken on a global scale to suppress today's rising inflation.

LET THEM EAT IPADS

Recently, the President of the New York Federal Reserve and former head economist of Goldman Sachs, Bill Dudley, spoke to an audience in the New York borough of Queens. Dudley was challenged with questions about interest rates and inflation. He was asked: "when was the last time, sir, you went grocery shopping?" Struggling to reply, Dudley explained that the iPad2 is the same price as the first iPad, suggesting that while food prices may have gone up, technology prices had not. His response was widely reported in the press the following day. Paraphrasing the infamous remark attributed to Marie Antoinette, the headlines read: "let them eat iPads"!

One consequence of negative real interest rates and higher inflation is that investors will feel compelled to switch out of interest bearing assets (cash, term deposits and bonds) and into growth assets (shares, property and commodities). This switch will not necessarily suit the risk profile of many investors preparing for retirement. Nor is such switching likely to be driven by a belief that the risk adjusted returns will be superior. Instead, switching is likely to occur in an attempt to preserve the purchasing power of investors' capital from the corrosive effects of inflation. Such switching is currently underway. In the United States for example, in January 2011 alone \$75 billion was redeemed from cash funds while \$20 billion moved into share orientated funds.¹

Unfortunately, too often money that flows out of cash or term deposits into higher risk and return assets, without the support of a well thought out financial plan, flows back into cash at the worst possible time – that is, after a temporary setback in the value of growth

1 The National Association of US Investment Companies: Trends in Mutual Fund Investing February 2011.

assets, thereby crystallising losses for investors. Such an investment approach is unlikely to enable investors to compound their wealth over long periods at a faster rate than term deposits. Consequently, a portion of the population will miss out on the long-term benefits of accumulating wealth through growth assets.

For those in retirement with the bulk of their money in interest bearing assets, negative real interest rates and higher inflation means that their retirement capital will purchase less and less over time. Unless iPads become edible, term deposit investors face the prospect of a progressively diminishing standard of living.

PLANNING FOR AN INFLATIONARY FUTURE

So what are the alternatives? Since 2007 NZ Funds Management has focused on improving the framework by which clients are able to access a personalised retirement plan (constructed with the help of their financial advisor) and a matching investment portfolio (managed by NZ Funds Management).

Currently we are finalising a number of improvements to the framework, designed to make the link between clients' personalised retirement plans and their two primary investment goals (accumulate a targeted level of wealth at retirement and then deliver a targeted, inflation protected, level of income throughout retirement) more tangible and transparent. The enhanced framework will also enable clients to assess the merits of accelerating their wealth accumulation objective by complementing their personalised retirement plan with a KiwiSaver Scheme.

In order to maximise the reliability of meeting clients' retirement savings or retirement income goals, each personalised retirement plan and matching investment portfolio should contain an allocation to all of the four major investment categories: Cash, Income, Inflation, and Growth. And, through clients' financial advisers, each plan and portfolio should regularly be rebalanced to adjust for changes in interest rates, inflation, capital market movements, and changes in personal saving and spending circumstances.

In the next section we provide a brief update on the investment management of the four major investment categories: Cash, Income, Inflation and Growth. These categories are currently referred to in the Investment Statement as: Cash, Near-Term Spending, Maintaining Capital and Future Growth.

CASH

As the Government Guarantee scheme rolled off, the **Money Market Portfolio** was progressively redeemed out of call accounts with the four major trading banks and the investments replaced with bank bills issued by ANZ, Westpac, BNZ and ASB. This change enhanced the portfolio's returns modestly. The overriding objective of the portfolio in this category continues to be stability in value and immediate availability of capital.

Given the highly indebted nature of New Zealand households, we do not expect the Reserve Bank of New Zealand to raise interest rates significantly any time soon. Returns from cash are therefore likely to continue to lag inflation, especially on an after-tax basis. As emphasised in the previous section, we continue to caution clients to hold little more than is needed for immediate use in cash. For most clients this equates to one or two years spending needs in retirement, or an emergency allocation if you are still accumulating wealth for retirement.

INCOME

NZ Funds Management now manages two portfolios in the Income investment category.

The **Core Income Portfolio** remains heavily weighted towards the high-quality end of the investment-grade corporate bond spectrum. The bonds of large, market-leading companies with strong balance sheets are favoured. The resulting portfolio of bonds contains investment grade and investment grade quality bonds issued by New Zealand, Australian and American companies.

The **International Income Portfolio** is focused solely on investing in internationally issued corporate and government bonds. The bonds in this portfolio are selected by Bill Gross, Mark Kiesel and the team at PIMCO and Dr Michael Hassenstab and his team at Franklin Templeton, while NZ Funds Management's fixed interest team oversee an allocation to high-quality global government bonds.

INFLATION

Inflation remains the clearest and most pressing danger to clients' savings. As explained in our letter to all clients last year, the **Mid Term Growth Portfolio** increased its allocation to both inflation linked bonds and inflation sensitive growth assets such as utility shares, listed property trusts and commodities. This allocation increased the portfolio's emphasis on capital appreciation, as the world transitioned from a deflationary state to an inflationary one. The investment results of this change in asset allocation have to date been positive.

In the first quarter, the **Global Property Portfolio** similarly increased its allocation to listed property trusts and now holds a portfolio of premium New Zealand, Australian and internationally listed property trusts. The international component of the portfolio is managed by Sydney-based Resolution and the domestic component by NZ Funds Management. Many of the team at Resolution were formerly senior members of the LendLease Property Team. The Global Property Portfolio continues to seek to track the returns of the global and domestic property markets, without the high transaction costs and illiquidity associated with direct property ownership and with a strong focus on the management of risk.

GROWTH

In addition to generating returns from income and inflation orientated assets, most clients should hold some allocation in their plan to long-term growth orientated assets. The predominant growth asset is shares, but growth assets can also include commodities, currencies and longer term bonds.

Growth assets can be hard to own for long enough periods of time, to reap the rewards they are capable of generating. This discipline has been especially difficult during the last ten years when global share prices have risen and fallen sharply several times, yet failed to end the decade meaningfully higher than ten years earlier.

We are also acutely aware of the lacklustre performance of NZ Funds Management's growth portfolios since the Global Financial Crisis ended. Consequently, during the last nine months, research efforts by NZ Funds Management have focused on the growth portfolios. The findings of that research are discussed under the next section *Improving the reliability of achieving growth*.

SPECIAL SITUATIONS

Of all the portfolios available through NZ Funds Management's investment platform, the now closed **Super Yield Fund** was the most severely affected by the Global Financial Crisis. The primary asset class accessed by the Fund was global high yield credit.

After five years of strong returns, the Super Yield Fund was seriously affected by the Global Financial Crisis as investors around the world collectively sought to sell credit. As a result the price of high yield credit bonds collapsed, in some cases to significantly below their long term value. The rapid change of stability in price for the underlying bonds, coupled with uncertainty about their future value, led to significant redemptions from the Super Yield Fund. The ongoing consideration of client equity issues (between those wishing to exit and those remaining invested) led NZ Funds Management to close the Fund to redemptions in August 2008 and to systematically liquidate the remaining investments over a timeframe which we believe is most likely to maximise the outcome for clients in the Fund.

“ It is pleasing to see that over the last year almost 90% of NZ Funds Management’s existing clients chose to stick with their long-term retirement plans. Further, since the beginning of the year, we have begun working with a number of new independent financial advisers and a significant number of new individuals, families and trusts. ”

The **Credit Opportunities Portfolio** was a special situation strategy that, among other things, enabled clients who had invested in the Super Yield Fund to accelerate the rebuilding of their capital. Year to date the Credit Opportunities Portfolio has performed strongly as selective credit assets continue to recover. Of particular note is an investment within the Credit Opportunity Portfolio, which has attracted expressions of interest at a significantly higher level than where it is currently valued. Again, in order to ensure client equity, the Credit Opportunities Portfolio is now closed to new clients until the positive values of the underlying bonds can be crystallised. We have taken the step of closing the Portfolio to new clients to ensure that the full benefit of any increase in value accrues to existing clients currently invested in it. Existing clients are however free to exit should they require their capital immediately.

CONCLUDING THOUGHTS

A personalised retirement plan provided by NZ Funds Management, in partnership with financial advisers throughout New Zealand, is one of the few ways by which New Zealanders can seek to protect the purchasing power of their savings from inflation without having to negotiate the pitfalls of a handful of directly held shares and bonds or rental property ownership.

While we have all – as investors, investment managers and as a nation – experienced a number of setbacks during the Global Financial Crisis, nothing that has occurred should change the ability of clients to achieve a financially rewarding experience from their retirement plans over their lifetime. We believe that when clients review their long-term returns from the top of the next economic cycle – rather than from the bottom of the cycle from which we have begun to recover – they will feel pleased with their retirement programme.

It is therefore pleasing to see that over the last year almost 90% of NZ Funds Management’s existing clients chose to stick with their long-term retirement plans. Further, since the beginning of the year, we have begun working with a number of new independent financial advisers and a significant number of new individuals, families and trusts.

We look forward to reporting to you again later in the year.



Michael Lang

Principal and Chief Investment Officer



PLEASE NOTE: THIS SECTION CONTAINS IMPORTANT LEGAL INFORMATION CONCERNING YOUR INVESTMENTS.

Improving the reliability of achieving growth

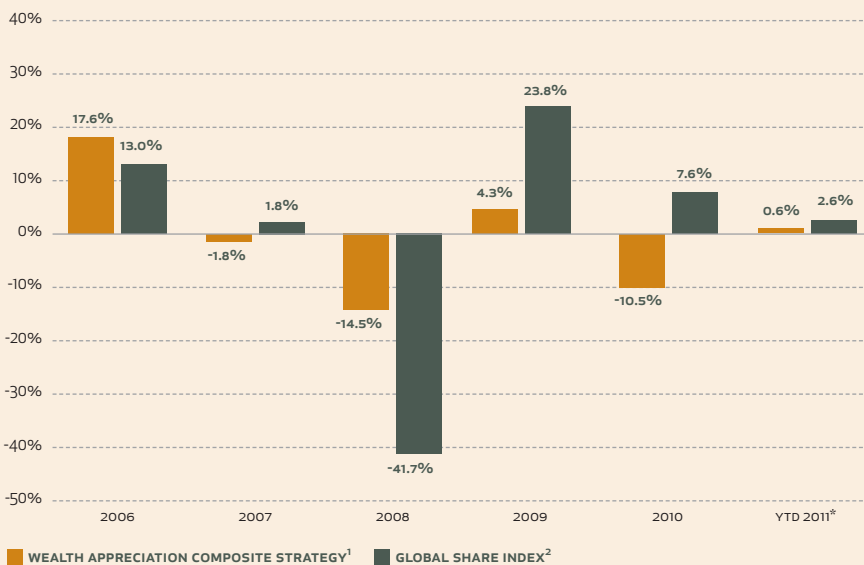
By Dave Wilson

“Time brings change; it is the strategy which matters”

CRISPIN ODEY, FOUNDING PARTNER, ODEY ASSET MANAGEMENT

The principle behind NZ Funds Management’s investment approach is to seek to maintain a balance between preserving capital and growing wealth, which is appropriate to the investment category in which the portfolio sits. Over the last five years the rewards from this approach in the Growth investment category have been mixed. The sharpest impact of the Global Financial Crisis was successfully mitigated in most clients’ growth oriented portfolios, but the portfolios have subsequently lagged the global share market during the initial stages of the recovery.

COMPARISON BETWEEN WEALTH APPRECIATION COMPOSITE STRATEGY AND GLOBAL SHARE INDEX DURING THE GLOBAL FINANCIAL CRISIS



SOURCE: BLOOMBERG, NZ FUNDS MANAGEMENT CALCULATIONS.



DAVE WILSON
PRINCIPAL AND INVESTMENT
STRATEGIST

Any investment approach is unlikely to navigate both stages of such a violent collapse in value and subsequent partial (but ongoing) recovery, perfectly. Given a choice, we would rather the situation NZ Funds Management's clients find themselves in today – that is where their growth orientated portfolios generally outperformed during the Global Financial Crisis but have underperformed so far during the recovery phase. The alternative, faced by many investors elsewhere, is to have been down 40–50% during the Global Financial Crisis and to require a subsequent positive return of 67–100% in order to recover the starting position. In our experience, few clients, especially those close to or in retirement, can stomach that level of decline, irrespective of the rate at which the value of the investment rises subsequently.

We are however aware that the objective of the Growth investment category is to grow clients' capital and not merely to seek to preserve it. Having systematically applied a number of enhancements to the way in which portfolios in the Cash, Income, and Inflation investment categories are managed, NZ Funds Management's recent focus has been on improving the reliability with which Growth portfolios meet clients' growth objectives.

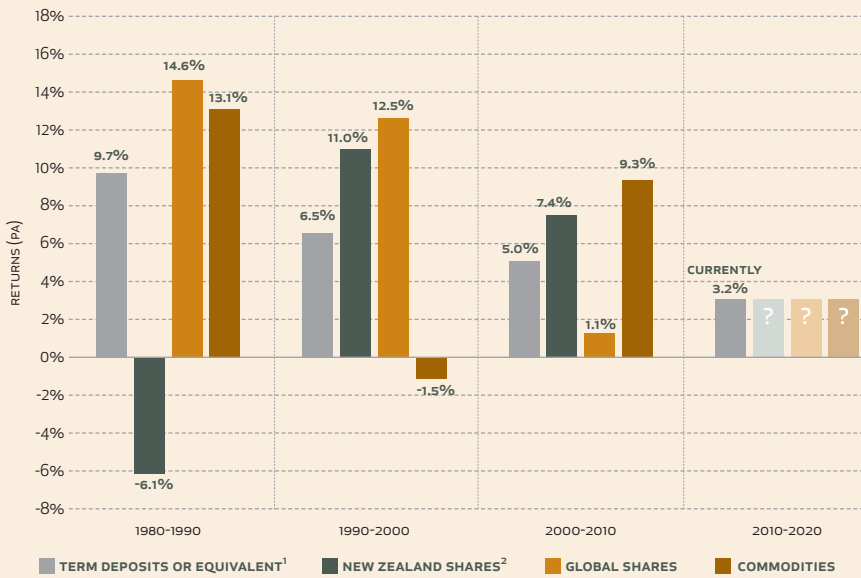
The starting point for researching enhancements to clients' growth portfolios was to review the performance characteristics of three major growth asset classes: global shares, New Zealand shares and alternative growth assets such as commodities and currencies – over an extended period of time.

Private market assets, which have made significant contributions to clients' growth portfolios over the last fifteen years, were also researched. However, private market assets tend to be highly illiquid and vulnerable to being locked up should all clients wish to redeem at once. After the Global Financial Crisis, clients expressed a clear desire for liquidity – defined as the ability of clients to withdraw funds (within the terms of the notice period). As a result the remaining private market assets held within the growth portfolios, such as private equity and private debt, are being exited. As at March 2011, the Balanced Growth, Diversified Growth and Wealth Appreciation Portfolios had exposure of 2% or less to private market assets.

In studying the performance characteristics of growth assets it is instructive to look at their returns decade by decade and then compare these with the after tax returns from term deposits over the same period.

Please note: * Year to date as at 30 April 2011. (1) The Wealth Appreciation Composite Strategy has been developed to illustrate the long-term performance of the investment strategies followed by the Wealth Appreciation Portfolio. It is not the return of the Portfolio. The Composite Strategy is made up of unit trusts that are considered to have similar objectives and strategic asset allocations. The returns of the Wealth Appreciation Composite Strategy are after management fees (but not advice fees) and after tax using an assumed PIE tax rate of 28% for purposes of comparison over the entire period even though the PIE tax regime only started 1 October 2007 and different PIE tax rates have applied since it started. (2) The global share index used is the MSCI World Index (in local currency terms). It has been adjusted for an assumed PIE tax rate of 28%. An assumed fee of 1.75% pa has been deducted from the global share index to reflect the cost of obtaining a passive global share market exposure using an Exchange Traded Fund and the brokerage associated with purchasing it.

GROWTH ASSET RETURNS BY DECADE 1980 TO 2010



SOURCE: BLOOMBERG, NZ FUNDS MANAGEMENT CALCULATIONS.

Several conclusions can be drawn from this analysis. First, during any one 10-year period it is extremely hard to predict which type of growth asset will generate the highest return and which will disappoint. During the 1990s global shares delivered exceptionally strong returns, whereas commodities disappointed investors. In contrast from 2000 to 2010 (as most NZ Funds Management clients know), global shares failed to grow clients' wealth – irrespective of whether or not active hedging strategies were followed. Over the same period commodities outperformed both New Zealand shares and global shares, by some margin.

In order to provide a more reliable and less volatile growth experience over rolling 10-year periods, it logically follows that clients should own a diversified mix of growth assets. Owning a diversified mix of growth assets ensures that during each decade, the growth of clients' wealth will not depend solely on one type of growth asset.

Although NZ Funds Management's current suite of growth portfolios are diversified, they have primarily relied on the global share market to generate returns. Furthermore, unlike in the Income and Inflation investment categories where clients have become diversified across more than one portfolio, in the Growth investment category clients tend to be invested in just one growth portfolio to meet all their growth objectives.

Another research finding related to client investment preferences. Those to whom we talked agreed with the philosophy of holding a more diversified range of strategies in the growth component of their investment portfolio, but indicated a wish to be able to personalise their long-term growth exposure by tilting toward New Zealand shares or away from shares and toward alternative growth assets, such as commodities and currencies.

Finally, the research showed that irrespective of the type of growth asset to which they were exposed, the longer clients remained invested, the more the anomalies of any one decade of returns were smoothed out, and the more likely clients were to earn a higher rate of return than term deposits.

Please note: For comparison purposes all returns are stated after tax, with an assumed PIE tax rate of 28% over the entire period even though the PIE tax regime only started 1 October 2007 and different PIE tax rates have applied since then. No adjustment has been made for assumed investment management fees or advice fees, nor for the potential for returns to be above (or below) the corresponding asset class index. (1) Term deposit returns have been estimated using the New Zealand 90-day bank bill index. (2) New Zealand share returns are shown from late 1985 onward, because a gross return index (which includes the contribution of dividends) was only available from late 1985.

As part of the review process, NZ Funds Management will be reconfiguring the portfolio design, asset allocation, investment managers, and risk management strategies used by a number of the portfolios in the Growth investment category. Some of these changes have already occurred, while others will occur over the remainder of the calendar year. At the conclusion of this process each growth portfolio should have a more specific and independent growth driver. A summary of the changes taking place follows:

PORTFOLIO	CURRENT STRATEGY	ENHANCED STRATEGY
WEALTH APPRECIATION PORTFOLIO	Diversified blend of assets	An increased allocation to growth assets
DIVERSIFIED GROWTH PORTFOLIO	Diversified blend of assets	A diversified blend of assets with a focus on global shares
BALANCED GROWTH PORTFOLIO	Diversified blend of assets	A diversified blend of assets with a focus on alternative growth assets such as commodities
DIVIDEND YIELD PORTFOLIO	New Zealand share focus	Ability to include growth shares and the inclusion of additional downside protection strategies

Following this transition each growth portfolio will continue to have, at its core, the objective of seeking to grow clients' capital over the long-term. No one growth portfolio is expected to achieve a significantly higher long-term rate of return than another. Unlike today, however, the performance patterns of each of the growth portfolios can be expected to be quite different from one another, reflecting the different types of growth assets held within each portfolio.

By ensuring that clients are exposed to more than one growth portfolio, the probability that clients' growth assets will suffer a second decade of lacklustre returns should be substantially reduced as they will no longer be relying mainly on the performance of a single growth asset or portfolio. Instead, with the help of their financial adviser, clients will now be able to diversify across the range of different growth portfolios, each with a different predominant return driver. Clients will now also be able to tilt their growth assets toward New Zealand and Australian shares, global shares, or alternative growth assets such as commodities and currencies should they wish. These changes should result in clients' investments being spread across a wider range of investment managers and strategies, thereby reducing their reliance on any single growth asset class or investment management approach.

“Following this transition each growth portfolio will continue to have, at its core, the objective of seeking to grow clients' capital over the long-term. No one growth portfolio is expected to achieve a significantly higher long-term rate of return than another.”

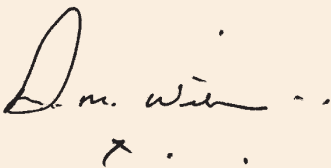
There are no costs for switching or rebalancing between any of the portfolios used to make up clients' personalised retirement portfolios. Therefore NZ Funds Management strongly recommends that clients discuss diversifying their growth assets across the reconfigured portfolios with the help of their financial adviser.

Over the last twenty years NZ Funds Management has constantly sought to enhance clients' investment outcomes by seeking to optimise the combination of assets and investment managers they own in their portfolios (and the tax to which those portfolios are subject). Should the selection of managers and/or assets held not deliver outcomes consistent with our expectations, then we will continue to change them until they do.

NZ Funds Management's investment philosophy will however remain constant, that is, seeking to maintain a balance between preserving capital and growing wealth, appropriate to the investment category in which the portfolio sits. We will also seek continually to enhance the way in which our philosophy (labelled Absolute Returns through Mitigation of Risk, or ARMOR) is implemented.

It is important to note that the changes discussed will mean that all of NZ Funds Management's growth portfolios will be more closely aligned to rising and falling markets than over the last four years, because the application of certain downside protection strategies will be modified. This is being done to achieve, what we believe will be, a better allocation between risk and return in clients' growth portfolios. As Crispin Odey, who has astutely guided his clients through two financial market collapses and subsequent booms, observed "time brings change; it is the strategy which matters".

We look forward to keeping you up to date with the research and development NZ Funds Management is applying to your personalised investment portfolio. Meantime we encourage you to meet regularly with your financial adviser to ensure that your personalised retirement plan is regularly rebalanced to account for portfolio enhancements (such as those discussed above), asset class movements and your ongoing contributions and withdrawals.



Dave Wilson

Principal and Investment Strategist



New Zealand's first qualitatively
reviewed KiwiSaver Scheme Portfolios

Reviewed by 

NZ Funds *KiwiSaver* *Scheme first*

NZ FUNDS MANAGEMENT HAS BECOME THE FIRST KIWISAVER INVESTMENT
MANAGER IN NEW ZEALAND TO HAVE ITS KIWISAVER SCHEME PORTFOLIOS
QUALITATIVELY RESEARCHED BY A THIRD-PARTY RESEARCH HOUSE.

The three portfolios in the NZ Funds KiwiSaver Scheme all earned recommendations from leading Australian research house, Lonsec. The Income Strategy received a rating of 'Highly Recommended', while the Inflation Strategy and Growth Strategy both received a rating of 'Recommended'.

After a series of research meetings with NZ Funds Management over an extended period, Lonsec's reports noted that the company observed a "strong investor focused culture, supplemented by extensive research, and a strong corporate governance and compliance regime".

Further, the reports noted Lonsec's conviction that the NZ Funds Management portfolios reviewed "can achieve their objectives and, if applicable, outperform peers over an appropriate investment timeframe".

Lonsec observed a strong risk management culture at NZ Funds Management.

The reports also noted that NZ Funds Management has "competitive advantages over its peers in people, process and product design". Lonsec considered the research approach of NZ Funds Management "to be diligent and thorough and with a greater consideration of end investor needs than is sometimes apparent amongst more 'benchmark relative' peers."

ABOUT LONSEC

Lonsec provides financial advisers with in-depth, quality managed funds research, spanning a range of traditional and alternative asset classes. Lonsec's research team has consistently been well rated by fund managers in the annual 'Rate the Raters' survey published by one of Australia's premier financial publications Money Management. In 2010, this survey was extended to financial advisers for the first time. The combined results saw Lonsec awarded the inaugural 'Fund Ratings House of the Year 2010'.

Please note: The Lonsec Research Reports (Reports) were commissioned by NZ Funds Management. Lonsec Limited prepared the Reports using comprehensive and objective criteria and received a fee from NZ Funds Management for the preparation of the Reports. The Reports were prepared for use by financial advisers, and are not suitable for use by the general public. They do not constitute a recommendation to purchase, hold, redeem or sell any product(s). Lonsec ratings relate to specific funds, not to managers. The Reports do not mean or imply that Lonsec rates NZ Funds Management as a manager at a certain standard.

Indicative asset allocation benchmarks *for personalised retirement plans*

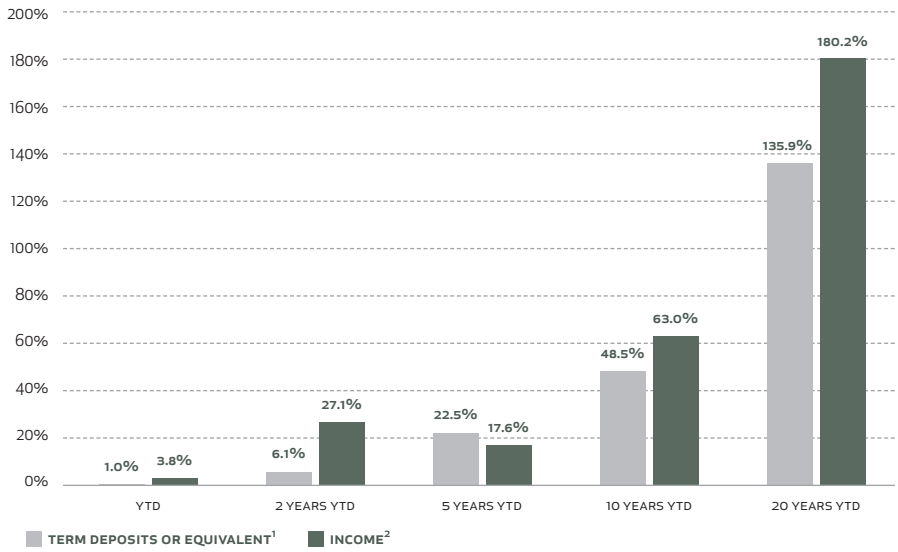
OVER THE LONG-TERM, SHARES AND VARIOUS OTHER FORMS OF GROWTH ASSETS HAVE CONSISTENTLY OUTPERFORMED THE RETURNS OF CASH.¹ THERE IS A LOT OF CONFUSION, HOWEVER, ABOUT WHAT CONSTITUTES A LONG-TERM INVESTMENT AND HOW FAR SHARES AND OTHER FORMS OF GROWTH ASSETS CAN UNDERPERFORM OVER SHORTER PERIODS OF TIME. AS CLIENTS GET CLOSE TO, OR ENTER RETIREMENT, AN IMPORTANT TOOL USED TO REDUCE THE VOLATILITY OF RETURNS IS ASSET ALLOCATION. OVER TIME, CLIENTS' RETIREMENT PLANS ARE DESIGNED TO REDUCE THEIR ALLOCATIONS TO GROWTH ASSETS AND TO INCREASE THEIR ALLOCATION TO INCOME AND INFLATION ORIENTATED ASSETS.

The outcomes of three indicative asset allocation benchmarks are shown below. The three benchmarks track the returns of a combination of asset classes (such as cash, bonds and shares) relative to term deposits (which we track via the 90-day bank bill index). The combinations of assets indicate the diverse spread of the assets that should be represented in client investment portfolios. Clients' asset allocation (the allocation clients receive to asset classes such as cash, bonds and shares) should change to match the different stages of their life. Consequently, three different combinations are shown: income orientated benchmark, balance orientated benchmark and growth orientated benchmark. The benchmarks are designed to give clients an indication of the investment timeframe and the volatility of returns associated with a retirement plan. They also provide an indication of the benefit of committing to a long-term retirement plan.

In order to make the benchmark comparable with clients' investment portfolios, the asset class returns used to create the benchmark have been adjusted for investment management fees, but not adviser fees, and an assumed PIE tax rate of 28%. Please note, these are not the actual returns of clients' personalised investment portfolios nor are they the actual returns of the portfolios managed by NZ Funds Management. If you wish to learn more about the actual long-term returns associated with investing in NZ Funds Management's portfolios please see the **Portfolio Insights**. A copy of the Portfolio Insights is available through your financial adviser or on the NZ Funds Management's website: www.nzfunds.co.nz.

1 Siegel, Jeremy J. *Stocks for the Long Run: The Definitive Guide to Financial Market Returns and Long-Term Investment Strategies*. 3d ed. New York: McGraw-Hill, 2002.

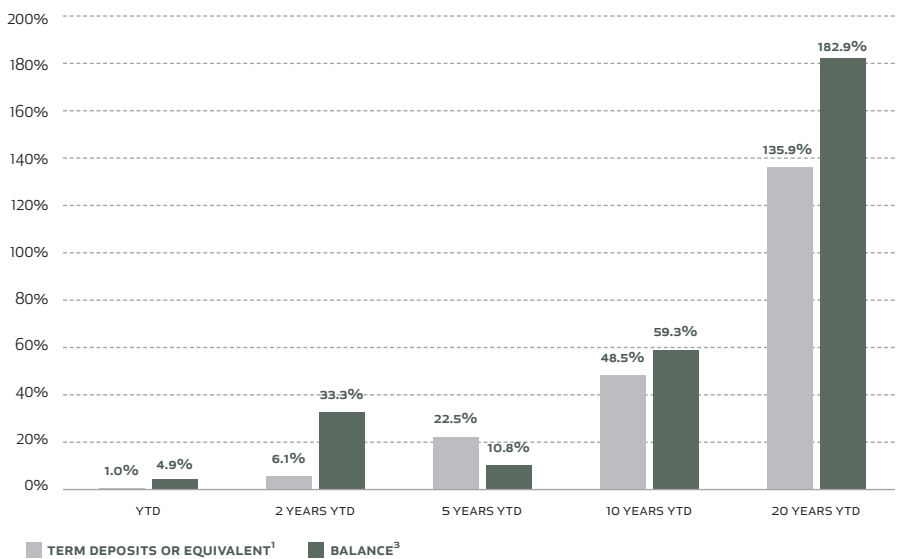
INCOME ORIENTATED ASSET ALLOCATION BENCHMARK



SOURCE: BLOOMBERG, NZ FUNDS MANAGEMENT CALCULATIONS.

The income orientated asset allocation benchmark is indicative of the combination of assets held in a retirement plan designed to deliver a targeted (and inflation adjusted) level of income throughout retirement. The benchmark allocation of assets is primarily made up of income and inflation orientated assets. Over a 20-year period (which roughly corresponds with clients' time in retirement from the age of 65 to 85) the benchmark allocation of assets would have delivered a significantly better outcome than term deposits. However, over shorter periods, such as over the last five years, the benchmark allocation of assets would have lagged term deposits. It is pleasing to see that over a two-year timeframe the benchmark allocation of assets has resumed growing at a faster rate than term deposits.

BALANCE ORIENTATED ASSET ALLOCATION BENCHMARK

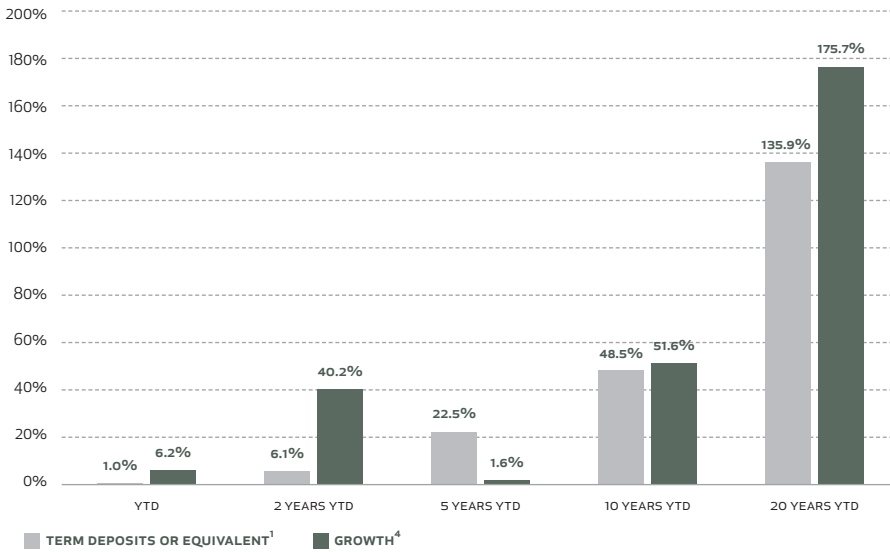


SOURCE: BLOOMBERG, NZ FUNDS MANAGEMENT CALCULATIONS.

The balance benchmark allocation of assets is indicative of the combination of assets held in a retirement plan designed for clients who anticipate retiring in the short to medium term. Such clients require a combination of assets which provide some capital stability as well as the potential for wealth accumulation. These client retirement plans and corresponding investment portfolios should balance the desire to continue growing wealth, with the need for about half of client savings to be invested in more stable assets (for example, such as those utilised in NZ Funds Management’s income and inflation orientated portfolios). As a consequence the benchmark allocation of assets is made up of a balanced mix of income, inflation and growth assets with a tilt towards income and inflation assets.

In a return by period comparison between the income orientated asset allocation benchmark (discussed above) and the balance orientated asset allocation benchmark, returns from the five-year timeframe in the balance orientated asset allocation benchmark have lagged term deposits slightly more than the income orientated asset allocation benchmark, but have delivered a comparable level of return over long-term timeframes.

GROWTH ORIENTATED ASSET ALLOCATION BENCHMARK



SOURCE: BLOOMBERG, NZ FUNDS MANAGEMENT CALCULATIONS.

“ It is pleasing to see that over a two-year timeframe the benchmark allocation of assets has resumed growing at a faster rate than term deposits. ”

“When comparing the different benchmarks it is important to bear in mind that the growth asset returns depicted above are currently being viewed from near the bottom of the economic cycle.”

A growth orientated retirement plan is designed to help clients accumulate a targeted level of wealth during their working lives and should transition into a more balanced investment portfolio as clients near retirement, as discussed above. The growth orientated asset allocation benchmark is designed to be indicative of the allocation of assets held in a growth orientated retirement plan. The benchmark allocation of assets is made up of income and growth assets with a tilt towards growth assets.

As discussed above, after several decades of significantly higher returns than term deposits, global shares delivered little or no growth for more than ten years from 2000 to 2010 – despite several significant rises and subsequent falls. Consequently the benchmark’s 10-year returns are only slightly above term deposits. However, over a twenty-year timeframe the benchmark returns are still markedly higher than term deposits.

When comparing the different benchmarks it is important to bear in mind that the growth asset returns depicted above are currently being viewed from near the bottom of the economic cycle. When viewed from the top of the economic cycle, the benchmark for growth assets is expected to be significantly further ahead than term deposits and also significantly further ahead than the equivalent return by period numbers generated by the income and balance asset allocation benchmarks. Economic cycles are discussed in more detail in the section titled: *Investment market outlook*.

Please note: For comparison purposes all returns are stated after tax, with an assumed PIE tax rate of 28% over the entire period even though the PIE tax regime only started 1 October 2007 and different PIE tax rates have applied since then. (1) Term deposit returns have been estimated using the New Zealand 90-day bank bill index. For term deposits, no adjustment has been made for assumed investment management fees or advice fees. (2) (3) (4) The benchmark returns are based on NZ Funds Management’s current opinion on what the indicative asset allocation of the three different types of retirement plans should be. The returns shown in each of the outcomes apply the same PIE tax regime (as applicable currently) across all the published periods even though the PIE tax regime only started on 1 October 2007.

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