NZ FUNDS

CIO Report: Q1 - Q2 2016

March 2016

First quarter review

Each quarter we include a section on investment returns. This quarter we thought it might be helpful to set out the returns of each portfolio we manage, year by year.

Clients' portfolios are of course made up of a diversified mix of the PIE portfolios set out below. Each client will own a unique blend, specific to (and changing with) their age, risk profile and investment objectives.

When comparing our returns with term-deposits, or other sources of investment returns **please note all returns are after fees and tax at the highest applicable tax rate***. The returns shown are therefore what clients should receive each year, less any fixed charge for their adviser's time.

Calendar returns to 14 March 2016 after fees and tax

NZ Funds Managed Portfolio Service	YTD[†]	2015	2014	2013	2012	2011	Since inception[†]	Inception date
Core Cash Portfolio	0.39%	2.33%	2.28%	1.83%	1.78%	1.82%	26.85%	28 Feb 2008
Core Income Portfolio	1.04%	1.69%	3.89%	2.31%	5.92%	2.82%	31.28%	23 Jul 2008
Global Income Portfolio	1.26%	0.74%	3.04%	1.58%	5.16%	2.21%	24.88%	31 Oct 2008
Core Inflation Portfolio[1]	-0.98%	0.32%	9.47%	4.12%	9.03%	1.92%	42.44%	31 Oct 2008
Property Inflation Portfolio	-2.00%	7.00%	13.48%	1.92%	17.66%	-5.56%	42.05%	31 Oct 2008
Equity Inflation Portfolio[1]	-0.18%	6.31%	13.95%	8.89%	6.50%	-0.44%	108.07%	31 Oct 2008
Core Growth Composite Strategy[2]	-5.68%	2.91%	5.79%	24.85%	13.05%	-9.09%	89.34%	1 May 2003
Global Multi-Asset Growth Portfolio[3]	-0.69%	-20.14%	-15.50%	-2.05%	-3.23%	-	-38.16%	7 Nov 2011
Global Equity Growth Composite Strategy[2]	-7.05%	5.94%	12.60%	22.32%	15.00%	-12.51%	121.90%	6 Mar 1996
Dividend and Growth Composite Strategy[2]	2.16%	12.22%	14.98%	3.63%	18.41%	-10.04%	326.94%	2 Dec 1992
Capital Opportunities Portfolio	-6.86%	3.73%	9.01%	12.47%	20.61%	13.51%	79.94%	23 Jul 2008
NZ Funds KiwiSaver Scheme	**YTD[†]**	**2015**	**2014**	**2013**	**2012**	**2011**	**Since inception[†]**	**Inception date**
KiwiSaver Income Strategy	1.24%	1.01%	3.43%	2.01%	5.64%	2.56%	17.02%	31 Oct 2010
KiwiSaver Inflation Strategy	-0.82%	1.29%	10.72%	5.27%	8.66%	-0.27%	26.99%	31 Oct 2010
KiwiSaver Growth Strategy	-7.75%	4.70%	9.88%	26.12%	15.15%	-10.61%	37.87%	31 Oct 2010
Term deposit index[4]	**YTD[†]**	**2015**	**2014**	**2013**	**2012**	**2011**	**Since inception[†]**	**Inception date**
Six month term deposit rates	0.46%	2.78%	2.60%	2.65%	2.82%	3.06%	-	-

* The tax rate applied is either the highest PIE tax rate (28% or 30%) or the highest corporate tax rate (33% or 30%) applicable during each return period.

† Year to date and since inception returns are to 14 March 2016.

1 Performance is measured since the launch of the APS platform (now known as NZ Funds Managed Portfolio Service) on 31 October 2008. The post tax since inception returns for the Core Inflation Portfolio and the Equity Inflation Portfolio include the benefit of formation tax losses under the PIE rules.

2 The Composite Strategies are used to illustrate the long-term performance of the investment approach used in managing the Portfolios. They do not represent the historic returns of the Portfolios, nor are they indication of the future returns of the Portfolios.

The Composite Strategies are tax-adjusted to remove, as much as possible, the impact of the different tax regimes that applied during the calculation period.

3 The inception date shown is the inception date of the current investment strategy.

4 Source: RBNZ, NZ Funds Calculations. The highest marginal personal tax rate was used in these calculations.

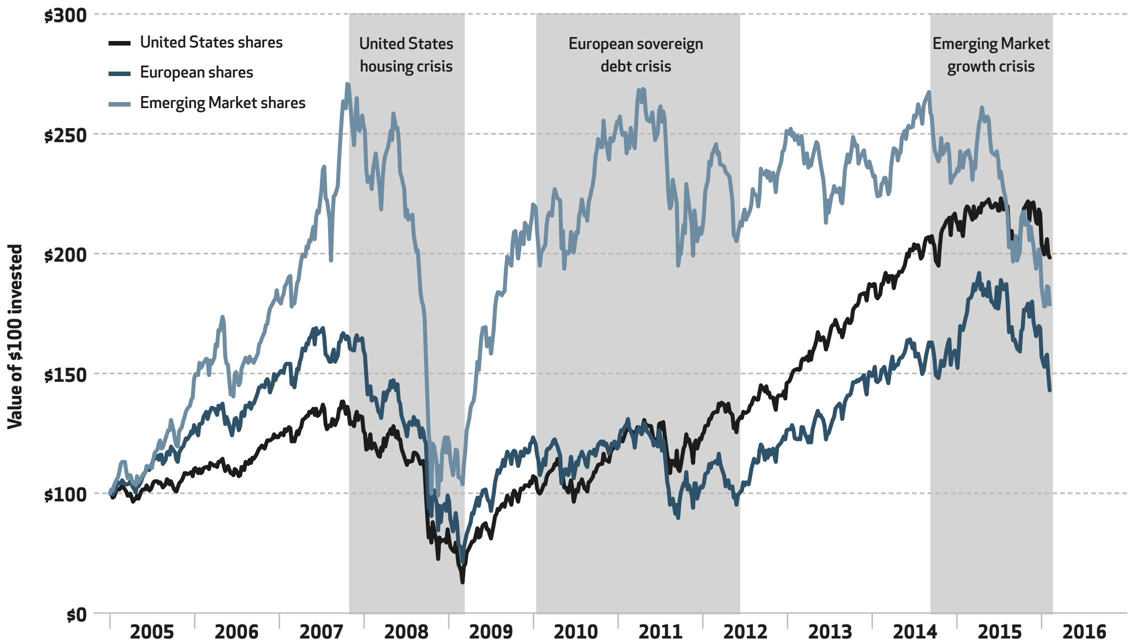
Pre tax returns are stated after Portfolio fees and expenses, but before any advisory fees or investor tax. Post tax returns are stated after Portfolio fees and expenses and investor tax at the highest Prescribed Investor Rate (PIR). From 1 October 2008 to 30 September 2010 the highest PIR was 30%. Since 1 October 2010 the highest PIR has been 28%. Past performance is not necessarily an indication of future returns.

Investment themes for 2016

Following seven years of economic recovery, financial markets have entered a period of higher volatility. Much, if not all, of the volatility stems from concerns over China's growth and oil prices. China represents the third wave of the Global Financial Crisis. Unlike many downturns, the Global Financial Crisis is a debt-related crisis. It originated in the United States, through excessive borrowing and aggressive 'sub-prime' lending. It was resolved by recapitalising the American banking system in 2009. However, it then spread to Europe in 2011, where successive governments of Portugal, Ireland, Greece and Spain had over borrowed. This led to a period of European Union imposed austerity which saw unemployment rise and countries question the merit of their European Union membership.

Throughout this period, in order to maintain its growth rate, China borrowed heavily to build everything from high-speed rail links to entire cities. China's trading partners, riding on its coat tails, earned nicknames such as 'the lucky country' (Australia) and 'the rock star economy' (New Zealand). In recent years however, China's ability to borrow and build productive assets appears to be reaching a natural limit. It is the Party's hope that as state spending declines, China's growing middle class will fuel economic growth by embracing small luxuries, like lattes and cinema tickets.

Asia - The third wave



Source: S&P 500, Euro Stoxx 50 Index, MSCI emerging markets index. All values in United States dollars.

We recently travelled to Hong Kong to learn more about the problem first-hand. During the course of the week we spent a day with the management teams of the two largest casino operators in Macau, attended the two-day Global Macro conference along with 2,000 others, and had a series of one-to-one meetings with some of the top local investors.

In the first quarter the investment team, overseen by our Investment Committee (which is chaired by NZ Funds Chief Executive, Richard James and attended by senior members of the firm and from time to time our independent director, Greg Horton) began an intensive review process. To date we have reviewed: the universe of specialist managers we work with (earmarking two for redemption and one for inclusion); the weight to each major asset type; and the investment case for each individually held bond and share. We expect the process of discarding investments where the upside potential is limited and reinvesting the proceeds into more of the most compelling investments clients already own, will in time add to client outcomes.

The following is a short synopsis of our views following our research trip and internal review process:

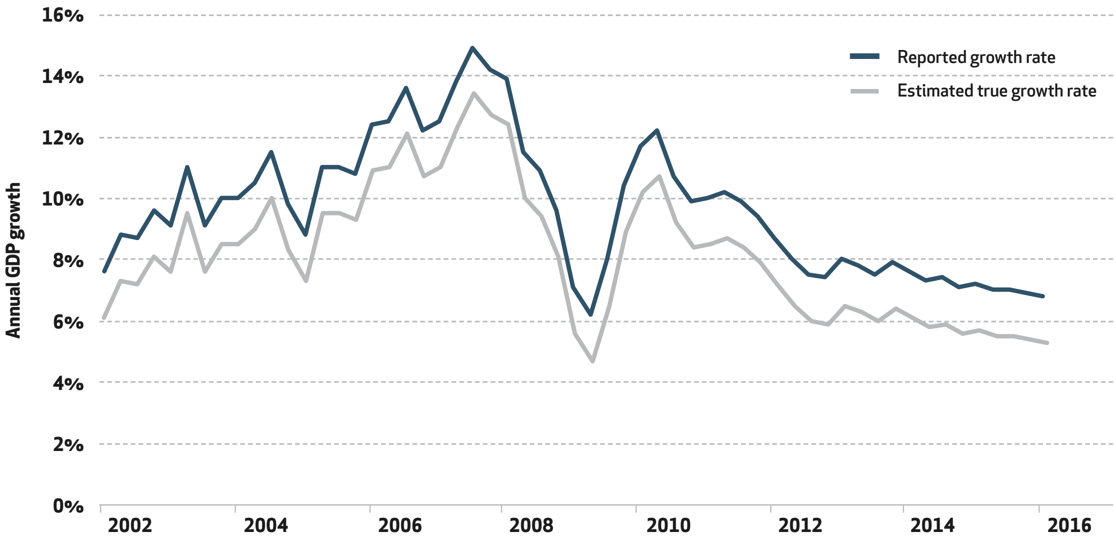
China

China faces slowing growth and rising debt. Over a decade of excessive infrastructure spending and urbanisation has created a property bubble which is now correcting. Economic growth is reported to be approximately 6%, but is estimated to be 1-2% less than reported. Most importantly, growth continues to slow as rising consumption is still insufficient to offset declining infrastructure spending.

In the short term, China must also contend with a fixed exchange rate which is too high. If the People's Bank of China allows the Chinese currency to devalue, it will put pressure on a large number of Chinese companies which have borrowed offshore (it would increase their debt burden). On the other hand, a high exchange rate hurts China's exporters that are major contributors to GDP.

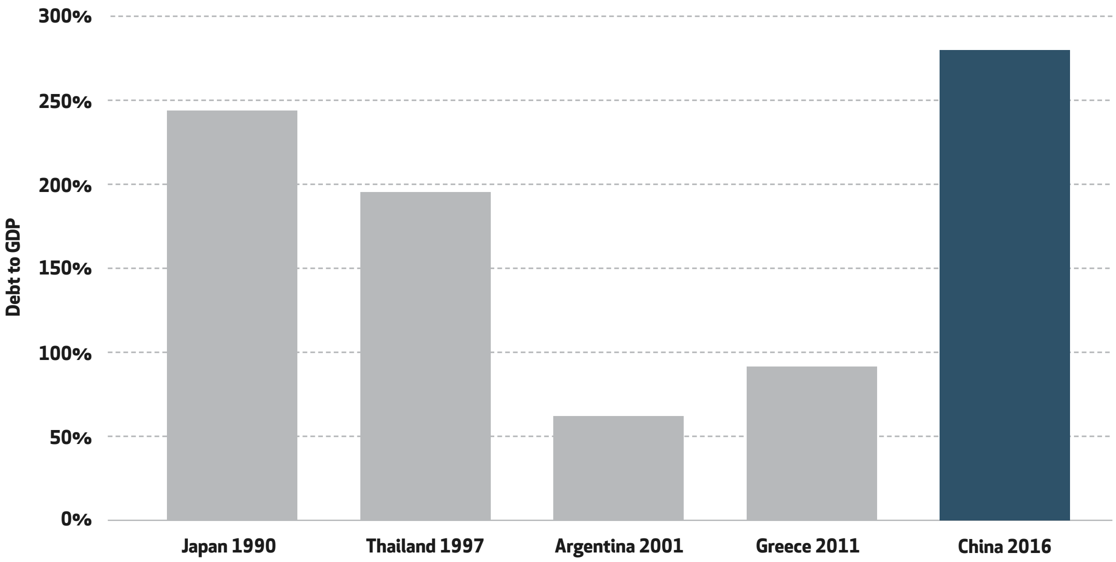
We believe the problems in China are more significant than many think. China needs to reduce its debt by either realising non performing loans and sharply devaluing its currency, or by facing a longer period of weak economic growth, much as Japan did. Either way, in the short term, the risks of further meaningful downside are too high for a long-term allocation to the region.

Asia - The great fall of China



Source: National Bureau of Statistics of China, NZ Funds estimates.

Asia - How much debt is too much?



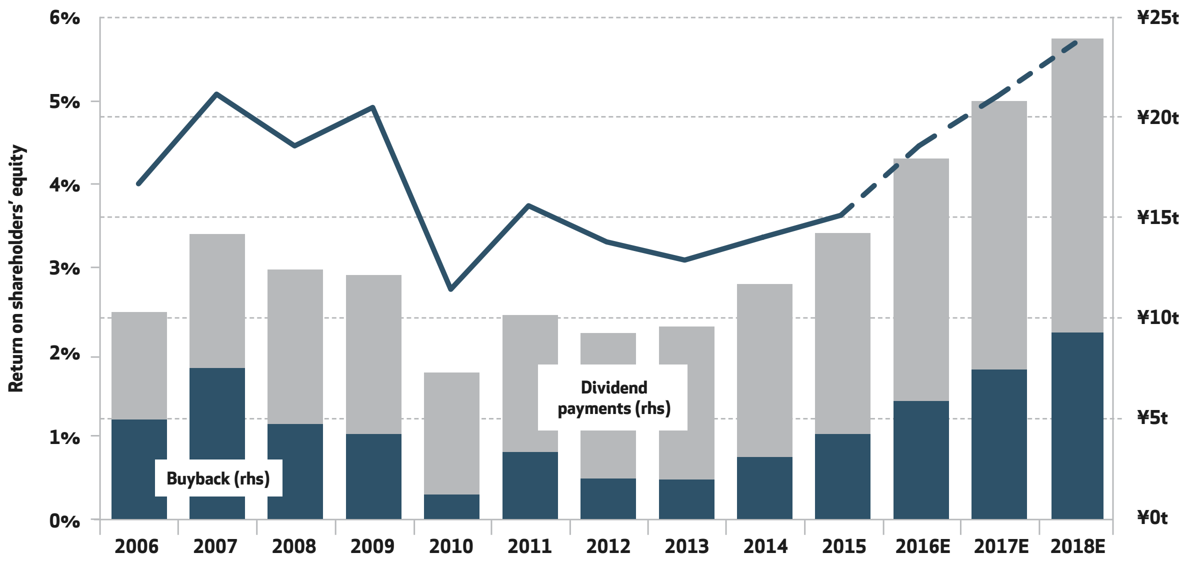
Source: National Bureau of Statistics of China, NZ Funds estimates.

Japan

Japan represents an exception to this rule. Whereas China faces a strong growth hangover, Japan is only now emerging from three decades of price and cost cutting. We think Japanese shares are two or three years into a multi-year period of strong share price appreciation fuelled by rising domestic demand, improving profit margins and shareholder friendly corporate governance reforms. After outperforming many developed markets over the last 12 months, the average Japanese company still only trades on 13x earnings or a 10% premium to book value. In contrast, many American, European and Australasian companies are valued at twice that level or more.

No capital gain comes without challenges, and Japan certainly has those. Japan must contend with an aging workforce although it has higher female workforce participation than America, Europe or even New Zealand. It is also vulnerable to a slowdown in China but that is in part mitigated by strong internal consumption that makes up 58% of its GDP. Despite these challenges, we are growing increasingly optimistic about the long-term upside potential in Japanese shares.

Governance reforms help drive shareholder returns to record levels



Note: Based on TSE1-listed 1,816 firms with consolidated data available from March 2009. For periods prior to March 2009, calculation is based on available data.
Source: Toyo Keizai, QUICK, FactSet, Goldman Sachs Global Investment Research and estimates for 2016-2018.

Japan - Largest portfolio holdings

Company	Sector	Forecast Earnings Growth	Forecast Dividend Yield	Expected Return
Fast Retailing	Retail	21.0%	3.8%	24.8%
Nippon Telegraph & Telephone	Telecommunications	10.2%	5.0%	15.2%
FANUC	Industrial Robotics	-5.1%	5.4%	0.3%
SoftBank	Telecommunications	10.0%	3.4%	13.4%
KDDI	Telecommunications	8.0%	5.0%	13.0%

Source: Bloomberg, NZ Funds calculations at 8 March 2016. Includes $31m notional Nikkei 225 futures exposure. All values in New Zealand dollars.

New Zealand

We believe New Zealand is more vulnerable to a slowdown in China than many would like: we face a flattening in Christchurch rebuild spending; milk prices that are meaningfully below the long-term sustainable price for production; the potential for rising unemployment; and in Auckland, a residential property bubble. Helping to offset this we have low interest rates, a weak exchange rate and strong positive net migration.

We have selectively increased our exposure to New Zealand shares favouring large essential spend–orientated blue chip companies with strong dividend yields. We continue to avoid commodity orientated companies without pricing power (such as Fonterra Co-operative Group) and discretionary consumer orientated businesses (such as Sky Network Television). We also own very few small capitalisation companies which are dependent on earnings growth, rather than dividend payments, for delivering shareholder returns.

New Zealand - Economy mixed

Source: Bloomberg, NZ Funds calculations.

New Zealand - Largest portfolio holdings

Company	Client Holdings	Forecast Earnings Growth	Forecast Dividend Yield	Expected Return
Chorus	$34m	2.9%	7.4%	10.3%
Meridian Energy	$29m	3.5%	9.0%	12.5%
Metlifecare	$27m	10.7%	1.3%	12.0%
TrustPower	$12m	4.6%	7.4%	12.0%
Z Energy	$12m	4.7%	6.7%	11.4%

Source: Bloomberg, NZ Funds calculations at 7 March 2016. Forecast Dividend Yields shown gross of imputation credits.

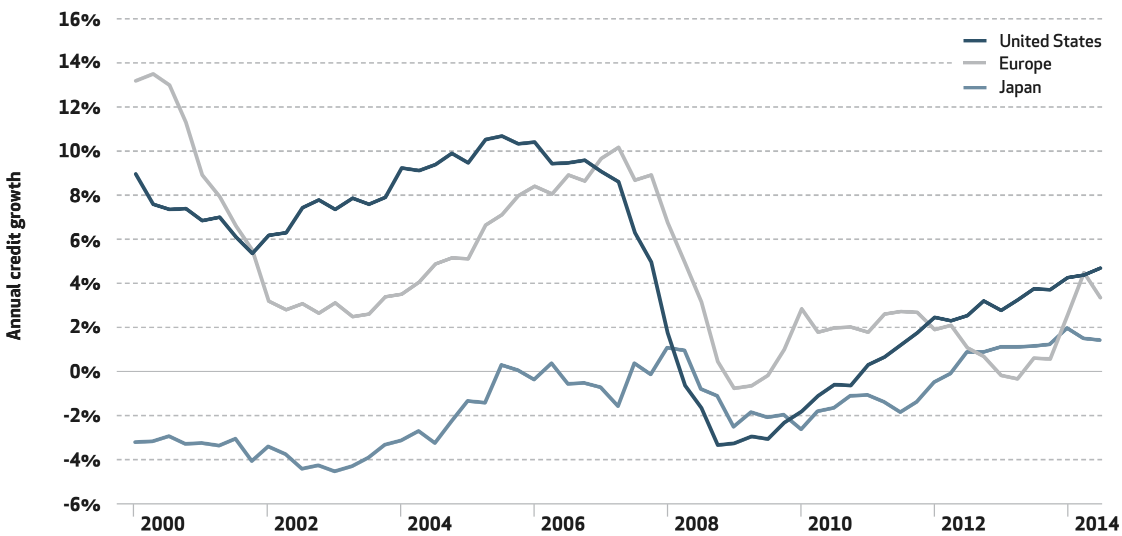
United States/Global Economy

Despite the weak start to the year we see little wrong with the United States economy, or Europe's. Economic growth is forecast to be between 2.0 – 2.5% which is in line with the average since 2009. And while market sentiment is sensitive to news on oil and China, most listed American businesses are not. United States corporates generate 65% of their revenue from selling to Americans who currently enjoy rising employment, rising wages and a boost from lower oil prices.

Consensus is for around 5% earnings growth from listed American companies, little or no change in margins and a slight contraction in valuations caused by a gradual rise in United States interest rates. This would result in returns in the 5-10% range. Valuations remain of moderate concern; in Europe and America they are generally toward the top end of fair (arguably lower end of expensive), however markets can remain at these levels for many years without "correcting".

We continue to own a long-term index orientated exposure to American and European companies, but given higher than usual valuations we have increased the proportion of clients' assets managed by experts in the region. Three such specialists are: Kynikos Associates, who adds value by shorting the weakest shares in an index, rather than owning more of the strongest shares in an index; LSV Asset Management, which was founded by three famous academics who decided to manage money based on their research and now oversee US$82 billion using their value approach; and New York based hedge fund, Suvretta Capital Management, which has delivered returns of 8.6% per annum since NZ Funds first invested in October 2014, despite considerable share market volatility.

World credit growth = GDP growth



Source: International Monetary Fund.

United States/Global - Largest portfolio holdings

Company	Client Holdings	Forecast Earnings Growth	Forecast Dividend Yield	Expected Return
Johnson & Johnson	$5m	5.2%	5.1%	10.3%
Microsoft	$4m	4.9%	5.0%	9.9%
Twenty-First Century Fox	$4m	-2.1%	3.1%	1.0%
Total	$4m	-33.0%	8.7%	-24.3%
Pfizer	$3m	3.9%	6.1%	10.0%

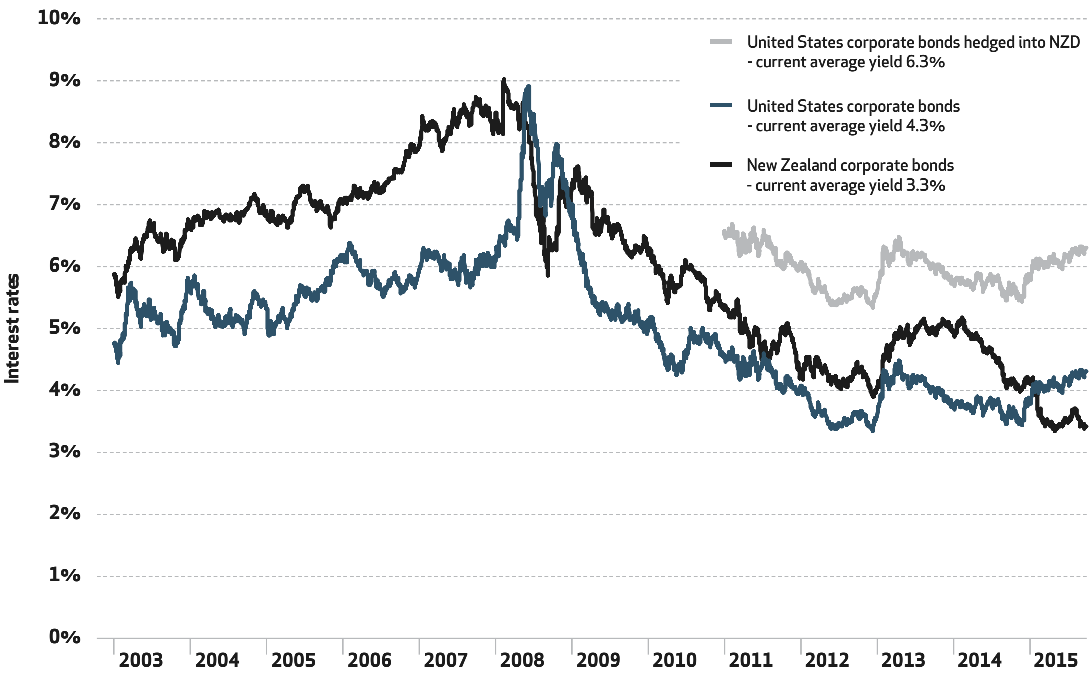
Source: Bloomberg, NZ Funds calculations at 31 December 2015. All values in New Zealand dollars.

Corporate Bonds

Following the Reserve Bank of New Zealand's surprise interest rate cut it is also worth discussing the merit of corporate bonds. Corporate bonds have been promoted as a handy way to earn a premium over term deposits. And ordinarily this is the case. However, few clients are aware that approximately 50% of the 200 individual bonds on issue in New Zealand yield less than term deposits! We feel owning some of these bonds is like picking up pennies in front of a steam roller.

To illustrate how expensive New Zealand bonds have become, clients can purchase investment grade rated bonds issued by some of the largest companies in the world, such as Apple or Verizon Communications, and earn 1 or 2% more in interest per annum after hedging all exchange rate risk out – which is exactly what we have been doing on clients' behalf in their income orientated portfolios.

United States - How do United States Investment Grade bonds compare?



Source: S&P; NZ Corporate Bond Index; Juli Corporate Bond Index; Bloomberg; NZ Funds estimates.

United States/Global - Largest portfolio holdings

Company	Client Holdings	Credit Rating	Bond Expiry Date	New Zealand dollar yield
Apple	$8m	AA+	9 years	4.7%
Oracle	$8m	AA-	9 years	4.7%
Verizon Communications	$7m	BBB+	8 years	5.1%
QBE Capital Funding III	$6m	BBB	25 years	7.1%
Macy's Retail Holdings	$5m	BBB+	8 years	6.5%

Source: Bloomberg, NZ Funds calculations at 4 March 2016. All values in New Zealand dollars.

Themes for 2016

The investment focus for 2016 falls under six themes. First, an increased allocation to strong dividend paying, large market capitalisation New Zealand shares. This underwrites a core level of return in the inflation and growth orientated portfolios, dampening any share market decline, and aiding any share price appreciation. Second and third, clients' international growth assets are predominately invested in the large developed markets of United States, Europe and Japan and underweight China. Fourth, we have increased clients' exposure to international investment grade bonds to take advantage of their premium over locally issued bonds. Fifth, we will be actively managing clients' exposure to the three asset classes we expect above average volatility from: interest rates, foreign currencies, and oil. Finally, we will continue to partner with a range of international specialists, including down-side orientated hedge funds, to seek to capture asset price appreciation and mitigate periods of downside volatility.

Investment themes

According to Chinese astrology 2016 is the year of the fire monkey. The fire monkey is ambitious, adventurous, and from time to time irritable. We expect financial markets to be much the same this year. Thank you for investing with us, and for your continued confidence.

Michael Lang, CFA
Chief Investment Officer

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