NZ FUNDS

CIO Report: Q4 2015

January 2016

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Fourth quarter review

Returns over the last 12 months failed to meet our expectations, and we expect you feel similarly.

During the second half of 2015 our performance was negatively impacted by the sharp decline in oil prices, our limited exposure to longer-dated bonds and our higher exposure to international shares relative to New Zealand shares. Sometimes the markets reward your positioning and other times they do not. The last few months have certainly been the latter.

We were particularly disappointed with the performance of the Core Inflation Portfolio and its KiwiSaver equivalent, the KiwiSaver Inflation Strategy. In a volatile market, as we experienced in 2015, it is difficult to both protect clients' capital and achieve growth.

Portfolio management is a dynamic endeavour. We are continually analysing and refining how we implement client portfolios, taking into account the changing market environment and the insights from our own experiences and research. We continue to refine the portfolios in the ongoing pursuit of balance between capturing upside and mitigating downside.

In KiwiSaver we have now completed five years using our active approach. The period witnessed a total return for KiwiSaver members of 60%* in the Growth Strategy, 33%* in the Inflation Strategy and 22%* in the Income Strategy. To December 2015 investment profits had added $14.4 million in total to the NZ Funds KiwiSaver Scheme which stood at $127 million at year end.

Across both the NZ Funds Managed Portfolio Service and KiwiSaver Scheme an evaluation of the proportion of positive market returns captured, relative to the proportion of downside experienced, indicates good results for the approach over the medium term.

60 year old model client outcome (after tax and fees[1]) as at 31 December 2015

NZ Funds Managed Portfolio Service	1 year	2 year (pa)	3 year (pa)	4 year (pa)	Since inception[2] (pa)
Performance[1]	1.97%	4.12%	5.25%	6.24%	5.86%
Index[3]	2.01%	4.23%	6.19%	6.62%	6.38%
Up capture[4]	97%	89%	84%	86%	84%
Down capture[4]	97%	79%	83%	70%	67%

[1] Client outcome is after all tax and fees paid by the Portfolios and assumes the highest PIR is paid by the client. [2] 11 November 2011. [3] Index is calculated as 30% 90 day bank bill index, 30% Barclays Global Aggregate Index (hedged to NZD) and 40% MSCI All Country Index (hedged to NZD). Taxed at the highest marginal tax rate. A fee of 0.75% has been deducted to reflect the cost of accessing and rebalancing the index.
[4] Calculated using monthly prices. The capture measure is the average proportion of the index performance achieved in months that the index either appreciated (up capture) or declined (down capture).

40 year old model client outcome (after tax and fees[1]) as at 31 December 2015

NZ Funds KiwiSaver Scheme	1 year	2 year (pa)	3 year (pa)	5 year (pa)	Since inception[2] (pa)
Performance[1]	4.24%	6.93%	11.92%	7.81%	7.56%
Index[3]	1.79%	4.60%	7.91%	6.11%	6.80%
Up capture[4]	141%	119%	131%	122%	120%
Down capture[4]	122%	95%	103%	117%	122%

[1] Client outcome is after all tax and fees paid by the Strategies and assumes the highest PIR is paid by the client. [2] 1 November 2010. [3] Index is calculated as 20% 90 day bank bill index, 20% Barclays Global Aggregate Index (hedged to NZD) and 60% MSCI All Country Index (hedged to NZD). Taxed at the highest marginal tax rate. A fee of 1.00% has been deducted to reflect the cost of accessing and rebalancing the index.
[4] Calculated using monthly prices. The capture measure is the average proportion of the index performance achieved in months that the index either appreciated (up capture) or declined (down capture).

*Please note that past performance is not necessarily an indication of future returns.

Surviving market turmoil, should it occur...

Share markets have begun the year with a sharp decline. To the end of January, the United States share market had fallen 5.1%, global shares were down 5.4%. Even the recently stable, dividend yielding, local market had suffered a 2.5% setback.

Is it time to panic? We don't think so.

The client portfolios we manage are not the share market. Instead they hold a diversified range of investments selected and overseen by local and international investment specialists. There are a number of reasons we believe clients should feel confident that their portfolio will withstand the current market malaise. But first a brief summary of the market's current concerns.

A slower China impacts all

The growth rate of the Chinese economy has been slowing for a number of years now. How fast this is occurring no one outside of China knows. The depreciation of the Chinese Renminbi in August and again in January raised concern that China may be slowing faster than expected, demonstrated by capital flight, and that the "State knows best" veneer may be starting to crack. Over the medium term China faces a growth digestion problem: it has an extended property market, stock market, debt market and currency market. In our view China needs to devalue its currency and face the risks of a currency war, or tough out a recession. With China now integrated into the world's trading system, whatever happens next in China will be felt by all.

The great fall of China - stalling economic growth?

Source: National Bureau of Statistics of China.

Lower oil prices are a double edged sword

Global share markets have also been tracking the collapsing price of oil. Over the last 12 months oil has fallen 38% driven by anaemic global demand growth and excess supply from Saudi Arabia, North American shale producers and, more recently, renewed Iranian supply. While lower petrol prices leave more money in American and European wallets, this is to the detriment of oil producing nations and companies. Lower oil is likely to lead to a sharp economic downturn for those emerging market economies who depend on oil exports such as Russia, the Arab states, Venezuela and Brazil. And lower emerging markets growth, like slower Chinese growth, could lead to less growth for all of us. Financial markets would prefer a goldilocks oil price: not too high, but not too low.

The price of a barrel of oil

Source: Bloomberg.

Company profits on the wane?

The United States is currently in the midst of company profit announcements. In aggregate this is showing a decline in profits, with company profits expected to fall by around 6% from a year ago. This is the first decline in company profitability since the 2008-2009 global recession. While most of these declines are in the energy sector (for the reasons explained above), there is widespread concern that this decline could signal that global share markets are overvalued. There is also concern that the decision by the United States' central bank (the Federal Reserve) to raise interest rates will slow the economy and place additional downward pressure on company profitability.

Economists are notorious for being unable to forecast recessions. Nevertheless, most economic indicators are suggesting the United States economy is continuing to grow and at present is unlikely to fall into recession. Company profitability is also a mixed basket with sectors such as healthcare, consumer discretionary and telecommunications reporting profit growth. These sectors are also large employers so unemployment seems unlikely to rise in the medium term.

Staying the course

Despite these concerns there are a number of reasons to feel comforted, especially if you have been working with an Authorised Financial Adviser or are using our proprietary LifeCycle asset allocation approach in your KiwiSaver scheme. Here are our top five.

1. Our client portfolios are widely diversified

Client portfolios contain a lot more than just shares.

A diversified portfolio is unlikely to rise (or fall) as much as the share market. In total NZ Funds uses approximately forty different asset types to build a client portfolio. These range from cash and government bonds to listed property, commodities and shares as well as foreign currencies like the United States Dollar and the Euro.

More than just shares: A broad universe of investment opportunities

Income

New Zealand Government Bonds	Australian Corporate Bonds
Australian Government Bonds	International Corporate Bonds
International Government Bonds	Mortgage-Backed Securities
New Zealand Corporate Bonds	Government Sponsored Bonds

Inflation

New Zealand Inflation Linked Government Bonds	New Zealand Listed Property
New Zealand Inflation Linked Corporate Bonds	International Listed Property
International Inflation Linked Bonds	Commodity Futures
New Zealand Floating Rate Bonds	Other Foreign Currencies
International Floating Rate Bonds	Alternative Asset Specialists
Inflation Sensitive Shares	Floating Rate Mortgage Bonds

Growth

New Zealand Shares	Precious Metals Futures Contracts
Australian Shares	Base Metals Futures Contracts
International Shares	Hedge Funds
Emerging Market Shares	Futures Contracts & Options
Small Company Shares	Government Bonds
Oil & Gas Futures Contracts	Corporate Bonds
Agricultural Futures Contracts	Mortgage-Backed Securities

*NZ Funds is an active investment manager. Any assets referred to above may or may not be held by the Portfolios and Strategies at any given point in time.

Each asset type has the potential to generate returns over time. Importantly, the timing of when returns are generated differs by asset type. For example, long-term investment grade bonds and government bonds tend to do well when economic growth is weak, commodities tend to rise when inflation rises, and foreign currencies offer profit opportunities during periods of volatility.

Diversity of returns across the economic cycle

Asset class	1995 - 2000	2001 - 2005	2006 - 2010	2011 - 2015	Cumulative
International Shares	97%	11%	11%	55%	276%
New Zealand Shares	22%	104%	9%	96%	430%
Commodities	42%	66%	6%	-51%	22%
Bonds	47%	37%	27%	25%	219%
Property (Listed)	38%	121%	15%	47%	417%
Hedge Funds	98%	47%	36%	19%	372%

Source: MSCI All Country Equity Index (in local currency), NZSE40 Gross (to Jan 2001), NZX Portfolio Index (from Jan 2001), Bloomberg Commodity Index, CITI World Bond Index (hedged to USD) (to Dec 2001), Barclays Global Aggregate Total Return (Hedged to USD) (from Dec 2001), FTSE EPRA/NAREIT Developed World Listed Property Index (in USD), Credit Suisse Hedge Fund Index.

2. Our client portfolios are actively managed by global experts

We take an active approach to managing our clients wealth. We believe it makes sense to select which companies to own, locally and internationally, and to seek to reduce clients' exposure to those assets which become overpriced or threaten to erode in value.

To assist us in implementing such an approach, NZ Funds has built up a network of global investment specialists. They include some of the biggest, and best, in the world. In many of these relationships our clients enjoy exclusive management arrangements, bespoke mandates, and access to research and investment market insights.

Our network of global investment specialists

Astenbeck
Southport CT, USA
FUM: USD 2.6 billion[1]

Blackrock
New York City NY, USA
FUM: USD 4.77 trillion[2]

LSV Asset Management
Chicago IL, USA
FUM: USD 82 billion[3]

Paulson & Co
New York City NY, USA
FUM: USD 19.3 billion[4]

Semper Capital Management
New York City NY, USA
FUM: USD 1.3 billion[5]

State Street/ DoubleLine
Los Angeles CA, USA
FUM: USD 76 billion[6]

Suvretta
New York NY, USA
FUM: USD 1.6 billion[7]

Kynikos
New York NY, USA
FUM: USD 3 billion[8]

Universa
Miami FL, USA
FUM: USD 246 million[9]

Wellington Management
Boston MA, USA
FUM: USD 898 billion[10]

Brevan Howard
London, United Kingdom
FUM: USD 27 billion[11]

H2O
London, United Kingdom
FUM: USD 8 billion[12]

Harness
Vésenaz, Switzerland
FUM: USD 619 million[13]

International Standard Asset Management
London, United Kingdom
FUM: USD 1.05 billion[14]

Odey Asset Management
London, United Kingdom
FUM: USD 11.2 billion[15]

TT International
London, United Kingdom
FUM: USD 8.4 billion[16]

Devon
Auckland, New Zealand
FUM: NZD 1 billion[17]

NZ Funds
Auckland, New Zealand
FUM: NZD 900 million[18]

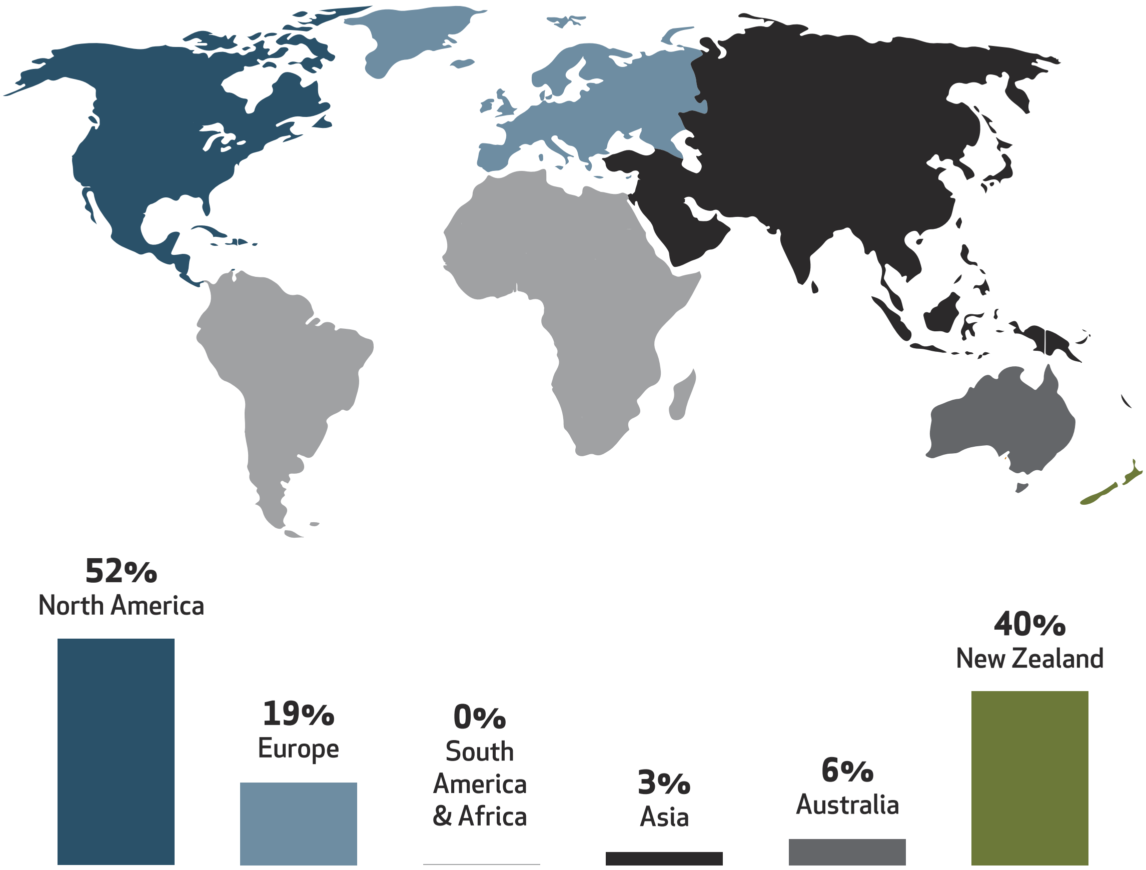
*List of investment managers at 26 November 2015. [1] Astenbeck Capital Management at 31 October 2015. [2] BlackRock at 30 September 2015. [3] LSV Asset Management at 30 September 2015. [4] Paulson & Co at 1 March 2015. [5] Semper Capital Management at 1 April 2015. [6] DoubleLine at 30 June 2015. [7] Suvretta Capital Management at 1 April 2015. [8] Kynikos Associates at March 2015. [9] Universa Investment at August 2015. [10] Wellington Management at 30 September 2015. [11] Brevan Howard at 27 February 2015. [12] H20 Asset Management at 31 March 2015. [13] Harness Investment Group Limited at October 2015. [14] International Standard Asset Management at 1 November 2015. [15] Odey Asset Management at 30 October 2015. [16] TT International at 30 June 2015. [17] Devon Funds Management at March 2015. [18] NZ Funds at 31 October 2015.

3. Our clients own few emerging market assets

Our typical client portfolio has around 46% invested in New Zealand and Australia. This exposure enables clients to invest in what they know and take advantage of New Zealand's favourable tax regime for Australasian shares. However, NZ Funds also diversifies clients' portfolios internationally so that they are not reliant on any one economic region to achieve their financial goals. The two largest regions in which clients hold investments are North America at 52% and Europe with 19%.

Clients' exposure to emerging markets (including China) has been modest for a number of years. This is predominantly due to concerns that the low interest rate environment in the United States will affect these countries.

Not reliant on one economy: Clients' local and international spread



NZ Funds average client estimate as at 31 December 2015.

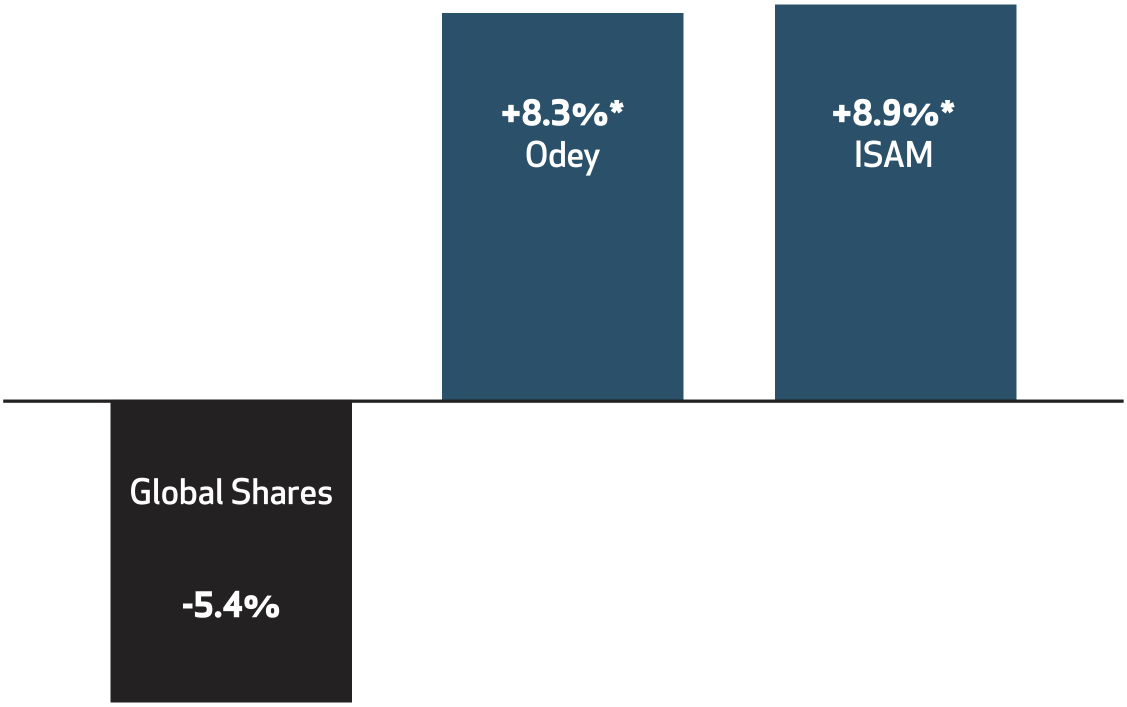
4. Our client portfolios have downside mitigation strategies

Among the investment specialists we employ are a group of managers who seek to profit from financial market volatility. For example, United States based Universa holds a portfolio of deeply out-of-the-money options which have the potential to sharply appreciate in value should global financial markets decline significantly. International Standard Asset Management (ISAM) – the London based trend following futures manager – seeks to profit from significant rises or falls in the prices of financial futures contacts. United Kingdom based Odey Asset Management invests a portion of client assets in whichever asset they believe will benefit most from a change in global macroeconomic conditions. Crispin Odey, the manager of the fund, currently has a negative view on the global economy and this is reflected in his fund's positioning.

January 2016 was one of the worst starting months financial markets have experienced for a number of years. While Universa did not make a meaningful contribution (they tend to profit from larger and more extended declines) both ISAM and Odey were up over 8% for the month against a world share market which fell more than 5%.

We remain confident that should we experience a deeper and more protracted decline, our downside managers will come to the fore.

Profiting from fear: January 2016



Source: NZ Funds, MSCI, Bloomberg. *Please note that past performance is not necessarily an indication of future returns.

5. Got a plan? Stick to it

Our primary objective remains to grow clients' capital after tax and fees over time, at a faster rate than term deposits. In order to achieve this clients need a financial plan and a corresponding investment portfolio and the disclipline to stay the course.

The most important role we, and the advisers we work with, perform is helping each client design and implement a financial plan for life. We can then match the assets each client owns to their personal financial objectives – whatever they may be.

An Authorised Financial Adviser should ensure that each clients' plan and portfolio is regularly reviewed (and rebalanced where necessary) to take into account any major changes in circumstances, in either the client's life or in financial markets.

History shows that having a portion of your wealth invested in growth orientated assets, like local and international shares, really pays off over time, even if it gets tough from time to time. It is important to remember that over every 15-year period since World War II shares have produced positive returns. In many of those periods growth oriented investors more than doubled their money, far exceeding the returns available from term deposits during the same period.

The power of growth assets

AGE: 45
RETIRES AT 65

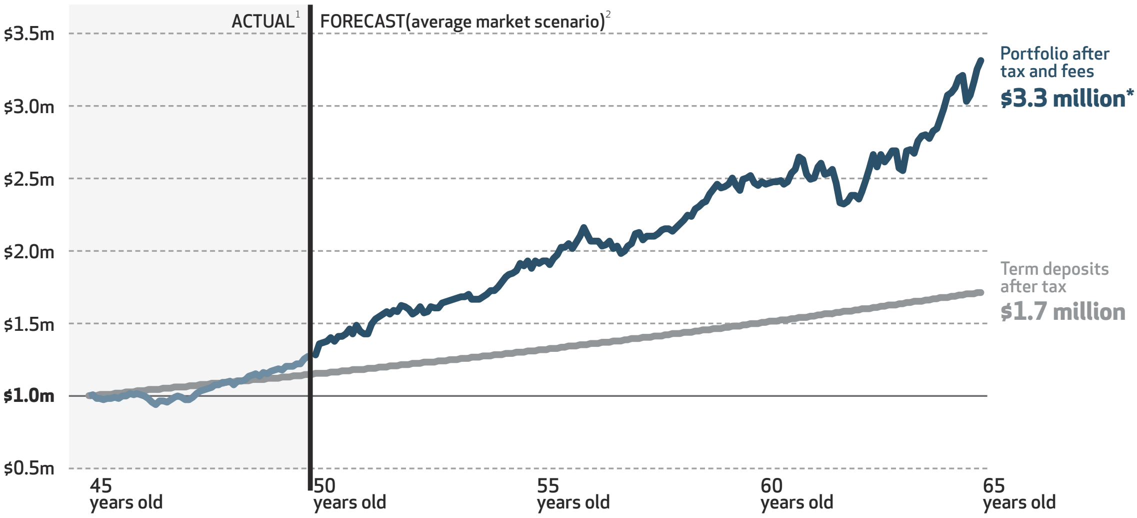
INVESTMENT:
$1.0M

MODERATE
RISK PROFILE

TIMEFRAME:
20 YEARS

PIE TAX RATE:
28%

TILTS:
NONE



Source: NZ Funds. *Please also note that past performance is not necessarily an indication of future returns.
[1] This assumes the client invested five years ago and recieved the actual market return from June 2010 - June 2015.
[2] The forecast return assumes the average market return as experienced from 1991 - 2014.

Whatever your objective, there is real benefit in meeting regularly with your Authorised Financial Adviser to discuss progress and make whatever adjustments may be needed, including adjusting your risk profile up or down, if need be.

Members of the NZ Funds KiwiSaver Scheme who have elected to use NZ Funds' proprietary LifeCycle process will automatically have their exposure to growth assets managed according to their age. This enables our KiwiSaver members to get the most out of growth assets early on in their working life, and to gradually transition some of those growth assets into income and inflation assets as they get nearer to retirement.

Summary

2015 was a tough year to be an investor, with the return of higher uncertainty and volatility across most financial markets. While a well diversified client wouldn't have lost money, we were not satisfied with the rate at which we grew our clients' capital over the course of the year.

Despite the more challenging environment nothing fundamental has really changed. Our collective focus remains on ensuring that each of our clients holds a well diversified and actively managed portfolio of quality assets, matched to an up-to-date financial plan. If we can achieve that we should enable clients to weather periods of global financial market volatility and in so doing, accumulate meaningfully more capital over time.

Thank you for investing with us, and for your continued confidence.

Michael Lang, CFA
Chief Investment Officer

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