



**DAVE WILSON**  
BCA (ECON.), CA, CFA, AFA  
PRINCIPAL & INVESTMENT STRATEGIST

# How NZ Funds manages money

The global appeal of Jamie Oliver, Bear Grylls and our own Nigel Latta is not so much that they are experts in their field, but that they are able to articulate what they do in a way that we can understand and relate to.

Every investment management process should begin with a statement about what the manager is seeking to accomplish. It should address what level of return is being targeted, how much risk is to be taken and how much liquidity is likely to be required, and be articulated in a way you can understand.

## Comparative Investment Approaches

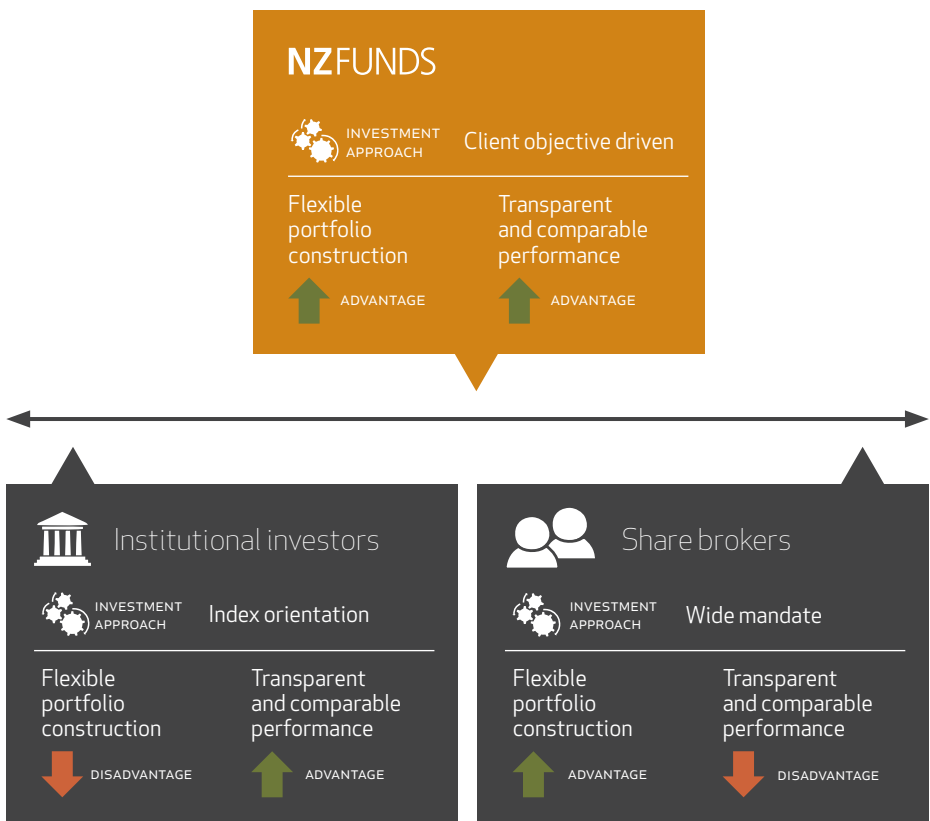
There are a variety of different approaches to setting an investment portfolio's objective. It is useful to compare and contrast our approach with the approaches taken by many institutional investors (such as banks or insurance companies) and share brokers.

Most institutionally managed portfolios have as their investment objective, the objective of matching or bettering a financial index. There are thousands of financial indices globally and each is calculated using different criteria, for example the NZX50 is made up of the fifty largest stocks in New Zealand and replaced the NZSE40 in 2004. Both are commonly bypassed by the NZX Portfolio Index which limits the weight of any company to 5% unless it has appreciated since the index was last rebalanced. Confused? We are too.

The benefit of this approach is that it is relatively easy to calculate whether a portfolio has, over the business cycle, outperformed or underperformed the chosen index. The downside is that matching or even beating a financial index does not necessarily help New Zealanders meet their financial goals. New Zealand individuals, families and trusts invest to achieve real world objectives, such as generating income in retirement to live off, or seeking to grow their capital faster than the bank. Whether an investment manager beats a financial index by declining - 40% in a year when the index records a - 45% drop is of little use. You cannot eat relative performance.

In contrast, many share brokers, who act both as investment adviser and fund, bond and share pickers all at once, have the flexibility to buy whatever you agree to hold. The downside of such an approach is that in the excitement of having an allocation of shares in an upcoming IPO "set aside for you" it is easy to lose sight of real world objectives. For example, which financial need is met by owning a chain of petrol stations? What is more frustrating for clients is that it is very difficult to tell whether a share broker is doing an excellent job or a poor one. Unlike fund managers, whose investment returns are scrutinised relative to competitors on a monthly basis, the investment management track record of individual share brokers is not transparent.

### NZ FUNDS' APPROACH OFFERS YOU THE BEST OF BOTH WORLDS



## NZ Funds' Approach

In setting each portfolio's objective, we seek to occupy a middle ground. We wish to manage money to clearly defined client-orientated investment objectives, which are often best met by combining a wide range of different asset and security types. This necessitates a wide investment mandate. On the other hand we wish to offer you transparency, and comparability. Every one of our portfolios, including those in our KiwiSaver scheme, are 100% transparent and available on the front page of our public website through our monthly Portfolio Insight and Portfolio Profile publications. These documents also provide transparency of historic performance, including transparency of performance where the type of investment vehicle or name of the portfolio or fund has changed over time.

Our portfolio objectives are set using clearly defined client-orientated investment objectives. While the objectives for each portfolio in an investment category are the same, the assets which each portfolio holds, in order to meet that objective, are likely to differ. Each portfolio's objective addresses the recommended investment timeframe in order to maximise the likelihood of achieving your objectives and addresses both risk and return. Each portfolio's objectives should make intuitive sense to you. If capital stability and access to your investment at short notice are of primary importance, it would be counterintuitive for your Portfolio Manager to seek to generate high returns, or hold illiquid long-term investments. In contrast if you wish to grow your capital at a faster rate than the bank offers, you will need to be willing to invest for a longer period of time, have less ability to access your capital at short notice and be comfortable with more risk and volatility.

### CLIENT-ORIENTATED INVESTMENT OBJECTIVES

#### Cash

To provide a source of capital, by investing in income-orientated assets using an active investment management approach.

- Core Cash Portfolio

#### Income

To provide a degree of stability to your investment, by primarily investing in income-orientated assets using an active investment management approach.

- Core Income Portfolio
- Global Income Portfolio

#### Inflation

To mitigate the impact of inflation on your investment over the medium and/or long-term by investing in income-orientated assets and growth-orientated assets using an active investment management approach.

- Core Inflation Portfolio
- Property Inflation Portfolio
- Equity Inflation Portfolio

#### Growth

To grow your investment over the long-term by investing in income-orientated assets and growth-orientated assets using an active investment management approach.

- Core Growth Portfolio
- Global Multi-Asset Growth Portfolio
- Global Equity Growth Portfolio
- Dividend and Growth Portfolio
- Capital Opportunities Portfolio

SOURCE: NZ FUNDS MANAGED PORTFOLIO SERVICE INVESTMENT STATEMENT.









## Asset Class Valuation and Inclusion

Presented with a client-orientated investment objective and risk and liquidity constraints – but flexibility in terms of the breadth of assets that may be selected – the first step of the investment process is to estimate the rate of return for each major asset class.

Valuation is the only long-term compass we possess. As interest rates, bond yields, property and share market prices fluctuate, so too will their expected rate of return. And as the future expected rate of return fluctuates, so too should the assets used to seek to meet the objectives of your portfolio. In general, an asset class that has performed strongly is an unlikely candidate for inclusion in a portfolio, while an asset class that has fallen in value is much more likely to deliver gains than losses going forward.

By way of example, with United States shares trading on 16x earnings, our global share market valuation methodology – which uses a seven year forecast with mean reversion to a long-term fair market multiple based on a pre-tax rate of return of 10% - indicates a forecast rate of return for you of between 7% and 9% pa. A similar process can be applied to other geographic regions.

### GLOBAL SHAREMARKET REGIONAL ANALYSIS: SEVEN YEAR MEAN REVERSION

Share market	Current price	Dividend yield (pa)	Cyclically adjusted P/E	Current P/E	Current EV/EBIT	Current EV/EBITDA	Average expected return
 S&P 500	1707	2.0%	20	16	14	10	7%
 S&P TSX60	723	3.1%	16	16	14	9	7%
 Dow Euro Stoxx	2809	4.0%	11	17	13	8	6%
 FTSE100	6620	3.7%	17	18	12	8	9%
 Nikkei 225	14064	1.5%	28	24	18	10	0%
 ASX200	5096	4.3%	16	21	14	11	7%
 NZX 50	4575	4.4%	23	21	18	11	4%
 CSI 300	2274	2.6%	14	11	11	10	15%
<b>MSCI Average</b>		<b>2.3%</b>	<b>18</b>	<b>17</b>	<b>13</b>	<b>9</b>	<b>6%</b>

SOURCE: NZ FUNDS CALCULATIONS, NUMBERS ARE ESTIMATES ONLY.

Long-term returns can also be estimated for each of the other major asset classes used to meet the objectives of a portfolio. With each asset class, be they different types of bonds, commodities, geographic regions or industry sectors, we seek to develop a forecast rate of return and measure of risk.

Once an asset class has been marked for inclusion in a portfolio, the best way to gain exposure needs to be determined. There are three different ways to invest in an asset class; exposure can be gained by buying individual securities; by buying an index fund, ETF or futures contract which passively tracks one of the financial indices; or by employing an investment manager who specialises in investing in that asset class.

## Manager Evaluation and Selection

NZ Funds maintains a watching brief, on your behalf, on a wide range of global investment specialists. Year to date our investment team has met or conference called with 24 share managers, seven bond managers and 21 hedge fund and alternative securities managers.

Specialist investment managers do not come cheaply. A significant portion of the fees you pay are used to procure their services. As we wish to ensure the total fee paid, including that paid to specialist managers, is fair and reasonable it is important that you receive value for money from your managers.

When selecting a specialist manager the focus is on whether they have a transparent and repeatable investment approach that is philosophically aligned with NZ Funds. The research process also considers how a new manager might complement, or interfere with, each portfolio's existing managers and investments. As a result less time is spent analysing whether managers are under or out performing a financial index and more time is spent understanding whether their investment approach helps to meet your objectives.

### SPECIALIST MANAGERS BY REGION AS AT AUGUST 2013

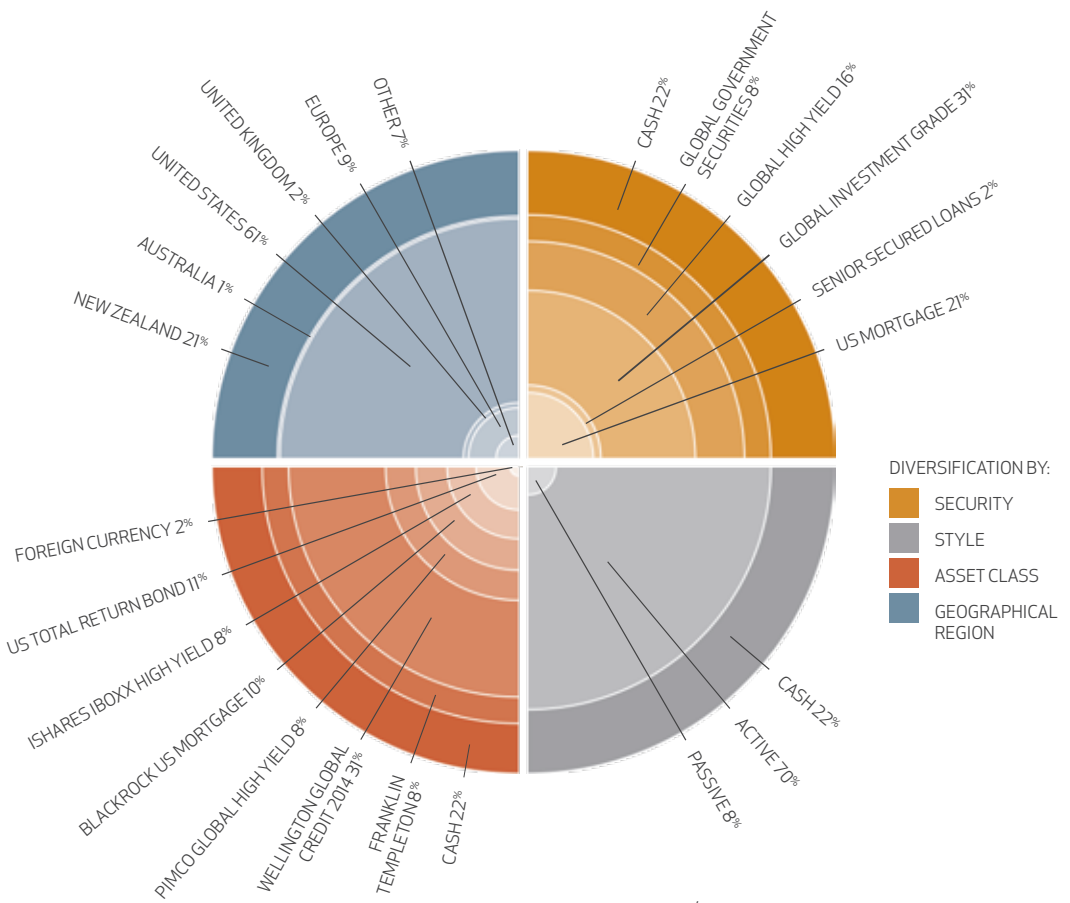


## Portfolio Construction

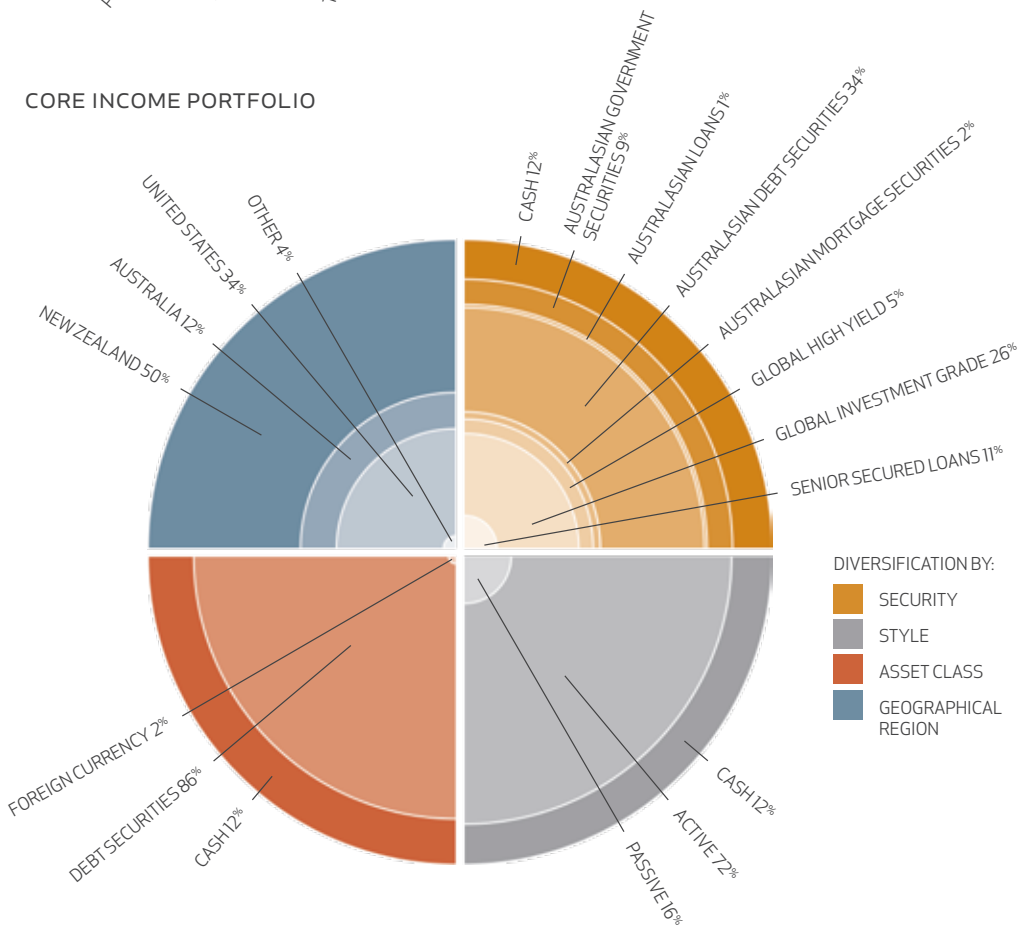
The process of intelligently building a portfolio consists at the most basic level of buying the investments which are best suited to meeting the objectives of the portfolio and making room for them by selling lesser investments. However, there is more that can be done to improve the reliability of a portfolio and this is done by studying the relationship between each candidate for a portfolio. Simply put a portfolio containing two assets which will double over the next ten years, will generate the same rate of return as a portfolio with one asset that will double over the next ten years. However, if the portfolio with two assets contains an asset that in any one year zigs when the other asset zags, you will enjoy a much smoother ride. The more uncorrelated asset classes, security types and investment approaches a portfolio contains, the more stable it should be. This approach is helped further by ensuring you own two different portfolios to meet your income objectives, three to meet inflation mitigation objectives and up to five to seek to grow your capital over the long-term.

# Diversification within the Income Category AS AT 31 JULY 2013

## GLOBAL INCOME PORTFOLIO / NZ FUNDS KIWISAVER SCHEME INCOME STRATEGY



## CORE INCOME PORTFOLIO



SOURCE: NZ FUNDS, ESTIMATES ONLY. MORE INFORMATION AVAILABLE ON REQUEST.

## Security Valuation

Over the last 20 years we have also honed the research models used for individual security selection, to match the objectives for our clients, and in particular their holding period.

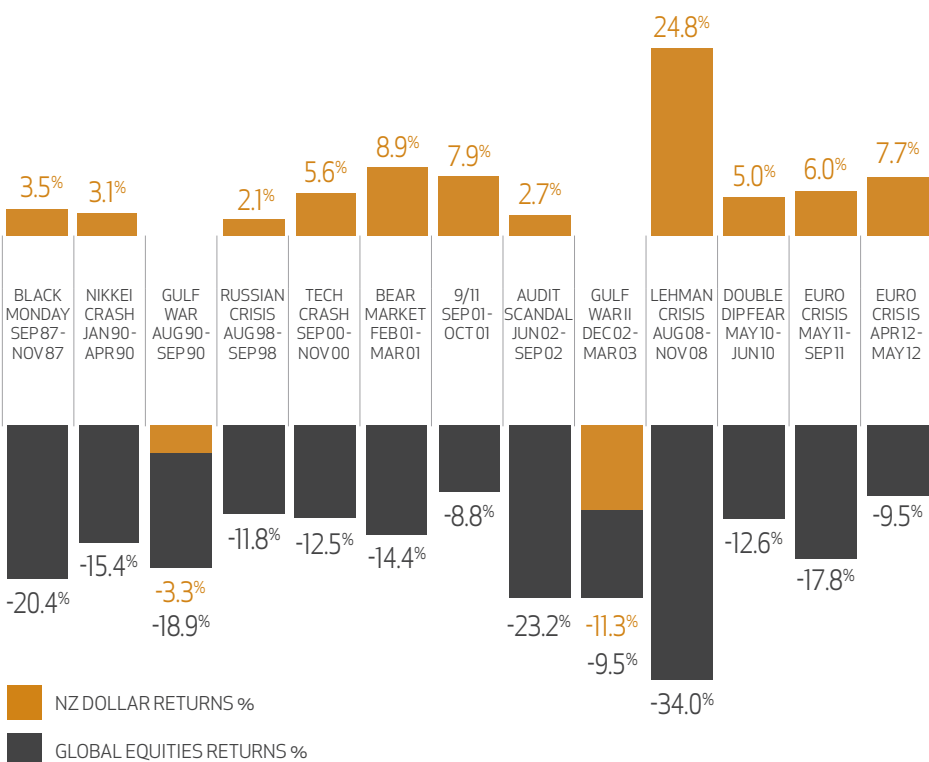
By way of example, credit rating agencies assign a credit rating based on the likelihood of investors' capital being repaid when a bond becomes due. In some cases a long-term bond may not be due for ten or more years and when this is issued by a company with cyclical earnings it may trade at a steep discount. Our research focuses on the likelihood of the bond being "money good" over the timeframe set by the investment category, for example "two or more years". If over this timeframe the cyclical company's earnings are growing the bond may prove to be an ideal candidate for an income orientated portfolio.

In this way, our approach to security valuation enhances the likelihood of meeting your investment objectives and gives us a comparative advantage in the marketplace.

## Macro Risk Management

Most investment processes focus on optimising portfolios for what is anticipated to lie ahead, and for periods of time this can generate exceptional outcomes. However, while we enjoy contemplating the future, our investment management process requires Portfolio Managers to acknowledge that they will not be able to forecast the future reliably. This requires portfolios to be constructed with two views in mind: assuming all goes to plan; and what if things go wrong. Risk cannot be avoided – as risk avoidance would also mean return avoidance – however we can seek to mitigate it. This means we may place investments in your portfolio that are expected to perform strongly in stressed periods. These investments vary widely from downside orientated hedge funds, to owning commodities, currencies or interest rate futures or utilising credit default swaps. The investments added to mitigate a portfolio's downside risk change depending on what the portfolio owns, whether the downside mitigation investments are expensive or cheap and at what point in the economic cycle we are in. A downside orientated "macro" allocation across one or more asset types in many of the portfolios we manage is an important feature of our investment platform.

FOREIGN CURRENCY EXPOSURE AS A DOWNSIDE RISK MITIGATOR

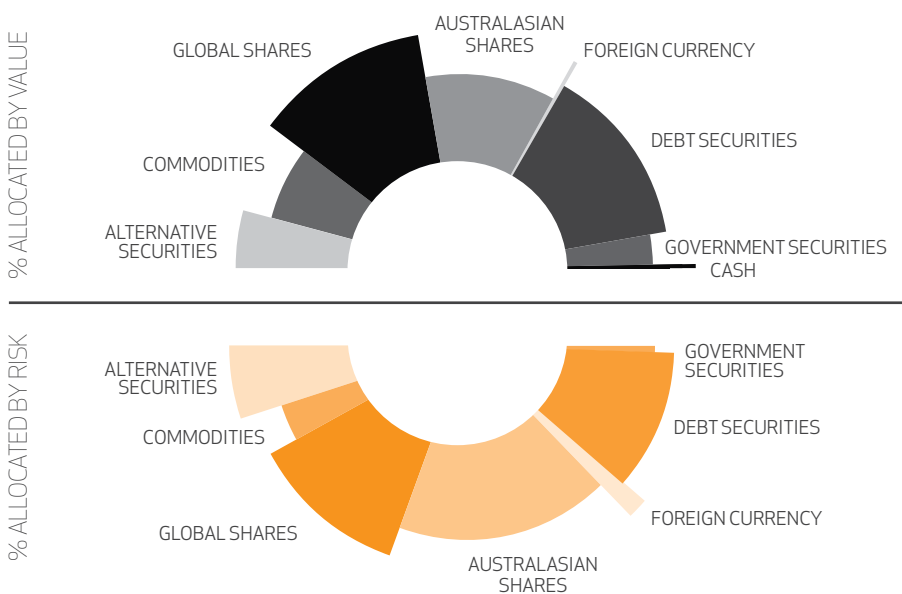


SOURCE: MSCI, BLOOMBERG, NZ FUNDS CALCULATIONS.

## Micro Risk Management

Many risks are subjective, hidden and unknown. Sometimes, the best approach to risk management lies not in seeking to anticipate the future, but in responding to the current reality. NZ Funds uses a risk management system which enables your portfolio managers to quantify the risk and return contribution of each investment contained within a portfolio on a daily basis. This enables us to identify and address poorly performing investments on a daily basis. We also receive daily reports detailing the amount of risk each security contributes to your portfolio and whether this risk contribution has changed. This can be quite different from the asset weight of each security in the portfolio. These reports ensure we have the ability to respond quickly to unforeseen events. We believe our ongoing research and development of risk management technology will over time be an important point of differentiation and a source of comfort for you.

VALUE AT RISK IS AS IMPORTANT AS POSITION SIZE –  
CORE INFLATION / NZ FUNDS KIWISAVER SCHEME INFLATION STRATEGY



SOURCE: NZ FUNDS, AS AT 5 AUGUST 2013.

## Summary

In managing your wealth, our overriding philosophy is to seek to maintain a balance between preserving capital and growing wealth in a manner that is consistent with each portfolio objective. The portfolio objectives set out in both the NZ Funds KiwiSaver Scheme and NZ Funds Managed Portfolio Service Investment Statements, outline what each portfolio seeks to accomplish on your behalf.

Ultimately, the success of any investment approach is determined by whether clients enjoy a higher rate of return (on an after tax and after fees basis) than they could have earned by holding a bank term deposit. We believe our client-orientated investment philosophy, developed over two decades of managing money on behalf of New Zealanders, consistently implemented by professionals who share a common culture and set of values, is the most reliable way to meet your objectives, and expectations.

**David Wilson**

Principal and Investment Strategist