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Market overview

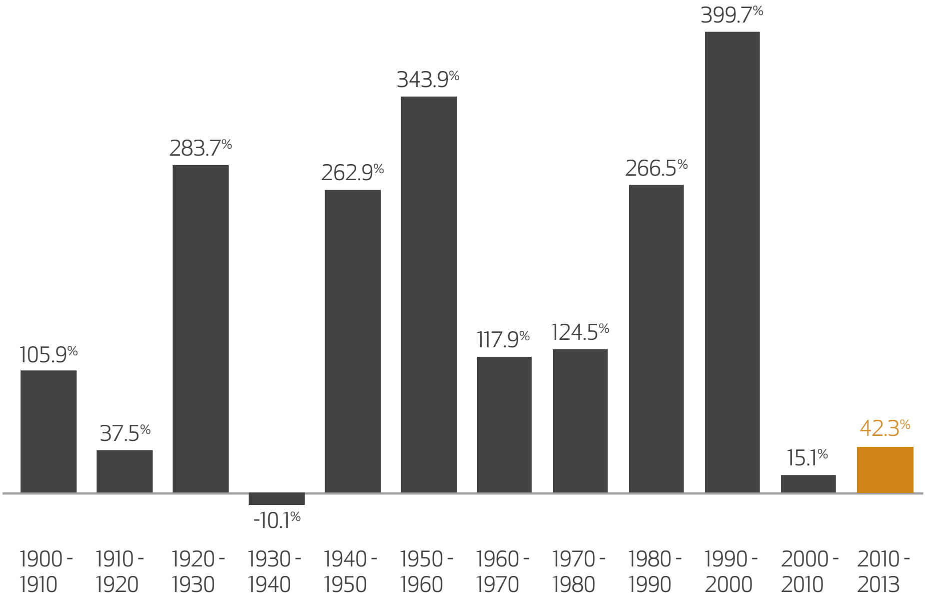
Clients' portfolios started the year on a strong note, generating positive returns for both KiwiSaver and Managed Portfolio Service offerings. Shares made up between 90% of portfolios for indicative clients under the age of 45 and 45% of portfolios for clients over 65 years old.

After a cracking first quarter during which global shares appreciated in value by 12.5%, one could not help but suspect they were ripe for a correction. Sell in May and go away, as they say.

Prior to shares weakening in June, we were prepared and reduced clients' net exposure by 10-15% in anticipation of a correction of the magnitude of 10% (or more). After all, the horrors of 2008 are still fresh in everyone's mind.

Despite that, we believe we are not near the top of the cycle and our core hypothesis on shares continues to be for further appreciation. Any such hypothesis must be grounded in valuation, it is the only long-term compass we possess.

ANNUAL RETURNS FROM GLOBAL SHARES BY DECADE



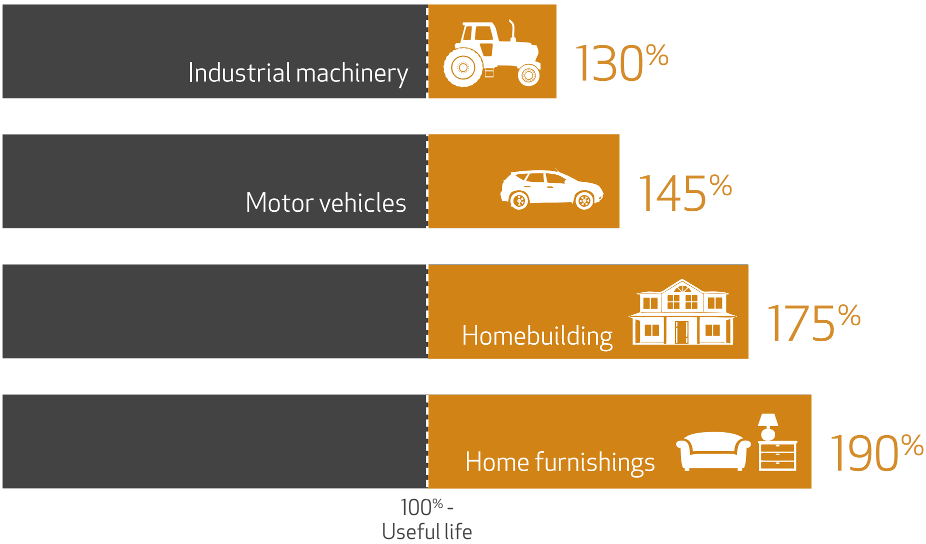
SOURCE: S&P500 INDEX, BLOOMBERG, NZ FUNDS CALCULATIONS.

United States

Our valuation methodology (seven year forecast with mean reversion to a long-term fair market multiple representing a pre-tax rate of return of 10%), indicates that United States shares trade on 16x earnings, (14x EBIT and 10x EBITDA). Such a valuation equates to a forecast rate of return for clients of around 7% per annum, to which around 2% can be added in currency hedging points as you are paid for hedging the majority of your foreign holdings back into New Zealand dollars. When these two factors are combined, the estimated annual long-term rate of return rises to 9%, not bad considering there is little or no tax to pay thanks to the PIE tax structure.

When combined with anecdotal evidence of an ongoing recovery in the United States economy (despite the much discussed fiscal cliff), and evidence of the potential for a significant wave of capital replacement spending, there are several compelling reasons to favour global and United States based shares over cash, government bonds and most commodities.

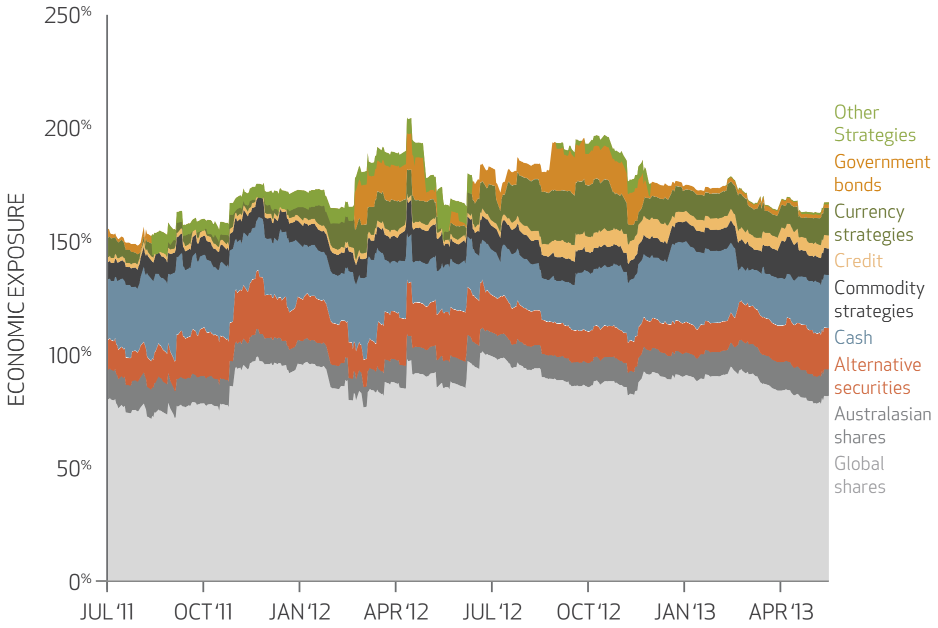
UNITED STATES ASSET LIVES ARE EXTENDED, REPLACEMENT WILL BOOST EARNINGS



SOURCE: ODEY ASSET MANAGEMENT.

Additionally currencies, high yield bonds, mortgage-backed securities and floating rate bank loans together with liquid alternative assets such as hedge funds and manager alpha, offer similar risk adjusted opportunities to shares and we have accordingly positioned your portfolios to benefit from each of these sources of return.

CLIENTS ARE DIVERSIFIED ACROSS A WIDE RANGE OF ASSETS – INDICATIVE KIWISAVER CLIENT 45 YEARS OLD

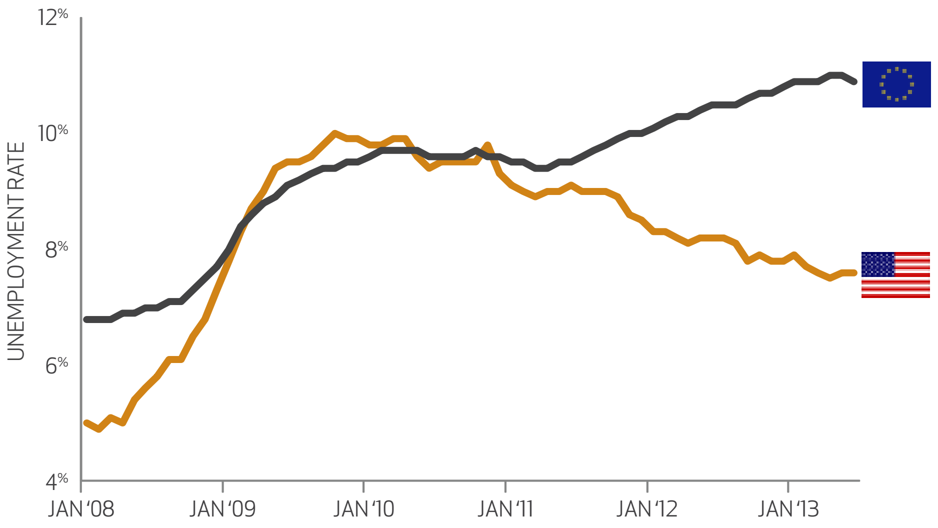


SOURCE: NZ FUNDS, ESTIMATES ONLY. MORE INFORMATION AVAILABLE ON REQUEST.

Europe

While European companies theoretically offer a similar rate of return to United States and New Zealand based companies, their reluctance to embrace Milton Friedman's capitalism will likely see the Eurozone underperform the United States. Accordingly you only own a modest allocation of European shares. However, thanks to the European Community's inability to embrace economic reform, all companies in the region have become discounted to a similar degree. This provides your European managers with a target rich environment for a stock picking investment approach.

CAPITALISM: FREEDOM TO FIRE MEANS FASTER TO RE-HIRE



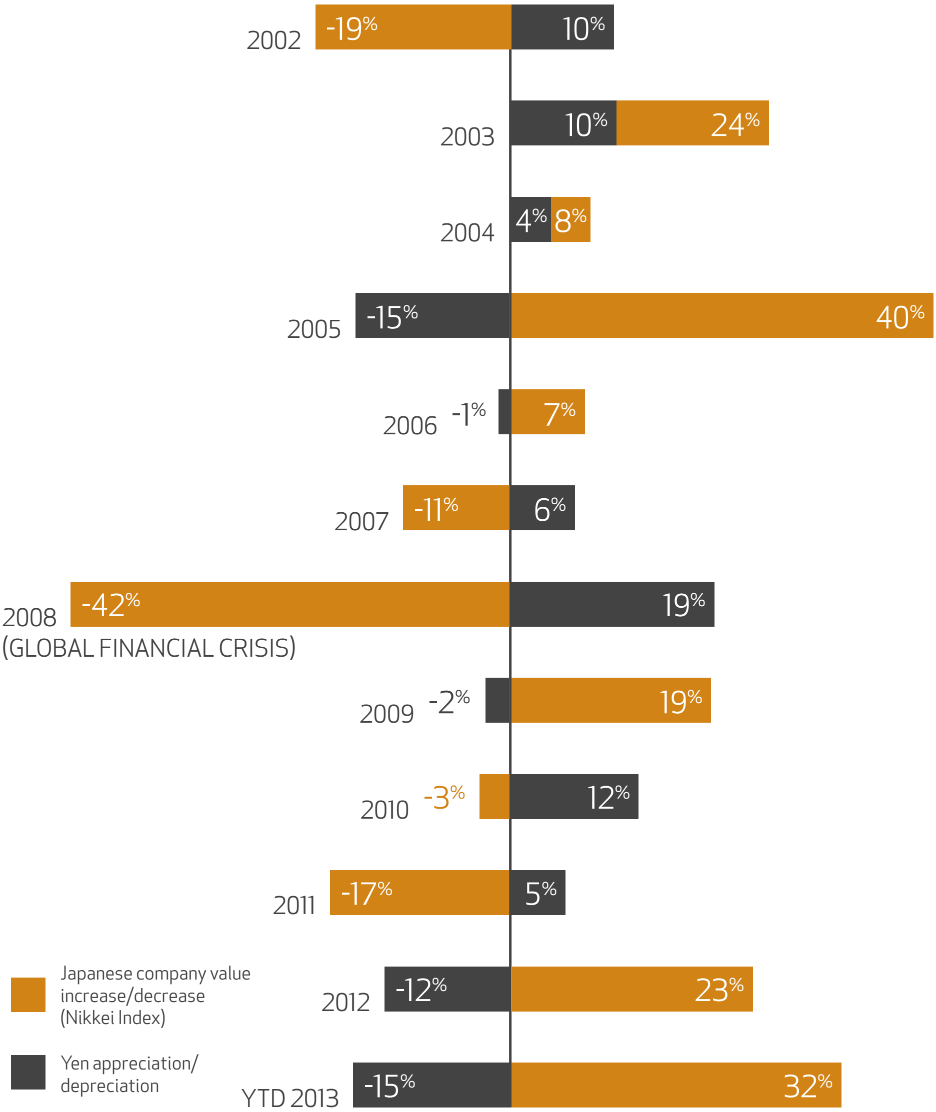
SOURCE: BLOOMBERG, BUREAU OF LABOR STATISTICS, EUROSTAT.

Asia

Japan and Emerging Markets represent two valuation anomalies. On face value Japan only offers a 1% return per annum for the next seven years, but valuation can at times be misleading. Japanese companies have endured over two decades of low domestic demand and a high currency, much like New Zealand in 1992. In such an environment only the strong could survive and they did that by cutting costs, reducing prices and becoming more efficient. Lean-manufacturing was designed by an American but mastered by the Japanese. A significant depreciation in the Yen could unleash these Samurai. Could a 40% increase in relative competitiveness result in a 40% increase in sales, dropping straight through the lean cost structure to the bottom line?

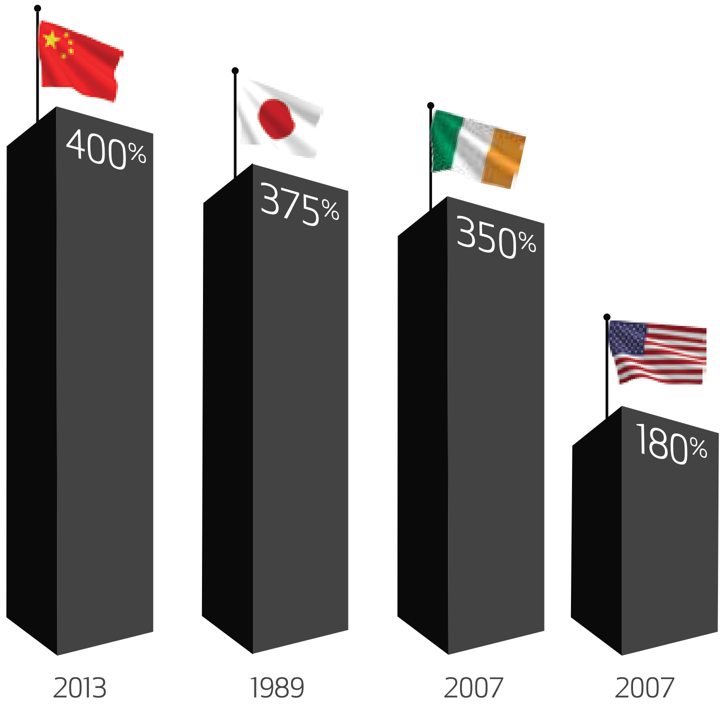
In contrast China appears to offer an 11% per annum growth rate, but has chosen to peg its currency to the United States dollar, faces sharply rising labour costs, and is highly levered. Cycles (and cyclical companies) are hard to capture with a static valuation approach. China faces the downward leg of the economic cycle, America the upside. It is quite conceivable that America's economic growth rate will overtake China's within five years. What is of more concern than a cyclical downturn in the economy is the degree to which Chinese property prices have inflated. A sharp correction in property would leave the highly levered Chinese banks as vulnerable as Western banks were during the Global Financial Crisis. We continue to research ways to enable you to profit from such an event, should it occur.

A DECLINING YEN IS POSITIVE FOR JAPANESE COMPANIES



SOURCE: BLOOMBERG, NZ FUNDS CALCULATIONS.

THE WORLD'S TALLEST BUILDINGS? PRE-CRASH PROPERTY PRICES RELATIVE TO GDP

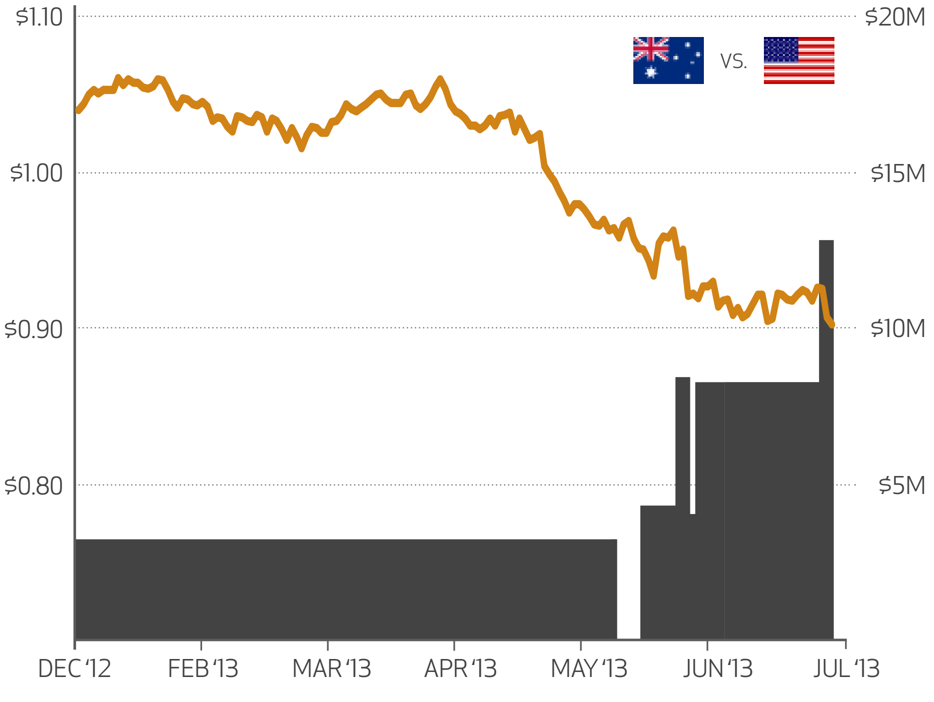


SOURCE: COMMENTARY BY JAMES CHANOS, KYNIKOS ASSOCIATES.

Australasia

As the evidence grows that China is slowing, capital that has favoured emerging markets over developed markets will reverse. This process has implications for cyclical Australian commodity producers and in turn the Australian economy and dollar. New Zealand on the other hand is less exposed to a Chinese slowdown, but more exposed to event risk be it foot and mouth or contaminated milk powder. Year to date, your portfolios have been correctly positioned for a Chinese slowdown and have profited, in particular, from being short the Australian Dollar against both the New Zealand Dollar and United States Dollar.

THE NOT SO LUCKY CURRENCY (AND PORTFOLIO EXPOSURE $M)



SOURCE: BLOOMBERG, NZ FUNDS CALCULATIONS.

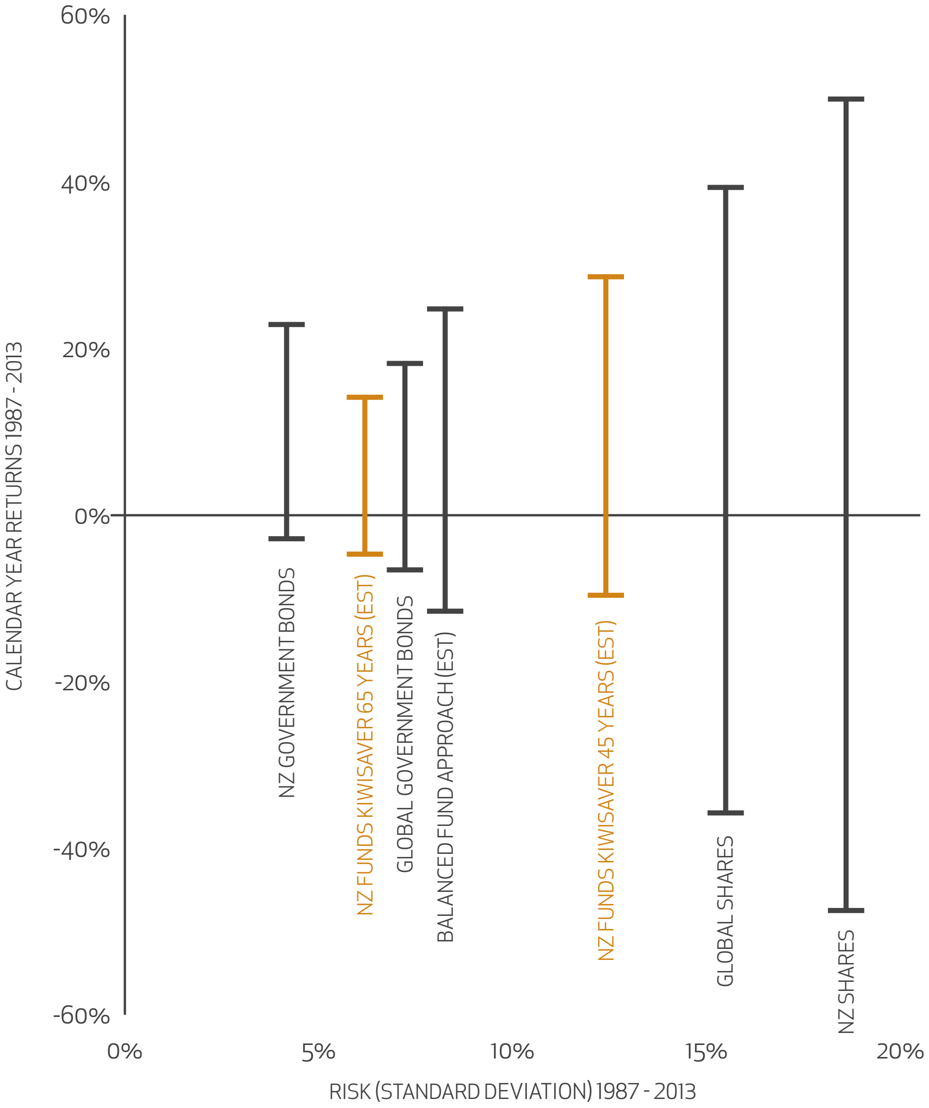
Risk Management

NZ Funds' daily securities and manager risk report, which is discussed in further detail in the article titled "How NZ Funds Manages Money", has year to date identified movements in global property prices, mortgage bonds, gold and certain alternative security managers that have warranted further analysis, and in some cases corrective action.

A significant detractor within a number of portfolios has been Paulson's PFR Gold Fund. Your Portfolio Managers filed for redemption late last year, but the staggered exit rules meant you have continued to hold a 1-2% allocation in some portfolios for longer than has proven ideal. We expect the final holding to be sold in September. While gold has merit in a deteriorating economic environment, it is likely to suffer as the United States recovers.
We expect gold to feature more meaningfully again in your portfolios, but not until the slack in the system (unemployment) has been absorbed and upward real wage pressure begins to bite.

When considering the risks associated with shares, the risk management job is no less easy. Neither New Zealand nor global shares were particularly overvalued, broadly trading at today's valuations when they collapsed in 2008. NZ Funds' investment approach uses valuation as our guide, but actively seeks to mitigate the downside. Accordingly, we continue to include in your portfolios a range of assets which we anticipate could help offset a sharp decline in global financial markets.

NZ FUNDS' INVESTMENT APPROACH SEEKS TO MANAGE DOWNSIDE VOLATILITY



SOURCE: VARIOUS INDICES, NZ FUNDS ESTIMATES ONLY. ASSUMPTIONS AND CALCULATIONS AVAILABLE ON REQUEST.

At different points in the cycle, currency exposure can help mitigate financial downside. Portfolios have benefited year to date from holding a foreign currency exposure and we anticipate they would profit further if global financial markets soured. Similarly, periodic short exposure to Australian credit spreads has proven to be both profitable and guarded against a more material financial market decline. Finally, in case of an unforeseen collapse we continue to hold an allocation to downside orientated hedge funds designed to complement the macro (currency, interest rate and derivative) positions we manage on your behalf.

Having undertaken a lengthy due diligence process, including a site visit during our global review of managers, we recently appointed Los Angeles based hedge fund manager, Universa Investments L.P. Universa will be used to mitigate the potential for a left-tail event such as occurred in 1987 and during the 2000 and 2008 share market collapses. Universa is expected to manage a portion of the capital within the Income, Inflation and Growth categories and in the NZ Funds KiwiSaver Scheme. Due diligence is also underway on several new managers shortlisted for analysis following our recent overseas trip. We look forward to updating you as and when they are appointed.

Summary

We have all enjoyed a 12-month period of strong returns. Only time will tell if we are also capable of delivering during periods when loss mitigation takes precedence over return chasing. In your favour we have an experienced set of individuals who share a common culture and set of values and have weathered and learned from a number of financial downturns over the last two decades. Additionally, over the last five years considerable research and development, done in conjunction with Authorised Financial Advisers, has also gone into the design and construction of your portfolio.

Michael Lang
Chief Investment Officer