NZFUNDS

Why own inflation-orientated assets?

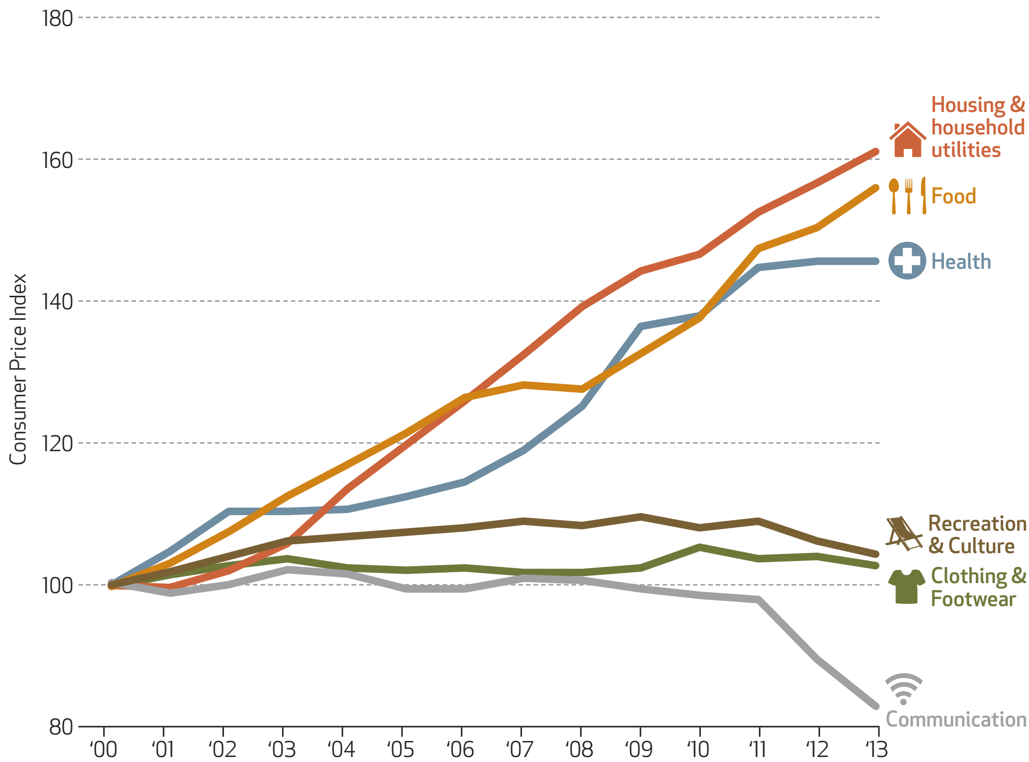
Inflation is a persistent increase in price levels. It hurts us because it erodes the purchasing power of the money we save. And because an unexpected increase in inflation can cause both bonds and shares to decline, it can be just as harmful to those saving for retirement as it is for those in retirement.

This article explains how inflation affects your portfolio, discusses its unpredictable nature and provides an overview of NZ Funds' LifeCycle® approach, which incorporates inflation mitigating assets into clients' savings and retirement portfolios.

About inflation

Reported inflation, or headline inflation as it is often called, has remained subdued at around 2.3% a year for over 20 years now. However, there are as many types of inflation as there are types of goods. For example, since 2000 the price of food, housing and healthcare have increased by approximately 50%, whereas the price of recreation and leisure has only increased by 10%. Over the same period the price of communication has actually fallen. Each New Zealander is therefore exposed to his or her own unique set of inflationary forces.

ALL INFLATION WAS (NOT) CREATED EQUAL



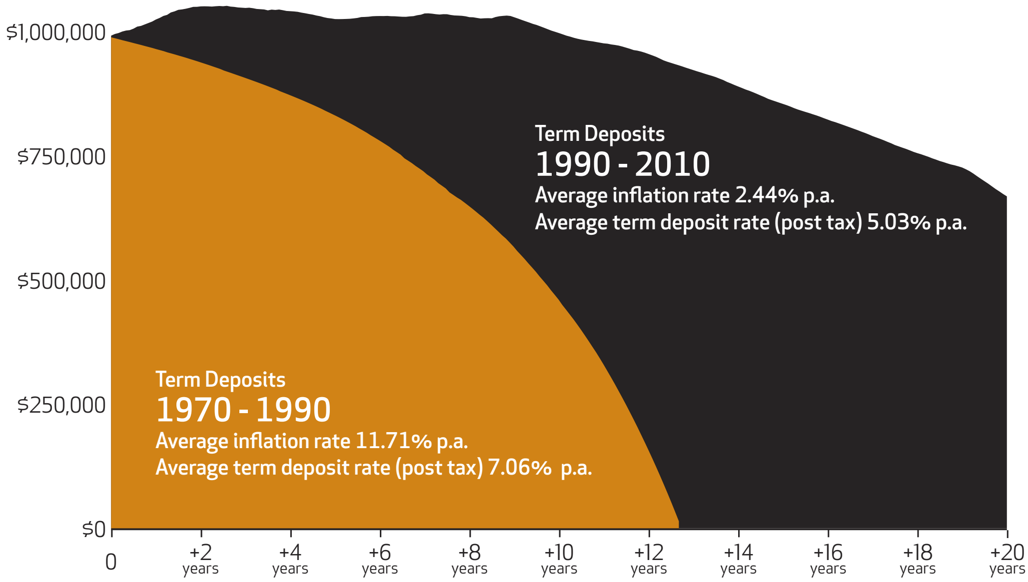
SOURCE: CONSUMER PRICE INDEX MARCH 2013 QUARTER - SUPPLEMENTARY TABLES, NZ FUNDS CALCULATIONS.

Who does inflation hurt?

A common generalisation made about inflation is that New Zealanders who are still earning an income have a natural "hedge" against inflation. This is because, as prices rise, their earnings will probably rise too. However, as they approach retirement, their inflation sensitivity begins to rise. Inflation is therefore seen as being most harmful for those in retirement because they are no longer earning and must live off their savings.

The truth is more insidious. Inflation hurts both working and retired New Zealanders. To illustrate how inflation can erode a retiree's unprotected retirement fund, let us compare a hypothetical retiree with $1,000,000 invested in term deposits (and a PIE tax rate of 28%), drawing down 5% or $50,000 a year to fund their retirement in the high inflationary period (1970 to 1990) with the same scenario in a low inflationary period (1990 - 2010). In the high inflationary period, the retiree would have exhausted their savings two-thirds of the way through their retirement. In contrast, in a low inflationary environment their retirement fund would still amount to $674,000 after 20 years of inflation-adjusted $50,000 a year withdrawls.

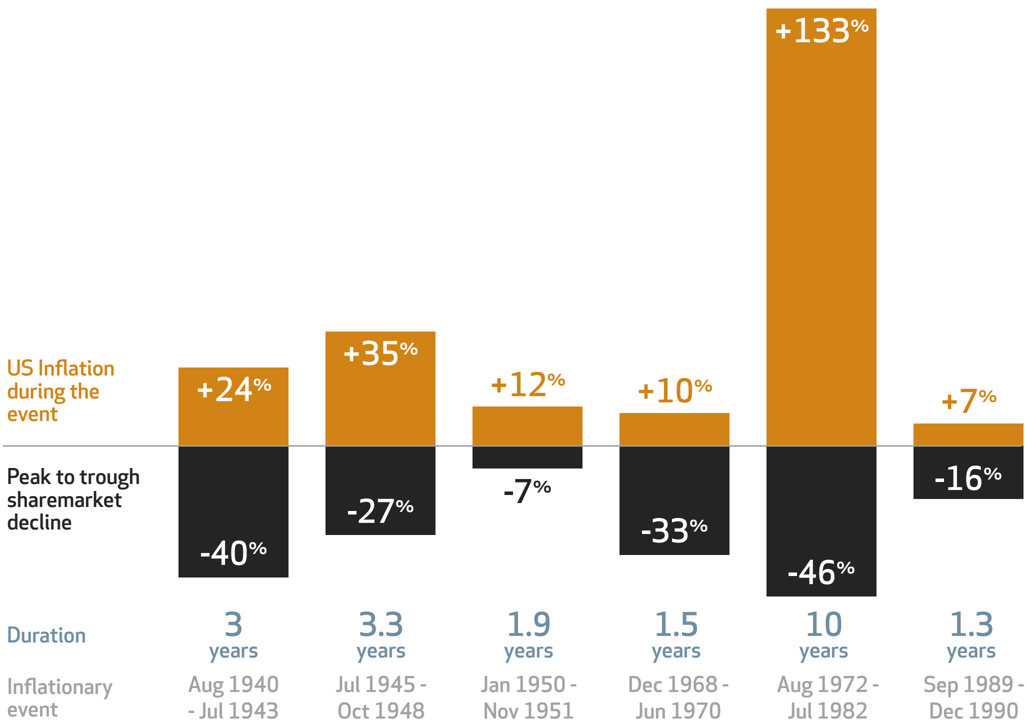
HOW INFLATION CAN IMPACT A RETIREE'S PORTFOLIO



SOURCE: RESERVE BANK OF NEW ZEALAND, NZCPCCPI INDEX, NZ FUNDS CALCULATIONS ASSUMING A PIE TAX RATE OF 28% AND AN INFLATION-ADJUSTED ANNUAL WITHDRAWAL OF $50,000.

A less commonly understood effect of inflation, is its impact on those saving for retirement. Most New Zealanders use a combination of growth and income assets to save for retirement. We have seen that income -orientated assets, like term deposits and bonds, do not hold up well under the corrosive force of inflation, but what about shares? Here the impact of inflation is mixed. Share markets typically respond negatively to an unexpected rise in inflation as investors worry about its long-term impact on companies and the economy. The silver lining for long-term savers is that given time, shares – unlike term deposits and most bonds – have a good track record of recovering their losses. In fact, the shares of certain types of companies actually stand to benefit from inflation over the long term. However, for growth-orientated investors saving for retirement the immediate effect of an unexpected rise in inflation is likely to be a drop in the value of their savings.

HOW INFLATION CAN IMPACT A SAVER'S PORTFOLIO



SOURCE: UNITED STATES INFLATION MEASURED BY CPERNSA INDEX. UNITED STATES SHARES MEASURED BY S&P500 INDEX, MAXIMUM DECLINE FROM 12 MONTHS PRIOR TO EVENT TO END OF EVENT.

How worried should we be?

Fortunately, inflationary shocks are relatively rare. Since 1969 New Zealand inflation has risen above 5% a year on only four separate occasions. These historic inflationary events have lasted an average of 4.4 years before the inflation rate returned below 5% a year again.

Less fortunately, rising inflation is difficult to predict. One of the potential catalysts for inflation is the printing of money; all other things being equal the more money there is chasing the same number of goods, the higher the price for those goods (or services). In recent years economic weakness has lead the Federal Reserve (the United States equivalent of our central bank, the Reserve Bank of New Zealand) and a number of other countries' central banks, to print money by electronic quantitative easing. While plenty of time remains for the electronic money printed to be withdrawn, no one can confidently predict the outcome of such enormous monetary expansion. As a consequence, economists' forecasts for inflation remain highly divergent, making inflation-aware investing all the more important.

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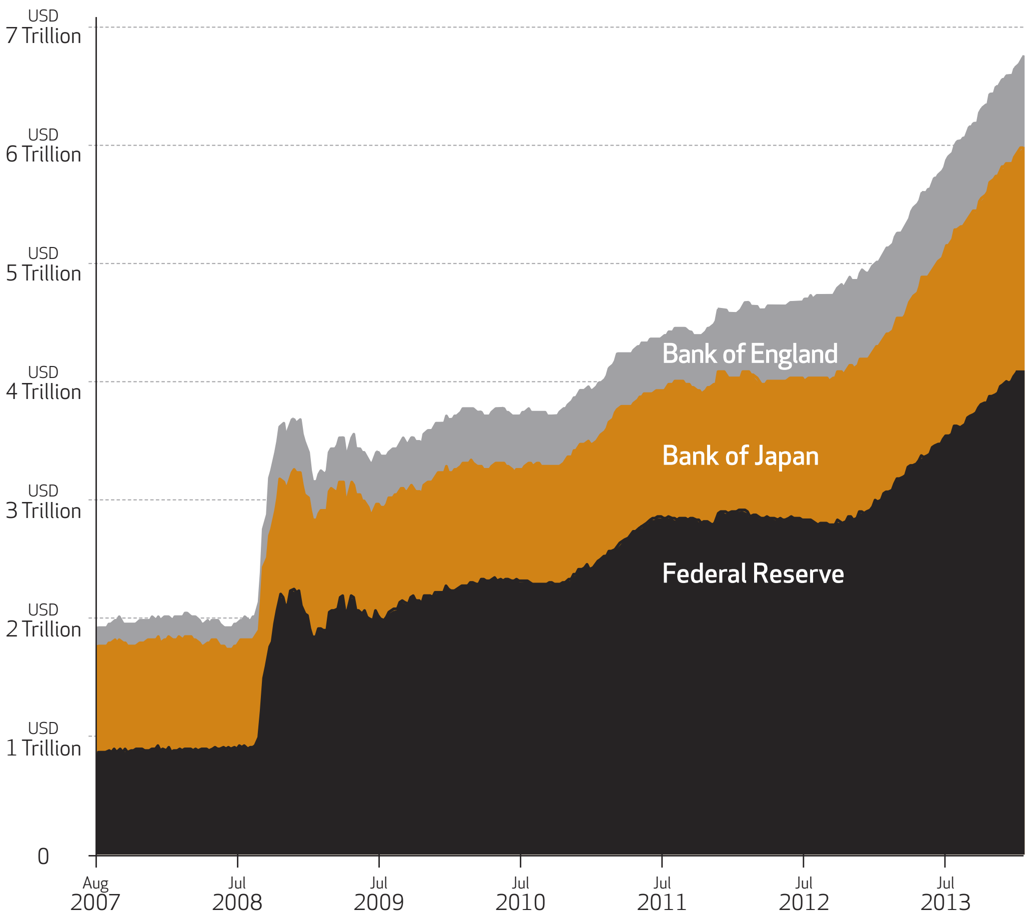


SOURCE: FEDERAL RESERVE BANK, BANK OF JAPAN, BANK OF ENGLAND.

What are inflation-mitigating assets?

Inflation-mitigating assets are investments which have historically performed well during periods of rising or high inflation. They can broadly be divided into two categories: income-orientated assets such as inflation-linked bonds and floating-rate bonds, and growth-orientated assets such as inflation-sensitive shares and commodities.

The types of bonds which perform best during periods of rising inflation are those where the interest rate is not fixed, but resets periodically – much like a term-deposit. Both floating rate bonds and most mortgage bonds exhibit this characteristic. Because of their relatively short payback period and their higher yield, high-yield bonds have historically fared well during periods of rising inflation as well. Finally, there are inflation-linked bonds, such as those issued by the New Zealand Government and Transpower New Zealand, which increase in value as inflation increases.

These investments may sound like ideal hedges against inflation, but each type of bond comes with its own set of complications. For example, inflation-linked bonds may fail to fully capture all of the inflation in the economy as they only track the government-calculated Consumer Price Index. Then there is always the risk of default, or short-term capital loss if interest rates were to rise faster than inflation. Even if, on an after tax basis, inflation-linked bonds for example manage to maintain their purchasing power during a period of rising inflation, there is no spillover benefit to help clients limit the impact of inflation on the rest of their savings. In order to do that, clients need assets which go up more than one-for-one with rising inflation.

Growth-orientated inflation assets are ideal for helping to mitigate the impact of inflation on a broader investment portfolio. Not only do they have the potential to rise in value to offset inflation but in some cases they can appreciate by a factor of two or three times the inflation rate.

The primary growth-orientated inflation assets are those linked either directly or indirectly to real assets, such as commodity futures, listed commodity producing companies or listed property and/or infrastructure assets. For example many highly regulated utilities distributing electricity, gas or water are, under their agreements with the regulator, able to put up their price each year by the rate of inflation. Similarly, many property companies have inflation clauses built into their long-term rental agreement with tenants. Other growth-orientated inflation assets can include healthcare companies and technology companies where their cost of production does not rise as quickly as they are able to put up prices.

Unfortunately, growth-orientated assets also tend to be more volatile and can, over the short-to-medium term, whipsaw a client's overall portfolio either up or down. On the other hand, because they react more powerfully to inflation over the medium-to-long term, they can help mitigate the impact of inflation for not only the portion of the portfolio that is invested in inflation-orientated assets, but for a client's entire savings portfolio or retirement fund.

ABILITY TO MITIGATE INFLATION VARIES BY ASSET TYPE - 31 JAN 2009 TO 31 JAN 2014

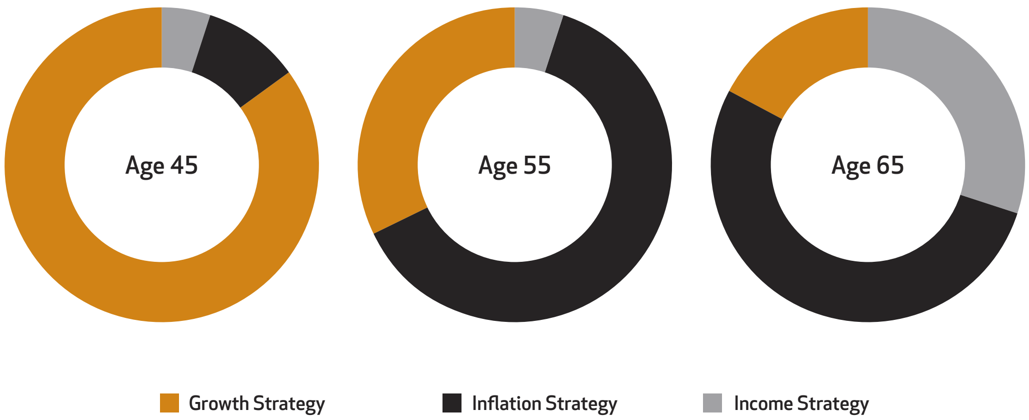
		5-Year Inflation Increase	5-Year Asset Returns	Correlation	Relative Return
Income	Floating rate bonds	11%	9%	30%	0.8x
	Inflation linked bonds	11%	30%	57%	2.8x
	Property bonds	11%	125%	26%	11.7x
	Mortgage bonds	11%	22%	34%	2.0x
	High yield bonds	11%	123%	5%	11.5x
Growth	Utilities shares	11%	68%	28%	6.4x
	Healthcare shares	11%	131%	10%	12.3x
	Technology shares	11%	150%	9%	14.1x
	Property shares	11%	149%	21%	14.0x
	Commodities	11%	14%	68%	1.3x
	Inflation	11%	11%	100%	1.0x

SOURCE: US CPI, BUREAU OF LABOUR. OTHER ASSET VARIOUS SOURCES, NZ FUNDS CALCULATIONS.

NZ Funds' approach

NZ Funds developed its proprietary LifeCycle® approach to better manage New Zealanders' KiwiSaver retirement funds. The LifeCycle® approach ensures that clients are diversified across Income, Inflation and Growth assets. This process also ensures that, as clients near retirement, their KiwiSaver portfolio is seamlessly rebalanced to reduce their exposure to growth assets and increase their exposure to inflation and income-orientated assets. A similar approach applies to NZ Funds clients' investments outside of KiwiSaver, where Authorised Financial Advisers ensure clients are diversified across Cash, Income, Inflation and Growth assets. These approaches counter the natural increase in inflation sensitivity New Zealanders encounter as they move to becoming increasingly reliant on their investment savings to fund their lifestyle.

NZ FUNDS KIWISAVER SCHEME LIFECYCLE® PROCESS – POINT IN TIME ASSET ALLOCATION*



*TO LEARN MORE ABOUT NZ FUNDS LIFECYCLE® PROCESS, SEE THE NZ FUNDS KIWISAVER INVESTMENT STATEMENT OR GO TO WWW.NZFUNDS.CO.NZ/KIWISAVER_PORTFOLIO_INFORMATION.HTML

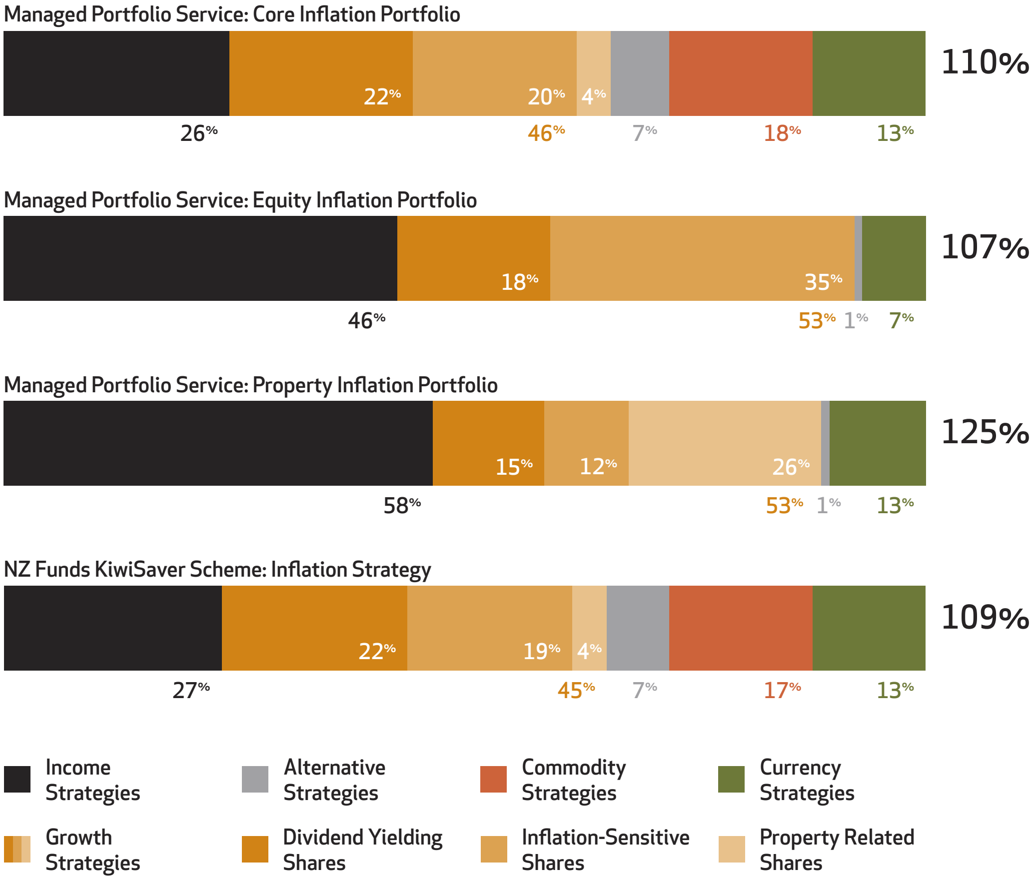
As discussed, there is no silver bullet which can protect New Zealanders from inflation. There are however a range of assets, which taken together and held over an appropriate period of time, have the potential to be powerful inflation mitigators. An allocation to inflation-orientated strategies has the potential to help limit the impact of inflation on not only the portion of a client's portfolio invested in the inflation strategies, but their entire savings or retirement portfolio. In this way, the inflation-orientated assets which we include in clients' portfolios complement and enhance the robustness of a traditional portfolio approach which would otherwise remain vulnerable to an unanticipated rise in inflation.

TRADITIONAL PORTFOLIO CONSTRUCTION VS. INDICATIVE NZ FUNDS APPROACH

FOR ILLUSTRATIVE PURPOSES ONLY. SOURCE: NZ FUNDS. INDICATIVE ASSET ALLOCATION ONLY.

NZ Funds manages three separate strategies in the inflation space: the Property Inflation Portfolio, the Equity Inflation Portfolio and the Core Inflation Portfolio. The Property Inflation Portfolio primarily invests in a mixture of property and infrastructure related property trusts, shares and bonds. The Equity Inflation Portfolio primarily invests in the shares of companies which are sensitive to a rising inflation rate, such as healthcare, consumer staples, energy and gold miners. Lastly, the Core Inflation Portfolio and its sister fund, the NZ Funds KiwiSaver Inflation Strategy, own a diversified combination of assets divided between growth-orientated inflation-sensitive assets such as commodities and dividend yielding shares, and income-orientated inflation-sensitive assets such as inflation-linked bonds and floating rate bonds. Just as there are different types of inflation, each of our inflation strategies gives clients exposure to inflation-sensitive assets in different ways.

NZ FUNDS' INFLATION-ORIENTATED PORTFOLIO & ASSET ALLOCATION



SOURCE: NZ FUNDS MANAGED PORTFOLIO SERVICE PORTFOLIO INSIGHTS 31 JANUARY 2014; NZ FUNDS KIWISAVER SCHEME PORTFOLIO INSIGHTS 31 JANUARY 2014.

Conclusion

Inflation represents nothing less than a risk to New Zealanders' retirement plans. Whether you are saving for retirement, or drawing down on your savings in retirement, even a modest level of inflation can be disruptive. It is hard to predict when inflation will occur, and by the time inflation is clearly rising, inflation-sensitive assets are likely to have already reacted. This makes timing moves into inflation-sensitive assets difficult.

Our LifeCycle® approach, which provides the blue-print for constructing client portfolios for our KiwiSaver and Managed Portfolio Service clients, incorporates an exposure to inflation-orientated strategies into clients' portfolios and increases the allocation as they age. In much the same way as we would buy both fire and flood protection for our home, NZ Funds seeks to mitigate against either a collapse in asset prices, or a bout of unanticipated inflation.

If you are unsure whether your current investment strategy takes inflation into account, your Authorised Financial Adviser can help you construct a strategy that incorporates an appropriate level of inflation protection for your portfolio depending on your age, risk profile, wealth, tax, liquidity needs and spending goals.

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