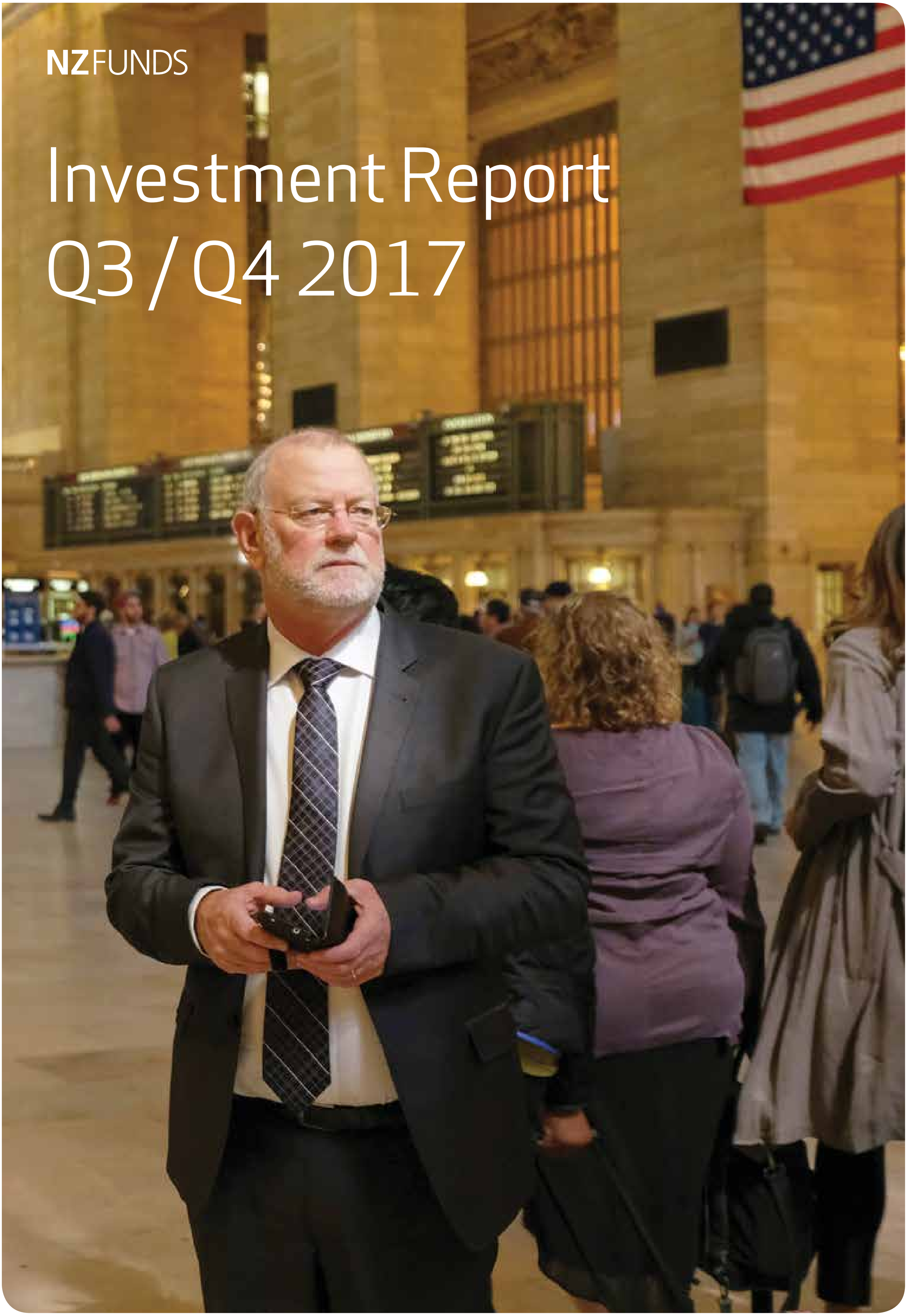
Investment Report Q3 / Q4 2017



Cover: David Wilson, Investment Strategist, Manager Research Meetings, New York, 2017. Photographer: Mark Smith.

Third quarter review

NZ Funds offers clients a globally diversified, value orientated approach with downside mitigation. This enables us to focus on the long-term investment goals of our clients – wealth generation and preservation of capital.

Most investors understand that a broadly diversified portfolio has less risk. However, many investors are surprised to learn that geographic and asset class diversification also improves returns over the long run. Value investing does provide excess returns in the long run, but this requires a patient mindset. Downside mitigation helps with capital preservation but also enables our clients to take advantage of periods of market turmoil.

In this quarter's investment report, we explain our investment approach and why we believe we are well placed to achieve long-term wealth generation for our clients, despite occasional periods of soft returns as has occurred over the last two years in the inflation sector Portfolios.

Returns after portfolio fees and before tax to 31 August 2017

TERM DEPOSIT INDEX	12 MONTH [1]	2016 [1]	2015 [1]	2014 [1]	2013 [1]	2012 [1]	SINCE INCEPTION [2]	INCEPTION DATE
Six month term deposit rates	3.30%	3.29%	4.17%	3.90%	3.98%	4.24%	30.69%	31 Oct 2010

NZ FUNDS KIWISAVER SCHEME	12 MONTH [1]	2016 [1]	2015 [1]	2014 [1]	2013 [1]	2012 [1]	SINCE INCEPTION [2]	INCEPTION DATE
KiwiSaver Income Strategy	1.76%	5.94%	1.44%	4.52%	2.76%	7.89%	32.95%	31 Oct 2010
KiwiSaver Inflation Strategy	-0.64%	1.98%	1.08%	11.57%	5.69%	9.95%	37.60%	31 Oct 2010
KiwiSaver Growth Strategy	9.05%	-2.93%	7.13%	11.79%	27.91%	16.42%	67.42%	31 Oct 2010

NZ FUNDS MANAGED PORTFOLIO SERVICE	12 MONTH [1]	2016 [1]	2015 [1]	2014 [1]	2013 [1]	2012 [1]	SINCE INCEPTION [2]	INCEPTION DATE
Core Cash Portfolio	1.80%	2.20%	3.25%	3.19%	2.55%	2.48%	33.56%	28 Feb 2008
Core Income Portfolio	1.97%	4.93%	2.34%	5.44%	3.20%	8.30%	54.88%	23 Jul 2008
Global Income Portfolio [3]	1.28%	5.60%	1.03%	4.02%	2.19%	7.20%	44.88%	31 Oct 2008
Core Inflation Portfolio [3]	-0.19%	0.34%	-0.31%	9.83%	4.04%	8.15%	36.53%	31 Oct 2008
Property Inflation Portfolio	-2.21%	-1.74%	7.34%	14.21%	2.73%	18.84%	53.59%	31 Oct 2008
Equity Inflation Portfolio [3]	-2.27%	-0.72%	5.14%	13.30%	7.54%	4.79%	43.28%	31 Oct 2008
Core Growth Portfolio [5]	2.76%	-5.61%	5.03%	7.55%	26.06%	13.68%	152.03%	1 May 2003
Global Equity Growth Portfolio [5]	13.87%	-2.13%	8.08%	14.99%	22.74%	15.81%	238.41%	6 Mar 1996
Global Multi-Asset Growth Portfolio [4]	-3.46%	16.88%	-16.54%	-13.96%	-2.02%	-3.30%	-35.05%	7 Nov 2011
Dividend and Growth Portfolio [5]	8.06%	10.44%	13.00%	15.78%	5.69%	18.50%	700.18%	2 Dec 1992

1. Returns for each year are annualised. 2. Since inception returns are cumulative to 31 August 2017. 3. Performance is measured since the launch of the APS platform (now known as NZ Funds Managed Portfolio Service) on 31 October 2008. 4. The inception date shown is the inception date of the current investment strategy. 5. The since inception information represents a composite strategy, which is 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 an indication of the future returns of the Portfolios.

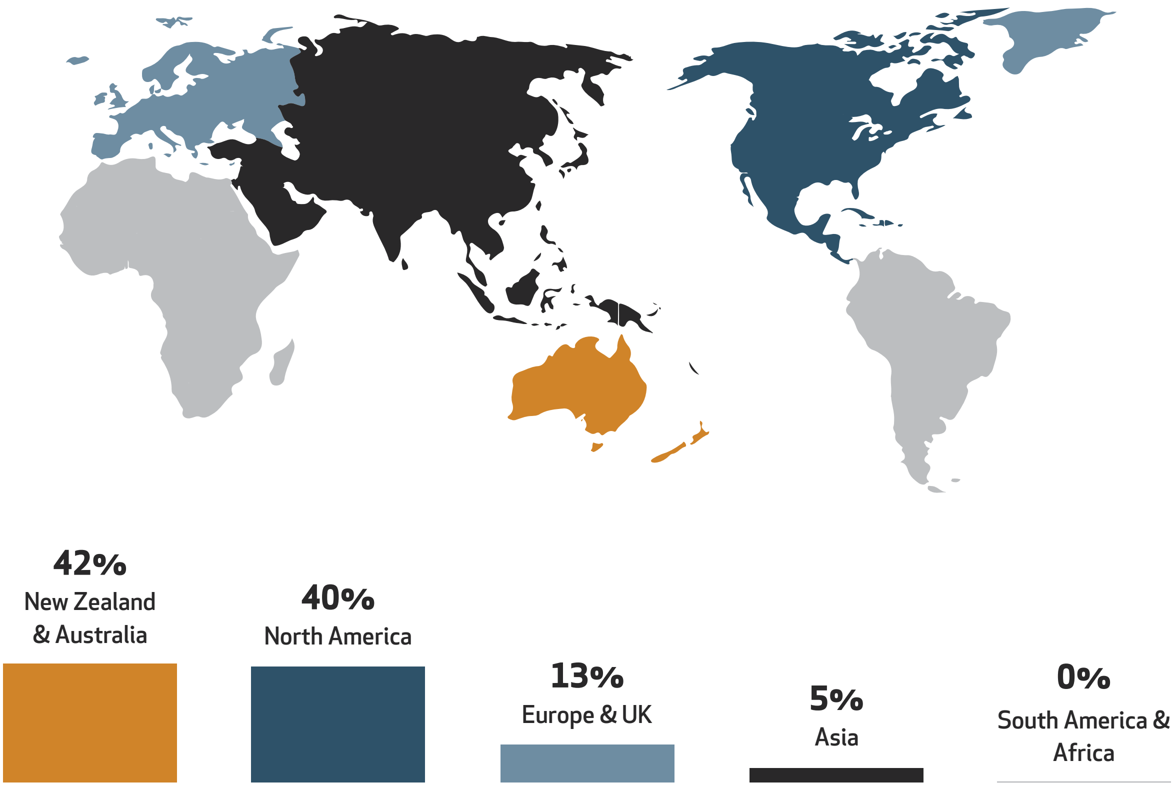
Pre tax returns are stated after Portfolio fees and expenses, but before any advisory fees or investor tax. Past performance is not necessarily an indication of future returns.

Global diversification

What do we mean by global diversification?

New Zealand securities will always form a core part of our clients' portfolios. However, one of the fundamentals of good investing is diversification. At NZ Funds, we maintain a balanced approach to investing clients' capital in New Zealand and global assets of comparable quality. Figure 1 summarises our geographic exposures as at 31 August 2017.

Figure 1: Global diversification of client portfolios



To gain a globally diversified exposure to different asset classes, we use a combination of internally and externally managed strategies. NZ Funds manages assets in-house where we believe we have an advantage in doing so, and partners with global managers to invest the remainder of clients' capital.

When we look for global diversity, a unique advantage we have, is our ability to identify and access top performing global managers. We have over two decades of research on managers across numerous asset classes and geographies. This gives us a rich database from which we can select managers that we believe will give our clients the strongest risk-adjusted returns over the long term.

Our global manager selection process continually evolves. As part of our ongoing due diligence, we hold meetings with potential and existing managers throughout the year. Our schedule includes travelling to Asia, New York and London, where many of the world's leading managers are based.

Figure 2: Global network of investment managers

NZ Funds	Auckland, New Zealand	FUM: NZ$ 1.04 billion [1]
H2O	London, United Kingdom	FUM: US$ 12.4 billion [2]
International Standard Asset Management	London, United Kingdom	FUM: US$ 3 billion [3]
Impala	New Canaan CT, USA	FUM: US$ 2.2 billion [4]
Kynikos Associates	New York City NY, USA	FUM: US$ 3.3 billion [5]
LSV Asset Management	Chicago IL, USA	FUM: US$ 97 billion [6]
Suvretta	New York NY, USA	FUM: US$ 14.3 billion [7]
Universa	Miami FL, USA	FUM: US$ 1.9 billion [8]

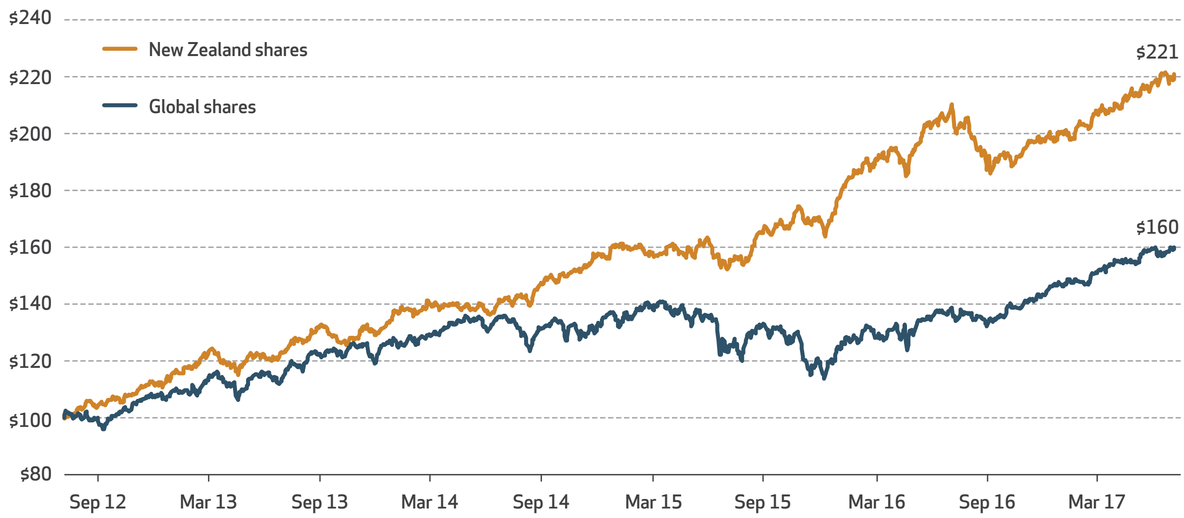
List of investment managers at 1 September 2017: 1. NZ Funds at 31 August 2017. 2. H2O Asset Management at 31 January 2017. 3. International Standard Asset Management at 3 April 2017. 4. Impala at 1 November 2016. 5. Kynikos Associates at 30 June 2016. 6. LSV Asset Management at 1 January 2017. 7. Suvretta Capital Management at 1 January 2017. 8. Universa at 31 July 2016.

New Zealand shares have outperformed

Global diversification does, however, mean clients' portfolios will deviate from time to time from a portfolio solely invested in New Zealand shares. This is exactly what has occurred in recent years. Figure 3 highlights the exceptional performance generated by New Zealand shares when compared to global shares since 2014.

Our clients have benefited from this performance by investing in a portfolio of high dividend yielding New Zealand and Australian shares through NZ Funds Dividend and Growth Portfolio, which has returned 13.01% annually for the past five years, to the end of August 2017. While we expect New Zealand shares to continue to perform well, we do not expect them to outperform global shares in perpetuity.

Figure 3: Global diversification – short-term New Zealand shares have outperformed [1]



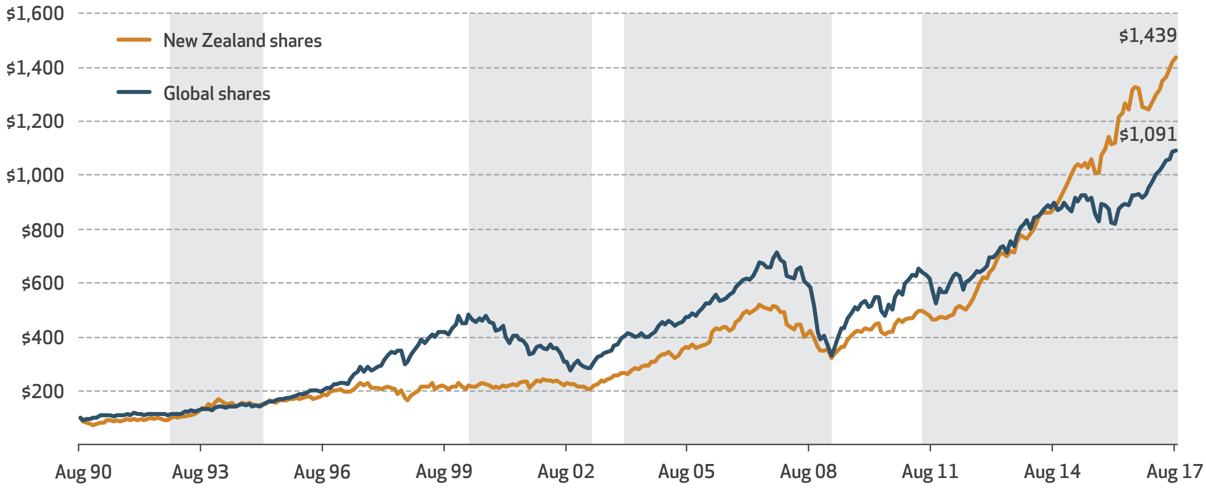
The strong performance of New Zealand shares relative to international shares reflects the recent strength and stability of the New Zealand economy compared to the slowly recovering American and European economies. In its recently released Economic and Fiscal Update 2017, Treasury forecast that the New Zealand economy is expected to continue its steady growth over the next four-year forecast period. Growth in real GDP is forecast to pick up to 3.7% in mid-2019 (from 2.7% today).

1. Source: Bloomberg. August 2012 – August 2017, NZ Funds calculations. New Zealand shares, S&P NZX 50 Index Gross with imputation credits, Global shares, MSCI ACWI.

While the outlook for New Zealand is positive, the economic and fiscal outlook is subject to a range of assumptions, risks and uncertainties. As a commodity exporter, New Zealand's terms of trade are exposed to a raft of risks including a sharper than anticipated slowdown in growth in China as well as changes to regulatory settings in other key overseas markets. Furthermore, growth in domestic demand may be lower than expected if New Zealand households' expectations are dampened by continuing slow wage growth or a weaker outlook for house price growth.

These risks highlight that even in periods of strong growth, very real vulnerabilities still exist and there are dangers with keeping all your eggs in one basket. Therefore, we aim to generate strong and stable returns for our clients by investing globally. Figure 4 shows us that on a longer-term basis, global diversification has its benefits. The unshaded areas of the chart indicate periods where global shares outperform New Zealand shares

Figure 4: Global diversification – longer-term, benefits will prevail [2]



Being globally diversified also corrects for 'home bias'. Home bias occurs when a portfolio is overweight securities that are based on a portfolio's country of origin. This happens because of the natural human tendency for people to avoid things that are unfamiliar. For example, when we know the company, we are more comfortable with holding the shares. We feel like we have more information about it. But that feeling is often a false comfort and leads to portfolios that are under-diversified – and are therefore unlikely to get the best possible risk-adjusted returns.

Value approach

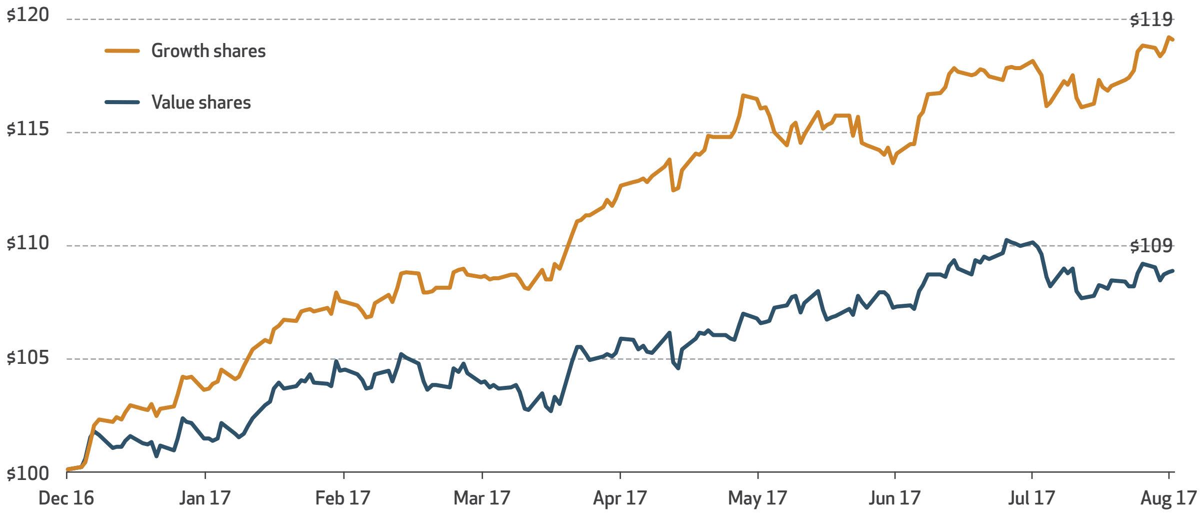
Value investing is a long-term mind set

Not only should client portfolios be globally diversified, but investing also requires a contrarian mindset and a long-term investment horizon. Value investing is the art of buying securities which trade at a discount to their intrinsic value. This approach has historically offered investors a premium over the market and is supported by decades of academic and practitioner research. [3]

Patience is a virtue in value investing. Value investing is not always in favour and does not always outperform over shorter time periods. Figure 5 highlights that year-to-date growth has outperformed value. During such periods, the most expensively priced stocks in the market become even more expensive, usually on the expectation of ever increasing growth rates.

2. Source: Bloomberg. August 1990 – August 2017. New Zealand shares, NZSE 40 Gross (Aug 90 – Jan 01) S&P NZX50 Portfolio Index (Jan 01 onward), Global shares, S&P Global 1200 Gross Index. 3. Fama, Eugene F.; French, Kenneth R., *"Common Risk Factors in the Returns on Stocks and Bonds"*. Journal of Financial Economics. 33 (1): 3–56, 1993.

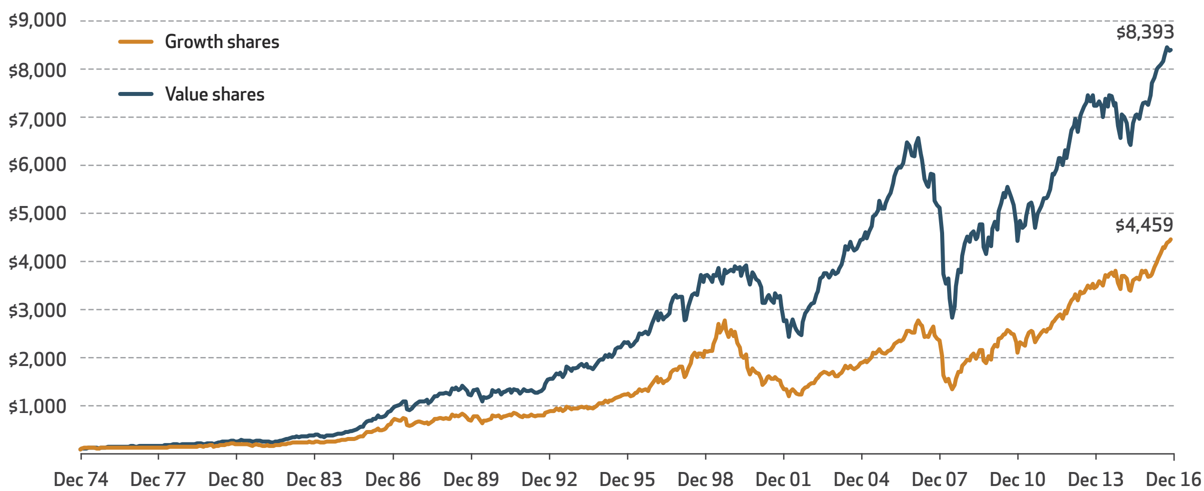
Figure 5: Value approach – short-term growth shares have outperformed value shares [4]



Benjamin Graham's landmark book Security Analysis [5] summarises the present situation nicely when he wrote *"the market is not a weighing machine…rather should we say that the market is a voting machine, whereon countless individuals register choices which are the product partly of reason and partly of emotion."* The metaphor suggests that in the short-term prices are driven by sentiment, while in the long-term trends are driven by something you can measure concretely – financial results. Over the last year approximately one third of the return of the United States share market's strong performance has come from six growth shares: Facebook, Apple, Amazon, Google, Microsoft and Netflix. The average price to earnings ratio of these stocks is now close to 100x. The average price earnings ratio of the "value" component of the S&P500 index is 18x. The last time the valuation gap was this pronounced was in 2000. This was followed by a period of very strong returns from value orientated shares and a slump in technology and growth orientated shares which lasted almost a decade.

In July of this year, Goldman Sachs also warned that the stock market has an "elevated valuation metric on almost every level". Their analysis suggests that the forward price to earnings ratio of the S&P 500 has risen by 80% since 2011 and now trades at the 89th percentile compared with the past 40 years with the typical share at the 99th percentile of its historical valuation.[6] Figure 6 highlights the outperformance of value over growth over the last 17 years and recognises the long-term benefits of value investing.

Figure 6: Value approach – longer-term, benefits will prevail [7]



4. Source: Bloomberg. December 2016 – August 2017, NZ Funds calculations. Growth shares, MSCI Global Growth Index, Value shares, MSCI Global Value Index. 5. Graham, Benjamin, David, L.; Dodd, Sidney Cottle, et. al.: *"Security Analysis: Principles and Techniques"*, 4lhed. New York McGraw - Hill Book Co. Inc., 1962. 6. David Kostin, Equity Strategist, Goldman Sachs Research. 7. Source: Bloomberg 1974 - 2016. Growth shares MSCI Global Growth Index, Value shares MSCI Global Value Index.

NZ Funds' approach to value investing

At NZ Funds we are constantly considering the best way to capture the value premium. Our value approach is present both in assets we manage in-house as well as when we select our global managers. The true value investor is trying to dig out securities that are, for one reason or another, mispriced and misunderstood by the wider market. Whether a share trades at a low or high earnings multiple is meaningless in and of itself. More important is how accurately the price that it can be bought for reflects its intrinsic value.

Our research helps us to regularly improve our value based approach and ensure we are considering all the factors that could help drive returns and reduce risk. We cannot forecast exactly when the market will recognise the intrinsic value of the companies in which we are invested, but by placing emphasis on strong business fundamentals and low valuations, as value investors we can recognise companies with considerable potential for sustainable long-term share price appreciation.

A company whose shares are trading below their long-term intrinsic value still has the potential to grow earnings, albeit at a slower rate than quickly growing market superstars, like New Zealand's A2 Milk and software company Xero. Perhaps more importantly, in the event of a share market crash, either the company's long-term intrinsic value or its dividend yield can provide a sea-anchor to slow its fall, whereas a pure growth orientated company may mirror or exceed the broader share market fall.

When we look to partner with global managers, we tend to favour value orientated managers such as our current global share managers LSV Asset Management and Suvretta Capital. LSV will typically have a deep value orientation relative to its benchmark. They have a quantitative and qualitative process to identify companies with low price to earnings, low price to cash flow, and high dividend yields.

Suvretta is a global, long-short manager. It believes that industry fundamentals drive stock performance as much as individual company performance. While it can and does hold growth shares, Suvretta's method of identifying sectors and companies within a sector has both a value and a quality bias. Suvretta deploys capital in industries with the strongest secular growth, owning the best companies with unrealised intrinsic values. Conversely, it shorts the worst companies in weak and contracting industries.

In our Q1 / Q2 2017 Investment Report, we discussed areas of the market where value opportunities exist. This included the banking and finance and metals and mining sectors. Our global managers continue to see significant value upside in these sectors relative to expensive sectors such as technology. Consequently, these sectors make up components of our value managers' portfolios but are by no means the only themes within clients' domestic and global investments.

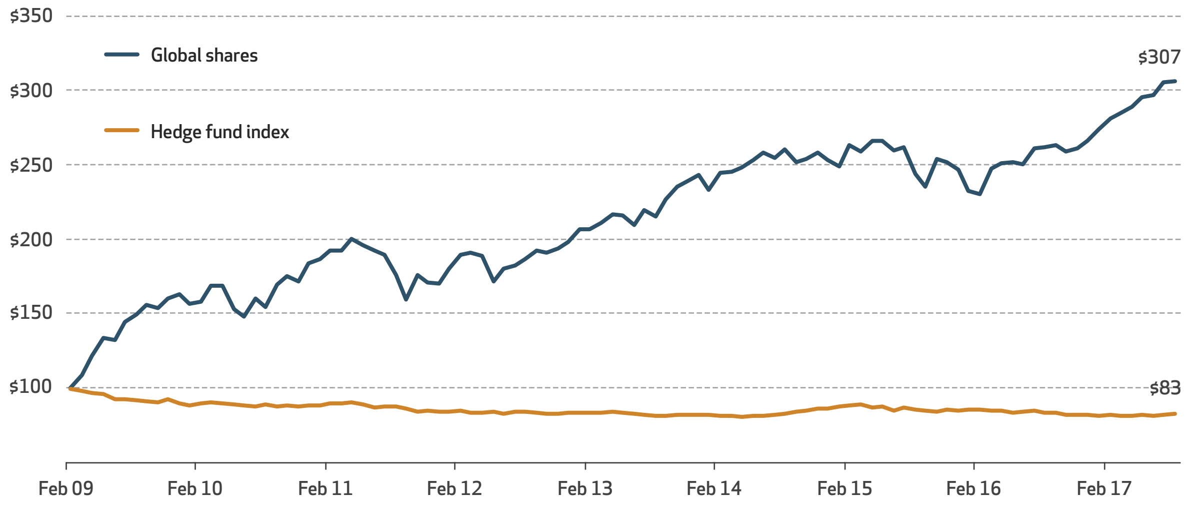
We also noted in the Q1 / Q2 Investment Report that the catalyst for the long-term performance of these sector themes are not solely dependent on United States President Trump, but would be accelerated by initiatives in tax and infrastructure spending. The benefits of the Chinese Belt and Road Initiative are already positively impacting the metals and mining sector where we believe we are still early in the cycle.

Downside mitigation

As we explained in our third quarter investment report in 2015, managing our clients' wealth is a game of two halves. While we are seeking to capture the upside, there are periods when mitigating the downside needs to take centre stage. We seek to mitigate risk in several ways which include using specialist hedge fund managers, currency management and the ability to hedge in a crisis.

In the 2015 report we also discussed that mitigating the downside is important for several reasons. First, our clients expect to draw down on their capital whenever they wish. A material slump in the value of their portfolio makes that difficult. Second, we want our clients to emerge from each successive economic downturn in the strongest position possible to capture the upside, as this can make a significant difference to their wealth over time. However, in the short-term, including downside mitigation in clients' portfolios will dampen returns. This is exactly what has occurred since March 2009, as New Zealand and international shares have risen and hedge funds in general have lost value..

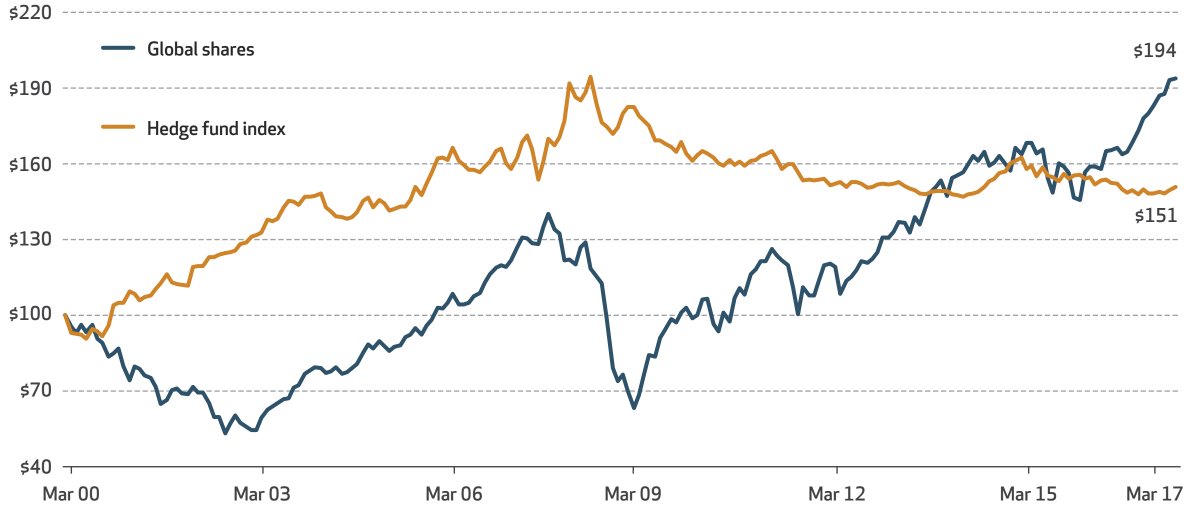
Figure 7: Downside mitigation – short-term hedge funds have underperformed [8]



However, New Zealand and global shares do not rise smoothly year after year. Shares face two headwinds over time: medium-term declines caused by a local or international economic downturn; or, short sharp drops caused by an economic or geopolitical crisis. In both cases hedge funds can make a valuable contribution to a well diversified investment portfolio, but in different ways.

Global market performance following the 'dot-com' crash in 2000/01 is a good example of a medium term pullback. Global shares initially recovered from 2003 but then slumped only five years later in the Global Financial Crisis (GFC). Overall, during the period between 2000 and 2009, global shares delivered no capital gain, averaging -5.0% per annum (-36.8% cumulative return) over nine years before dividends.[8] However, in the same period, the average hedge fund measured by Hedge Fund Research rose 6.9% per annum (82.6% cumulative).[9]

Figure 8: Downside mitigation – longer-term, hedge fund ownership can be beneficial [9]

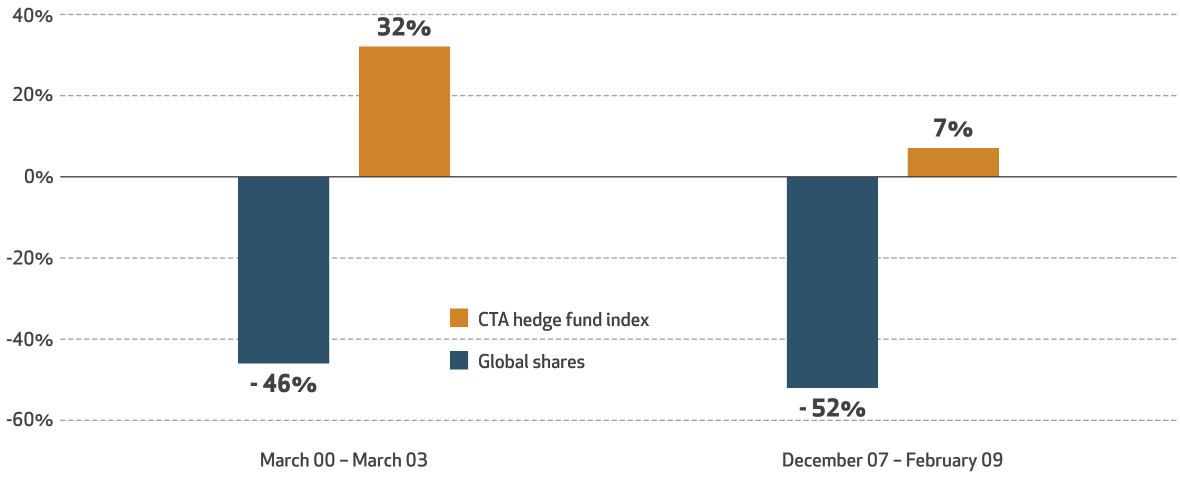


The second type of situation where hedge fund ownership can prove valuable is during a short sharp downturn, commonly known as a share market 'crash'. New Zealand and global shares have experienced such sharp downturns twice in the past 20 years, once from 2000 to 2003 and again from 2008 to 2009. Such events are popularly known as left-tail or black swan events.

8. Source: Bloomberg. February 2009 – August 2017, NZ Funds calculations. Global shares, MSCI ACWI in USD, Hedge funds, Hedge Fund Research Global Hedge Fund Index. 9. Source: Bloomberg. March 2000 – August 2017. Global shares, MSCI ACWI in USD, Hedge funds, Hedge Fund Research Global Hedge Fund Index.

The term 'black swan' was popularised by writer and academic Nassim Nicholas Taleb to describe extreme events that are difficult to predict and more likely to happen than is forecast. High share market valuations, increased consumer leverage and extraordinary central-bank stimulus are among the factors that make a black-swan event more likely now than at any time since the GFC. Figure 9 shows the benefits of hedge funds during such events.

Figure 9: Downside mitigation – longer-term, hedge fund ownership can be beneficial [10]



NZ Funds' approach to downside mitigation managers

NZ Funds' left tail managers, Universa and International Standard Asset Management (ISAM), seek to profit from significant market declines and black swan events. Universa focus on buying deeply out-of-the-money options, which cost a small amount each year to buy and hold, but have the potential to pay-off in a share market collapse.

Universa estimate that in a rapid decline of over 20% in global shares, each $1 invested with Universa would rise in value six-fold. Holding an investment in clients' portfolios which has the potential to generate a significant amount of cash during a downturn, which can then be used to buy assets at distressed prices, is in our view an ideal way to help compound clients' wealth over the long term.

ISAM plays a similar role in clients' portfolios to Universa, but seeks to achieve this in a very different way. ISAM uses a momentum-based approach. It screens over 220 global futures markets, and invests when a medium-term trend (either upward or downward) emerges and thus has the potential to generate large gains during either a prolonged rise or fall in markets.

Currency management

The final component of NZ Funds investment approach is our active management of global currency exposure. Any purchase of an international asset, made to ensure clients hold globally diversified portfolios, comes with foreign currency exposure. There are two simple currency management options for clients who hold international investments in their portfolio. They can own international investments without any currency hedging. In that situation clients' portfolios are fully exposed to the volatility of the exchange rate between New Zealand and whichever currency their international investment was purchased in. This may increase the volatility of a portfolio. Alternatively, exchange rate volatility can be removed by fully hedging all international investments back into New Zealand dollars to remove exchange rate risk.

10. Source: Bloomberg, NZ Funds research. March 2000 – March 2009. CTA hedge fund index, HFR Macro CTA Index, Global shares, ACWI in USD.

The downside of owning a fully hedged portfolio of international assets is that, despite owning global investments, clients' portfolios are completely dependent on the purchasing power of the New Zealand dollar. Should an economic recession occur, such as during the Asian Crisis in 1997/98, or worse yet should there be a natural disaster such as an earthquake or outbreak of foot and mouth disease, the New Zealand dollar might lose much of its value against other currencies. Local investors in United Kingdom experienced this kind of wealth destruction when the British Pound lost almost 20% of its value following Brexit.

NZ Funds seeks to ensure clients have much of the benefit of being hedged into New Zealand dollars, but we can hold other global currency positions to ensure clients have some diversification outside of the New Zealand dollar. The size of the exposure depends on our assessment of the relative value of the New Zealand dollar against the major global currencies. Position size also reflects the nature and risk profile of the portfolio (income versus growth assets) and the proportion of global assets held in that portfolio.

Business

This year has been another strong year for NZ Funds, with the number of accounts growing by 2% to over 13,000, while funds under management has increased to over $1.04 billion.

The NZ Funds KiwiSaver Scheme was acknowledged in David Chaplin's KiwiSaver Annual Market Report 2017 as being one of the top five fastest growing schemes in New Zealand for the third year running and providing clients with an overall return in the top five of all KiwiSaver providers.[11]

We recently launched a Superannuation and United Kingdom and Australian pension transfer service, both of which have been well received by clients and advisers. We now have a strong pipeline of clients transferring from older, less competitive New Zealand based schemes.

Lastly, we continue to invest in growing the team behind your investments. We would like to welcome Stephan Clark who joins us, as Head of Compliance from Goldman Sachs and Dave Haslam, Head of Trading, who is also a Goldman Sachs alumni. We also welcome back James Grigor, CFA who has returned to NZ Funds after nine years away, where he worked in United Kingdom private equity and more recently as Head of Private Wealth Investments for Macquarie Bank New Zealand.

Summary

Whatever uncertainties are on the horizon, whether they be political, environmental or economic, having a globally diversified value investing approach provides a powerful driver for long term returns.

While we will continue to maintain clients' exposure to strong New Zealand and Australian listed dividend paying companies, we are not moving away from our philosophy of international diversification, or our strong bias toward United States and global shares and bonds.

Downside mitigation is necessary to counter the tendency of clients to crystallise losses during periods of heightened volatility. High share valuations in the technology sector, increased consumer leverage and extraordinary central-bank stimulus are among the factors that make a black swan event more likely in the near future.

We expect the benefits of our approach to become more tangible as the market's cycle develops and in the years to come. Once again, thank you for entrusting your capital to us over the long term.

11. Source: Chaplin, D., "KiwiSaver the 10th King of all it surveys KiwiSaver Annual Market Report 2017". 2017

New Zealand Funds Management Limited

Level 16, Zurich House

21 Queen Street
Private Bag 92163, Auckland 1142
New Zealand

T. 09 377 2277
E. info@nzfunds.co.nz
www.nzfunds.co.nz