NZ FUNDS

CIO Report: Q2 2015

July 2015

Photographer: Michael Lang
'View from Suvretta's office'

Second quarter review

Many of our long-term clients have the skills to manage their own investments, but they want to spend their time in other ways. They may be partners in legal or accounting practices, run their own businesses, or just enjoy extra time with family and friends. They recognise that developing a wealth management strategy, ensuring it evolves as their lives evolve, and managing a diversified selection of world-class managers, is a full time job. This quarterly report provides insight into the work that goes on behind the numbers.

Returns for the second quarter of 2015 were flat. As each client's portfolio is customised to their risk and savings (or spending) profile, we use five indicative portfolios to track progress. Over the last 12 months, portfolio returns have been between 5.45% and 12.95% after fees and tax (assuming a PIE rate of 28%). This compares favourably with a 12 month return after tax of 2.85% from the Reserve Bank's term deposit index.

Clearly, clients' portfolios also come with a higher level of risk than term deposits. We seek to mitigate that risk in a number of ways which include using specialist hedge fund managers. Those managers are the focus of this report.

Performance overview after fees and investor tax as at 30 June 2015

NZ Funds Managed Portfolio Service	1 year	2 year	5 year	Since inception	Inception date
Core Cash Portfolio	2.56%	4.55%	10.37%	18.72%	28 Feb 2008
Core Income Portfolio	3.81%	7.89%	19.98%	29.70%	23 Jul 2008
Global Income Portfolio	0.99%	3.83%	15.25%	21.68%	31 Oct 2008
Core Inflation Portfolio	4.65%	14.76%	34.85%	45.75%	31 Oct 2008
Property Inflation Portfolio	7.92%	17.28%	35.41%	37.27%	31 Oct 2008
Equity Inflation Portfolio	10.16%	23.96%	52.97%	101.51%	31 Oct 2008
Core Growth Portfolio	10.64%	29.48%	38.10%	37.96%	31 Oct 2008
Global Multi-Asset Growth Portfolio	-17.73%	-16.58%	-	-22.96%	7 Nov 2011
Global Equity Growth Portfolio	17.22%	32.37%	39.41%	36.17%	31 Oct 2008
Dividend and Growth Portfolio	14.60%	27.40%	39.65%	42.64%	31 Oct 2008
Capital Opportunities Portfolio	7.58%	24.47%	74.36%	89.33%	23 Jul 2008
Term deposit index (after tax)	**2.85%**	**5.42%**	**14.97%**	**-**	**-**

NZ Funds KiwiSaver Scheme	1 year	2 year	3 year	Since inception	Inception date
KiwiSaver Income Strategy	1.29%	4.58%	7.93%	13.87%	31 Oct 2010
KiwiSaver Inflation Strategy	5.63%	17.20%	27.48%	28.97%	31 Oct 2010
KiwiSaver Growth Strategy	14.50%	33.19%	61.05%	49.37%	31 Oct 2010
Term deposit index (after tax)	**2.85%**	**5.42%**	**8.34%**	**-**	**-**

Source: Post tax returns are stated after Portfolio fees and expenses and investor tax at the highest Prescribed Investor Rate (PIR). From 1 October 2008 to 30 September 2010 the highest PIR was 30%. Since 1 October 2010 the highest PIR has been 28%. Past performance is not necessarily an indication of future returns.

Hedge Funds

The concept of a hedge fund is simple; it is an investment operation established to grow the wealth of its investors and owners. Unlike most investment managers who focus on buying and holding a certain type of asset, for example shares or bonds, hedge funds are able to invest in a wide range of assets and use investment instruments and techniques which are not ordinarily available to traditional fund managers, or personal investors. These include using derivatives, options and leverage and the ability to profit from either a rise, or fall, in the price of an asset.

An essential component of managing investments is constant vigilance. This is especially the case when working with hedge funds. Our approach to managing hedge fund risk is simple. We assume even professionals (including us) can make mistakes and size our clients' holdings so that should any one hedge fund fail, our clients' overall portfolios can continue. The analogy we use internally is that each portfolio should be built like a centipede: even if it loses a leg, it can keep on running.

As part of our ongoing due diligence, we held 111 meetings with investment managers last year, and have had 84 meetings so far this year. Our schedule includes travelling to New York and London where many of the world's leading managers are based.

Long-Short

During our most recent trip we met with two very different managers, both of whom take a long-short approach to portfolio management on our, and our clients' behalf. Suvretta is a New York based hedge fund founded by Aaron Cowen in 2012. Aaron is the former Co-Portfolio Manager of SAC Capital, a hedge fund which compounded its clients' wealth by approximately 25% p.a. for over 21 years, equivalent to turning $100,000 into $10.8 million. Investment organisations as successful as SAC Capital are often ideal for our clients, but many are closed to new investors.

To overcome this problem, the NZ Funds Investment & Research team tracks a number of leading hedge funds, waiting for a catalyst which might enable us to invest. When SAC Capital stopped managing public funds, many of its top investment personnel set up their own hedge funds. In their first years of business, we met with three of them. Our clients' investment[1] with Aaron Cowen's Suvretta came out of those meetings. Since we invested, Cowen has grown clients' investments at an annualised rate of 23% p.a. In time we expect he too will close to new investors.

TT International (TT) on the other hand is one of Europe's long-standing hedge fund managers. TT was founded by a portfolio manager from Fidelity International, Tim Tacchi, in 1988. Today TT manages over US$8.4 billion. We have admired TT's culture and single minded focus on hedge fund management for over a decade. As is typically the case, their top performing specialist fund, the European Long-Short Equity Fund is so successful that it has been closed to new investors for many years. However, in meeting with TT in 2013, we learned that one of the team, Vikram Kumar, had earned the partners approval to start a second European specialist fund. By investing with Vikram in his first year, we were able to secure advantageous terms, known in the industry as "founder's class". Vikram is a specialist in small-to-medium-sized European companies, the types of companies it is hard to gain exposure to by investing in a share market index. Together with the other members of his team, he meets around 800 companies a year, selecting around 50 for inclusion in clients' portfolios.

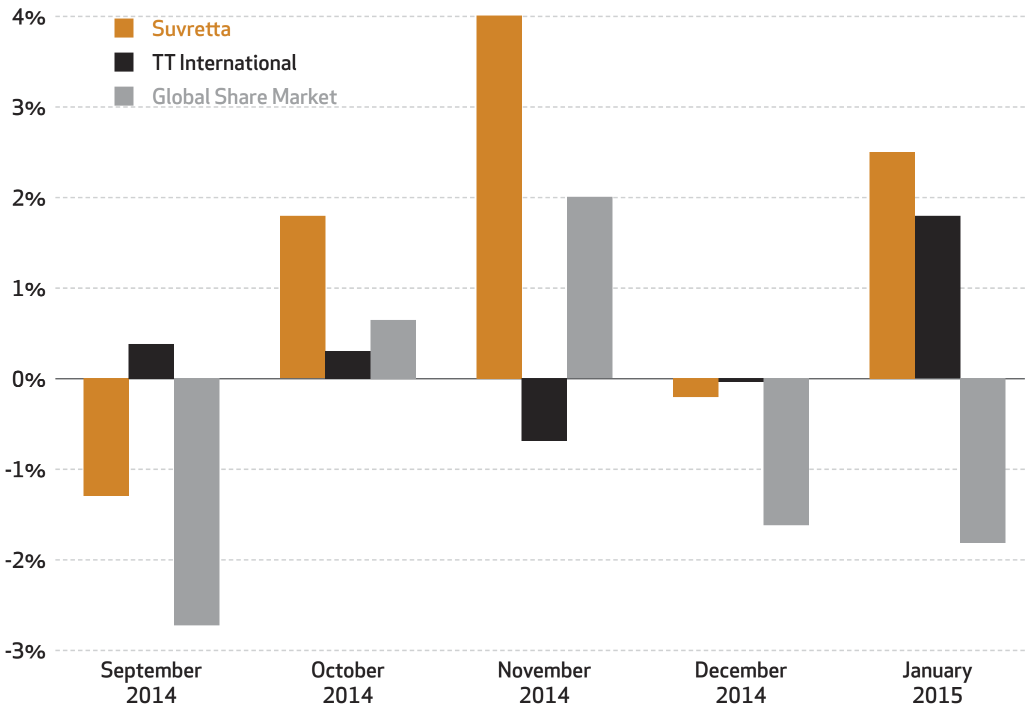
Despite a difference in investment focus (medium-sized European companies as opposed to large US firms) both Vikram and Aaron use the same long-short investment approach. For every dollar invested, long-short managers will typically invest approximately 120% of clients' capital in the companies where they see strong upside potential, and then sell short (sell and then seek to buy back later at a lower price) another portfolio of companies which they think are overvalued or face significant competitive headwinds. Overall, clients are only 60% exposed to the share market's volatility (120% long less 60% short, equals 60% exposure).

If the manager is a good judge of company quality and price, his or her strong companies will rise in value faster than the long-term share market average of approximately 10%, while his or her weak companies should rise less quickly, or even fall. In a year where shares are up 10%, a long-short manager's long shares might be up 12%, while their short shares may only rise 8%. Putting the two

together (a 120% exposure to +12%) less (a 60% exposure to -8%) gives a return of 9.60% – approximately the same return as the share market, but with less share market risk. In a downturn, the share market might fall -10%. Ideally, the strong companies will fall by less (say 8%) whereas the poor companies might fall by more (say 12%). Thus in a -10% down market a long-short portfolio might only fall by -2.4%; (a 120% exposure to -8%) plus (a 60% exposure to +12%).

A good quality long-short manager is therefore able to grow client capital at a similar speed to the share market, but with less exposure to share market volatility. This is exactly what both Suvretta and TT did during the share market's recent pullback in late 2014.

Managers in downturn



Source: Suvretta, TT International, Bloomberg. NZ Funds calculations based on MSCI World Index.

While many of the managers we meet use a long-short approach, we also work with a number of hedge funds which have more focused areas of expertise. Three such managers are Paulson, Odey and Astenbeck; which like TT and Suvretta are managed by exceptionally successful and focused individuals.

Merger Arbitrage

John Paulson founded Paulson & Co in 1994 after an investment banking career with Bear Stearns. Since then he has grown his clients' capital by 1,316.4%[2]. He is now one of the most sought after hedge fund managers in the world[3] and manages a portion of our clients' savings in KiwiSaver and in the Managed Portfolio Service.

Paulson's focus is merger arbitrage. Put simply, he is an expert in corporate takeovers. When one company makes a takeover offer for another, it might offer $2.00 per share, however as there is a risk the takeover will not succeed, the share price of the company being acquired might only rise to $1.80. Paulson and his team will quickly evaluate whether they think the takeover will be successful or not. They might consider how the offer is being funded, whether anti-competitive clearance is needed, and what the major shareholders on both sides think. If the deal is successful in, for example, 6 months, Paulson's investors would earn $0.20 per share. While this only represents an 11% return, annualised it equates to over 20% p.a. Paulsons' clients also stand to benefit from topping bids, where the offer price is increased. While investors risk a loss if the takeover offer is withdrawn, they face very little share market risk, as once a company is under takeover, it tends not to fluctuate with the share market.

By visiting Paulson regularly, including on our most recent trip, we have been able to secure a customised fee arrangement which we feel better suits our clients' objectives.

Paulson International Merger Arbitrage spreads 31 March 2015

Target/Acquirer	DIRECTV*/AT&T	Time Warner Cable/ Comcast	Pharmacyclics/ AbbVie	Talisman Energy/ Repsol SA
Target location	U.S.	U.S.	U.S.	Canada
Transaction size (bn)	$43.1	$41.9	$15.8	$8.0
Offer price	$95.00	$162.35	$261.25	$8.00
Target stock price	$85.10	$149.88	$255.95	$7.68
Net spread**	$4.70	$12.50	$5.30	$0.40
Gross return	5.5%	8.3%	2.1%	5.6%
Closing date	29 May 2015	30 June 2015	29 May 2015	1 May 2015
Annualised returns	33.7%	33.4%	12.6%	65.4%

Source: Paulson & Co. as at 31 March 2015.
* DIRECTV spread assumes below stock collar. ** Net spread adjusts for expected net dividends.

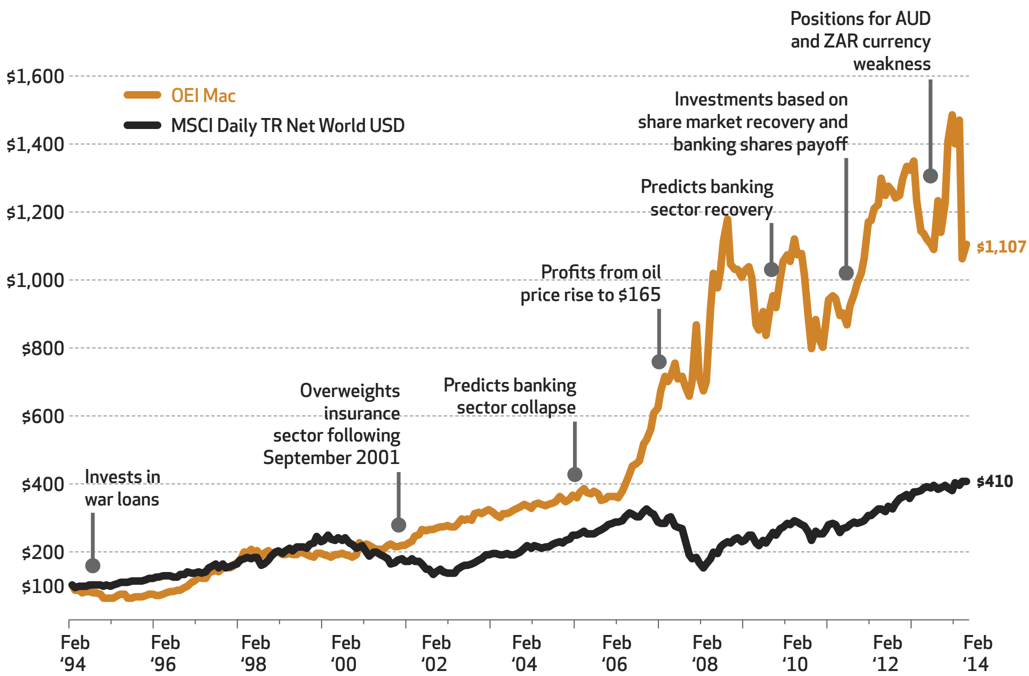
Global Macro

One of the most influential financiers in England is Crispin Odey. Crispin established Odey Asset Management with the support of George Soros in 1991 and today oversees US$12.8 billion. In fact, the night Soros and his Portfolio Manager Stan Druckenmiller made over US$1 billion for their investors speculating on the collapse of the British Pound, Soros was on the phone to Druckenmiller in Crispin's London office.

Crispin seeks to buy sustainable businesses at a fraction of their long-term value. He does this by buying them when they are out of favour with investors. For instance, he correctly foresaw that the value of insurance companies would rise after the September 11 attacks in 2001. During the 2008 Global Financial Crisis, he anticipated the banking sector would come under pressure and positioned his clients to profit from a fall in the share price of banks. That year his return was 54.8%. The next years he purchased large holdings in a number of English banks, forecasting that in time they would repair their damaged balance sheets and recover.

In general, we have found United States based investors tend to be inwardly focused, while English based managers are outwardly focused. Crispin is no exception. He uses his background in History and Economics to profit from changing global macroeconomic variables such as interest rates, inflationary expectations and currency markets, as demonstrated by his exceptional track record. NZ Funds began working with Crispin and his investment team of over 100 people in 2009.

OEI Mac Net Returns from February 1994



Source: Odey Asset Management fund performance, Bloomberg. NZ Funds calculations and annotations.

Commodity Trading

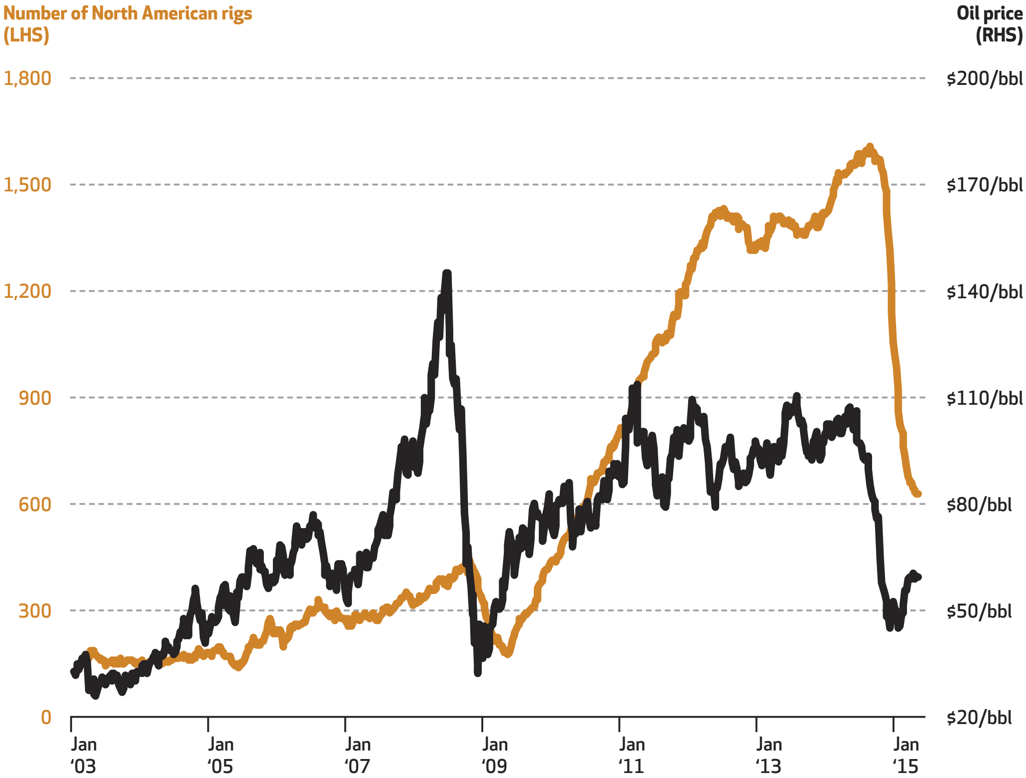
Commodities are one of the least understood investments in clients' portfolios. They have a number of features that make them best suited to specialist traders. Commodities are difficult for individuals to buy and often impossible to store. As a result, most of the world's commodities trade via futures contracts. These in turn are extremely volatile and must be repurchased regularly (as they expire).

Countering these negatives is the diversification benefit of holding commodities which are significant. Over the long-term, commodities have on average risen by 8% p.a. Commodities are also a powerful source of inflation protection; $1 worth of commodities can help protect $1.75 of client funds[4]. Finally, commodities are skewed to the upside, meaning they tend to leap in value when things go wrong, which helps differentiate them from most other assets clients hold.

During our recent visit to Connecticut, we met the team at Astenbeck Capital Management. Astenbeck was founded by Andy Hall in 2010. Andy has traded oil, gas and metals for more than 40 years. In 2009, Andy's reported share of the profit he had generated trading oil for Phibro LLC was around US$100 million; so Andy set up his own business: Astenbeck. Today, Astenbeck is one of the largest commodity orientated hedge funds in the world with US$3.5 billion in funds under management. Their approach is to capture gains from oil, gas and metals, while protecting clients' capital against significant falls which periodically occur in commodity markets. It is an approach we feel is aligned with our own, and as a consequence we are adding Astenbeck to clients' portfolios, and in particular the Managed Portfolio Service through the Global Multi-Asset Growth Portfolio.

Andy Hall's views on oil during our meeting are of particular interest. In his opinion, oil is getting set up for a significant uplift. Few investors understand that while shale gas has helped cause short term oil prices to collapse from over US$100 per barrel to around US$60 per barrel today, shale can only supply around 6-10% of the world's oil needs. Longer term, deep sea wells and arctic exploration (or equally expensive alternatives) are needed. Such production takes many years of preparation to bring to market. Instead of planning ahead, most companies and countries are now cancelling these projects. This will leave the world with more demand than supply and a two or three year lag before new sources of supply come online. In his view, the longer oil stays at US$60 per barrel, the more explosive the upside potential.

Oil rig count follows oil price down



Source: Baker Hughes, Bloomberg. NZ Funds calculations.

Left-tail managers

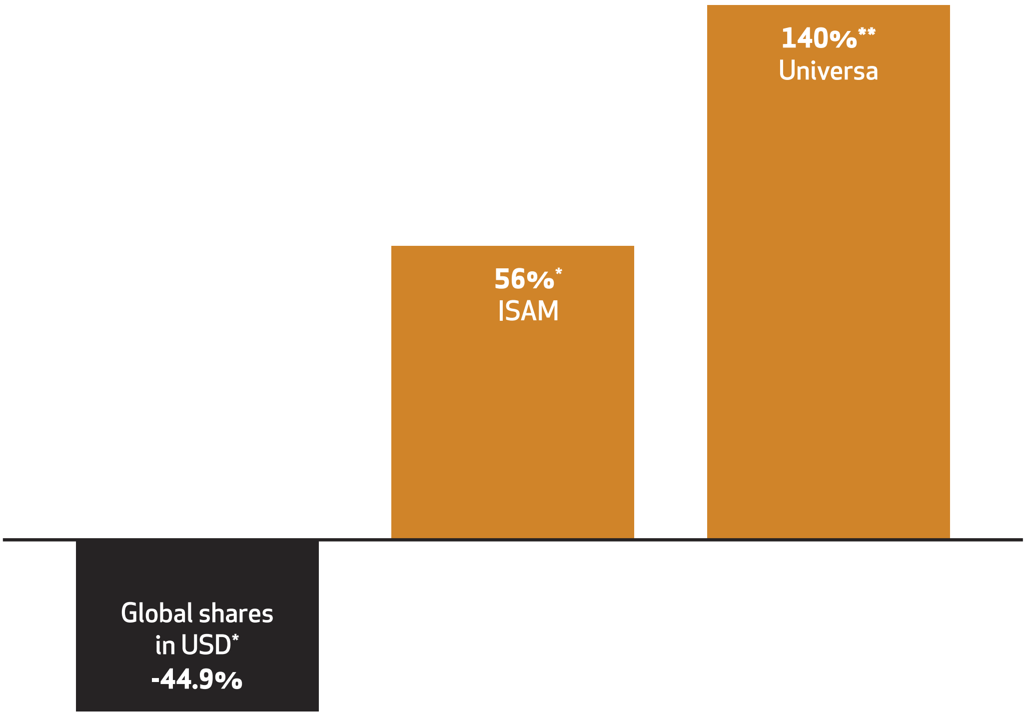
The final category of specialist hedge fund that clients' portfolios contain is left-tail managers. The name comes from a normal probability distribution graph, where the far left represents years in which the market falls by exceptionally large amounts, the middle represents the most commonly earned return, and the far right represents exceptionally strong returns. Left-tail managers seek to profit from significant market declines. NZ Funds currently holds investments with Universa and ISAM.

East Coast based Universa was founded by Mark Spitznagel, the former head of Morgan Stanley's secretive equity options proprietary trading division in New York. On Wall Street, he is known for having placed a hugely profitable billion dollar derivatives bet on the stock market crash of 2008, and for profiting from the 2000 tech crash. Mark and his team focus on buying deeply out of the money options, which cost a little each year to buy and hold, but have the potential to pay-off in a share market collapse. We estimate that in a rapid decline of over 20% in global equities, 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, and 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. In addition to NZ Funds, Universa is reported to have large Chinese and Middle Eastern sovereign wealth funds among its clients.

International Standard Asset Management (ISAM) plays a similar role in clients' portfolios to Universa, but seeks to achieve this in a very different way. ISAM was founded by Lord Stanley Fink – the former CEO of MAN Group in London – and Larry Hite, one of the forefathers of systematic trading. ISAM uses a momentum-based approach. It screens over 130 global futures markets, and invests when a medium-term trend (either upward or downward) emerges. Last year the portion of clients' portfolios managed by ISAM's returned approximately 92%.

Downside protection offered by left-tail managers, 2008 case study



Source: NZ Funds, Bloomberg.
* 12 months ending 31 Dec 2008.
** Sept-Dec 2008. Hypothetical Black Swan Protection Protocol results prepared for NZ Funds based on its notional position as calculated by Universa. Actual results may vary in the future.

Fees

By generating such a strong return on clients' funds, ISAM earned themselves a significant performance fee. Fees are an area of sensitivity, and concern, for both clients and managers. We have the same expectations around the investment specialists we appoint as our clients have of us: namely that the fee payable is an accurate reflection of the level of return and quality of service delivered. When negotiating fees with investment specialists we seek to balance paying a fixed annual fee, irrespective of the level of return delivered or risk taken, with paying a variable fee which can help align the specialist manager's interests with that of our clients. As a result, we have negotiated a range of different fee structures, designed to encourage our managers to meet our New Zealand clients' objectives. If you would like to know more about your fees, please don't hesitate to contact us or your Authorised Financial Adviser.

12 month period ending 31 March

NZ Funds KiwiSaver Scheme*	2013	2014	2015
Income Strategy			
Target base fee	0.95%	0.95%	1.15%
Performance fee	0.00%	0.00%	0.01%
Returns (after fees; before tax)	**6.53%**	**2.36%**	**4.36%**
Inflation Strategy			
Target base fee	1.15%	1.15%	1.35%
Performance fee	0.08%	0.07%	1.26%
Returns (after fees; before tax)	**11.67%**	**4.05%**	**13.19%**
Growth Strategy			
Target base fee	1.30%	1.30%	1.50%
Performance fee	0.63%	0.62%	2.95%
Returns (after fees; before tax)	**15.91%**	**15.93%**	**25.14%**

NZ Funds Managed Portfolio Service**	2013	2014	2015
Indicative Client 40 years old			
Target base fee	2.67%	2.67%	2.67%
Performance fee	0.72%	0.58%	2.11%
Returns (after fees; before tax)	**10.89%**	**7.19%**	**11.11%**
Indicative Client 60 years old			
Target base fee	2.40%	2.40%	2.40%
Performance fee	0.49%	0.40%	1.51%
Returns (after fees; before tax)	**9.65%**	**5.75%**	**10.30%**

* NZ Funds does not receive performance fees for the NZ Funds KiwiSaver Scheme. All performance fees accrue to external specialist managers.

** NZ Funds may receive performance fees for the Managed Portfolio Service. Details are available in the Investment Statement which is available via our website.

Summary

In the past, we have written about a worrying amount of instability in the financial system, both domestically and abroad. Over the last year or so, many major asset classes have suffered a dislocation. In currency markets, we have seen a rapid collapse in value in the Euro and Swiss Franc, as well as the New Zealand and Australian dollars. In Europe, German bond yields collapsed below zero and then rebounded, while many commodities including oil and milk powder are meaningfully lower than a year ago. The exception remains shares, which may now face a correction. The degree to which share market gains are being driven by central banks rather than fundamentals remains unclear. The merit of holding hedge funds in such an environment, in our view, is not.

There is a perception amongst New Zealanders that most investment management organisations offer a similar service. I hope the discussion on NZ Funds' use of specialist hedge fund managers helps demonstrate that nothing could be further from the truth. NZ Funds prides itself on its ability to combine top international managers with over twenty-five years of local investment experience.

Michael Lang
Chief Investment Officer

1 All client investments are held indirectly through the portfolios managed by NZ Funds.

2 Paulson Partners LLP cumulative performance from July 1994 to 31 March 2015. Returns of individual investors may vary.

3 31 December 2014, Paulson & Co was the 12th largest hedge fund in the world.

4 August 1972-July 1982, US CPI and S&P Goldman Sachs Commodity Index.

Investment Statement(s): For further information or to request a copy of the NZ Funds Managed Portfolio Service Investment Statement or the NZ Funds KiwiSaver Scheme Investment Statement, please contact NZ Funds or see our website www.nzfunds.co.nz

NZFUNDS

New Zealand Funds Management Limited

Auckland

Level 16, Zurich House
21 Queen Street
Private Bag 92163, Auckland 1142
New Zealand

Phone - 09 377 2277
Email - info@nzfunds.co.nz
www.nzfunds.co.nz

Follow us on twitter.com/nzfunds

Wellington
Level 3
Central on Midland Park
40 Johnston Street
Wellington 6140

Phone 04 473 7701

Christchurch
Unit 7a
9 Sir Gil Simpson Dr
Burnside
Christchurch 8053

Phone 03 366 9088

Wanaka
Unit 7
12 Frederick Street
Wanaka 9305

Phone 03 443 2300

Dunedin
Level 2
Bracken Court
480 Moray Place
Dunedin 9016

Phone 03 477 4647

Invercargill
98c Yarrow Street
Invercargill 9810

Phone 03 218 2895