NZ FUNDS

CIO Report: Q4 2014

January 2015

Full year review

We had another strong year in 2014. Our clients enjoyed strong after tax and fees returns: an average 40 year old gained 5.9% and an average 60 year old gained 6.3%. This compares favourably with the primary alternative, term deposits, which returned only 2.6% after tax (assuming a 33% tax rate). Over the last three years, an average 60 year old client has enjoyed an after tax and fees return of 7.7% pa.[1]

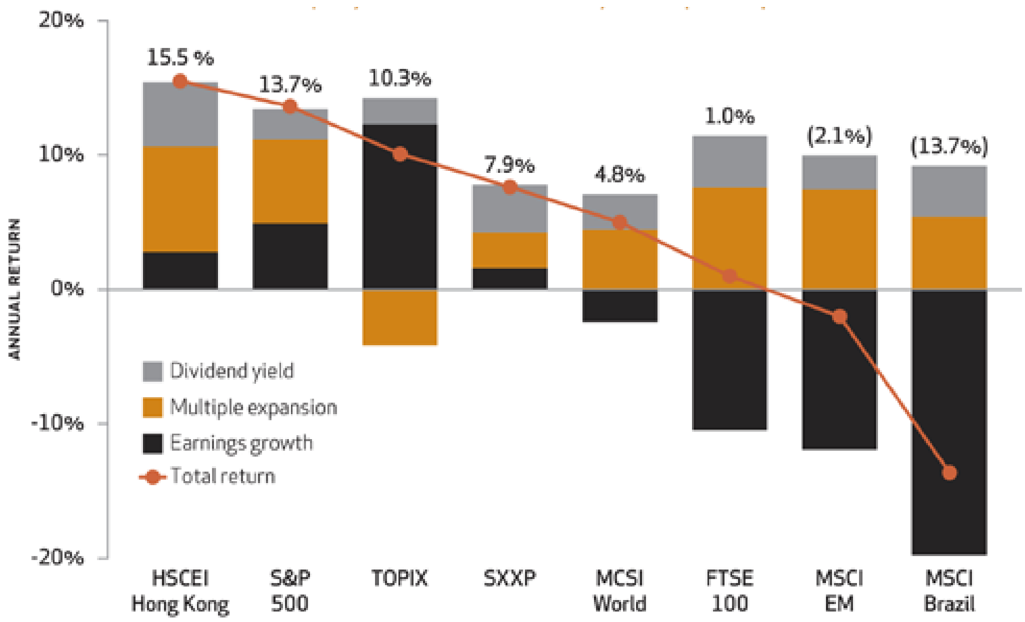
At an individual portfolio level, our investment process achieved solid operating results with 13 of the 14 portfolios bettering their reference indices, while the exception, Core Growth Portfolio, lagged by only 51bps. Pleasingly, each of the four portfolio managers we have been developing internally managed one or more strongly performing portfolios, aided by the disciplined process that has been established over the past five years.

NZ Funds' goal is to grow clients' wealth over time. In order to do this, we are long-term investors in growth orientated assets. However, we have a dual mandate. We must also mitigate downside. This is necessary to counter the tendency of clients to redeem during periods of heightened volatility. During 2014, the Global Multi-Asset Portfolio tested our ability to mitigate the downside and is discussed in more detail below. We expect 2015 and 2016 to provide additional opportunities to showcase our investment approach.

Current approach

Listed company valuations have now risen for five consecutive years. Much of this increase is warranted, as the average company has increased its earnings. However, the increase in valuation is increasingly coming from multiple expansion: paying more for each dollar of earnings, which is not sustainable.

Global equity returns being driven by multiple expansion



Source: Odey Asset Management, Morgan Stanley

Composition total returns by region up to year-end 2014 - based on forward consensus EPS/PE

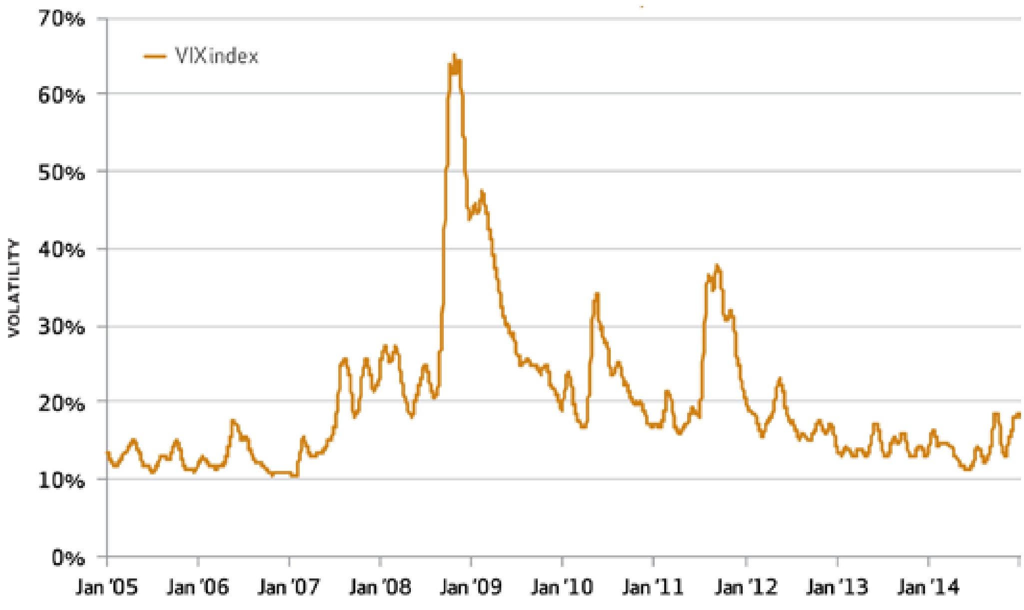
1 Pre tax returns are stated after Portfolio fees and expenses, but before any advisory fees or investor tax. Post tax returns are stated after Portfolio fees and expenses and investor tax at the highest Personal Income Rate (PIR). From 1 October 2008 to 30 September 2010 the highest PIR was 30%. Since 1 October 2010 the highest PIR has been 28%. Past performance is not necessaily an indication of future returns.

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

With increasing multiples comes the potential for increased volatility. For a number of years now, volatility, as measured by peak to trough declines, has been minimal. We expect 2015 to be punctuated by increased volatility.

Volatility is likely to be higher, partially due to the US regulator's careful dismantling of the safety net of liquidity which was formerly provided by the market-makers or proprietary trading desks of the major global investment banks.

United States share market volatility

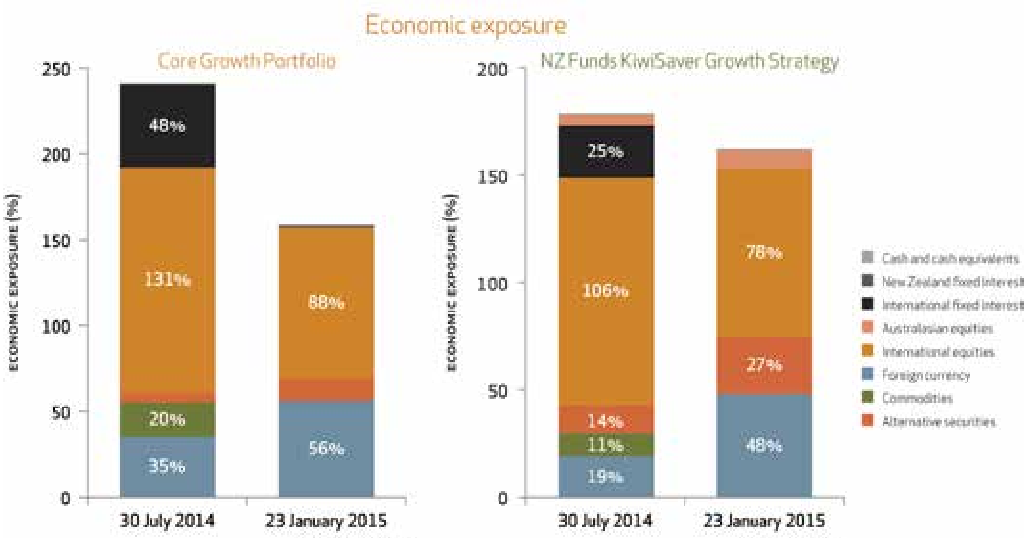


Source: NZ Funds, Bloomberg

Recent global events have highlighted to us the importance of not overstaying our welcome in the share market. We have for several years now taken advantage of a recovering global economy, attractive company valuations and a low interest rate environment to modestly leverage ourclients' portfolios. This single asset class leverage has now been largely unwound and replaced by a value-orientated approach to the ownership of listed companies.

Any rise in volatility is attractive to hedge funds who seek to capitalise on the dispersion of individual securities performance, or profit from a reversal in global macro fortunes. Accordingly, as we reduce clients' share market exposure, we are increasing their investments in hedge funds. In the next phase of the investment cycle, there is a risk however that should global shares continue to rise, clients' portfolios will temporarily lag.

Our changing economic exposure



Source: NZ Funds

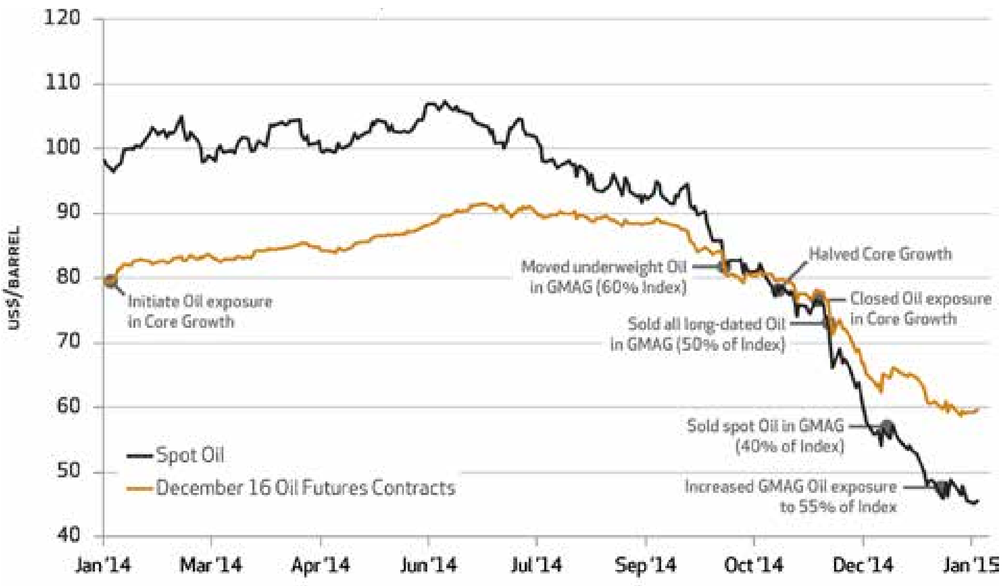
Oil

The background to oil's decline is now well understood. The development of fracking technology has enabled America, the largest global consumer of oil, to produce an additional 4m bbls a day, repositioning it from being an importer to an exporter. Saudi Arabia announced it was unwilling to give up market share by continually reducing its own production, and a price war has ensued.

In a price war, the lowest price producers – or those with the largest balance sheets – prevail. An analysis of shale producers and their operations show they stand to lose. Their cost of production is around US$85/barrel and their operations are largely funded by high yield debt. We began the quarter bullishly overweight oil. However, as oil declined we aggressively reduced clients' exposure. We continued selling until US$55 at which time clients' oil exposure in Global Multi-Asset had been reduced to 10%.

Based on an analysis of previous oil supply shocks from Verleger, it would not be unexpected to see oil trade at under US$50/ barrel for a considerable period before recovering. Nevertheless, we have already begun re-accumulating oil, including a 10% stake in large, dividend paying, oil producers to protect against a sharp rebound.

Oil price & Portfolio trades



Source: NZ Funds, Bloomberg

Swiss Franc

The Swiss had chosen not to debase their currency to the extent United States, Japan and Europe have through quantitative easing. However, they wished to limit the appreciation of the exchange rate against the declining Euro by implementing a cap, a level above which the currency pair could not rise. On 15 January 2015, the Swiss National Bank removed the cap causing the Franc to rapidly appreciate.

A number of NZ Funds' global managers held large positions in the Swiss Franc. In particular, **Harness Macro Currency Fund** declined -8.1% as a result of the move. Harness manages money for the Global Income Portfolio and KiwiSaver Income Portfolio. The impact in the Portfolios was around -32bp. We were in touch with the founder and his investment team almost immediately. They were able to demonstrate that the unexpected nature of the event was an excellent test of their position size limits and risk management rules. They also pointed out that last year they were able to profit from the Swiss Franc by a similar amount.

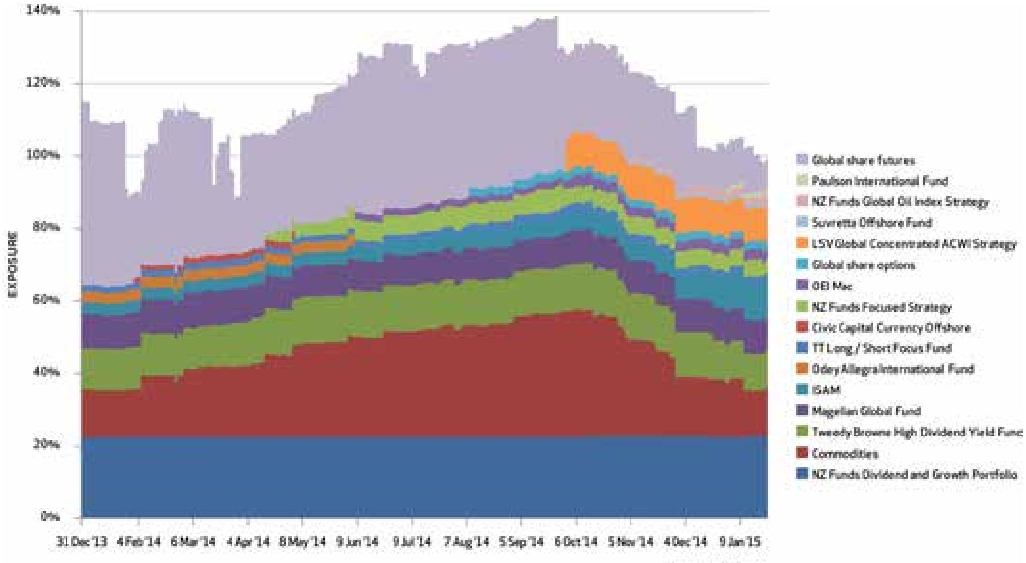
The investment team was also able discuss clients' positions with the most senior members of the investment team at **ISAM**, **TT Funds**, **Odey** and the **Civic Capital Currency Fund**, all of whom profited (either directly or indirectly) from the Swiss Franc's rise. We are very pleased with the depth of the relationship we have established with our managers. We are increasingly seen as fellow practitioners with valuable insights into our managers' positions and as such enjoy an unprecedented degree of transparency and openness.

In aggregate, the Portfolios profited from the sharp appreciation in the Swiss Franc.

Managers

As discussed above, it is particularly hard to reduce clients' share ownership when they are performing well, but as valuations rise needs must. During the quarter we reduced clients' levered ownership of shares and reweighted their capital into a number of hedge funds including: ISAM, Harness, Odey, Paulson, Suvretta and Universa. We believe the global network of managers that we have built have the ability to match the market in a modest up-year and significantly outperform in a down-year. We also deployed funds with United States based bond managers PIMCO and Wellington, and with the quantitive value share manager LSV.

Managed Portfolio Service growth category exposure



Source: NZ Funds

NZ Funds also redeemed from **Commodity Strategies**, despite strong relative returns from Rob Holroyd and his team. Rob had recently lost a major client, which left NZ Funds as the last investor of substance in his fund. Unfortunately, we were unable to come to a suitable arrangement to move forward with and redeemed given the business risk. We have since received back all clients' funds, which were ring fenced in a separate account administered for us by the global investment bank UBS.

Securities

Meridian Energy is New Zealand's largest electricity generator, meeting 30% of the country's demand. On client's behalf we purchased just over 11.5m shares at an average price of $1.05 in late 2013. This made the company our client's second single largest equity position and ensured it accounted for approximately 2% of funds under management.

The business has performed well over the course of the year, and clients' shares are now worth $20 million, an increase of $9 million. In addition, clients' portfolios have received $1.3 million in dividends. Josh Wilson who oversees clients' New Zealand share holdings has spent considerable time appraising the replacement cost of Meridian Energy's monopolistic assets. He estimates this to be over $9bn, more than 20% above its current enterprise value. Over time we believe the company will be entitled to earn a fair return on the replacement cost of the capital it has invested. Should this occur, Meridian Energy's earnings would increase substantially, catalysing a further rise in its market value.

Refining NZ owns and operates New Zealand's only oil refinery and the pipeline that connects its output to Auckland. As with Meridian Energy, Refining NZ's assets are the product of the Government's privatisation of its Muldoon era think big projects. Using the same valuation methodology as we applied to Meridian Energy, we believe the business has the potential to double its share market value over time. A meeting with recently appointed CEO Sjoerd Post this summer left us impressed by his process-driven approach to optimising the business. We have accumulated a modest shareholding and will look to opportunistically add to clients' holdings, as and when an opportunity arises.

As with much of our research, our analysis of Refining NZ led us to reconsider the strategic nature of **Z Energy**'s assets, which include a 15.4% shareholding in Refining NZ. We believe the company is very well managed. The current market value ascribed to the company's assets does not, in our opinion, accurately reflect the long-term earnings power of the business. We also believe it will benefit from having two long-term value-creation orientated shareholders in the New Zealand Superfund and Infratil, as we have seen with Metlifecare. Consequently, we have also upped our ownership of Z Energy and now hold a $3.3 million shareholding on behalf of clients.

10 largest individual securities held (as at 31/12/2014)

TOP 10 SECURITIES ACROSS AN INDICATIVE CLIENT'S MPS PORTFOLIO	
Metlifecare	$19,662,022.36
Meridian Energy	$17,917,799.87
Mighty River Power	$10,366,069.70
Transpower Finance 4.115% 15/05/2020	$9,142,232.04
Chorus	$8,551,176.08
Servcorp	$7,297,589.51
Microsoft	$6,848,455.87
Spark New Zealand	$6,638,080.17
Mighty River Power 6.9% 11/07/2044	$5,927,628.18
New Zealand Government Inflation Linked Bond 4.5% 15/02/2016	$5,611,725.73

TOP 10 SECURITIES ACROSS AN INDICATIVE CLIENT'S NZ FUNDS KIWISAVER SCHEME STRATEGY	
Metlifecare	$2,879,046.66
Meridian Energy	$2,468,513.58
New Zealand Government Inflation Linked Bond 4.5% 15/02/2016	$1,403,202.95
Transpower Finance 4.115% 15/05/2020	$1,316,355.64
Microsoft	$959,397.68
Mighty River Power	$957,666.19
Spark New Zealand	$822,225.97
Restaurant Brands	$652,695.70
Fletcher Building	$589,865.66
Port of Tauranga	$562,869.65

Governance

During the quarter a system to record the rationale for all trades was implemented. It operates by sending a time and date stamped email listing the rationale for the trade to a secure address. The email is accessed and reviewed by funds management and compliance. This complements the current system of regularly holding minuted team meetings to debate and document investment decisions ahead of execution; and filing all research and analysis on NZ Funds' firm-wide intranet.

The investment team also participated in a comprehensive compliance training session during the quarter. The sessions spanned two afternoons and were run by our legal & compliance team. The training refreshed attendees understanding of the current rules, regulations, internal protocols, fiduciary duties and applicable penalties. Case studies on each of the major areas were presented. Attendees used NZ Funds' clicker technology to record their response to multi-choice questions and their answers were collectively debated and reviewed.

We wish the companies, advisers and New Zealanders whose funds we oversee a safe and prosperous 2015.

Michael Lang
Chief Investment Officer.

Managed Portfolio Service: Performance (Part 1)

Cumulative returns to 31 December 2014

Managed Portfolio Service			Actual Portfolio Returns						Historic Investment Profile Returns	
Category	Portfolio		1 month	3 months	6 months	1 year	2 years	5 years	10 years	Since inception
Cash	Core Cash Portfolio[2]	Pre tax	0.31%	0.88%	1.77%	3.19%	5.82%	13.91%	-	25.11%
		Post tax	0.22%	0.64%	1.27%	2.28%	4.16%	9.79%	-	17.22%
Income	Core Income Portfolio[3]	Pre tax	-0.03%	1.47%	3.14%	5.44%	8.82%	30.39%	-	40.90%
		Post tax	-0.02%	1.06%	2.26%	3.89%	6.29%	21.00%	-	27.76%
	Global Income Portfolio[1]	Pre tax	-0.03%	0.81%	1.99%	4.02%	6.30%	26.27%	-	32.61%
		Post tax	0.01%	0.64%	1.61%	3.04%	4.68%	18.31%	-	22.43%
Inflation	Core Inflation Portfolio[4]	Pre tax	0.47%	0.47%	2.33%	9.83%	14.26%	26.57%	-	32.53%
		Post tax	0.52%	0.88%	2.95%	9.47%	13.98%	34.89%	-	43.38%
	Property Inflation Portfolio[1]	Pre tax	2.36%	4.62%	6.66%	14.21%	17.32%	34.97%	-	41.70%
		Post tax	2.24%	4.07%	6.50%	13.48%	15.65%	30.32%	-	35.46%
	Equity Inflation Portfolio[4]	Pre tax	0.07%	2.82%	6.84%	13.30%	21.83%	29.80%	-	35.82%
		Post tax	0.17%	3.11%	7.18%	13.95%	24.07%	51.40%	-	96.06%
Growth	Core Growth Composite Strategy[6]	Pre tax	0.02%	2.92%	6.64%	7.55%	35.58%	31.90%	76.44%	144.74%[8]
		Post tax	-0.74%	1.60%	4.81%	5.79%	32.08%	26.83%	-	n/a
	Global Multi-Asset Growth Portfolio[1]	Pre tax	-2.92%	-8.38%	-16.08%	-13.96%	-15.69%	-30.63%	-	-30.23%
		Post tax	-3.38%	-9.06%	-16.74%	-15.50%	-17.23%	-31.35%	-	-31.25%
	Global Equity Growth Composite Strategy[5]	Pre tax	2.65%	7.16%	14.41%	14.99%	41.14%	29.91%	74.14%	191.26%[8]
		Post tax	2.08%	6.10%	12.21%	12.60%	37.74%	26.41%	-	n/a
	Dividend and Growth Composite Strategy[7]	Pre tax	1.79%	6.78%	9.77%	15.78%	22.37%	30.36%	44.88%	481.54%[8]
		Post tax	1.66%	6.47%	8.92%	14.98%	19.15%	26.92%	-	n/a
	Capital Opportunities Portfolio[3]	Pre tax	-0.48%	0.09%	5.58%	8.77%	27.59%	109.89%		101.62%
		Post tax	-0.32%	0.20%	5.83%	9.01%	22.61%	77.18%		86.26%

IMPORTANT: Please refer to the Notes for the footnotes relating to this page.
Past performance is not necessarily an indication of future returns.

Managed Portfolio Service: Performance (Part 2)

Annualised returns to 31 December 2014

Managed Portfolio Service		Actual Portfolio Returns							Historic Investment Profile Returns	
Category	Portfolio		1 month	3 months	6 months	1 year	2 years	5 years	10 years	Since inception
Cash	Core Cash Portfolio[2]	Pre tax	0.31%	0.88%	1.77%	3.19%	2.87%	2.64%	-	3.33%
		Post tax	0.22%	0.64%	1.27%	2.28%	2.06%	1.89%	-	2.35%
Income	Core Income Portfolio[3]	Pre tax	-0.03%	1.47%	3.14%	5.44%	4.31%	5.45%	-	5.47%
		Post tax	-0.02%	1.06%	2.26%	3.89%	3.10%	3.89%	-	3.88%
	Global Income Portfolio[1]	Pre tax	-0.03%	0.81%	1.99%	4.02%	3.10%	4.78%	-	4.68%
		Post tax	0.01%	0.64%	1.61%	3.04%	2.31%	3.42%	-	3.33%
Inflation	Core Inflation Portfolio[4]	Pre tax	0.47%	0.47%	2.33%	9.83%	6.89%	4.83%	-	4.67%
		Post tax	0.52%	0.88%	2.95%	9.47%	6.76%	6.17%	-	6.01%
	Property Inflation Portfolio[1]	Pre tax	2.36%	4.62%	6.66%	14.21%	8.32%	6.18%	-	5.81%
		Post tax	2.24%	4.07%	6.50%	13.48%	7.54%	5.44%	-	5.04%
	Equity Inflation Portfolio[4]	Pre tax	0.07%	2.82%	6.84%	13.30%	10.38%	5.35%	-	5.09%
		Post tax	0.17%	3.11%	7.18%	13.95%	11.39%	8.65%	-	11.53%
Growth	Core Growth Composite Strategy[6]	Pre tax	0.02%	2.92%	6.64%	7.55%	16.44%	5.69%	5.84%	7.97%[8]
		Post tax	-0.74%	1.60%	4.81%	5.79%	14.93%	4.87%	-	n/a
	Global Multi-Asset Growth Portfolio[1]	Pre tax	-2.92%	-8.38%	-16.08%	-13.96%	-8.18%	-7.05%	-	-5.67%
		Post tax	-3.38%	-9.06%	-16.74%	-15.50%	-9.02%	-7.25%	-	-5.89%
	Global Equity Growth Composite Strategy[5]	Pre tax	2.65%	7.16%	14.41%	14.99%	18.80%	5.37%	5.70%	5.84%[8]
		Post tax	2.08%	6.10%	12.21%	12.60%	17.36%	4.80%	-	n/a
	Dividend and Growth Composite Strategy[7]	Pre tax	1.79%	6.78%	9.77%	15.78%	10.62%	5.45%	3.78%	8.29%[8]
		Post tax	1.66%	6.47%	8.92%	14.98%	9.16%	4.88%	-	n/a
	Capital Opportunities Portfolio[3]	Pre tax	-0.48%	0.09%	5.58%	8.77%	12.96%	15.98%	-	11.50%
		Post tax	-0.32%	0.20%	5.83%	9.01%	10.73%	12.12%	-	10.13%

IMPORTANT: Please refer to the Notes for the footnotes relating to this page.
Past performance is not necessarily an indication of future returns.

Managed Portfolio Service: Notes

Returns

Pre tax returns are stated after Portfolio fees and expenses, but before any advisory fees or investor tax. Post tax returns are stated after Portfolio fees and expenses and investor tax at the highest Personal Income 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.

Historic Investment Profiles

The Historic Investment Profiles have been developed to illustrate the long-term performance of the investment categories represented by the relevant Portfolios.

The Historic Investment Profiles are not the historic returns of the Portfolios.

They illustrate the historical performance of the NZ Funds approach of managing assets of the type held within the respective NZ Funds Managed Portfolio Service Portfolio to which each Historic Investment Profile relates.

The Historic Investment Profiles are tax-adjusted to remove, as much as possible, the impact of the different tax regimes that applied during the calculation period. The pre tax returns are also stated after Portfolio fees and expenses, but before any advisory fees or investor tax. The post tax returns are stated after Portfolio fees and expenses and investor tax at the highest Personal Income Rate (PIR).

For more detail on the calculation of each of the Historic Investment Profiles please contact NZ Funds.

The performance of the Historic Investment Profiles is not an indication of future Portfolio returns.

Footnotes for pages 8 & 9

1 Inception date was 31 October 2008.

2 Inception date was 28 February 2008.

3 Strategy inception was 23 July 2008.

4 Performance is measured since the launch of the APS platform (now known as NZ Funds Managed Portfolio Service) on 31 October 2008. The post tax since inception returns for the Core Inflation Portfolio and the Equity Inflation Portfolio include the benefit of formation tax losses under the PIE rules. For more detail, please contact NZ Funds.

5 Composite strategy inception was 6 March 1996.

6 Composite strategy inception was 1 May 2003.

7 Composite strategy inception was 2 December 1992.

8 Pre tax equivalent gross return (for more detail, refer to the performance page for each Portfolio/Historic Investment Profile).

NZ Funds KiwiSaver Scheme: Performance (Part 1)

Cumulative returns to 31 December 2014

NZ Funds KiwiSaver Scheme		Returns						
Strategy		1 month	3 months	6 months	1 year	2 years	3 years	Since Inception
Income	Pre tax	0.00%	0.91%	2.21%	4.52%	7.40%	15.88%	20.41%
	Post tax	0.04%	0.72%	1.78%	3.43%	5.50%	11.46%	14.41%
Inflation	Pre tax	0.61%	0.89%	3.11%	11.57%	17.91%	29.61%	31.26%
	Post tax	0.64%	1.17%	3.53%	10.72%	16.55%	26.64%	26.41%
Growth	Pre tax	2.42%	6.63%	11.07%	11.79%	42.99%	66.47%	49.72%
	Post tax	1.59%	5.48%	9.43%	9.88%	38.58%	59.57%	42.75%

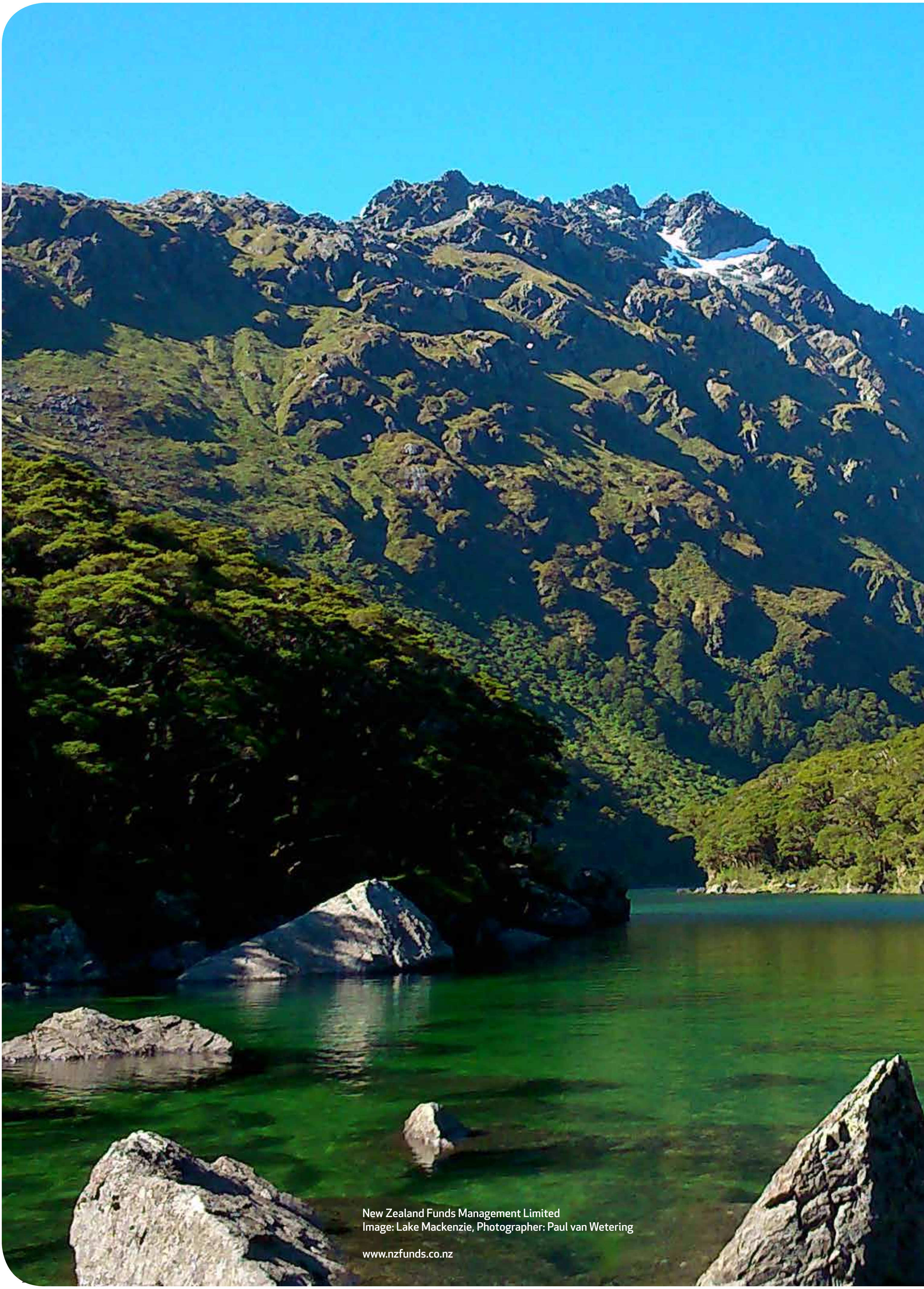
Before tax returns are stated after Strategy fees and expenses, but before any advisory fees or investor tax. After tax returns are stated after Strategy fees and expenses and investor tax at the highest Personal Income Rate (PIR). From 1 October 2008 to 30 September 2010 the highest PIR was 30%. Since 1 October 2010 the highest PIR has been 28%. Past performance is not necessarily an indication of future returns.

NZ Funds KiwiSaver Scheme: Performance (Part 2)

Annualised returns to 31 December 2014

NZ Funds KiwiSaver Scheme		Returns						
Strategy		1 month	3 months	6 months	1 year	2 years	3 years	Since Inception
Income	Pre tax	0.00%	0.91%	2.21%	4.52%	3.64%	5.04%	4.56%
	Post tax	0.04%	0.72%	1.78%	3.43%	2.71%	3.68%	3.28%
Inflation	Pre tax	0.61%	0.89%	3.11%	11.57%	8.59%	9.03%	6.75%
	Post tax	0.64%	1.17%	3.53%	10.72%	7.96%	8.19%	5.78%
Growth	Pre tax	2.42%	6.63%	11.07%	11.79%	19.58%	18.52%	10.17%
	Post tax	1.59%	5.48%	9.43%	9.88%	17.72%	16.86%	8.92%

Before tax returns are stated after Strategy fees and expenses, but before any advisory fees or investor tax. After tax returns are stated after Strategy fees and expenses and investor tax at the highest Personal Income 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.



New Zealand Funds Management Limited
Image: Lake Mackenzie, Photographer: Paul van Wetering

www.nzfunds.co.nz