NZFunds
Investment Report H1 2021

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Business update

Over the last few years the conversations around KiwiSaver have been dominated by modest returns and the benefits of low fees. Recently, there has been much discussion about the $1.2 billion that investors switched from growth to income funds during the recent COVID-19 -driven sell off.

However, there has been little discussion of behavioural economics, which identifies that investors often feel compelled to switch at low points in the cycle. Or of the solution, which is access to high quality, affordable, financial advice.

Internationally there continues to be a steady stream of academic research quantifying the benefits of working with a financial adviser over an investment lifetime. One study showed that individuals and families who were fortunate enough to work with an adviser accumulated more than twice as much as those who invested on their own.

The year ending 31 March 2021 was a seminal one for NZ Funds. Our investment approach, which continues to be unique in New Zealand (but more common overseas), successfully mitigated the downside for investors during a frightening time. We then captured the upside as financial markets recovered.

What made the year particularly noteworthy for the team at NZ Funds was the chance to help those who were less fortunate. With the help of over 300 financial advisers – most notably Sue Stewart, Director and Financial Adviser at Medical Financial Advisers – we were able to assist 2,700 distressed New Zealanders who were invested with a wide range of predominately low-cost providers whose services did not include financial advice. In a time of crisis, website information, chatbots and overloaded call centres simply don't pass muster.

In our view, the idea that KiwiSaver is generic, and the less you pay the better off you will be, could not be further from the truth. It is no accident that the average NZ Funds KiwiSaver member's balance is now $38,000 (compared to an industry average of $26,000). This is despite a large number of new investors joining in recent months with initially lower balances.

We believe professional financial advice can help you understand and manage investment risk and navigate your choice of manager, asset allocation and contribution rate. And for those already enjoying retirement, it can help protect and manage your wealth much better than a chatbot can.

Portfolio returns before tax and fees[1]

Fees may vary by service type and account size

	Returns to 30 June 2021	2020	2019	2018	2017	2016	2015	2014	2013	Inception
Term Deposit Index										
Six month term deposit	**0.42%**	2.46%	3.32%	3.33%	3.35%	3.29%	4.17%	3.90%	3.98%	
NZ Funds KiwiSaver Scheme										
Income Strategy	**4.02%**	3.34%	8.55%	2.01%	5.56%	7.15%	2.53%	5.51%	3.92%	31 Oct 2010
Inflation Strategy	**9.35%**	17.21%	21.67%	-4.50%	9.74%	3.35%	2.36%	12.81%	7.04%	31 Oct 2010
Growth Strategy	**24.37%**	35.85%	18.57%	-6.87%	18.69%	-1.49%	8.63%	13.17%	29.73%	31 Oct 2010
LifeCycle 0–54 y/o	**21.81%**	32.27%	18.38%	-6.17%	17.11%	-0.55%	7.76%	12.79%	25.90%	31 Oct 2010
LifeCycle 65 y/o	**13.74%**	20.55%	16.88%	-3.62%	10.00%	3.75%	3.60%	10.71%	9.68%	31 Oct 2010
NZ Funds Managed Superannuation Service[2]										
Income Strategy – British Pounds	**7.87%**	-0.47%	10.86%	0.36%	–	–	–	–	–	11 Aug 2017
Growth Strategy – British Pounds	**22.87%**	29.05%	0.56%	–	–	–	–	–	–	03 Dec 2019
Income Strategy	**3.10%**	3.42%	8.60%	2.03%	–	–	–	–	–	25 Jan 2017
Inflation Strategy	**7.28%**	16.50%	21.60%	-4.37%	–	–	–	–	–	25 Jan 2017
Growth Strategy	**17.87%**	34.39%	20.15%	-6.74%	–	–	–	–	–	25 Jan 2017
NZ Funds Advised Portfolio Service										
Core Cash Portfolio	**0.20%**	0.56%	1.65%	2.26%	2.19%	2.61%	3.66%	3.60%	2.95%	28 Feb 2008
Core Income Portfolio	**3.61%**	4.46%	6.80%	5.01%	5.76%	6.55%	3.92%	7.06%	4.83%	23 Jul 2008
Global Income Portfolio	**3.03%**	2.86%	11.79%	-1.27%	5.31%	7.25%	2.58%	5.62%	3.83%	31 Oct 2008
Core Inflation Portfolio	**1.38%**	11.54%	23.78%	-2.68%	12.64%	3.20%	2.50%	12.92%	7.17%	31 Oct 2008
Property Inflation Portfolio	**-2.83%**	5.67%	21.18%	3.49%	9.44%	1.05%	10.40%	17.40%	5.26%	31 Oct 2008
Equity Inflation Portfolio	**11.39%**	18.14%	21.92%	-6.44%	9.29%	2.12%	8.14%	16.58%	10.74%	31 Oct 2008
Core Growth Portfolio	**29.63%**	46.69%	13.69%	-10.30%	15.95%	-3.08%	7.74%	10.59%	32.50%	01 May 2003
Global Equity Growth Portfolio	**23.35%**	34.16%	22.25%	-7.78%	21.94%	-0.38%	11.40%	19.25%	28.59%	06 Mar 1996
Dividend and Growth Portfolio	**4.82%**	12.83%	26.89%	-3.99%	22.93%	13.86%	16.89%	20.06%	8.65%	02 Dec 1992
NZ Funds Income Generator										
Income Generator	**4.52%**	5.17%	–	–	–	–	–	–	–	22 Oct 2020

1. Returns are for the period 1 January to 31 December except as noted. Returns are stated before tax, Portfolio/Strategy fees, and expenses, and any advisory fees. Past performance is not necessarily an indication of future returns.

2. 2017 returns for NZ Funds Superannuation Service Income Strategy British Pounds, Income Strategy, Inflation Strategy and Growth Strategy are from inception (not annualised). 2019 returns for NZ Funds Superannuation Service Growth Strategy British are from inception (not annualised).

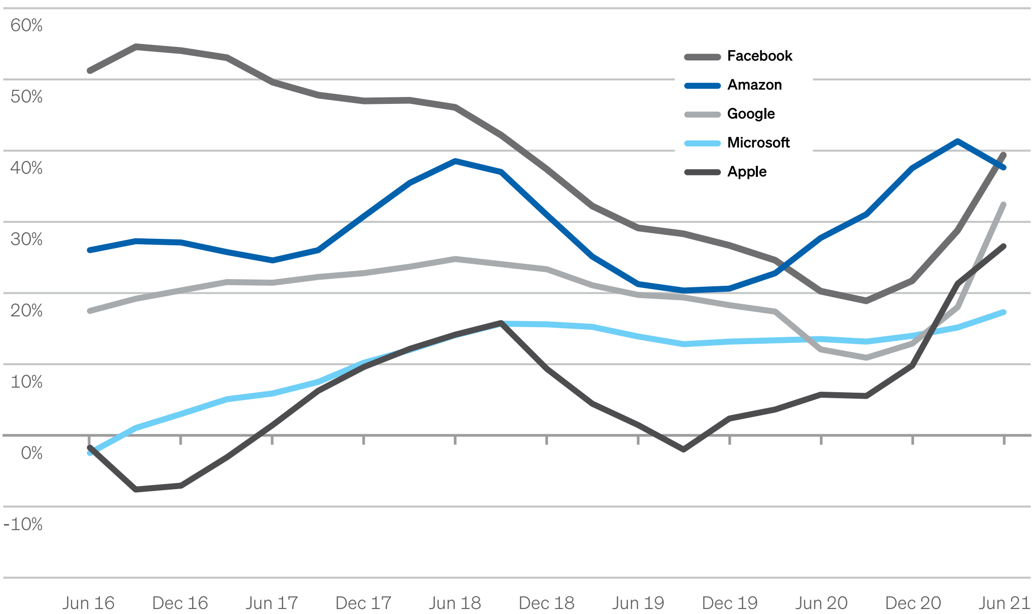
Investment update

After a strong start to the year asset prices in a number of areas have moderated. The global share market has now priced in a rebound in consumer spending, interest rates have stabilised and commodity prices have reached record highs. This has led to weaker returns during the Northern Hemisphere's summer, when many asset managers are on leave and trading volumes are low.

We speak regularly with our global investment partners and the good news is that global economic growth has resumed. While different variants of the COVID-19 virus will cause periods of slower growth, the ever-increasing number of people in the economy who are getting vaccinated means that mortality will continue to fall and the ability of people to get on with life will continue to rise. This is good news for asset prices.

Over the medium term we expect local and international shares will continue to rise, but at a much more modest pace. Our investment team and our global partners remain overweight in the large, strongly growing technology companies: Facebook, Amazon, Apple, Microsoft, Google and Uber. We expect these companies will continue to win market share and compound their earnings for decades to come, in much the same way as Coke, Gillette and General Electric did 50 years ago.

FAAMG | Revenue growth year-on-year



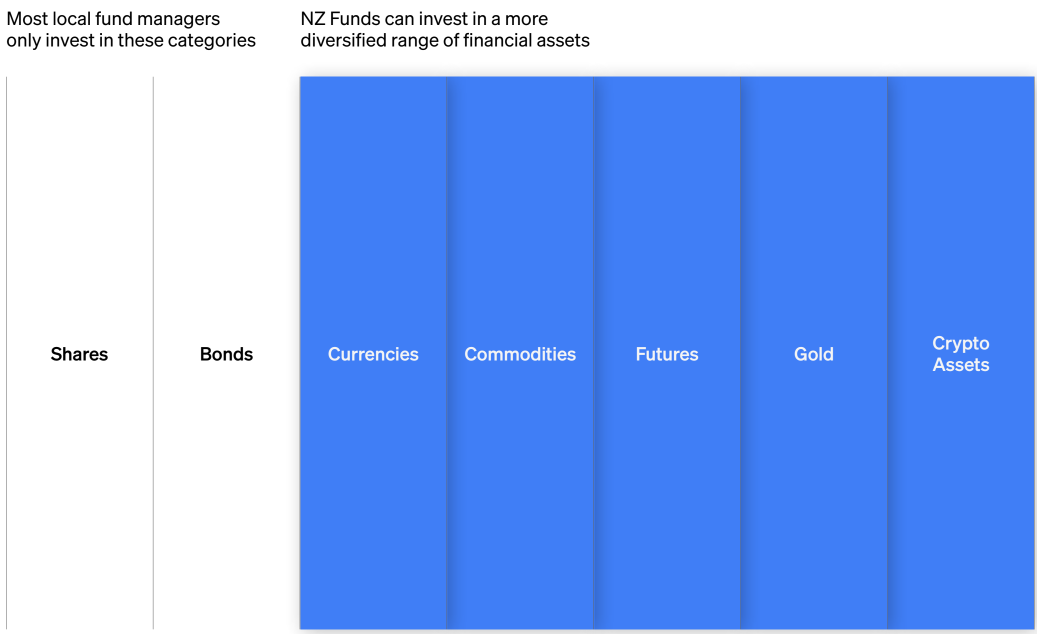
Investment approach

As NZ Funds continues to add clients in record numbers, we want to reiterate our approach to managing your (and our) lifetime savings. Traditionally, New Zealand fund managers have focused on investing in shares and bonds. This is consistent with a developing and relatively unsophisticated financial market.

In the more mature, self-directed retirement savings markets of the United States, United Kingdom and Australia, managers use the additional asset classes of alternative assets (hedge funds), currencies and commodities to ensure clients' portfolios are more broadly diversified.

Diversification is one of the undisputed tenets of finance. Diversification improves risk-adjusted returns over time and is often referred to as the only 'free lunch' in financial markets. Put differently, an inability to diversify leads to inferior risk-adjusted returns.

Intelligent investment approach for the new market realities

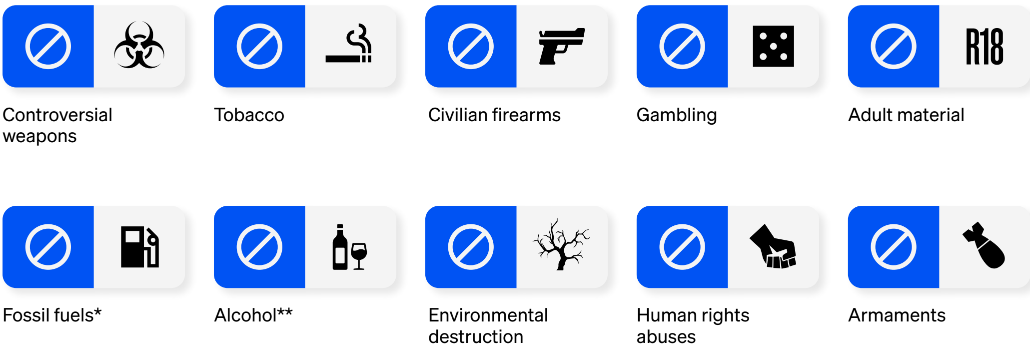


We believe that listed shares and bonds are central to long-term investing and therefore to managing New Zealander's wealth. But in line with global norms, New Zealanders should also benefit from access to additional asset classes and modern investment techniques, without which our citizens would be at a disadvantage globally.

The additional asset classes NZ Funds invests in are all highly liquid and have full, daily price discovery. This is important as it means risk can be managed (for example, by selling at a moment's notice) and clients' investments can be accurately priced so that transactions can occur daily without investor inequity.

We also believe the benefits of managing your money in a socially responsible way are compelling. To apply a responsible approach to all the investments we manage, we have partnered with global research giant ISS ESG. This Scandinavian-based firm helps us monitor and exclude investments globally for nuclear weapons, controversial weapons, armaments, firearms, tobacco, pornography, palm oil, alcohol, gambling and various categories of fossil fuel production, distribution and services. More information is contained in the appendix.

NZ Funds Responsible Investment Policy[1]



Portfolio construction

NZ Funds manages each portfolio or strategy against a core index, for example, Global Shares (MSCI World ex Fossil Fuels Index) or Global Bonds (The Bloomberg Barclays Global Aggregate – Corporate index). Our portfolios and strategies are built with a core exposure to the relevant benchmarked asset class, for example 80% to 120% to Global Shares, or Global Bonds.

Depending on the asset class, investment cycle and proprietary research, a portfolio or strategy's core exposure may be gained through purchasing securities directly, investing with specialist international managers or purchasing index-tracking futures contracts.

Currency exposure primarily gained through the purchase of global investments is managed dynamically. That is, the degree to which a portfolio is hedged depends on whether the international currency is cheap or expensive (value assessment) and trending upward or downward (momentum assessment).

1. NZ Funds' Responsible Investment Policy exclusions do not cover derivatives, including futures and options of any kind, as they do not fund companies in the same way as issued securities. Some exclusions are subject to a revenue threshold. For more information about NZ Funds' Responsible Investment Policy see https://www.nzfunds.co.nz/Assets/Documents/shared/responsible-investment-policy.pdf.

* See Appendix for more information about exemption for Contact Energy.

** See Appendix for more information about exemption for LVMH Moët Hennessey Louis Vuitton.

Downside mitigation

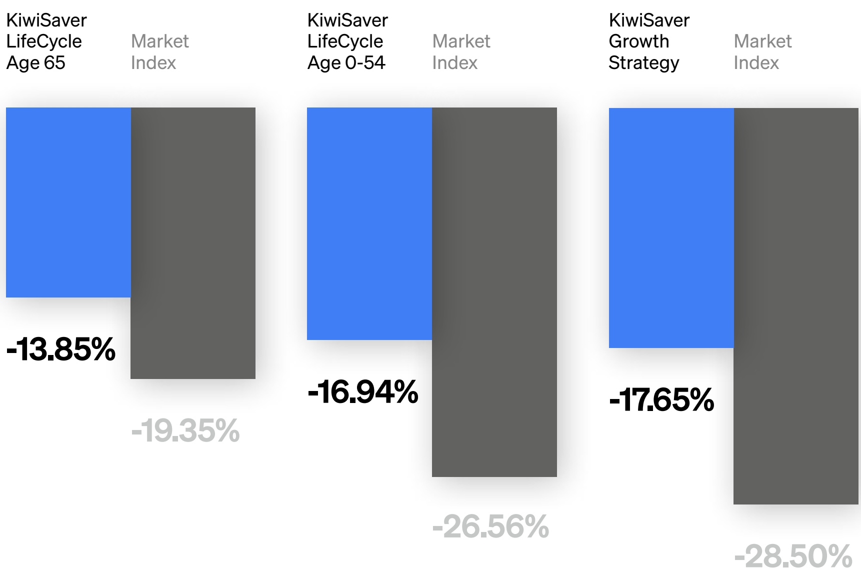
In a rapidly falling market, caused for example by the outbreak of COVID-19, NZ Funds may either reduce clients' exposure to the asset class by, for example, selling shares (go to cash), or retain clients' shares but reduce exposure by buying offsetting share market futures contracts. This is known as long-short hedging as it uses the same asset class.

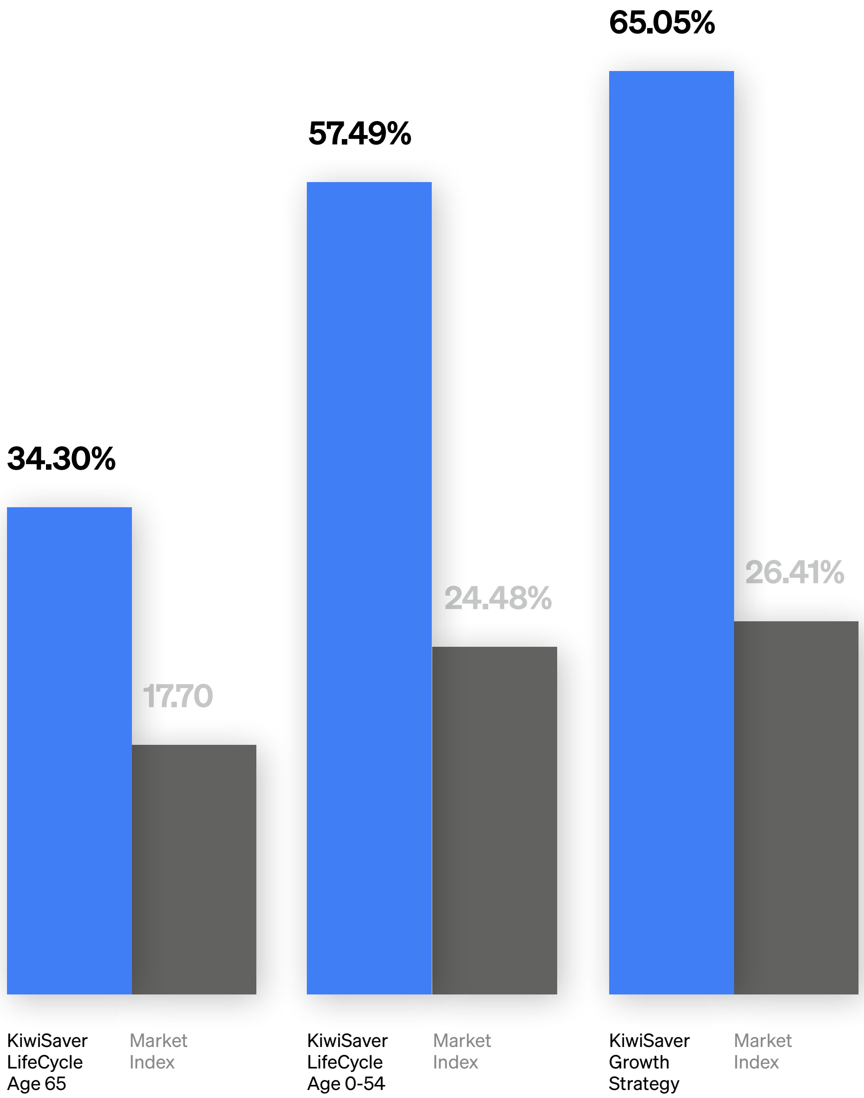
NZ Funds may also selectively tilt towards alternative assets (non-shares) which are capable of rising in value during periods of financial volatility (for example, gold or US dollars). The rise in value of safe haven assets helps partially offset the decline of global shares. This is known as macro-hedging as it uses different asset classes.

NZ Funds calls this 'downside mitigation'. A portfolio or strategy using this technique is likely to rise and fall in line with the relevant index (for example, the global shares MSCI World ex Fossil Fuels Index) but is designed to fall by less in a share market downturn.

Downside mitigation helps our clients stay the course during periods of extreme financial market volatility by reducing the need to switch from growth to income or cash at the worst possible time.

COVID-19 Sell-Off – 1 January 2020 to 23 March 2020





COVID-19 Sell-Off and Rebound – 1 January 2020 to 30 June 2021

Upside capture

In a rising market, caused for example by a global recovery following the successful manufacture of COVID-19 vaccines, NZ Funds may either increase clients' exposure to the asset class (for example, shares) by purchasing additional share market exposure through futures contracts, or selectively tilt toward alternative assets (non-shares) which are capable of rising in value during periods of economic recovery (for example, commodities and, more recently, cryptocurrencies).

NZ Funds calls this investment approach 'upside capture'. A portfolio or strategy using this technique is likely to rise and fall in line with the relevant index (for example, MSCI World ex Fossil Fuels Index) but is designed to add additional value by periodically tilting to a wider range of asset classes which share a common economic driver.

Risk management

Risk management is fundamental to funds management. Over the last 30 years NZ Funds has developed a series of risk management tools designed to mitigate the chance retail investors suffer a permanent loss of capital. Not all tools are investment orientated (some are advice orientated as discussed in the introduction) and not all investment orientated techniques are applied to all investments (different assets types require different investment techniques). NZ Funds uses the following tools and techniques to manage risk.

Research: NZ Funds employs a highly experienced team of inhouse portfolio managers, each of whom has global private equity and/or hedge fund experience, global consultants (including a contractually retained international consultant based in London/New York) and has access to third party research from a wide variety of local and international research houses, including research by international asset class specialists.

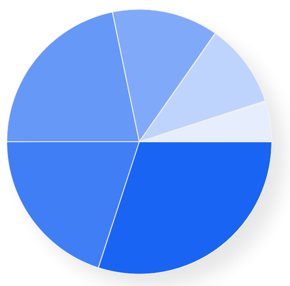
Portfolio construction: All portfolios are constructed from the most recent reference portfolio with the objective of mitigating risk (in a falling market) or capturing the upside (in a rising market) against the portfolio's benchmark. Reference portfolios and benchmarks are periodically reviewed by the Investment Committee. Positions are sized and managed using beta analysis and value at risk (VAR) and are regularly assessed against historical downturns. (For example, how would this portfolio perform in the Global Financial Crisis in 2007–9, or the Tech Wreck in 2000–1?)

Security diversification and liquidity risk: NZ Funds' wide mandates mean each portfolio is likely to hold a variety of different security types, even within a fixed asset class. For example, our bond funds commonly contain government bonds, corporate bonds, mortgage bonds, high yield bonds as well as futures to manage interest rate risk and credit default swaps to manage credit risk. This diversifies the portfolio against factor risk such as a credit spread sell-off (often accompanied by rallying interest rates), or an interest rate sell-off (often accompanied by tightening credit spreads).

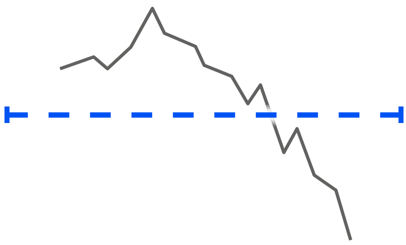
Downside mitigation specialist: In the case of retail portfolios with a significant growth orientated asset allocation, NZ Funds has appointed Universa to assist with permanent downside mitigation. The arrangement between NZ Funds and Universa is unique in New Zealand. Universa's Black Swan Protection Protocol is a permanent portfolio of out-of-the-money options managed by Universa. Universa has successfully mitigated the downside for NZ Funds' clients on several occasions. For more information see Wall Street Journal "Black Swan Fund made $1 billion" (30 August 2015) and Wall Street Journal "Hedge Fund Star Behind 4,000% Coronavirus Return" (8 April 2020).

Portfolio management system (Point): Over the last decade NZ Funds has developed its own risk and portfolio management system. We believe the Point system is unique in the New Zealand market. Point was designed and built by Dale Henderson who spent over a decade with one of the world's largest hedge funds (Marshall Wace) in London and New York. Dale is supported by a dedicated financial software team of four based in Christchurch. NZ Funds' Point system covers a wide range of functions from trade placement and execution, to portfolio management analytics (including risk measures such as VAR, stop loss setting, rapid portfolio rebalancing, trade position P&L and charting) and covers corporate actions and portfolio pricing.

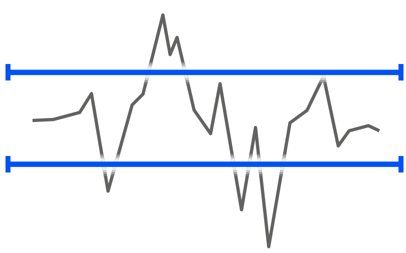
Risk management tools



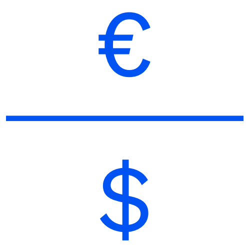
Spreading risk across asset classes



The Universa Black Swan Protection Protocol



Hedge fund techniques



Foreign currency hedging

Summary

NZ Funds offers a premium and highly differentiated investment service. In this report we have set out our intelligent investment approach. It is an approach which we have developed over three decades of managing New Zealanders' life-time savings.

We believe that New Zealanders who want to have their wealth managed by a professional investment team, rather than an index-tracking trading system, should be able to.

We believe that fees are an essential element of delivering considered financial advice and value adding active management, and that the benefit to clients of both is tangible and significant over time.

However, we are also aware that our portfolios and strategies are not easily accessible by most New Zealanders and the tools and techniques which we have used to deliver market-leading returns in recent years can seem intimidating for first time investors, or those who have low levels of investment confidence.

NZ Funds wants to make a much larger contribution to New Zealand's future. To do so, we will shortly be launching a number of new products and services in partnership with New Zealand's leading independent financial advisers. This includes a new entry level KiwiSaver choice. We believe our new KiwiSaver choice will help get those New Zealanders who are missing out enrolled and, in doing so, help build a brighter future for all of us.

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Appendix

NZ Funds' Responsible Investment Policy – Current Implementation

Investment Offering	Amount Invested	Responsible Investment Policy
KiwiSaver	$ 922,218,154	✓
Superannuation	$ 172,520,338	✓
Wealth Builder	$ 43,585,078	✓
Income Generator	$ 32,475,072	✓
Advised Portfolio Services	$ 1,660,414,465	✓

Asset type	Status	% Amount Invested
Direct/Indirect Securities	Follows all exemptions	77.56%
Equity Index Futures[1]	No direct funding	16.87%
Commodity Futures[1]	No direct funding	0.02%
Subtotal		**94.45%**
Contact Energy[2]	Exception granted	1.56%
LVMH Moët Hennessey Louis Vuitton[2]	Exception granted	0.14%
External Investment Managers	Policy communicated	3.85%
Total Investments		**100.00%**

Policy Application Information

1. Derivatives of all kinds, including futures and options, are specifically considered by NZ Funds' Responsible Investment Policy. The Policy considers them to not require excluding as they are not tied to any source or method of production, nor do they provide funding to underlying excluded activities. This is in line with global norms.
2. Securities held where an exemption has been granted:
   i. Contact Energy

      Contact Energy was granted an exemption from exclusion on 14 July 2020. The security would ordinarily be excluded under 4. xii of NZ Funds' Responsible Investment Policy; however, an exception was granted because of Contact Energy's industry-leading commitment and strategy to decarbonise New Zealand's energy sector.

   ii. LVMH Moët Hennessey Louis Vuitton

      LVMH was granted an exemption from exclusion on 14 July 2020. The security would ordinarily be excluded under 4. viii of NZ Funds' Responsible Investment Policy; however, an exception was granted because, following the acquisition of Tiffany & Co, the forecast percentage of revenue from alcohol is now less than the 10% threshold.

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