NZ FUNDS

Investment Report H2 2020

Peter Ashworth, Principal, Dunedin_

Cover: Peter Ashworth, Principal_ Dunedin. Photographer, Mark Smith.

Business update

NZ Funds was established 32 years ago to help New Zealanders make better financial decisions. In 1988 we focused on helping New Zealanders diversify their savings away from a limited number of locally listed shares into more robust, globally diversified professionally managed portfolios.

NZ Funds was one of the first to provide access to globally diversified portfolios with long-term asset classes like emerging markets, Japanese equities, and small capitalisation shares. These investments were managed in partnership with world renowned investment organisations like Capital International in Los Angeles, Sanford Bernstein in New York and Wellington Asset Management in Boston.

A lot has changed since then, but not our relationship with the principals of Capital, Bernstein and Wellington. What also remains unchanged is New Zealand's need for robust high-quality investment infrastructure, capable of delivering the reliable long-term returns needed to protect and build wealth.

Over the last 50 years New Zealand's wealth has diminished. We have slipped from being one of the most prosperous nations in the OECD to being one of the least. One area where this is evident is in retirement saving. The countries we traditionally benchmark ourselves against, like Australia, the United Kingdom and the United States, have all saved more. The average Australian has over $144,000 in their Superannuation Fund, the average New Zealander only $19,430.

The good news is that with the right Kiwi can-do attitude and a bit of patience we will reverse this trend. We believe this is a task worth spending our careers on. Helping New Zealanders make better financial decisions is about a lot more than helping the wealthy get wealthier. It is as much about helping to build a savings base for everyone. This in turn enables a country to thrive commercially, medically, artistically and as a community.

Countries whose citizens have accumulated savings, like Norway, Switzerland and Australia, have more vibrant arts and culture, higher success rates with cancer, higher education levels, warmer homes, less domestic violence and lower suicide rates. Infrastructure that enables New Zealanders to save with confidence and access professional financial advice is therefore vitally important to all of us and worthy of NZ Funds' exclusive focus.

Portfolio returns before tax and fees - 1 January to 31 December 2020 [1]

Fees may vary by service type and account size.

	2020	2019	2018	2017	2016	2015	2014	2013	INCEPTION
TERM DEPOSIT INDEX									
Six month term deposit	2.45%	3.32%	3.33%	3.35%	3.29%	4.17%	3.90%	3.98%	
NZ FUNDS KIWISAVER SCHEME									
Income Strategy	3.34%	8.55%	2.01%	5.56%	7.15%	2.53%	5.51%	3.92%	31 Oct 2010
Inflation Strategy	17.21%	21.67%	-4.50%	9.74%	3.35%	2.36%	12.81%	7.04%	31 Oct 2010
Growth Strategy	35.85%	18.57%	-6.87%	18.69%	-1.49%	8.63%	13.17%	29.73%	31 Oct 2010
LifeCycle 0-54 y/o	32.27%	18.38%	-6.17%	17.11%	-0.55%	7.76%	12.79%	25.90%	31 Oct 2010
LifeCycle 65 y/o	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	-0.47%	10.86%	0.36%	7.81%	-	-	-	-	11 Aug 2017
Growth Strategy - British Pounds	29.05%	0.56%	-	-	-	-	-	-	03 Dec 2019
Income Strategy	3.42%	8.60%	2.03%	4.90%	-	-	-	-	25 Jan 2017
Inflation Strategy	16.50%	21.60%	-4.37%	7.73%	-	-	-	-	25 Jan 2017
Growth Strategy	34.39%	20.15%	-6.74%	14.28%	-	-	-	-	25 Jan 2017
NZ FUNDS ADVISED PORTFOLIO SERVICE									
Core Cash Portfolio	0.56%	1.65%	2.26%	2.19%	2.61%	3.66%	3.60%	2.95%	28 Feb 2008
Core Income Portfolio	4.46%	6.80%	5.01%	5.76%	6.55%	3.92%	7.06%	4.83%	23 Jul 2008
Global Income Portfolio	2.86%	11.79%	-1.27%	5.31%	7.25%	2.58%	5.62%	3.83%	31 Oct 2008
Core Inflation Portfolio	11.54%	23.78%	-2.68%	12.64%	3.20%	2.50%	12.92%	7.17%	31 Oct 2008
Property Inflation Portfolio	5.67%	21.18%	3.49%	9.44%	1.05%	10.40%	17.40%	5.26%	31 Oct 2008
Equity Inflation Portfolio	18.14%	21.92%	-6.44%	9.29%	2.12%	8.14%	16.58%	10.74%	31 Oct 2008
Core Growth Portfolio	46.69%	13.69%	-10.30%	15.95%	-3.08%	7.74%	10.59%	32.50%	01 May 2003
Global Equity Growth Portfolio	34.16%	22.25%	-7.78%	21.94%	-0.38%	11.40%	19.25%	28.59%	06 Mar 1996
Dividend and Growth Portfolio	12.83%	26.89%	-3.99%	22.93%	13.86%	16.89%	20.06%	8.65%	02 Dec 1992
NZ FUNDS INCOME GENERATOR [3]									
Income Generator	5.29%								22 Oct 2020

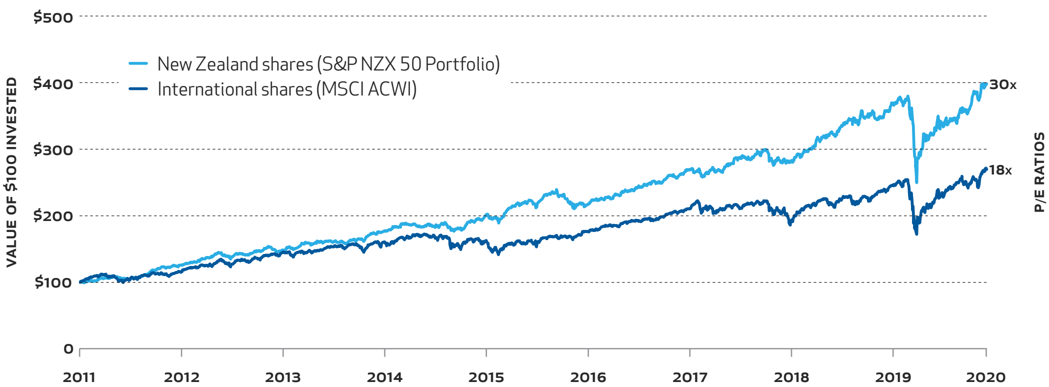
1. Returns are stated before tax, Portfolio/Strategy fees, and expenses, and any advisory fees. Past performance is not necessarily an indication of future returns.
2. 2017 returns for NZ Funds Superannuation Service Income Strategy British Pounds, Income Strategy, Inflation Strategy and Growth Strategy are from inception (not annualised). 2019 returns for NZ Funds Superannuation Service Growth Strategy British are from inception (not annualised).
3. 2020 returns for NZ Funds Income Generator are from inception (not annualised).

Market update

During the second half of the year financial markets began to recover. Today, in most cases, they are at or above their previous highs. Having successfully mitigated the downside, we were in the fortunate position of being able to buy a number of long-term investments at prices which may not be repeated in our lifetimes. These have already contributed positively to clients' portfolios earning solid risk-adjusted returns for 2020.

Looking forward we believe Covid-19 will have a lasting negative impact on some asset types and greatly assist returns in other areas. With the help of our global investment partners we believe we are well positioned for the years to come. What follows is an overview of where we have strategically positioned clients' investments; and of a number of areas where we sold or reduced clients' exposure following a large increase in value.

Investment markets have stabilised

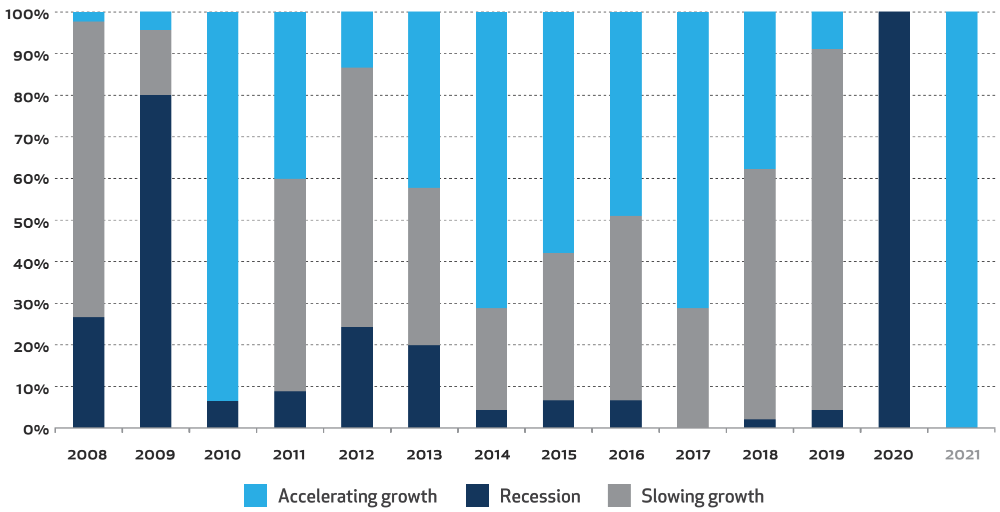


Source: Bloomberg, New Zealand shares S&P NZX 50 Portfolio Index, International shares MSCI ACWI net in local currency. Forecast price earnings ratios shown on right.

Economic growth

Without exception global economies have been caught off guard by Covid-19. Governments and central banks responded by increasing public spending and cutting interest rates. Economies around the world have responded better than expected, weathering lockdowns and a collapse in global travel. The cost, however, has been higher than expected. We forecast global economic growth will recover in 2021 as vaccines are distributed around the world.

Economic growth in turmoil but forecast to rebound



Source: OECD, June 2020 forecasts.

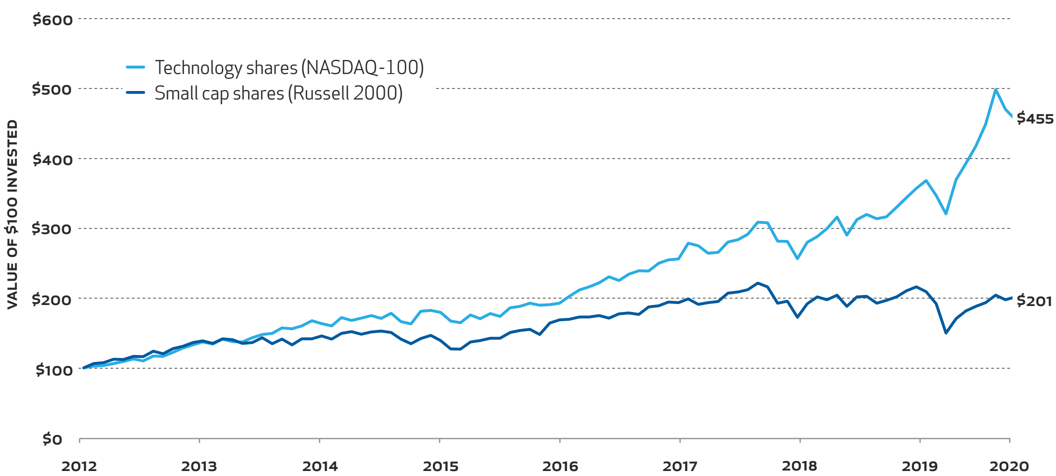
As economic growth rebounds some asset classes are better positioned than others. NZ Funds held a significant overweight to United States shares and in particular to technology companies.

Businesses like Apple, Google, Amazon, Microsoft and Facebook all continued to thrive despite Covid-19, as have emerging technology leaders like Zoom (video conferencing), Adobe (document management) and VeriSign (document signature).

However, a much broader range of businesses stand to benefit when the global economy recovers, which is why we have, together with our global investment partners, recently increased clients' ownership of small and medium sized businesses. These companies are still trading in aggregate at depressed prices.

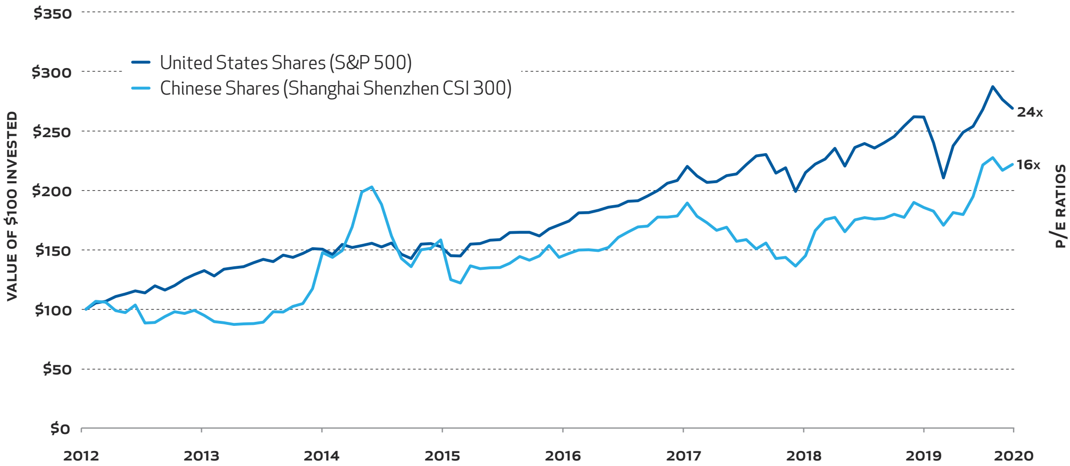
We have also increased clients' ownership of Chinese listed companies, as valuations in China are particularly cheap, especially given how well their command and control economy has handled the outbreak of Covid-19. We expect these two new asset classes to generate above average returns for some time to come.

Small cap shares are undervalued



Source: Bloomberg.

Chinese shares are undervalued



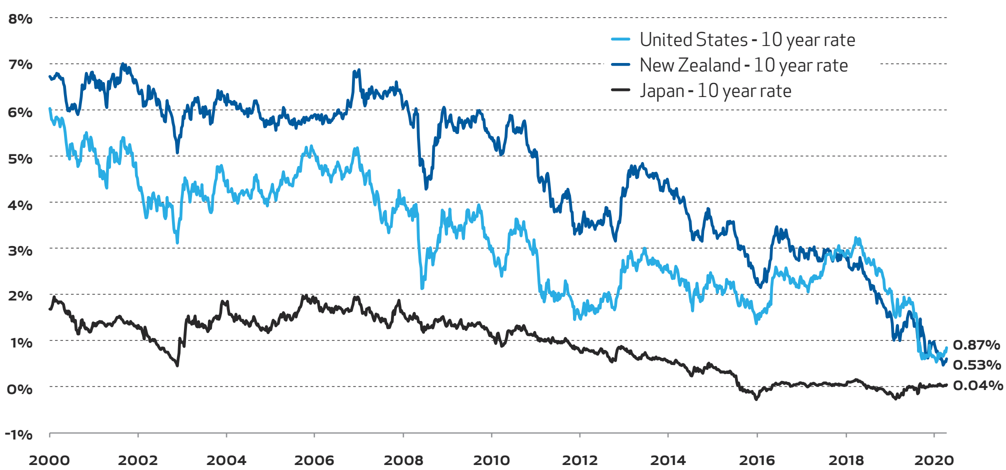
Source: Bloomberg. Forecast price earnings ratios shown on right.

Interest rates

Interest rates are forecast to remain close to, or below, zero for some time to come, leaving most developed nations in the world in the same position as Japan. While central bankers may well hold short-term interest rates artificially low to support the economy, long-term interest rates tend to reflect inflation expectations. A recovering economy will stoke inflationary fears and is likely to result in negative returns from government bonds, which have traditionally been a safe haven for investors.

Capital losses from long-term government bonds, and interest rates on term-deposits which after inflation and tax result in a loss in spending power, are new challenges for investors. Long-term investment track records, like the one NZ Funds has accumulated over the past three decades, are rarely the product of a single passive index orientated buy and hold decision. They are the product of carefully considering the merits of each investment held on clients' behalf.

Interest rates are all Japanese now



Source: Bloomberg.

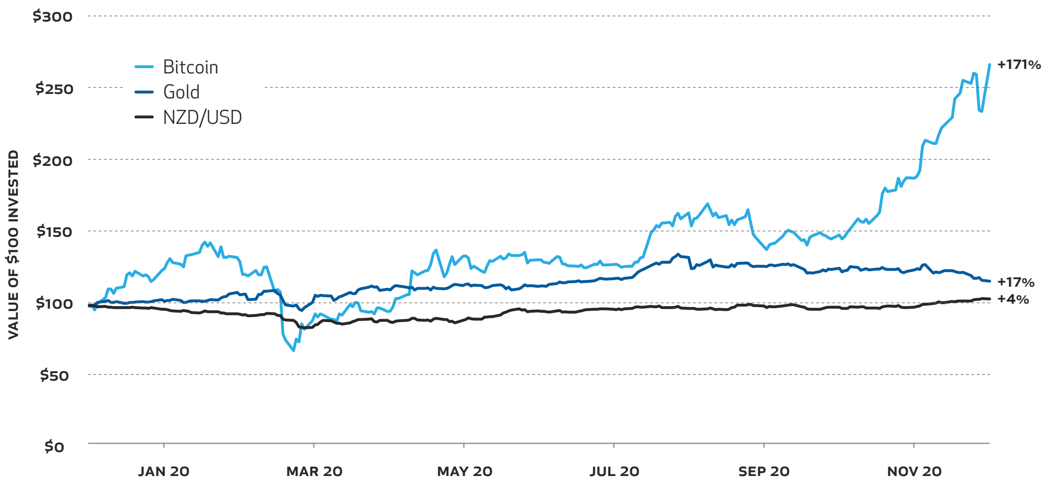
Global currencies

Another area where we think Covid-19 will have a lasting impact is currencies. Almost without exception, developed nations are now in the process of increasing both fiscal and monetary stimulus. Put simply, governments are borrowing and spending money while central banks print more.

Usually when this occurs, the country which spends and prints the most sees its currency depreciate in value against its trading partners. However, this time round, it is anyone's guess who has debased their currency the most. The United States, with their poor handling of Covid-19, Great Britain in their inability so far to exit the European Union smoothly, or New Zealand with its rapid accumulation of government debt.

Two assets classes which are not available for printing are Gold and Bitcoin. Early in 2020, NZ Funds purchased a modest exposure to Gold for clients. Gold subsequently rose from US$1,500 to around US$2,000 an ounce, where NZ Funds took short-term profits on clients' behalf.

Only two currencies are not being printed: Bitcoin and Gold



Source: Bloomberg.

We believe Bitcoin is a less understood, but equally useful investment tool, which should be treated no differently than a currency. We routinely consider whether to hedge clients' international investments back into New Zealand dollars, or keep them in United States dollars. Most central banks in the world – including New Zealand's – have now adopted programmes to "prepare" for the future adoption of digital currencies. We consider a modest weight to asset classes like Gold and Bitcoin to be useful tools, from time to time, to sit alongside hundreds of well-run share and bond positions. We purchase such assets on clients' behalf, to complete their investment portfolios, and not as a substitute for shares, bonds and listed property.

Performance

The year 2020 will be remembered as a case study in the theory that Crisis results in Change, and Change should be viewed as an opportunity to make money and not as a threat.

We began 2020 with client portfolios fully invested. However, thanks to three decades of managing money, we were vigilant. We knew it was late in the business cycle and the market was vulnerable to a correction. When we witnessed the outbreak of Covid-19 first hand in Hong Kong in January we suspected we had found a catalyst.

In the ensuing sell off, we were able to offset between 30% and 50% of market sell-off. What the numbers do not show, is that had markets fallen further we believe clients' portfolios would have been broadly capital stable. Fortunately the market did not decline further and instead rebounded sharply, in anticipation of a vaccine, and with it clients' portfolios.

In our last Investment Report (in March 2020) we looked at the performance of a number of managers during the downturn caused by Covid-19.

In this report, we look at the same managers' performance in the subsequent recovery. Pleasingly, this again shows the positive effect our downside mitigation strategies have had on client portfolios.

MANAGER / FUND	RETURN 1 JANUARY 2020 TO 19 MARCH 2020	RETURN YTD 2020 (TO 31 DECEMBER 2020) [1]
NZ Funds KiwiSaver LifeCycle (0-54 years old)	-13.8%	30.29%
Booster KiwiSaver Scheme Geared Growth	-27.3%	13.66%
Fisher KiwiSaver Growth	-16.1%	12.70%
Booster KiwiSaver Scheme High Growth	-18.7%	12.07%
BNZ KiwiSaver Growth	-14.8%	10.95%
BT Westpac KiwiSaver Growth	-18.4%	10.88%
Milford KiwiSaver Active Growth	-17.7%	10.36%
ANZ KiwiSaver Growth	-20.5%	9.04%
Generate KiwiSaver Scheme Focused Growth	-19.2%	8.57%
Generate KiwiSaver Scheme Growth	-18.1%	8.05%
ASB KiwiSaver Schemes Growth	-21.0%	6.41%
AMP KiwiSaver Lifesteps AMP Growth	-17.1%	6.14%
AMP KiwiSaver Lifesteps AMP Aggressive	-19.1%	5.47%
New Zealand Shares	**-24.5%**	**15.43%**
International Shares	**-27.6%**	**13.48%**

1. Returns are stated before tax, after fees. For long-term returns for the funds listed above, see the latest Fund Updates available on each manager's website. Year to date covers period 1 January 2020 - 31 December 2020. NZ Funds KiwiSaver LifeCycle (0-54 years old) is NZ Funds' most aggressive recommended asset allocation. It sits in Sorted 'Growth funds' category. LifeCycle is the NZ Funds KiwiSaver default investment option. 89% of NZ Funds KiwiSaver members are invested in LifeCycle. Past performance is not necessarily an indication of future returns. Returns are for the period 1 January 2020 to 31 December 2020 and are calculated by NZ Funds using latest available data for each calculation date. Market index data is for the same period and is sourced from Bloomberg. New Zealand Funds Management Limited is the issuer of the NZ Funds KiwiSaver Scheme, which incorporates the Strategies making up the NZ Funds KiwiSaver LifeCycle (0-54 years old). Further information is contained in the NZ Funds KiwiSaver Scheme Product Disclosure Statement. A copy can be downloaded from *www.nzfunds.co.nz*.

Summary

Our approach to protecting and growing wealth in a crisis can be best summarized as a three-step process: Survive, Adapt and Prosper. In order to Survive a manager must have the right investment management tools, such as downside protection options and the ability to invest in a broad range of asset classes, which we do.

In order to Adapt, a manager needs access to a global team of investment experts who are able to inform and guide New Zealand based clients. Global investment markets are rarely driven by New Zealand based issues. On the other hand, global issues have a significant impact on New Zealand investments.

With our international partners' help we identified a number of asset classes which we expect will materially increase in value over the coming decade. These include American small and medium sized shares which are highly leveraged to an economic recovery, Chinese listed state champions, which underpin President Xi Jinping ambitious growth aspirations, and emerging assets classes like Green Energy and Bitcoin.

Our investment in these higher returning asset classes has, however, been made in a size and manner which complements (rather than replaces) clients' long-term stable ownership of high-quality listed shares, bonds and property assets.

Overall, we remain focused on maintaining a broadly 40/60 split, with between 40% and 50% of clients' assets invested locally and between 50% and 60% invested globally. This has proven a prudent and sustainable strategy for over three decades now, and despite the many challenges the world faces, it is one area where we see no need to change.

NZ Funds would like to make a special mention of Peter Ashworth (whose photo appears on the cover). Peter is the regional head of our Dunedin Office. He is the 17th member of NZ Funds' team to have worked with clients, advisers, accountants, lawyers, regulators and colleagues for more than 20 years. He epitomizes the skill, integrity and thoughtfulness which we would like NZ Funds to stand for in the decades to come.

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