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PROFESSIONAL FINANCIAL ADVICE

Client Update

Market & Portfolio Update – January 2015

Global Shares

Global share markets finished January flat on average, but this was a combination of the United States market falling back moderately while European markets posted solid gains. A fall in the NZD from USD$0.78 to almost USD$0.72, driven by a lower outlook for NZ interest rates, significantly added to performance by supporting returns when translated into NZ Dollars.

While corporate earnings expectations were dampened in the United States, central bank policy was in the spotlight with European Central Bank president Mario Draghi announcing an extensive stimulus program to support confidence and investment in the European economy. This led to broad gains with European shares up almost 5%. Combined with Japan's ongoing stimulus program, total stimulus by central banks around the world is still running at the pace seen before the United States finished its quantitative easing program last year. This has been a strong factor supporting market performance.

New Zealand Shares

As expected, the New Zealand economy continued to show signs of slowing during January and the current drought looks to have an adverse impact on economic growth. New Zealand's largest GDP contributor, dairy exports, will be the most significantly affected industry. Despite the economy not growing as quickly, the New Zealand sharemarket had an impressive start to the year, returning 3% in January. The high-dividend paying electricity generators continued their recent strong performance to be the best performing sector returning an average 8% for the month. This was partly offset by the retail sector which continued to perform poorly as both the Warehouse and Kathmandu announced their Christmas sales were lower than expected and their profits for the current financial year will be lower than previously forecast.

Australian Shares

The Australian share market rallied strongly, as anticipation of lower interest rates led investors to seek out defensive high-yielding sectors and companies. The telecommunications sector led the market higher, followed closely by listed real estate trusts, with Telstra and Westfield Group both rising 9%. Construction companies continue to be well supported as building approvals remain at elevated levels, with lower interest rates also being a tailwind for the sector. The resource sector failed to participate in the rally though, as commodity markets continued their slide, falling another 5%. This was led by oil and iron ore falling 8% each, however the large cap mining companies, BHP & Rio Tinto, gave back less than 1% each, reflecting the low cost and diversified nature of both businesses.

Interest Rates

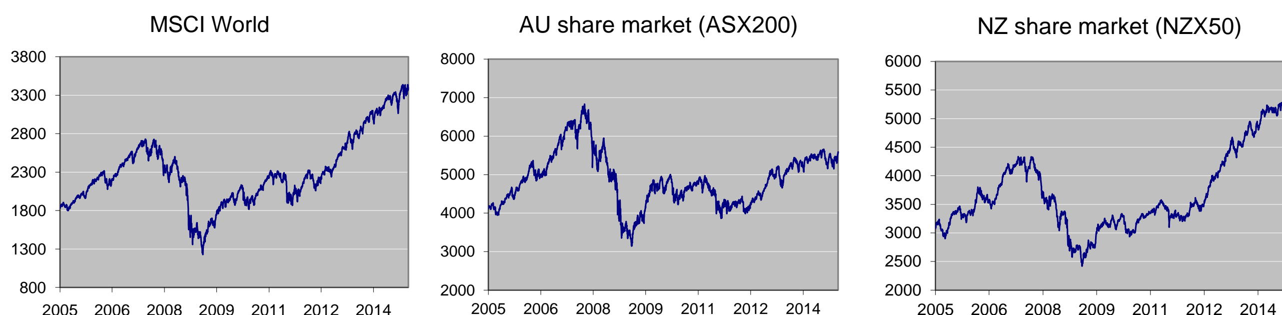
Global inflation continues to be absent from the major world economies, and lower oil prices are expected to reinforce this over 2015. This has led to a strong start to the year for fixed interest investments, which have benefitted from revaluation gains as yields on long-term bonds typically fell by around 0.5% across most developed markets, including New Zealand.

The Reserve Bank of New Zealand (RBNZ) maintained the Official Cash Rate (OCR) at 3.5% in its January meeting. However with the rate of inflation at only 0.8%, below the RBNZ inflation target of 1-3%, the Reserve Bank has since changed it's tone from an interest rate hiking bias to a more neutral stance whereby the OCR may be increased or decreased.

Summary of Market Movements as at 30 January 2015

Share Markets	30/01	31/12	1 Month Return	3 Month Return	12 Month Return	3 Year Return (p.a.)	5 Year Return (p.a.)
NZX50	5,744	5,568	3.2%	6.6%	17.8%	20.3%	12.7%
ASX 200 (local)	48,685	47,139	3.3%	2.0%	12.5%	14.5%	8.8%
ASX 200 (NZD)	52,254	49,366	5.9%	-3.1%	11.9%	7.8%	5.4%
MSCI (local)	3,368	3,390	-0.7%	1.5%	12.9%	16.0%	12.1%
MSCI (NZD)	6,166	5,834	5.7%	5.9%	19.4%	18.2%	10.3%
Fixed Interest Markets	**30/01**	**31/12**	**1 Month Change**	**3 Month Change**	**12 Month Change**	**3 Year Change (p.a.)**	**5 Year Change (p.a.)**
NZ 10-Yr	3.18	3.67	-0.48	-0.82	-1.37	-0.68	-2.44
US 10-Yr	1.64	2.17	-0.53	-0.69	-1.00	-0.16	-1.94
NZ OCR	3.50	3.50	0.00	0.00	1.00	1.00	1.00
Currencies	**30/01**	**31/12**	**1 Month Change**	**3 Month Change**	**12 Month Change**	**3 Year Change (p.a.)**	**5 Year Change (p.a.)**
NZD vs. USD	0.7258	0.7813	-7.6%	-7.2%	-11.4%	-4.4%	0.6%
NZD vs. AUD	0.9317	0.9549	-2.5%	5.0%	0.5%	5.9%	3.2%
MSCI Weighted NZD			-6.3%	-4.4%	-6.5%	-2.2%	1.8%
Commodities	**30/01**	**31/12**	**1 Month Change**	**3 Month Change**	**12 Month Change**	**3 Year Change (p.a.)**	**5 Year Change (p.a.)**
CRB Index	218.8	230.0	-4.8%	-19.5%	-22.8%	-11.2%	-3.8%
Oil	53.0	57.3	-7.6%	-38.3%	-50.2%	-21.8%	-5.8%
Gold	1,279	1,184	8.0%	9.1%	3.1%	-9.7%	3.4%

Summary of Market Indices as at 30 January 2015



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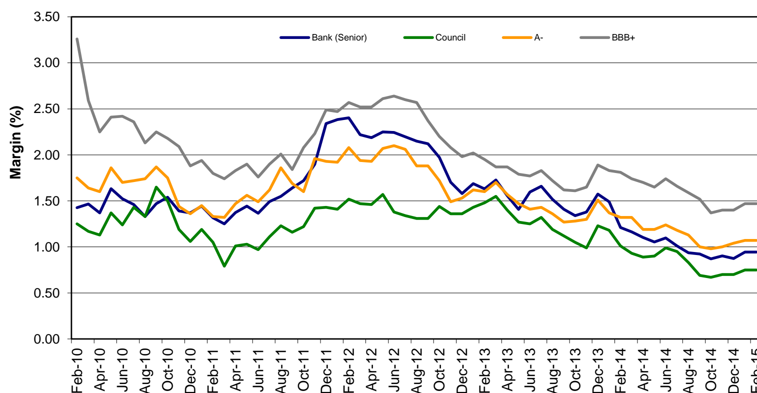
Navigating global credit markets

Over the past three years, a key theme driving investment markets has been a search for "yield" investments. This has taken place across a range of investment sectors – dividend yielding companies have been favoured, as well as typically higher-yielding markets (such as New Zealand shares). Bonds have performed well due to solid investor demand, particularly corporate bonds which have offered an income yield over and above that on government debt. Central bank policies have helped drive this outcome, with stimulus around the world aimed at keeping the general level of interest rates (and therefore borrowing costs) low.

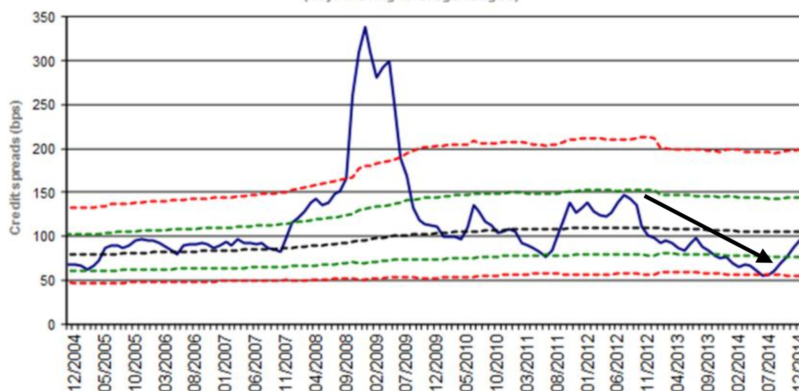
As we have discussed in earlier updates, the level of "credit margins" – the additional yield available in the market for corporate bonds compared to government bonds – is a key focus in managing your fixed interest investment allocation. Within New Zealand, credit margins have narrowed for bonds across a wide range of credit ratings over the past three years, as shown in the chart to the right. We have therefore been applying a keen eye to the terms of new corporate bond issues, to ensure that promised interest returns are in line with our assessed credit risk. However, relatively light levels of new bonds being issued has helped support our view on NZ corporate bonds in general, while the additional yield has remained reasonable in absolute terms.



Global markets have shown more fluctuation

This theme is also important within your global fixed interest holdings, where we generally maintain a 50/50 allocation between government bonds and corporate bonds. Over time, the additional yield on the corporate bond allocation is expected to enhance returns, while the government bonds provide an important ballast to the portfolio in times of financial market stress.

However, as with all portfolio allocations, our assessment of valuations and risk management is a key part of the approach. In the global bond market, stimulus saw the level of credit margins narrow more significantly than in New Zealand. As shown in the chart to the right, the difference in interest yield between top rated Aaa corporate bonds and those rated Baa (at the bottom of "investment grade") narrowed by almost two thirds from 2012 to 2014. For comparison, the dotted lines show a level of historical deviation from 10 year averages, with the red lines representing the range that credit margins should lie within around 95% of the time.



Investment approach driven by valuation assessment and risk management

The solid investor demand led to good revaluation gains on corporate bonds, but left their additional yield at the bottom end of historical norms. At those levels the normal 50% allocation to corporate debt became harder to justify relative to credit risks. This resulted in our reducing the corporate bond allocation by half, to 25% of the global fixed interest sector, with the sale proceeds reallocated to government bonds. Subsequent market performance has seen credit margins widen back to average levels, providing a more reasonable return outlook. Following this change, we have therefore now taken the opportunity to return your allocation to corporate bonds to the more neutral 50/50 level.

The fluctuation in credit margins shows the value of risk assessment compared to relative value. While our strategic investment framework sets the baseline settings for your long-run investment allocations, ongoing monitoring of medium-term return prospects compared to potential risks is a key active portfolio management activity aimed at delivering added value over time.

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Summary of Key Portfolio Monitoring Decisions

New Zealand Shares Portfolio

- During the month of January we reduced the portfolio's weight in Chorus, following the impressive performance during December (up almost 30%, as more immediate regulatory risk was reduced). To offset this reduction, we added DNZ Property Fund to increase the portfolio's exposure to the New Zealand property market.

Australian Shares Portfolio

- The portfolio's allocation to the healthcare sector has been increased from 6.0% to 7.5%, through the addition of private hospital operator Ramsay Healthcare. Ramsay owns and operates more than 150 hospitals, across multiple segments including vets, rural hospitals, psychiatric and medical-surgical hospitals. While started in Australia, Ramsay now has hospitals in the UK, France, Malaysia and most recently China. Ramsay's earnings profile is slightly defensive and will be a significant beneficiary of the growing global demand for private medical services.
- This addition has been offset through a slight moderation in the portfolio resources allocation, with BHP, Origin Energy and Woodside Petroleum all reduced.

NZ Fixed Interest Portfolio

- Global demand is likely to keep demand high for NZ bonds as they currently look relatively attractive compared to historically low global yields. With this view, we have increased the average maturity from 4 years to 4.5 years. This was achieved by reducing the shorter-maturity holdings, including selling the Auckland Council and ANZ bonds maturing in 2016. Replacement holdings included Local Government Funding Agency bonds maturing in 2021 and 2023, as well as 2027 NZ Government stock.

Corporate Bond Portfolio

- New Zealand corporate bonds will also likely be well supported, with a relatively attractive yield compared to global yields in conjunction with low issuance of new bonds by NZ corporates. This also supported increasing the effective average maturity of the Corporate Bond Portfolio by 0.25 years.

Global Fixed Interest Portfolio

- With a reduced exposure to global credit, the portfolio has had less exposure to the recent widening in global credit margins to more historically normal levels. Following the widening, we have increased the portfolio's allocation to international corporate bonds from 25% to 50%, and decreased the sovereign bond allocation from 75% to 50%.