

Investment insight

Interest rate risks

Executive summary

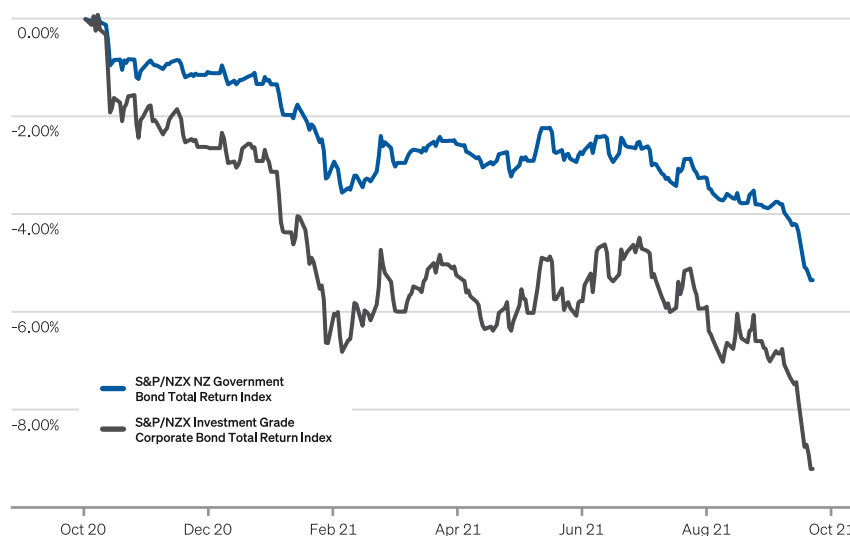
- The impact of increasing interest rates is a real and pressing risk lurking in low-risk assets.
- This is beginning to impact the performance of NZ bonds.
- For the 2021 year-to-date*, the New Zealand Corporate Bond Index has returned -4.3% while the New Zealand Government Bond Index has generated -6.8%.
- At NZ Funds, we have changed the way we build portfolios to generate the best return for our clients.
- Income Generator is an entirely new product which invests into shares but also uses put and call options to reduce volatility.
- In the Income Category, the big change is to use the tools that we have at our disposal to actively position the Portfolios to profit from rising interest rates.

* Performance data is to 21 October 2021.

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NZX Bond performance | Oct 2020 to Oct 2021 (YTD)



Source: Bloomberg

Many investors are worried that another share market crash is just around the corner, and this prevents them from taking the step of investing at least a portion of their savings into the share market. While sudden declines are risks that need to be faced occasionally in investment markets, they are less frequent than many anticipate.

What investors should be worried about is a more real and pressing risk lurking in assets they see as being low-risk. This is the impact of increasing interest rates, which will cause a slow but prolonged decline in the value of most bonds.

The sudden global shutdown in March and April 2020 saw governments announce record recovery packages and some of the largest budget deficits since World War II. At the same time central banks slashed interest rates to zero. These actions aimed to support

economies and encourage growth, and while the pandemic has continued for longer than many had envisaged, these actions have had the desired effect. Economies around the world have bounced back strongly – potentially too strongly in many cases and there is now a risk that inflation will become a problem for the first time in many years.

Now that the world is normalising, interest rates also need to return to more normal levels, similar to where they were before COVID-19. In New Zealand we saw the first indication of this early in October when the Reserve Bank of New Zealand increased the Official Cash Rate by 0.25%. This presents a major problem for many low-risk assets whose value is heavily influenced by the level of interest rates.

The impact of rising interest rates is already beginning to impact

performance. For the 2021 year-to-date*, the New Zealand Corporate Bond Index has returned -4.3% while the New Zealand Government Bond Index has generated an ugly -6.8%. Over the last 12 months, the numbers are no better for the New Zealand Corporate Bond Index at -5.4% and the New Zealand Government Bond Index at -9.2% .

Unfortunately, many investment managers in New Zealand continue to recommend portfolios comprised predominantly of these securities to their clients, and their clients' portfolios are showing similar returns.

At NZ Funds we always strive to do what we believe is best for our clients and sometimes that takes the courage to build portfolios in a very different way to those offered by other New Zealand investment managers.

New Zealand Funds has looked to meet the challenge that low interest rates have on lower-risk portfolios in two key ways.

Income Generator †

A year ago, we launched Income Generator into the market. This was an entirely new product for New Zealand that looked to invest into shares to generate higher returns but to reduce the risk of fluctuating share prices through the use of put and call options to reduce the volatility. To 21 October 2021, this Portfolio has returned 9.4% since inception. This has returned significantly more than would have been achieved from passively holding a mix of New Zealand corporate and government bonds.

Income Category

For the Portfolios in the Income Category, we have significantly changed their composition to address today's investment environment. Firstly, we have maintained very large cash holdings in order to sidestep declining prices. Typically, a portfolio might have 5% or 10% cash. At times this year, we have held close to 50% cash. More importantly, we have used the tools that we have at our disposal to actively position the Portfolios to profit from rising interest rates. Many other investment managers in New Zealand have neither the infrastructure nor the experience to be able to do this – NZ Funds has had this in place for almost a decade.

Having a short interest rate position does mean that the Portfolios experience more month-to-month variability of returns. However, this positioning has helped the year-to-date returns remain in between 2 - 4%. This is 8 - 10% better than that achieved from passively holding a mix of New Zealand corporate and government bonds.

Low-risk assets such as bonds have an important place in the portfolios of clients with a low risk tolerance as well as those who are in retirement; however, no solution is set and forget. In **09 April 2021 | Global insights shape our investment strategy** we described how we think about the different drivers of investment markets. As an active investment manager, NZ Funds is always asking the question 'what will deliver the best return for our clients' and if a new path is needed through the investment jungle, we are willing to find it.



Mark Brooks
Portfolio Manager

Mark is responsible for management of the Income portion of clients' portfolios at NZ Funds. This encompasses both New Zealand and Global fixed income securities.

After beginning his career with NZ Funds, Mark spent five years during the early 2000s in London managing a portfolio for a European credit hedge fund.

Since re-joining NZ Funds in 2007, he has built a strong track record of performance for clients across both local and global income.

* Performance data is to 21 October 2021.

† New Zealand Funds Management Limited is the issuer of the NZ Funds Income Generator. A copy of the NZ Funds Income Generator Product Disclosure Statement is available on request or by visiting the NZ Funds website at www.nzfunds.co.nz.

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