Monthly Review

For April 2022

NZFunds

Product Disclosure Statement

New Zealand Funds Management Limited is the issuer of the NZ Funds Advised Portfolio Service, the NZ Funds KiwiSaver Scheme, the NZ Funds Managed Superannuation Service, NZ Funds Wealth Builder, and NZ Funds Income Generator.

The Product Disclosure Statement and the Disclose Register contain important information to help you to understand how your money is managed and the risks associated with investing.

A copy of the NZ Funds Advised Portfolio Service Product Disclosure Statement, the NZ Funds KiwiSaver Scheme Product Disclosure Statement, the NZ Funds Managed Superannuation Service Product Disclosure Statement, the NZ Funds Wealth Builder Product Disclosure Statement, and the NZ Funds Income Generator Product Disclosure Statement is available on request or by visiting the NZ Funds website at www.nzfunds.co.nz.

Even if you have invested with NZ Funds for many years, please take the time to read these documents regularly as the content is frequently updated.

Important Legal Information

Markets

Economic update

In March 2020, financial markets struggled to adjust to the impact that the sudden onset of COVID-19 was having on the global economy. Given the breadth of the impact and the suddenness of the event, financial markets' reactions were equally violent with sharp falls across most asset types and a rush towards cash.

Move forward two years and once again financial markets are struggling to adjust to another shift of the goal posts. This time, however, the change has come in the form of higher interest rates. Unlike COVID-19 this change has not been sudden and has been well sign-posted. This has meant that the adjustment process for financial markets has been more gradual than it was in early 2020. While more gradual, the change in markets has been significant with the core asset classes of shares and bonds both experiencing negative returns year-to-date.

Why do markets need to adjust to this? The simple fact is that as central banks around the world act to rein in inflation, money is harder to come by and that this is something that percolates through all parts of the economy – from the standard household mortgage through to some the best known and most successful tech names of the last decade.

When money is easy to come by, this encourages risk-taking and pushes up the values of most assets. At the same time, it tends to narrow the valuation difference between high-quality assets and riskier assets. Financial market examples of this can be seen in the performance of riskier high yield bonds versus the more stable investment grade bonds and in the stellar performance of early-stage high-growth companies in 2020 and 2021. Closer to home, it is seen in the price of property across regional centres which have approached the valuations seen in our larger cities.

As money becomes harder to come by, investors and lenders naturally become more discerning in their investment selection. They either ratchet down the amount they are willing to pay or they expect a higher quality investment in return. This decision process can be seen by comparing the relative performance this year of high growth 'non-profit' tech companies, many of which have seen their share price decline by 50% or more, versus more stable and reliable sectors such as healthcare and consumer staples which have increased 20-30%.

Companies are adjusting to the scarcity of money by changing their focus. Growth without profit is not being rewarded, so the focus is shifting to generating profits and organic self-funded growth. This applies to both large and small companies. For the smaller companies it might be about survival as they cannot guarantee easy access to further funding. For the bigger companies it is about being more disciplined and focused on how they spend money in their businesses.

High profile examples of this are Uber, Amazon Facebook (Meta) and Netflix. Netflix didn't need to focus on account sharing when their subscriber numbers were growing rapidly but as their business matures, they need to focus on how to monetise the 100 million people who are piggy-backing on the 220 million paying subscribers. Similarly Uber has said in an open letter to employees that “they are serving a multi-trillion dollar market, but market size is irrelevant if it doesn't translate into profit”. So the focus in now not on growth but on generating cash flow.

This is an environment in which NZ Funds' active investment approach should shine versus a passive index investment style, as rigorous fundamental research can identify the companies that are well positioned to benefit or are agile enough to make the required adjustments.

Income Generator

Income Generator (the 'Portfolio') returned -0.3% in April. Since its October 2020 inception, it has returned +1.2%p.a. which compares favourably to the New Zealand share market return of -6.5%p.a. over the same period.

Since the start of the year Income Generator has significantly outperformed local and global share markets. The Portfolio is down -1.7% year-to-date compared to the New Zealand share market return of -9.5% and the global share market return of -12.8%.

January saw major share market indices record the largest month of negative performance since the height of the COVID-19 pandemic volatility in 2020. February began with continued concerns over high inflation levels across most economies before market attention turned to the invasion of Ukraine. March saw interest rates rise further, and the continuation of the conflict in Ukraine.

April saw continued reaction to economic factors including high inflation, rapidly rising bond yields and growing fears that we could be heading into a recession next year. This has paved the way for significant price moves across commodities, interest rates and share markets.

The Income Generator strategy is designed to limit losses in a negative share market environment. Income Generator's specific investments are heavily weighted towards high dividend-paying companies with strong cash flows and reasonable valuations. These companies avoided the worst of the current sell-off which was led by high growth companies with expensive valuations.

We had already decreased overall share market exposure in November and December last year in anticipation of potential share market weakness. We retain the ability to limit the downside with futures contracts and options, as we anticipate further potential share market volatility.

Share ownership

New Zealand

Spark New Zealand	5.66%
Auckland International Airport	5.25%
Contact Energy	5.24%
Chorus	5.21%
Mercury NZ Ltd	5.09%
Fletcher Building	4.98%
Kiwibank 4.93% perpetual	4.47%
Meridian Energy	3.95%
Infratil	3.21%
Mainfreight	3.06%
Summerset	2.00%
Ryman Healthcare	1.98%
Fisher & Paykel Healthcare	1.84%

Australian

Australia & New Zealand Banking Group	5.13%
Rio Tinto Ltd	5.04%
Goodman Group	4.83%
Telstra	4.34%
National Australia Bank Ltd	4.21%
Commonwealth Bank of Australia	4.08%
Transurban Group	3.48%
Wesfarmers	3.12%
Macquarie Group Ltd	2.92%
Woolworths Group Ltd	2.19%

Income Category

United States Dollar strengthens

Source: Bloomberg.

April was yet another challenging month for bond investors as interest rates continued to move rapidly higher, both in the United States and in New Zealand. Given the Category's strong performance over the first quarter and the fact that interest rates were approaching our target levels, we chose to dial back our short positions during the month. As a result, the Category broadly tracked the performance of the wider bond market during April.

New Zealand interest rates continued to move aggressively higher over the month. The decision by the Reserve Bank of New Zealand ('RBNZ')to increase the Official Cash Rate ('OCR') by 50bps to 1.50% in early April did see a temporary pause in this trend. However, wholesale markets have continued to build in a very aggressive path of OCR increases over the next year.

In their last full monetary policy statement, the RBNZ indicated that they saw the peak of the OCR being around 3.30%. Wholesale interest rate markets have gone well beyond this and are pricing in a peak of over 4%.

At this point we think this aggressiveness is unnecessary. The implication that this has for mortgages is significant and we are already beginning to see articles in the newspaper about borrowers struggling to adjust to much higher mortgage payments. This is not surprising as the banks' 'special rates' are now close to 5% and standard rates are between 5% and 6%. This is a

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Income Category

mammoth step up from the 2% to 3% rates that borrowers are rolling off and it means that some sections of the economy will experience economic distress over coming months.

Being short interest rates has been a significant benefit to the Income Category this year; however, as noted, interest rates generally are at or beyond our target levels. So how are we positioning the Income Category for the rest of the year?

The good news is that higher interest rates mean that once again corporate bonds offer an attractive yield. We are no longer faced with 2% or 3% yields. Instead, bonds are offering 4% or even 5%+ which is much more attractive. So, in general, we are reducing our cash holdings and slowly adding new positions to the Income Category.

The other change to positioning is including a larger exposure to currencies. For several years, currencies have been relatively unexciting and have moved in defined ranges. However, they are sensitive to changes in short-term interest rates, so as Central Banks have altered their cash rates, this has flowed through to the relative value of various currencies.

Broadly, we have looked to position the Income Category in two ways. Firstly, to be exposed to a generally stronger United States dollar which benefits from higher real interest rates in the United States, and secondly, to be long the United States dollar and short the Chinese Yuan. While the United States and other western nations are looking to tighten financial conditions to slow their economies, China is in the opposite position and is looking to stimulate growth which is weak due to lockdowns and a struggling property market. This suggests that the Chinese Yuan will weaken against the United States dollar.

Income Category returns[1]	April 2022	12 months
Advised Portfolio Service[2]	-2.92%	-0.84%
NZ Funds KiwiSaver Scheme	-2.73%	-0.24%
Managed Superannuation Service	-2.80%	-1.32%
Wealth Builder	-2.78%	-1.09%

1. All returns are after Portfolio fees but before investor tax. 2. The return calculations are based on a 50% allocation to the Core Income Portfolio and a 50% allocation to the Global Income Portfolio. Past performance is not necessarily an indication of future returns.

Inflation Category

Non-profitable technology basket | Performance pre-COVID 19 to April 2022

Source: Bloomberg.

The Inflation Category had a strong month in April.

April's performance was achieved in a very tough investment market which saw sell-offs of over -8% in many global share market indices, including the Nasdaq which fell by over -13%, making it the largest one month sell-off since the Global Financial Crisis.

In the Growth Category write-up this month, we set out more detail on what has been causing the share market weakness. We believe conditions will remain challenging for share markets for the near-term, however the Inflation Category has so far this year achieved positive returns even in this environment.

In April we continued with our strategy that has worked successfully this year. This included lower absolute share market exposure. This has been achieved by not only reducing total position sizes and holding more cash, but also by adding downside protection though share market put options. The Absolute Return Strategy, which sits within the Inflation Category, has used S&P500 and Nasdaq put options to generate significant returns in a share market that has been falling. We intend to continue using put options while market volatility remains high and tending to the downside.

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Inflation Category

The Absolute Return Strategy also generated returns through shorting a basket of United States non-profitable technology companies. This basket is down over 48% year-to-date as the rally in technology stocks, post the start of the COVID-19 outbreak, took the companies to unsustainably high valuations.

Our New Zealand and Australian shares portfolio performed slightly ahead of the New Zealand share market which fell 1.4% and the Australian share market which fell 85bps. Our strategy with this portfolio is to avoid owning companies that are trading on high valuations, as these generally have larger potential downside as interest rates increase.

Commodities returns for the Inflation Category were marginally positive in the month. The commodities rally we have seen this year paused somewhat in April as the market had to contend with lockdowns in China and a strong United States dollar. Both these factors tend to be negative for commodities prices. We are still positive on commodities but have reduced the size of our position in the short term and will look to increase it again as China begins to come out of its lockdowns.

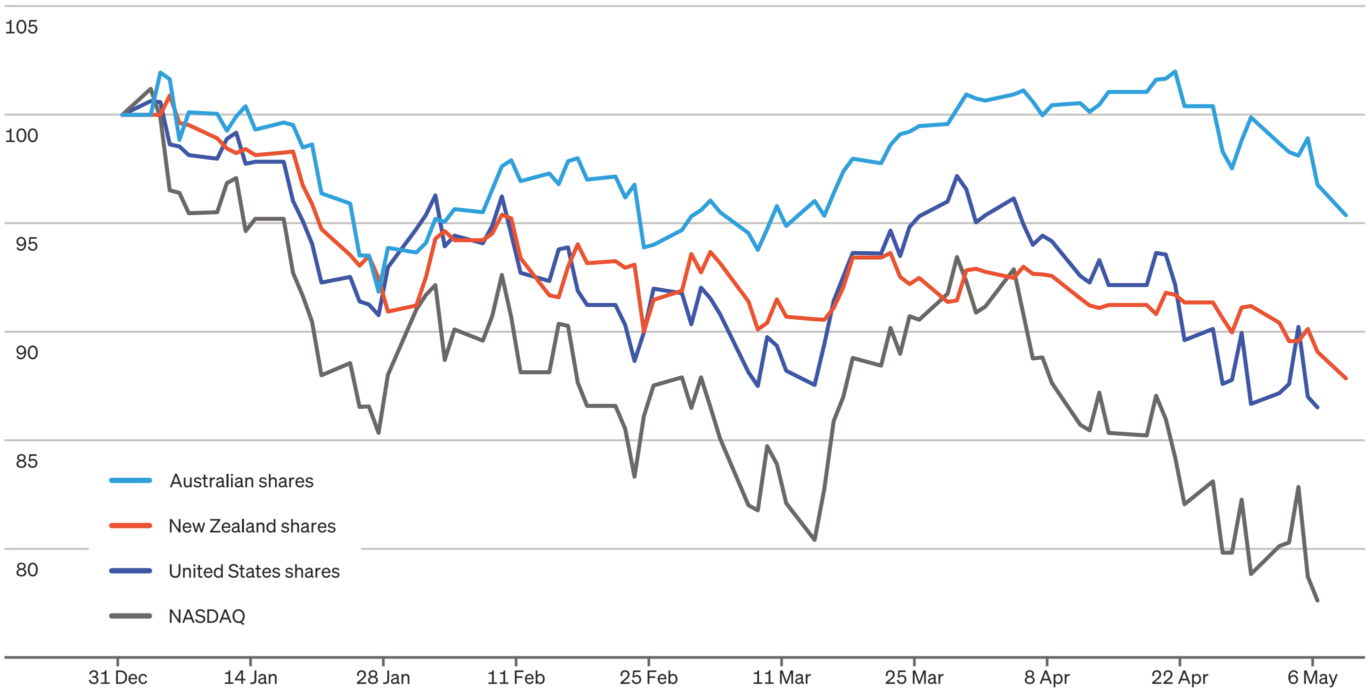
Heading into May, we have further reduced the gross exposure of the Inflation Category to manage the uncertain and volatile environment. We have added some more share market put protection to mitigate further potential share market weakness.

Inflation Category returns[1]	April 2022	12 months
Advised Portfolio Service[2]	-0.56%	-12.07%
NZ Funds KiwiSaver Scheme	0.87%	-9.69%
Managed Superannuation Service	1.06%	-9.64%
Wealth Builder	1.04%	-9.58%

1. All returns are after Portfolio fees but before investor tax. 2. The return calculations are based on a 34% allocation to the Core Inflation Portfolio, a 33% allocation to the Property Inflation Portfolio, and a 33% allocation to the Equity Inflation Portfolio. Past performance is not necessarily an indication of future returns.

Growth Category

Share market index performance | 2022 YTD, rebased to 100



Source: Bloomberg.

The Growth Category had approximately flat returns in April. This was a strong performance given share markets globally had one of their worst months since early 2020.

The performance of some selected global market indices in April include:

United States shares -8.7% (worst month since March 2020)

Nasdaq -13.3% (worst month since the Global Financial Crisis period)

Global shares -8.0% (worst month since March 2020)

However, local share markets performed better with the New Zealand share market down 1.4% and the Australian share market down 85bps.

Share markets continued to react negatively to macro factors including high inflation, rapidly rising bond yields and growing fears that we could be heading into a recession next year. The United States reported a surprisingly negative month-on-month GDP growth number last month which is helping to fuel concerns that economies are beginning to slow down. In particular, investors are concerned that high commodity prices will impact growth and corporate margins.

The United States megacap technology stocks are often seen as a bellwether for the health of the economy. Most of these companies reported results during

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Growth Category

the last week of April. The results showed that Q1 performance was still strong, however a number of companies guided to a potential slowdown in growth in coming quarters and higher costs. Amazon was the one standout on the negative side where it missed its earnings targets and guided to significant cost pressure this year. As one of the largest employers in the United States, Amazon's problems are likely to be felt by many other companies.

New Zealand shares have typically not seen the month-on-month volatility that many global share markets are seeing. However, the market sell-off year-to-date had extended to 6.7% by the end of April. Many New Zealand companies are also facing problems with high input costs for products and local interest rates moving higher.

Australian shares have been one of the few positive stories so far this year with the Australian share market up 1.4% year-to-date. This has been driven by its much higher exposure to commodities companies and banks which have performed well.

In April, the Growth Category made significant gains from commodity positions, in particular from corn and natural gas. The gains made in these were enough to largely offset the losses made in share market positions. We also made some returns from interest rates as United States government bond yields continued to move higher.

Heading into May, we have further reduced the gross exposure of the Growth Category to manage the uncertain and volatile environment. We have added some more share market put protection to mitigate further potential share market weakness. We have also decreased our overall commodities exposure. We remain bullish on commodities, however there are short-term risks such as the strong United States Dollar and China lockdowns that could weigh on prices.

Growth Category returns[1]	April 2022	12 months
Advised Portfolio Service[2]	-1.68%	-22.72%
NZ Funds KiwiSaver Scheme	-0.42%	-20.27%
Managed Superannuation Service	-0.33%	-20.65%
Wealth Builder	-0.36%	-20.73%

1. All returns are after Portfolio fees but before investor tax. 2. The return calculations are based on a 30% allocation to the Core Growth Portfolio, a 30% allocation to the Global Equity Growth Portfolio, and a 40% allocation to the Dividend and Growth Portfolio. Past performance is not necessarily an indication of future returns.

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