Addressing your questions…

As we approach the mid-way mark in the year, I thought it might be useful to reflect on the messages our team are relaying from you and your clients.

As an independent New Zealand owned company, working in partnership with independently-owned advice businesses, we pride ourselves on listening to what you are telling us - even if it may not always feel that way to you!

So, these are the issues we are hearing loud and clear today, and I wanted to give you my brief thoughts on each ….

You are making it too hard to do business…

We know that some of you think we make it more difficult to do business than it needs to be, especially in the AML space.

We really struggle with this because we strive for the opposite – to know your business better than anyone else could and to help you to grow a strong, efficient and sustainable business. We want to be straightforward to do business with.

But we also have a low appetite for taking on legal and regulatory risk. To the contrary, we strive to be seen by the regulator as a model financial services citizen.

The regulatory burden is a real issue for you and us. We share many of your frustrations. As a licenced investment manager and a financial advice firm, we experience both sides of increasing regulation and supervision.

Our goal is to minimise regulatory impact on business and comply with both the spirit and letter of the law. When we hear that others in the industry approach compliance matters differently, we review our processes and, where appropriate, make changes. However, copying the lowest common denominator is not always a smart choice and we always try and consider market practice against what we believe is right.

We are actively working on developing technology to help streamline regulatory compliance for all involved. We have embedded the use of electronic customer due diligence technology in our AML processes, which has simplified verification of identity and address information for many clients. In addition, we are digitising certain processes, such as switch transactions and are exploring ways to streamline client onboarding.

Your fees are too high…

It goes without saying that, all other things being equal, if we can lower fees we will improve performance outcomes for clients. But price is not the only consideration for clients and we aim to deliver a premium all round service to clients; and to the advisers who serve them.

At present, the base TER (ie. excluding performance fees) for a diversified client in our Managed Portfolio Service is 2.35%, in KiwiSaver it is 1.30% and in Managed Super is 1.45%.

We have a four-pronged approach to continuing to improve the pricing proposition for clients.

1. **Price all new services simply and competitively** – as can be seen in the market-leading pricing of our recently launched Managed Superannuation/QROPs Service.
2. Offer **differentiated pricing for high-value customers** ie. those with Managed Portfolio accounts of over $1 million with NZ Funds.

3. **Progressively reduce Managed Portfolio pricing**. This year we are reducing the growth and inflation category pricing by 2.5 basis points each quarter and the income category by 1.25 basis points per quarter.

4. **Progressively reduce advice pricing.** As we acquire advisory firms as part of the owner's succession plan, we typically convert each client to dollar rather than asset based pricing; and we are progressively reducing advice pricing to a point where each client would pay an advice fee which is below $5,000 **and** below 1% of assets.

While that reflects how our pricing proposition is evolving, we are at the same time investing heavily in new services to continue to broaden and improve our value proposition, for clients and their advisers.

We are very aware of the widespread focus on fees. In terms of our public fee disclosures, we take a highly conservative approach, choosing to report all performance fees, including those of all underlying external managers we employ. We are aware that this full disclosure approach is not universally followed, but like I said above, we do it because we think it is right.

The challenge of reducing the costs of investing for New Zealanders is one we face together.

We aim to be open about how we are progressing in that quest and as part of that broader goal we would also like to better understand your evolving approaches to advice pricing.

What is your Responsible Investment Policy…?

We are very aware that responsible investment is an area of growing investor interest. We include responsible investment considerations as part of our overall investment analysis. This approach is simple, principled and pragmatic, and can be summarised in five key points:

- Our company investment research must include consideration of environmental, social and governance matters.
- We contract a specialist independent research company to identify "red flag" companies. We currently use a leading global research company called ISS www.issgovernance.com/about/about-iss/
- No fund we manage will own securities issued by "red flag" companies involved in:
  - Controversial weapons; and/or
  - Global norms (environmental, social, or governance issues)
- We communicate to each underlying investment manager our wish for them to invest according to those same principles that we do.
- Any exemption to this approach must be approved by the Head of Risk, CEO and a Director who is not a member of the investment team.

At the widest level, we think investing "responsibly" makes good economic and commercial sense, but we are also aware that at the margins it can highly subjective.

What's going on with performance…?

We take an active approach to portfolio management. An active approach means that at any time, our portfolio positioning reflects our views of the likely course going forward.

Environmentally, interest rates globally have been cut to all-time lows and kept at those levels for almost a decade now. This intervention was known as quantitative easing. Consequently, certain segments of the share market have boomed, as have assets which benefitted from very low borrowing costs, most notably, residential property.

Globally, this expansion in asset prices did not create many jobs nor did it generate much economic growth and/or inflation. Especially given what preceded it, it has been an unusually low growth recovery.

Also, somewhat perversely, the shares of companies that typically do well during a recovery phase – commodities, banking and finance, metals and mining - have languished. Some of these companies can be purchased today at prices below where they were ten years ago.

We believe that we are currently seeing a "gear-change" into a new phase in the economic cycle. This new phase can be thought of as a "reflation" cycle (i.e. the gradual return of inflation) and could predominate for the next five to seven years.

The first sign of this change is the raising of interest rates by central banks. The Fed have started raising and are expected to continue down that path. In addition, many governments - especially United States and China - plan on dramatically increasing expenditure on infrastructure (bridges, roads, sewerage, water, border walls and the like) and defence.

This will see fiscal stimulus (ie. increased government spending) replace monetary stimulus (declining interest rates) and will likely accelerate the rate at which global interest rates rise.

For the past 18 months, we have been increasingly positioning client portfolios to benefit from this anticipated cyclical change.

With the benefit of hindsight, clearly we have been too early, and being early has created a drag on performance. We have also executed some of that positioning less than perfectly, and we have talked before about the work we are doing to improve our trading and execution capabilities.

Before we talk about our specific active positions, it is critically important to note that the core of every client's portfolio is made up of high quality New Zealand and global bonds and shares, a large portion of which is held either passively, or through long-term buy-and-hold type mandates.

On top of these core holdings we actively tilt the portfolio's positioning toward a set of global themes that reflect our medium-term views and where our research indicates superior return prospects exist.

Our key active positions, reflecting our reflation cycle theme, are currently:

1. We are positioned to benefit if long term interest rates rise, across both the income portfolios and several of the inflation and growth portfolios.
2. In addition to our broad equity exposures, we are overweight those sectors we anticipate will benefit most from rising interest rates and stronger economic growth - most notably, banking and metals and mining.
3. We are overweight the United States dollar against a basket of Asian currencies. We believe the USD will appreciate as the United States' more advanced monetary policy firming cycle plays out.

To date in 2017, the first quarter saw the market reward our active positioning and we started the year strongly. We have more than given that back in the second quarter as growing concerns about the United States' leadership have tempered near-term growth expectations.

We have no firm idea what the next two quarters will bring, but we can say that our confidence in our active positioning continues to build, especially following our recent research trip to the US where we met with numerous existing managers, potential managers and investment researchers.

With the caveat that if the facts change so may our views, we expect to continue to hold our active positioning and we expect that positioning will be rewarding for clients over an 18 to 24-month horizon, albeit not always in a linear fashion.

And a final word on people and process…

We have recently had PwC complete a gap analysis over our investment governance and trading processes. The work was a valuable exercise to help us enhance our investment process and execution and, in our view, no major changes were required following PwC's work.

Ultimately, managing money is a human capital business no matter what your philosophy. The recent addition to our team of portfolio manager James Grigor, CFA (ex-Head of Strategy for Macquarie NZ), portfolio systems leader Dale Henderson (ex Marshall Wace UK) and head trader Dave Haslam (ex UBS NZ), has significantly enhanced our investment capability and, in the long run, it is capability which differentiates good management from good luck.

We appreciate that we can sometimes make your job harder than you would like. But we do listen to what you are telling us. Keep talking to us about the issues you are facing and rest assured that we will keep working as hard as aver to positively differentiate ourselves.

And, as always, we are happy to talk to you or your clients on any matters, if that would be of assistance.