Pathfinder
Asset Management

World Equity Funds: Currency Hedging Update

25 September 2012

Guidance: no change to 75% after tax hedge
Outlook: lower near term hedging guidance likely

Purpose of this note: The purpose of this note is to update our guidance for the currency hedging of investments in our World Equity Funds. By way of reminder we operate a pair of funds – one currency hedged and one unhedged. NZ investors can select an *after tax* currency hedging ratio for their investment based on their risk/investment preferences and PIR tax rate. Please refer to the investment statement and prospectus for a full explanation.

Hedging guidance: Since launch of the funds in November 2011 we have provided guidance of a 75% *after tax* hedge. We currently retain the 75% guidance but are changing our future outlook. Our views and reasoning are set out below.

Review of "base case" guidance: We are very finely poised between retaining our 75% guidance and changing to a 50% *after tax* currency hedge. There are very good arguments supporting each view (which we summarise below). On balance we retain our 75% guidance but with an outlook of "*lower hedging ratio possible in the near future*". We have always warned that currency predictions – particularly short term - are notoriously unreliable. In our view the best value comes from a longer term approach to currency based on macro trends rather than a trading mentality.

Recent currency history: A higher rather than lower hedge has been beneficial for NZ investors since launch of the World Equity Funds. In November 2011 each of our Funds started with a $1.00 NAV. The Hedged Fund NAV has since risen to $1.1100 while the Unhedged Fund NAV is $1.0050 (as of 25 September 2012). The difference between these is purely the effect of currency with equity gains in the unhedged fund being eroded by the appreciating NZ dollar. We believe it is currently extremely difficult to have a high conviction on the NZ dollar versus the US dollar and Euro. There are sound arguments to justify either direction – we set these arguments out below.

Will the NZ dollar continue to rise? There are several reasons why the NZ dollar could continue to rise from here:

- Money printing (QE) in major economies could continue to debase those currencies relative to the NZ dollar. Trillions of new dollars have been injected in the global system (outside of NZ) since the onset of the GFC – until this money is withdrawn it could have a permanent impact on relative currency values.
- "Hot money" flows chasing higher interest rates could continue to drive up the NZ dollar.
- The NZ dollar could strengthen against the Australian dollar as their bulk commodity based economy slows and interest rates in Australia are lowered.
- New Zealand remains one of the "least worst" currencies as we continue to enjoy (relatively at least) better economic conditions than our peers plus a relatively buoyant soft commodity export bias.
- Previous relationships between asset classes have changed significantly due to central bank interventions. Historic relationships are less helpful since the advent of QE.

Will the NZ dollar fall from here? There are sound arguments for a fall in the NZ dollar. The problem is that the timing of any fall cannot be predicted and currency markets can remain over (or under) valued for long periods, in some cases years or even decades.

- We are particularly concerned that event risk in Europe could unexpectedly send the NZ dollar down if investors turn "risk off". Recent volatility in the Euro currency shows how politics and market flows can overwhelm objective fundamentals. On the recent ECB announcements (and speculation prior) the Euro rallied nearly 10% versus USD.
- The "real" NZ economy is hurting from the elevated NZ dollar. Exporters become relatively less competitive. Farmers do not receive the full benefit of higher commodity prices. The slowdown in Australia and China will have an impact. Currency markets can ignore economic realities for a period – but not forever. Most currency models value the NZ dollar around the low 70s vs the US dollar – will economic realities eventually force it to revert to levels expected by conventional valuation models despite the massive currency debasement efforts by the FOMC and ECB?
- NZ dollar strength has to a large degree been driven by quantitative easing (QE) policies of major central banks. We expected the NZ dollar to rise more strongly than it has since the announcement of QE3 – we believe we are seeing increasingly smaller impacts from QE policies on currencies. To us this indicates a risk that the NZ dollar may not trend significantly higher from here. If you are interested in more information on the currency impacts of QE, we discuss this in more detail in the schedule below.

Currency view - outlook: We are still relatively constructive on the NZD versus other currencies but our conviction is not as strong as previously. We see the risks of a stronger or weaker NZ dollar as finely balanced. We currently retain our guidance that a 75% *after tax* currency hedge ratio for the World Equity Fund is most appropriate, but this is finely balanced. Any further strength in the NZD will likely result in Pathfinder's *after tax* hedging guidance changing from a 75% ratio to a 50% hedge ratio. We will circulate a note if this transpires.

Notes for investors in Pathfinder World Equity Funds: Below are two key considerations for investors and their financial advisers when considering our hedging guidance:

- **<u>The reality of portfolios:</u>** We provide guidance on a stand-alone basis - meaning we look at an investment in our World Equity Funds in isolation from any other investments in a portfolio. It is likely that an investor's portfolio will also contain other international equity assets. These may be hedged or unhedged. If these are unhedged, an adviser may think it appropriate to run a higher *after tax* hedge than our guidance – as the excess hedge can "wash over" to other exposures. We see this approach as entirely logical, but it does require a full understanding of the circumstances such as (a) what are the exposures in the other funds? (b) do these other funds have any hedging in place? (c) how do the unhedged exposures compare to the hedging in the World Equity Fund?
- **<u>Individual investor preferences:</u>** Are the risk and investment preferences of the investor (and their financial adviser) consistent with the 75% guidance? Should the guidance be adjusted up or down for that particular investor?

Existing investors who wish to change their hedging ratio from 75% (*after tax*) can switch at any month end on a nil cost basis. There are no costs or spread incurred when transferring from the Hedged Fund to the Unhedged Fund (or vice versa).

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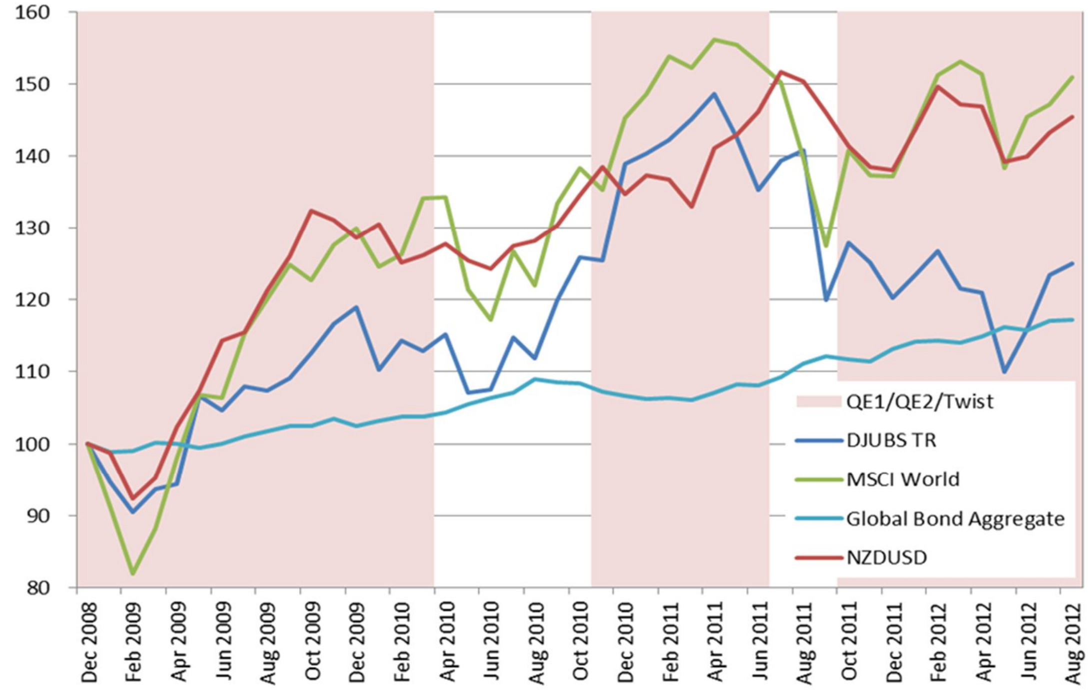
Schedule – QE background and QE3 impact

Since 2008 a large driver for currencies and asset values in general has been the impact from Central Bank easing policies. Recently the FOMC announced QE3 for the "open ended, whatever it takes" plan. Initially this policy will result in US$40 billion of mortgage backed securities (MBS) purchases per month. Previous (and current) QE has had the following impact on certain assets (Commodities, Global Equities, Global bonds and the NZDUSD):



What does this tell us? Firstly, QE1 and QE2 were very positive for equity prices (and also drove the strong NZ dollar). Secondly, an unhedged NZ investor through QE1 and QE2 missed the bulk of strong world equity markets. Note from the graph how global equity returns (green line) have been very similar to the appreciation in the NZDUSD cross rate (red line). An unhedged investor in offshore equities would have received almost none of that offshore equity return as it was offset by losses via currency appreciation.

The impact of easing: QE1 and QE2 both result in an increase in the Fed balance sheet as the Fed purchases securities outright, whereas operation Twist (which is on-going) involves the purchase of long dated Treasury bonds funded by the sale of short term bonds. QE3 is similar in nature to QE1 and QE2, i.e., an on-going net purchase program that will expand the Fed balance sheet by US$40 billion per month. Here is the impact on asset prices of each previous round of easing:

	QE1	QE2	Twist
Commodities	12.9%	7.8%	-2.3%
Global Equities	34.2%	13.0%	7.2%
Global Bonds	3.8%	0.7%	5.0%
NZDUSD	26.2%	5.4%	2.9%

What does this tell us? Over QE1, QE2 and then Twist the impact on markets was positive but increasingly weaker. This may translate into a positive benefit for markets from QE3, but by a less significant amount and over a less significant period.