

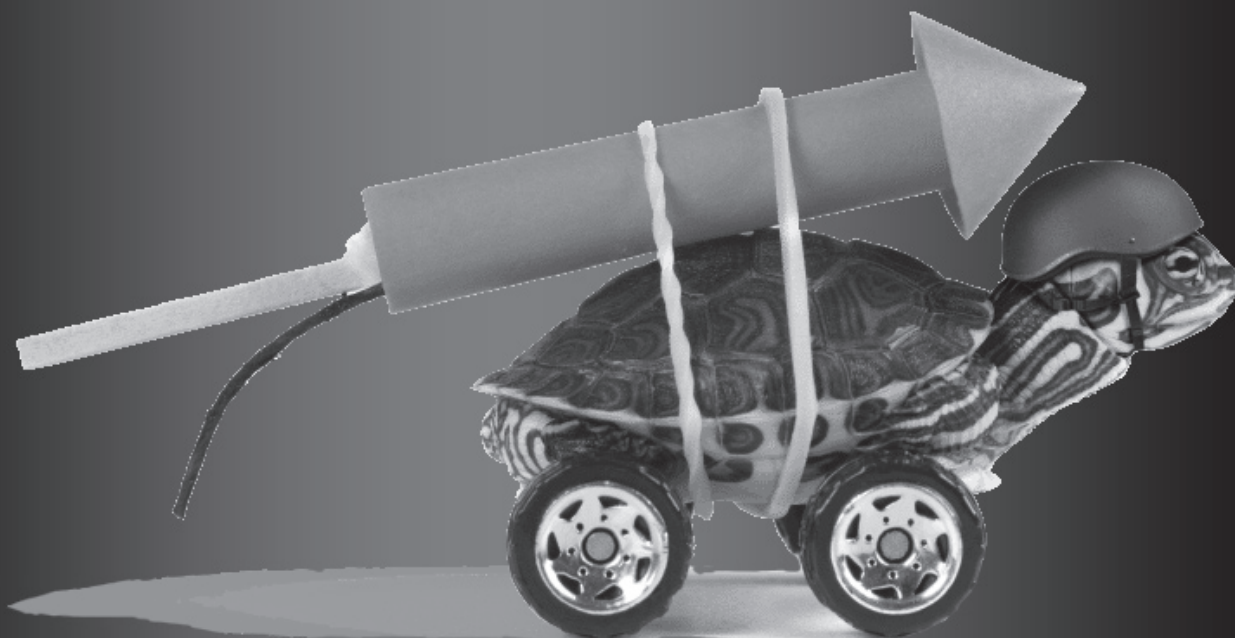
AonSaver Update

Brought to you by Russell Investments.

Quarterly newsletter

Global bonds re-energised

In general, thrills and spills usually belong to the world of equities, with their spectacular highs and lows. Bonds are designed for a quieter, less volatile life.

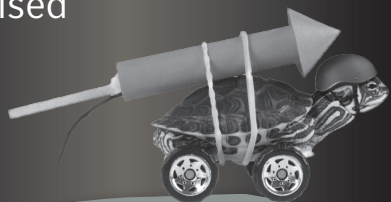


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Global bonds re-energised



However, the past three years have seen spectacular volatility in the bond markets with global fixed interest outperforming most asset classes (especially equities). Bonds are attractive because they provide consistent, stable returns with low volatility. Having selected bonds, do you invest locally or overseas?

It is a common perception that direct New Zealand bonds provide higher returns for less risk than global bonds. However, this belief has no basis in fact, theory or history says Russell's Sasha Mandich. "I'm not sure why global bonds have such a poor reputation in New Zealand. The reasons are

"The fact of the matter is that global markets are just as safe as New Zealand and offer more opportunities which show in the returns"

probably historic; in the past, there were global bond funds that experienced poor results because the currency was unhedged, he said. Currency management is critical for a global bond fund. Well-structured bond funds are managed completely differently and offer a healthy return for a relatively low risk. Global bonds outperformed New Zealand bonds over the last 5, 10 and 15 year periods and exhibited a lower risk profile".

In addition, New Zealand investors may feel more familiar with local investments and feel slightly

uncomfortable about investing in the much larger and 'unknown' global markets. The fact of the matter is that global markets are just as safe as New Zealand and offer more opportunities which show in the returns. For example over the past twenty years the compound return from hedged global bonds has been 1.8% pa higher than that from New Zealand bonds.

The reasons to select a hedged global bond fund include:

1. More Opportunity

The sheer size of overseas bond markets, which cover treasury bonds, corporate bonds, and asset backed securities, provides growth opportunities not easily found in New Zealand. For example the New Zealand government bond market is about NZ\$40bn in size, whereas all the securities in the Barclays Capital Global Aggregate Index have a combined face value of NZ\$44 trillion. New Zealand's market is a mere 0.1% of the global total. When you go to the supermarket do you restrict yourself to buying from the first half metre of the first aisle?

2. More liquidity

The lack of choice in the New Zealand bond environment exposes investors to the risk of not being able to sell bonds when they want to, and the possibility of having to settle for a low price.

3. More diversification

Global bonds diversify investments across country, issuer and asset class, reducing their risk to a lower level than that of New Zealand bonds.

Having decided to invest in global bonds, what exactly can global bond managers offer? A well selected manager and product will yield higher returns via active management of interest rates, credit sector and currency.

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Asset Class	Annual Standard Deviation of returns over the past 5 years
Hedged global bonds (BCGAI)	3%
Unhedged global bonds (BCGAI)	14%
NZX50 index	15%

Active Management

There are now numerous opportunities for global bond managers to add value which simply don't exist in New Zealand. Key to success in this environment of active management is the ability to gain an information advantage. Active managers can do this by regularly reviewing the market and readjusting investments, and by performing detailed security analysis. This is where a bond manager can really add value.

Currency Management

When selecting a global bond fund, choosing one that is hedged to the New Zealand dollar reduces the problem of currency fluctuations by fixing the rate at which it will buy and sell foreign currency and New Zealand dollars. As global bonds are bought and sold in the currency of the bonds' origin, the rate of currency exchange is an

important factor in determining the level of returns New Zealand investors receive. Not only does hedging improve investor returns, it minimises risk by removing an inherent risk of offshore investment vulnerability to fluctuating exchange rates. By contrast, unhedged global bonds are vulnerable to changes in currency values and are therefore more risky for investors. The table to the left compares the volatility of hedged and unhedged global bonds. The difference is significant and unhedged global bonds have a similar volatility to an equity investment. This highlights how crucial it is to maintain hedging on global fixed interest.

Has the Credit Crisis affected things?

Over the recent past the 'Credit Crisis' has gained a lot of media attention but what did it actually mean for global bond investors? To put things into context in the chart below shows the value of \$1 invested in the Barclays Capital Global Aggregate Index (BCGAI, hedged to NZD) over the past 10 years. Clearly the events of 2007-08 have not had a large impact on the global bond market. The securities that were at the centre of the credit crisis made up a relatively small portion of the global bond market and had a small effect on the market as a whole. This reinforces global bonds' ability to maintain low volatility returns in the worst of times and act as a dependable source of income.

The Value of \$1 Invested in The Barclays Capital Global Aggregate Index Over 10 Years

