NIKKO AM GLOBAL BOND FUND

Monthly Fact Sheet 31 December 2016

Investment objective

The objective of the Fund is to construct a portfolio of permitted investments that outperform the Fund's benchmark return by 1.0% per annum over a rolling three year period before fees, expenses and taxes.

Benchmark

Bloomberg Barclays Global Aggregate Index, hedged into NZD

Fund description

The Fund aims to provide investors with regular income by constructing an actively managed investment portfolio of permitted investments, with the potential for capital gains from global fixed interest markets.

The Fund gains its investment exposure by investing into the Nikko AM Wholesale Global Bond Fund. The nominated global manager (Goldman Sachs Asset Management) is responsible for the investment management of the assets of the Nikko AM Wholesale Global Bond Fund.

Currency management

Foreign currency exposures created as a consequence of capital markets investment remain hedged to NZD within an operational range of 98.5% to 101.5%. Currency hedging contracts are held in the Nikko AM Wholesale Global Bond Fund.

Management fees and other charges

A management fee of 0.65% per annum calculated as a percentage of the net asset value of the Fund will be calculated and deducted from the Fund.

Nikko AM may also recover expenses (including the Trustee fee) from the Fund up to a maximum of 0.25% per annum of the Fund's net asset value. An estimate of expenses as at the time of publication is 0.20% per annum.

Buy/sell spread

Nil

Strategic asset allocation

	Target	Range
Nikko AM Wholesale Global Bond Fund	100%	95% ⇔ 100%
Cash on call for investor transactions	0%	0% ⇔ 5%

Refer to the SIPO for full details of permitted investments and restrictions.

Performance

(NZD returns; before tax, after fees and expenses)

1 month	3 months	6 months	1 year
0.11%	-2.05%	-0.54%	5.14%

2 years (pa)	3 years (pa)	5 years (pa)	Inception (pa)*
4.50%	5.86%		5.79%

* December 2013

Asset allocation

Credit quality rating	Fund
AAA	36.0%
AA+, AA. AA-	9.1%
A+, A, A-	37.2%
BBB	17.5%
BB	0.2%

Sector	Fund	Index
Governments	36.4%	51.2%
Agency	4.8%	9.0%
Credit	21.1%	21.2%
Collateralised & MBS	31.4%	12.5%
Emerging market debt	3.7%	6.1%
Cash, derivatives, other	2.6%	0.0%

Duration and yield

Duration	Fund 6.67 years versus benchmark 6.75 years
Yield to Maturity	Fund 3.27% versus benchmark 3.07%

Commentary

The Fund out performed its benchmark over the month and quarter. Over the quarter security selection in governments and swaps added the most value of 0.13%, followed by sector allocation adding 0.07%, duration strategy, country allocation and stock selection within the securitized sector added 0.06% each.

US **Treasury yields** continued to trend higher in December, with a notable rise in shorter-dated bonds following the Fed's decision to proceed with its hiking path. Government bond yields diverged between the US and Europe over the month, with the US 10-year yield rising 7bps (+85bps for quarter), closing the year at 2.43%, while the yields on UK and German 10-year government bonds fell 17bps and 7bps (+49bps and +33 bps for the quarter), ending the year at 1.24% and 0.20%, respectively. The Japanese 10-year yield increased by 2bps (+14bps for the quarter), remaining relatively range-bound since the introduction of the Bank of Japan's (BoJ) 'yield curve control' and ended the month at 0.04%.

The portfolio has an underweight **duration** position in US rates and remains neutral in European and Japanese rates. While a hike in US interest rates in December was expected, the revision to interest rate projections, which point to a slightly steeper trajectory of interest rates, took markets by surprise. Three hikes are implied for 2017 and forecasts for growth and inflation were revised upwards, while the unemployment rate was revised down. US government yields have trended higher following Donald Trump's election victory, on expectations for fiscal stimulus and less regulation. Contained financial conditions and reasonable payroll employment gains will bolster the case for a rate hike in March.

Investment grade corporate spreads concluded the year tighter. Markets strengthened over December, with spreads on the Bloomberg Barclays Global Aggregate Corporates index tightening by 5bps to 125bps over sovereigns. Regionally, US and UK corporates outperformed their European counterparts, as spreads on the Bloomberg Barclays US Aggregate Corporate index and the Bloomberg Barclays Sterling Corporate index tightened by 6bps to end the year at 123bps and 143bps respectively, while the Bloomberg Barclays Euro Aggregate Corporate index tightened 3bps to 123bps over sovereigns. The portfolio is modestly overweight investment grade credit.

Factors supporting a more positive stance on the asset class include an improvement in corporate fundamentals, a pick-up in earnings, stabilizing leverage and positive seasonals. That being said, GSAM are cognisant of late-stage credit cycle characteristics, as well as the impact of a more hawkish stance by the Fed. As such the positioning is modest and GSAM are selective in their exposures. Within the portfolio, there is a down-in-quality bias (overweight BBB rated bonds), as GSAM continue to see scope for modest compression within the high quality spectrum. GSAM also prefer the intermediate part of the corporate term structure. Accommodative central bank policy supports the tactical overweight in European corporates, as does GSAM's view that European corporates are not as late in the credit cycle as US corporates. GSAM see value in the consumer products, pipelines and electrics industries, and are underweight media and automotive issuers.

Agency **mortgage-backed securities** (MBS) outperformed duration-neutral Treasuries by 6bps in December due to weakness in US Treasuries following the Fed rate hike, but underperformed by 11bps over the year as post-US election volatility led to extension in agency MBS. Primary mortgage rates increased almost 75bps following the election due to the rise in Treasury rates. Consequently the MBA refinancing index fell 20% in December to a post financial crisis low. The J.P. Morgan collateralized loan obligation (CLO) index returned 5.2% in 2016, marking the strongest year for performance since 2012. The portfolio is underweight agency MBS. Opportunities for positive excess return appear limited given current valuations and the significant extension of mortgage durations following the US election. Within the sector, and predominantly in Ginnie Mae securities, the portfolio is underweight lower coupon securities—where GSAM expect the quality of the outstanding float to continue to deteriorate—and overweight the 4% coupon. GSAM believe senior CLOs and Federal Family Education Loan Program (FFELP) asset-backed securities (ABS) offer attractive spread with strong credit protection and remain among the most compelling sectors in securitized products. GSAM are also positive on residential mortgage credit, particularly legacy non-agency MBS, which continue to benefit from negative net supply and show improving collateral performance.