NIKKO AM NZ INCOME STRATEGY

Factsheet 31 August 2019

Applies to: Nikko AM Income Fund (retail)

Market Overview

- US 10-year Treasury bond interest rates fell sharply over the month following on from the downward trend so far in 2019.
- The Federal Reserve Chairman Powell restated that downside risks to the US economy have increased, reinforcing the case for lower rates but not as quickly as President Trump demands.
- NZ bond markets produced strong returns over August due to large falls in NZ interest rates.
- The NZ Reserve Bank expressed their concerns around potential head winds to growth, surprising the market with a 50 basis point cut in the cash rate taking it to a record low of 1%.

Fund Highlights

- NZ bonds delivered very strong returns as yields fell.
- The supply/demand dynamics remain supportive of credit holdings as investors seek yield.
- Option Fund returns fell over the past month with the past year being a difficult one for the fund. US 10-year Treasury bond rates fell close to their Global Financial Crisis low points as investors fretted about lower economic growth. While additional rate cuts to short term rates are still data dependent it seems likely the Fed will deliver further rate cuts to help support the economy.

Portfolio Manager

Fergus McDonald,

Head of Bonds and Currency

Fergus is responsible for the investment of the Bond, Cash and Currency mandates. Fergus has been actively involved in the NZ financial markets since 1981. The portfolio management team for the domestic fixed income funds includes Ian Bellew, Fixed Income Manager and Matthew Johnson, Fixed Income Manager.

Overview

The strategy aims to provide investors with regular income from an actively managed investment portfolio while protecting the capital value of investors' funds.

Objective

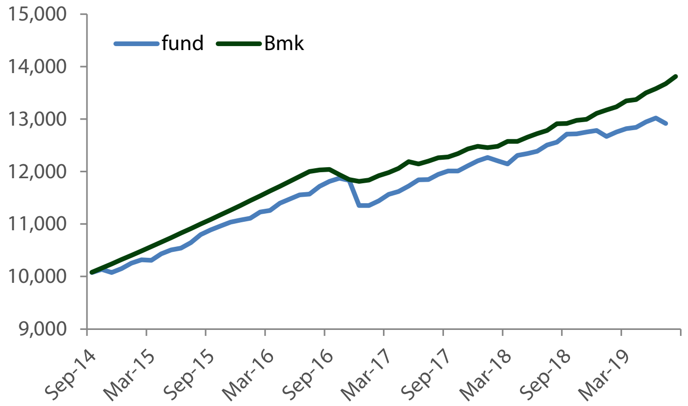
The aim is to construct a portfolio that earns a return of 6.5% per annum over a rolling three year period before fees, expenses and taxes.

Performance

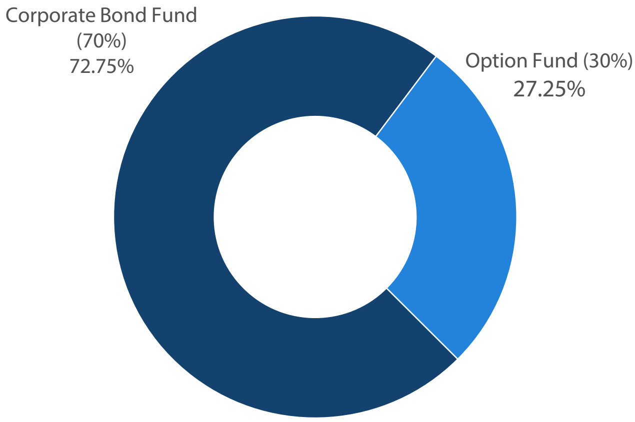
	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Retail[1]	-2.61%	-2.15%	0.21%	2.55%	4.80%	6.40%
Benchmark[2]	1.02%	2.32%	6.97%	4.70%	6.68%	8.32%

1. Returns are before tax and after the deduction of fees and expenses and including tax credits (if any)
2. Current benchmark: Composite of (from 1 July 2016) of 70% Bloomberg NZBond Credit 0+ Yr Index and 30% Bloomberg NZ Bond Bank Bill Index plus 4%pa. No tax or fees.

Five Year Cumulative Performance, $10,000 invested[1,2]



Asset Allocation



Top 5 Corporate Issuers*	(%)
Westpac New Zealand	13.16
ASB New Zealand	11.73
Bank of New Zealand	7.72
Kiwibank	6.30
ANZ Bank New Zealand	5.57

Credit Quality*	(%)
AAA	1.45
AA	55.37
A	21.33
BBB	19.68
Collateral & options & NR	2.17

Yield – Corporate Bond Fund
Fund (gross) 2.08% vs Benchmark 1.66%

*Aggregation of Option and Corporate Bond Funds

Option Fund Commentary

Fund returns fell over the past month with the past year having being a difficult one for the fund. 10-year US Treasury bond rates fell close to the lows experienced during the global financial crisis as investors fretted about lower economic growth. While additional rate cuts to short term rates are still data dependent it seems likely the US Federal Reserve will deliver further rate cuts to help support the economy. The US 10-year bond yield traded in a 61bps range over the month, moving between a high of 2.05% and a low of 1.44% before closing the month at 1.50%. The fall in rates is larger than we have seen over recent months, however it follows on from steady falls in the yield on US Treasury bonds. US 10-year Treasury bonds have fallen from a high point of 3.25% in November last year to a low of 1.44% in August 2019. Income levels generated from selling options has increased as a result of greater volatility in Treasury bond interest rates and uncertainty pervading financial markets. If volatility remains elevated for an extended period the income generating potential of the fund looks attractive. With short term interest rates more likely to fall than rise, the extent of any increase in longer term rates is also diminished. If current levels of volatility are maintained, income generated by the fund should remain at satisfactory levels however the speed and magnitude of yield changes in the US 10-year Treasury bond will continue to determine the total return of the fund in the months ahead. The frequency and cost of options being struck will also determine the total return of the fund.

Corporate Bond Fund Commentary

NZ bond markets produced strong returns over August due to large falls in NZ interest rates. There were some significant moves lower in bond rates globally with negative news about slowing economic growth and increasing uncertainty around global trade dominating the direction of financial markets. During the month the US 10-year bond rate plummeted 50 basis points (bps) in 2 weeks and volatility spiked on geopolitical news. There is no doubt we are in unusual times with interest rates at record lows, and this has extended the search for yield across equities and other asset classes. NZ government bond rates finished the month from 22 to 44 bps lower in yield across the curve with longer maturities falling more than shorter bonds. Swap rates outperformed similar maturities of government bonds falling an additional 2 to 5 bps reducing their spread above government bonds. There is now little slope or yield pickup along the government and swap yield curve apart from investing in credit. Credit was generally the best performing sector over the month, benefiting returns through a higher running yield and some credit margin contraction. Locally the NZ Reserve Bank expressed its concerns around potential head winds to growth and took an activist approach surprising the market with a 50 basis point cut in the cash rate taking it to a record low of 1%. The RBNZ believes that if it acts earlier in providing stimulus this will hopefully encourage an upswing in spending and investment and will likely make any potential future dip in growth shallower. It also noted that monetary policy need friends and they would like the government to bring forward and increase spending to provide additional support to the economy. Although growth has slowed expectations are that NZ GDP will still be around the 2 to 2.5% range which isn't bad. While growth is below potential and inflation low the bank appears to see little risk from adding stimulus to the economy sooner rather than later, we however expect the bank may pause before cutting interest rates further. We think the prospect of NZ having negative interest rates remains a low probability at this stage.

The fund outperformed the Bloomberg NZBond Credit benchmark over the month. A longer duration positioning and higher yield including margin contraction on credit holdings added value to the portfolio as longer term interest rates continued to decline.

While interest rates have declined significantly, we expect further modest declines in interest rates and our focus will be on maintaining a higher portfolio yield through buying quality non-government bond issues. We think there are still opportunities to pick up yield through selling short to maturity bonds and investing longer in maturity along the credit curve.

Key Fund Facts

Distributions

Retail fund: Calendar quarter

Estimated annual fund charges (incl GST)

Retail fund: 1.07%, refer PDS for more details

Hedging

All investments will be in New Zealand dollars

Buy / Sell spread: 0.0% / 0.0%

Strategy size $13.3m

Strategy Launch October 2007

Compliance

The fund complied with its investment mandate and trust deed during the month.

Contact Us

www.nikkoam.co.nz | nzenquiries@nikkoam.com