

NIKKO AM NZ INCOME STRATEGY

Applies to: Nikko AM Income Fund (retail)

Market Overview

- Interest rates on US 10-year Treasury bonds were volatile over the month but less so than previous months. Rates remain low as investors continue to fret about lower economic growth and trade issues.
- US 10-year bonds traded in a 36 basis point band, ranging between a high point of 1.86% and a low of 1.5% before closing the month at 1.69%.
- NZ bond markets moved higher in yield and the curve steepened during October. The pricing in of further interest rate cuts has been reduced as a consequence.

Fund Highlights

- The fund outperformed its benchmark in October.
- The Option Fund returned 2.40% for the month. The investment strategy of investing in NZ bank bonds and selling short term option contracts on 10-year US Treasury bonds remains unchanged. As a result of increased volatility in financial markets we have seen a rise in income the fund receives from selling short dated options on US Treasury Bonds.
- The Corporate Bond Fund underperformed benchmark although NZ bonds returns were generally negative as yields moved higher over the month. Credit margins stabilised on supply/demand dynamics.

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

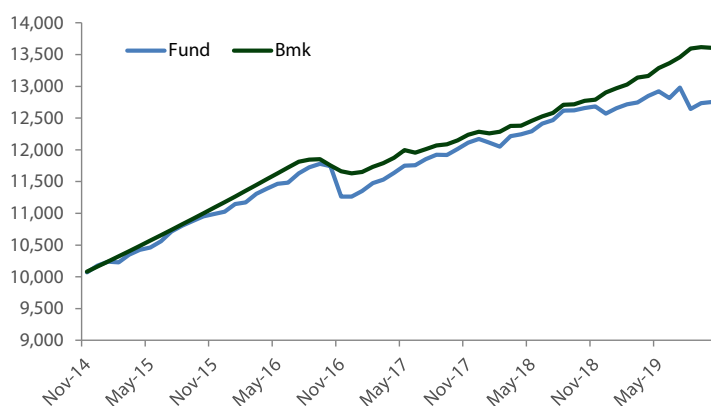
The aim is to construct a portfolio that earns a return of 6.5% per annum over a rolling three year period before fees, expenses and taxes.

Performance

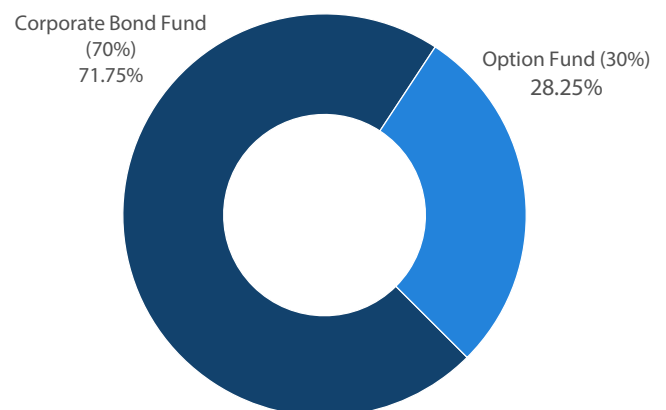
	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Retail ¹	0.14%	-1.77%	0.75%	2.78%	4.98%	6.22%
Benchmark ²	-0.08%	1.10%	6.54%	5.00%	6.35%	8.16%

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 Issuers*	(%)	Credit Quality*	(%)	Yield – Corporate Bond Fund
United States Treasury	16.98	AAA	18.28	Fund (gross) 4.04% vs Benchmark 3.16%
ASB New Zealand	11.27	AA	51.03	
Kiwibank	8.01	A	8.39	
Bank of New Zealand	6.38	BBB	18.33	
ANZ Bank New Zealand	5.25	Collateral & options & NR	3.97	

*Aggregation of Option and Corporate Bond Funds

Option Fund Commentary

The fund returned 2.40% (gross) over the month. US 10-year Treasury bond rates remain low as investors continue to fret about low economic growth, low levels of inflation and unhelpful global trade tensions. The fall in US rates has been significant with US 10-year Treasury bonds falling from a high point of 3.25% in November last year to a low of 1.43% in September 2019 before increasing somewhat to current levels.

Income levels generated from selling options has increased over recent months 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 but the frequency and cost of options being struck will also determine the total return of the fund.

Corporate Bond Fund Commentary

The returns from NZ bonds were generally negative over October as interest rates moved higher in yield following an improvement in market sentiment. With optimism that US/China trade negotiations may be improving and improved economic data there was some unwind of the negatives that were priced into bond yield curves for slower growth and further interest rates cuts. There has been quite a change in sentiment from market concern around the possibility of very low or negative cash rates in NZ to now only pricing one further interest rate cut of 25 basis points. Certainly there have been some reasonably large moves in interest rates over the past couple of months, with more volatility in longer maturity bonds as they have followed offshore rates higher, while short maturities have remained more anchored by low cash rates. Over the month medium to longer maturity bonds performed worse than short maturities. The 2021 NZ Government bond finished the month 7 basis points higher in yield, whereas the 2025 maturity increased by 13 basis points, and maturities 10 years and longer were up to 25 basis points higher in yield by month end.

Funds with longer duration positions underperformed those with less exposure to rising interest rates. On a sector basis NZ Government bonds performed poorly as buyers have been absent as yields moved higher. Shorter swap maturities narrowed in spread relative to similar maturities of government bonds and the longer maturities widened slightly. Credit performed reasonably well as the supply overhang of secondary bonds seems to have been readily absorbed by the market. If supply remains limited we would expect credit spreads to unwind the widening seen in the previous month. With the move higher in yields we have opportunistically added some bonds to the fund. While growth is below potential and inflation low, it seems likely shorter term NZ interest rates will remain low for some time. With little slope or yield pickup along the government and swap yield curve we still like investing in credit to achieve a higher portfolio yield. The fund underperformed the Bloomberg NZ Bond Credit benchmark over the month. A longer duration positioning, and some of the fund’s longer maturity bonds detracted value as the yield curve steepened in shape.

We will focus on maintaining a higher portfolio yield through buying quality non-government bond issues. We think believe are still some good opportunities to pick up yield through selling short-to-maturity bonds and investing longer in maturity along the credit curve.

Key Fund Facts

Distributions	Estimated annual fund charges (incl GST)		
Retail fund: Calendar quarter	Retail fund: 1.07%, refer PDS for more details		
Hedging	Buy / Sell spread:	Strategy size	Strategy Launch
All investments will be in New Zealand dollars	0.0% / 0.0%	\$12.8m	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

This document is issued by Nikko Asset Management New Zealand Limited (Company No. 606057, FSP No. FSP22562), the investment manager of the Nikko AM NZ Investment Scheme, the Nikko AM NZ Wholesale Investment Scheme and the Nikko AM KiwiSaver Scheme. This information is for the use of researchers, financial advisers and wholesale clients. This material has been prepared without taking into account a potential investor’s objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this document, who are not wholesale investors (in accordance with Schedule 1, Clause 3 Financial Markets Conduct Act 2013), or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement. Past performance is not a guarantee of future performance. While we believe the information contained in this presentation is correct at the date of presentation, no warranty of accuracy or reliability is given and no responsibility is accepted for errors or omissions including where provided by a third party. For full details on the retail and KiwiSaver funds, please refer to the relevant Product Disclosure Statement on nikkoam.co.nz.