

NIKKO AM INCOME STRATEGY

Applies to: Nikko AM Income Fund (retail).

Market Overview

- Equity markets globally were mixed with COVID-19 still dominating news along with the inauguration of President Biden
- The United States S&P 500 index fell 1.1%, the Japanese Nikkei 225 index gained 0.8%, the UK FTSE 100 index lost 0.8%, the Australian ASX 200 index added 0.3% and the MSCI World index ended the month down 0.2%
- The S&P/NZX 50 index rose 0.3% for the month
- With interest rates continuing to rise, short and medium term bonds were again the best performers in the fixed income sector and in general higher yielding lower quality bonds outperformed higher rated securities.

Fund Highlights

- The fund had a good start to 2021 driven by strong returns from some of the fund's equity holdings.

Distributions

- The defined distribution rate for 2021 is 3.0% p.a. This income will be distributed in four equal amounts each calendar quarter, based on the price as at 1 January 2021.
- The defined distribution rate (which is used to calculate the distribution you receive from the fund) will be set at the start of each calendar year, based on the price of the fund at that point.

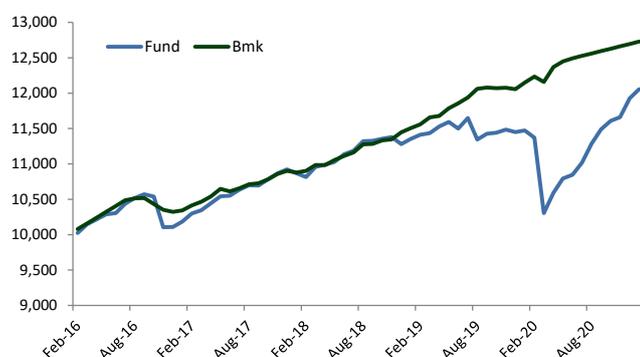
Performance

	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Retail ¹	1.08%	3.86%	5.08%	3.52%	3.81%	5.36%
Benchmark ²	0.27%	0.81%	4.77%	5.38%	4.95%	7.44%

1. Returns are before tax and after the deduction of fees and expenses and including tax credits (if any).

2. Current benchmark: RBNZ Official Cash Rate +3.00% p.a.

Five Year Cumulative Performance, \$10,000 invested^{1,2}



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.

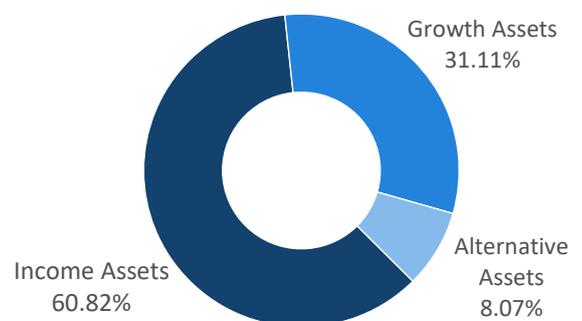
Overview

The strategy aims to provide investors with regular income from an actively managed investment portfolio. The fund invests in NZ fixed interest, Australasian equities and property. Equities with a good dividend stream and a focus on growing value over time are selected as an attractive alternative to fixed income securities. Equity selection is determined by the NZ investment team.

Objective

The objective of this fund is to outperform the RBNZ Official Cash Rate by 3.00 % p.a. over a rolling three year period before fees, expenses and taxes. Prior to June 2020, the objective and strategic asset allocation of fund were materially different. From 1 July these were amended to include equities.

Asset Allocation



Top 5 Fixed Income Issuers*	(%)	Top 10 Equities	(%)	(%)	Duration
Nikko AM Option Fund	8.07	Heartland Group	3.07	Spark	2.30
NZ Local Govt. Funding	7.85	Stride Property Ltd	3.04	Chorus Limited	2.29
Westpac Bank	7.29	Skellerup Holdings	2.43	Argosy Property	2.13
Kiwibank	4.71	Works Finance	2.41	Scales Corporation	2.11
Infratil	3.66	Mercury Energy	2.40	Genesis Energy	2.07

*Aggregation of directly held assets and Option Fund

Yield
Fund (gross) 2.02%

(applies to Fixed Income only)

Fund Commentary

The fund had a good start to 2021 driven by strong returns from some of the fund's equity holdings. Leading the charge was the Heartland Group up 12% followed by Mercury Energy, Genesis, Skellerup, and Chorus with share price increases in excess of 6%. Trailing the field were Contact Energy and Meridian who have seen large swings in prices pushed around by the competing forces of offshore ETF buying and valuation levels that are hard to justify using local metrics. Over the month the Income Fund trimmed its holdings in Meridian and Contact at close to the highs of the recent trading range. The fund has an exposure of just over 31% in equities in 13 names with a small additional holding in preference shares. The balance of the fund is held in fixed income securities and an 8% weighting to the Nikko Option Fund. Interest rates increased over the month with the largest movements occurring in longer maturities. This resulted in the fixed income sector posting small negative returns with the option fund gaining 0.41% over the month. With interest rates rising, short and medium term bonds were the best performers in the fixed income sector and in general higher yielding lower quality bonds outperformed higher rated securities. After long term bonds out performing shorter term bonds for most of 2020, long bonds performed poorly this month. The Reserve Bank seems less convinced of the need to lower the Official Cash Rate into negative territory as the economy recovery is stronger than anticipated and many of the stimulatory programmes remain in place. Inflation increased more than market expectations in the December quarter which is another indicator that New Zealand's economic recovery is well entrenched. The Funding for Lending programme (FLP) which started in December provides banks with low cost funding could push lending rates lower. With the Government and Reserve Bank focused upon reviving the economy to a robust state before thinking of removing stimulatory monetary policy settings we believe low cash rates will be with us well into 2022 or 2023 however longer term bond rates will be more influenced by global trends. Banks have cut their term deposit rates and are unlikely to increase them again while cash rates remain low. As mentioned above the banks will become less reliant on retail deposit funding over 2021 as they are able to borrow cheaply from the Reserve Bank if they wish to do so. In return the Reserve Bank will want to see some of this interest cost savings the banks enjoy being passed on to borrowers and in particular borrowers who want to invest in employment related activities. With these dynamics at play we believe it is appropriate for investors to seek income from more diverse sources than just interest rates alone. For the Income Fund this means investing in NZ companies listed on the NZX that pay an acceptable level of dividends or who have the likelihood of doing so in the future. The Income Fund has exposure to shares in companies that pay dividends likely to be higher than the interest rate that would be available if the companies issued fixed interest securities. The bond sector of the fund is invested primarily in medium to longer duration assets. At present we are happy to have exposure to longer term assets as the Official Cash Rate looks increasingly likely to remain low over the next two years at least. The prospect of low cash rates and the RBNZ keeping downward pressure on longer term rates by buying bonds in the secondary market will likely keep a lid on the size of any future interest rate rises for years to come. Low and stable short term interest rates represent both a threat and an opportunity for the fund. High levels of liquidity in the banking system has left many investors looking for a home for their money that will give them an opportunity to earn more than the rate on bank deposits. This search for income is likely to be an enduring theme for the next few years and we believe this environment should create opportunities for the fund to deliver an enhanced level of performance.

Key Fund Facts

Distributions

Distributions for this fund are defined annually and are effective for the calendar year. The annual defined income rate for 2020 is effective on a pro rata basis from 1 July 2020 for the balance of the calendar year.

The defined rate is gross of tax. Distributions are not a taxable event. Tax will be deducted (refunded) at 31 March and on full or partial withdrawals.

Hedging

All investments will be in New Zealand dollars

Estimated annual fund charges (incl. GST)

0.81%, refer PDS for more details

Buy / Sell spread: [Click to view](#) **Strategy size** \$4.33m **Strategy Launch** October 2007

Compliance

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

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