

Nikko AM NZ Corporate Bond Strategy

Monthly Update 31 October 2023

Assets are held in the Nikko AM Wholesale NZ Corporate Bond Fund. The Nikko AM NZ Corporate Bond Fund (retail) and the Nikko AM KiwiSaver NZ Corporate Bond Fund invest in units in the wholesale fund, which the commentary refers to.

Market Overview

- It has remained difficult for medium to longer maturity bonds with the market pricing rates higher for longer and increased government supply pressuring rates higher.
- The market has delivered further tightening that will weigh on consumers and businesses. Uncertainty around inflation and the economy remain and we will have to wait to get a better read on conditions.
- NZ credit holdings have helped through a higher yield with margins well behaved and supported by supply/demand dynamics.

Fund Highlights

- Shorter maturity bonds had positive returns moving lower in yield while longer maturities had negative returns as interest rates moved higher.
- The fund's duration was moved slightly longer when rates were high during the month. We are mindful of having less risk in uncertain times and have been taking incremental steps.
- The fund's yield looks more attractive with the rise in rates and flattening of the curve.

Performance

	One month	Three months	One year	Three years (p.a.)	Five years (p.a.)	Ten years (p.a.)
Wholesale¹	-0.19%	-0.92%	3.00%	-2.13%	1.72%	4.00%
Benchmark²	0.35%	-0.01%	3.74%	-1.59%	1.41%	3.25%
Retail³	-0.23%	-1.08%	2.30%	-2.81%	0.97%	3.19%
KiwiSaver⁴	-0.21%	-1.03%	2.32%	-2.82%	1.10%	

1. Returns are before tax and before the deduction of fees.
2. Current benchmark: Bloomberg NZBond Credit 0+ Yr Index. No tax or fees.
3. Returns are before tax and after the deduction of fees and expenses and including tax credits (if any).

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.

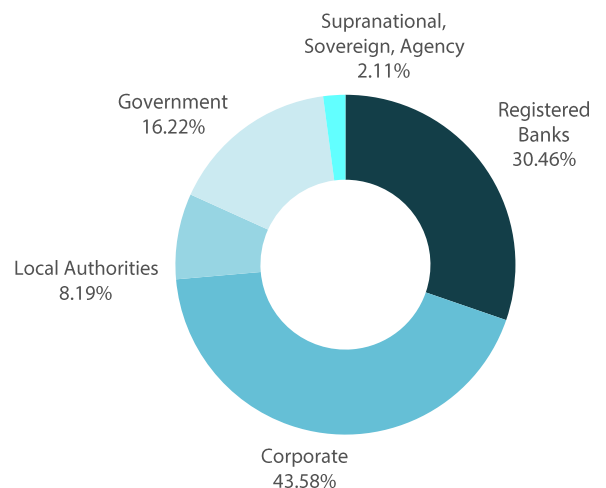
Overview

The strategy aims to generate income by constructing an actively managed investment portfolio of New Zealand bonds, deposits, and cash with the potential for capital gain from New Zealand dollar fixed interest markets.

Objective

The fund aims to outperform the benchmark return by 0.70% per annum before fees, expenses and taxes over a rolling three-year period.

Sector Allocation



Top 5 Corporate Issuers*	(%)	Credit Quality	(%)	Green, sustainable and social bonds
Housing New Zealand	9.4	AAA	35.91	16.78% of the fund
Westpac New Zealand	8.5	AA	21.82	Duration
Kiwibank	7.3	A	15.27	Fund 4.10 years vs Benchmark 2.86 years
NZ Tax Trading Co	4.4	BBB	27.56	Yield to Maturity*
TR Group	3.9			Fund (gross) 6.4% vs Benchmark 6.07%

*Include cash held by custodian

* Excluding the inflation component of government inflation linked bonds

Market Commentary

October was another tough month for NZ bond returns as interest rates continued to grind higher. The move higher in medium to longer term interest rates was the key driver of returns as capital loss from upward moves dominated the fund's income accrual. Longer maturity bond returns were negative while on a positive note, shorter bonds managed positive returns with rates out to 3 years lower, however overall returns were muted.

The NZ yield curve has become a lot higher and flatter with longer maturity bonds following the US 10-year bond higher as economic activity remains more resilient. It is frustrating that bond levels look attractive, but they keep getting cheaper as interest rates remain hostage to inflation and supply concerns which have pressured rates higher. In terms of sectors, swaps performed in line with government bonds with both sectors suffering similar moves higher in yields. Over October, movements in government bond yields were 2yr -14 bps, 5 yr + 11 bps and 10 yr + 27 bps. For comparison swap maturities were 2yr -14 bps, 5 yr + 9 bps and 10 yr + 26 bps. NZ credit has performed ok, helping through a higher yield with margins stable as the demand/supply dynamics continue to provide support.

The market has increased rates a lot since the RBNZ last hiked and conditions are likely restrictive enough to slow the economy and inflation, however given the lag of policy we expect meaningful improvement in data will take time. With rates elevated and given the balance of risks we think it makes sense locking in higher rates incrementally. So far, the repricing of high/higher rates for longer has pushed rates in one direction but with uncertainty still elevated we would expect volatility to see rates moving in both directions which would be more helpful for returns.

Fund Commentary

The fund performance was negative for the month of October and underperformed the Bloomberg NZ Corporate Bond benchmark. The move higher in interest rates was the main driver of absolute returns and relative returns. The fund had a moderate long duration position which was unhelpful as interest rates finished higher. Government bonds and swap had similar performances with maturities shorter than 3 years finishing lower in yield and medium to longer maturities higher. We prefer quality credit and typically hold a low weighting to lower yielding governments in the fund. Credit holdings have helped in terms of providing a higher yield while margins have been relatively stable.

The fund has been incrementally adding longer maturity bonds opportunistically to lock in higher rates for longer. In late October we added a small weighting of longer maturity bonds to the fund when yields were high. We will likely need to wait longer to get a better read on inflation and the economy, but we think bonds are looking a lot more attractive to investors given how far and fast yields have moved.

Key Fund Facts

Distributions		Hedging:	Any foreign currency exposure to be hedged to NZD within operational range of 97.5%-102.5%	Strategy Launch:	July 2009
Wholesale:	Calendar quarter	Exclusions:	Controversial weapons	Strategy size:	\$421.7m
Retail:	Calendar quarter				
KiwiSaver:	Does not distribute	Restrictions:	Adult entertainment, gambling, fossil fuels, alcohol stocks, tobacco stocks. For more information, please refer to the Statement of Investment Policy and Objectives (SIPO) on our website https://www.nikkoam.co.nz/invest/retail.	Buy / Sell spread:	Click to view
Estimated annual fund changes (incl. GST)					
Wholesale:	Negotiated outside of unit price				
Retail:	0.70%, refer PDS for more details				
KiwiSaver:	0.70%, refer PDS for more details				

Compliance

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

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