nikko am
Nikko Asset Management

NIKKO AM INCOME FUND

Monthly Fact Sheet 31 July 2016

Investment objective

The objective of the Fund is to construct a portfolio of permitted investments that earn a return of 8% per annum over a rolling three year period before fees, expenses and taxes.

Benchmark

Composite of (from 1 July 2016):	
Bloomberg NZBond Govt 0+ Yr Index	70%
Bloomberg NZBond Bank Bill Index plus 4% per annum	30%

Fund description

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

The Fund gains its investment exposures by investing into the Nikko AM Corporate Bond Fund and the Nikko AM Wholesale Option Fund which are managed by the Nikko AM NZ Fixed Income team.

Distributions

Quarterly. Last business days of March, June, September and December.

Currency management

Any foreign currency exposures of Nikko AM NZ Corporate Bond Fund created as a consequence of capital markets investment are hedged to NZD within an operational range of 97.5% to 102.5%. The Nikko AM Wholesale Option Fund hedges any foreign currency cash holdings to the NZD with an operational range of 98.5% to 101.5%. If there are any currency hedging contracts in place, they are held within the Nikko AM NZ Corporate Bond Fund and/or the Nikko AM Wholesale Option Fund.

Management fees and other charges

A management fee of 0.80% 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. Estimate of expenses as at 1 July 2016 are 0.25% per annum.

Buy/sell spread

Nil

Strategic asset allocation

	Target	Range
Nikko AM Wholesale Option Fund	30%	20% ⇔ 40%
Nikko AM NZ Corporate Bond Fund	70%	60% ⇔ 80%
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
1.28%	2.15%	4.36%	8.54%

2 years (pa)	3 years (pa)	5 years (pa)	Inception (pa)*
8.24%	7.77%	6.39%	7.89%

* October 2007

Distributions

Cents per unit	Mar	Jun	Sep	Dec
2016	1.25	1.50		
2015	1.00	1.25	1.50	1.25
2014	1.50	1.00	1.50	1.00
2013	1.50	1.50	1.50	1.50

Asset allocation (% of fund)

Nikko AM Wholesale Option Fund	35.6%
Nikko AM NZ Corporate Bond Fund	64.4%
Cash	0.0%

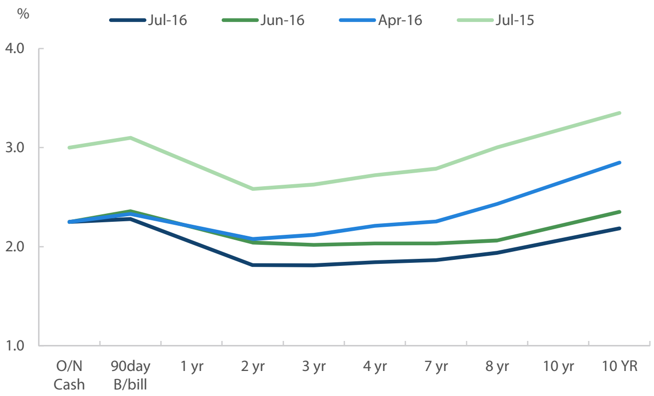
Top 5 corporate issuers (% of fund)

Westpac Banking Corporation	6%
Bank of New Zealand	6%
ANZ Bank New Zealand	5%
ASB Bank Limited	5%
NZ Government	4%

Corporate Bond Fund yield (gross)

3.5%

New Zealand yield curve



Commentary

The **Nikko AM Income Fund** is invested in the Nikko AM Wholesale Option Fund and the Nikko AM NZ Corporate Bond Fund.

The **Option Fund** bounced back after a poor June to record a gain of 1.91% in July. Financial market sentiment improved considerably over the month. The post Brexit damage to global risk appetite proved short lived and market participants concluded that it was a UK centric problem, with little spill-over risk outside the UK. In addition, it seems likely that global monetary policy will be easier-for-longer in the Brexit world. Given this sentiment it is not surprising US Treasury bond yields remain low and seem likely to stay low for the remainder of the year.

Over the month the US 10-year bond traded in a 31 basis point range from a low of 1.32% to a high of 1.63% before closing July at 1.45%, virtually unchanged since the end of June.

Expectations of further global policy easing and, in the case of the US, little chance of policy tightening kept a bid tone to global bond markets with historical lows being reached in a number of countries. With low global rates being the norm it is hard to see US rates rising significantly. This sanguine view was reinforced after the release of second quarter US GDP which grew 1.2% annualised, when 2.6% was expected. US economic growth is now tracking at a 1% rate in 2016, the weakest start to a year since 2011. This disappointing growth momentum must play on the mind of Fed officials and a further delay in US monetary policy tightening is becoming more likely.

As we have mentioned in previous commentaries we believe this environment remains favourable for the Option Fund, especially when viewed in context of a modest outlook for returns from other sectors of financial markets.

The primary source of income for the **Corporate Bond Fund** is interest earned from a diversified portfolio of New Zealand investment grade bonds.

All sectors of the New Zealand fixed income market performed well over July. The Corporate Bond Fund return was in line with the index performance with corporate bond holdings and swap rates performing better than similar maturities of New Zealand government bonds. New Zealand interest rates continued to move lower in yield with longer maturity swaps falling more than equivalent maturities of governments. Credit holdings performed well as the higher running yield was of benefit and the margins they trade at over swap rates were slightly lower to stable.

Over the month there were some new issues to market that received good support. This was positive as there had been little issuance locally to gauge market demand since the ructions in financial markets surrounding the Brexit vote.

New Zealand interest rates have continued lower as the global growth outlook remains weak and on expectations the Reserve Bank of New Zealand will further reduce the Official Cash Rate. Longer maturity bonds continued to be the best performing sector of the yield curve. The price of longer maturity bonds is more sensitive to changes in interest rates (they have a higher duration as their cash flows extend further into the future) and consequently their value increases more than shorter maturity bonds when interest rates move lower in yield.

Over the month the move lower in interest rates was relatively consistent across the yield curve resulting in an approximately parallel shift lower in interest rates. For example the 2-year swap rate moved 19 basis points lower in yield over the month, and the 10-year swap decreased by 22 basis points. For comparison the New Zealand Government Dec-2017 bond was 19 basis points lower in yield over the month, and the New Zealand Government Apr-2027 yield decreased by 14 basis points. The New Zealand yield curve is still upward sloping in shape with the 2-10 year swap spread at 40 basis points. Currently shorter maturities out to three years are somewhat anchored by the Official Cash Rate and therefore more influenced by the monetary policy actions of the Reserve Bank of New Zealand, whereas longer maturity bonds (7 years plus) have been more closely correlated to movements in US 10-year rates and our relative attractiveness compared to yields in other developed markets.

We are continuing to extend the duration of the Fund to take advantage of higher credit margins. Over our three year investment horizon we expect credit to add value over lower yielding government and swap bond investments. The accrual trade of having a higher yielding portfolio should ultimately be of benefit with a positive shaped yield curve as bonds roll down the yield curve and move lower in yield as they become closer to maturity.