nikko am
Nikko Asset Management

NIKKO AM INCOME FUND

Monthly Fact Sheet 31 August 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 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. As at the time of publication these expenses are estimated to be 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
0.80%	2.26%	4.94%	8.50%

2 years (pa)	3 years (pa)	5 years (pa)	Inception (pa)*
8.25%	8.01%	8.28%	7.91%

* 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	33.1%
Nikko AM NZ Corporate Bond Fund	66.9%
Cash	0.0%

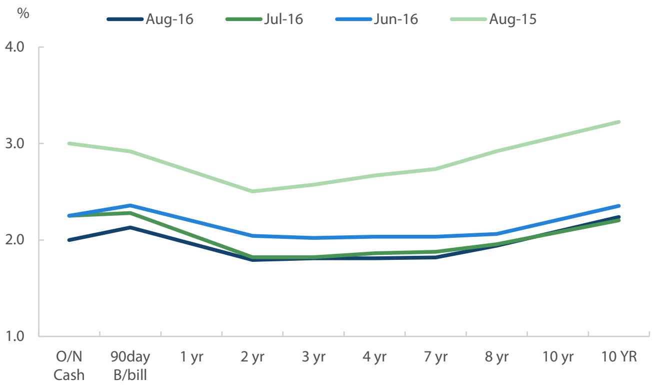
Top 5 corporate issuers (% of fund)

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

Corporate Bond Fund yield (gross)

3.45%

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** performed well over August, gaining 1.39%. This return compares favourably to the return generated from cash and bond markets as the low nominal yields on fixed income assets begins to constrict returns from these sectors. Income generated by the Option Fund by writing options on 10 year US Treasury bonds is not significantly impacted by low bond yields and we anticipate Fund returns will continue to outperform more traditional fixed income investment strategies over the year ahead.

US 10 year bonds traded in a narrow 18 basis point range over the month. Bond yields started the month at 1.47% and closed at 1.58%. The intra month low was 1.45% and the high point was 1.63%. Due to the narrow trading range, bond yields stayed within the option bands established by the Fund and resulted in an acceptable month of performance. A low level of volatility in markets at present has led to option premium income being lower than average but still high enough to generate an attractive level of return.

The Federal Reserve seem to be inching closer to their second rate rise, the first seeming an age ago in December 2015. A September hike is possible, however, a December 2016 move seems most likely to us as this will be after the November Presidential election. The US economy is steadily improving and we believe the Fed needs to protect their credibility by raising rates soon. While a move in rates in 2016 is probable, the Fed will be careful not to unsettle markets and therefore forward guidance on future moves is likely to indicate only a modest and slow increase.

The yield movement on longer dated Treasury bonds is likely to be muted even if short term rates rise as investors' global search for yield will ensure the demand for relatively high yielding US bonds remains strong.

We continue to believe this environment remains favourable for the Option Fund, especially when viewed in the context of a modest return outlook 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.

Over August the New Zealand Government Stock Index returned 0.16% while the All Swap Index returned 0.40% and the A Grade Corporate Index 0.49%.

The yield on the Fund is circa 1.5% higher than that of the New Zealand Government Stock Index. This higher than index yield contributed to the monthly outperformance as did the narrowing of credit and swap margins on non-government bonds held by the Fund.

The global 'hunt for yield' continues unabated and is a significant factor for the strong recent performance of higher yielding bonds with investment grade credit ratings. Lower cash rates in New Zealand and low rates globally force investors who require income to buy longer duration assets and non- government debt or a combination of both. This investment dynamic is unlikely to change in the near term.

The Reserve Bank of New Zealand (RBNZ) and the Reserve Bank of Australia both cut rates by 25 basis points to record lows of 2.0% and 1.5% respectively, only to see their currencies higher as these cuts had been well anticipated. The RBNZ maintained a strong easing bias however made the point it is taking a gradual approach towards trying to meet its 1-3% inflation target. The prospect of further cuts saw the 2-year swap rates 5 basis points lower at 1.99% and the 5-year swap rates 6 basis points lower at 2.09%. The long end of the New Zealand government bond curve was an exception to the fall in rates – 10 year government bonds were up 4 basis points to 2.24% as the market needed time to absorb a new $2 billion issue of April 2037 bonds.

We are continuing to extend the duration of the Fund's credit holdings to take advantage of higher credit margins available on longer term bonds. Over our three year investment horizon we except 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 as over time as bonds roll down the yield curve and move lower in yield as they become closer to maturity.