nikko am
Nikko Asset Management

NIKKO AM INCOME FUND

Monthly Fact Sheet 30 November 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 daily as a percentage of the net asset value of the Fund will be 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
-4.09%	-3.93%	-1.76%	2.48%

2 years (pa)	3 years (pa)	5 years (pa)	Inception (pa)*
5.73%	6.01%	6.39%	7.15%

* October 2007

Distributions

Cents per unit	Mar	Jun	Sep	Dec
2016	1.25	1.50	1.80	
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	31.70%
Nikko AM NZ Corporate Bond Fund	68.23%
Cash	0.07%

FundSource

Winner – New Zealand Fixed Interest Sector

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Top 5 corporate issuers

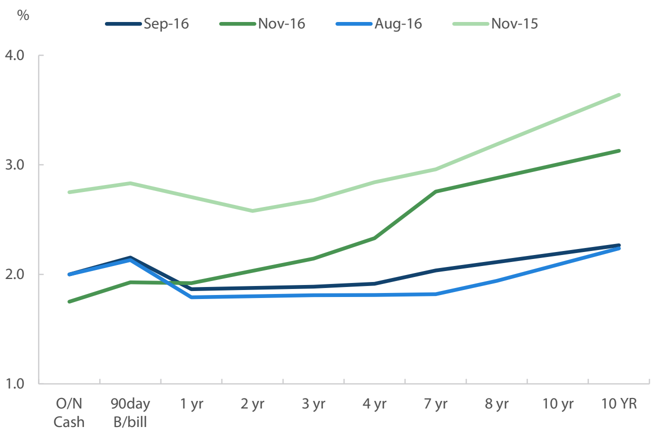
ANZ Bank	13.6%
Westpac Banking Corp	10.4%
Rabo	9.8%
Kiwi Bank	8.5%
ASB Bank	5.3%

Aggregated of Option and Corporate Bond Funds

Corporate Bond Fund yield (gross)

3.99%

New Zealand yield curve



Commentary

Corporate bond Returns from the NZ bond indices were negative in November as interest rates moved higher in yield. For the month the Bloomberg NZ Government bond index produced a return of -1.37% while the All Swap index returned -1.18%, and the NZ Bond Corporate A Index returned -0.66%.

It was a difficult month for bonds with yields moving higher through the month after the result of the US elections. Market sentiment turned negative for bonds on the perception that President Elect Trump's expansionary policies of tax cuts and a higher fiscal spend will promote growth, higher inflation and larger borrowings for the US. With more protectionist trade policies there will also likely be "winners and losers" which could impact our major trading partners. NZ's longer-term interest rates are typically highly correlated with movements in US interest rates, whereas shorter maturities are more influenced by local factors with low cash rates anchoring the front end of the yield curve. NZ interest rates followed similar moves to the US and the shape of the NZ yield curve steepened considerably (widening from a spread of 70 basis points between the 2 and 10-year swap rates to 100 basis points). Longer maturity bonds were the worst performing bond assets, and there was little difference between the performances of government bonds versus similar maturities of swap.

The Fund has a shorter duration (less exposure to changes in interest rates) and performed better than the benchmark as prices declined less when interest rates moved higher in yield. Corporate bonds moved higher in yield although credit margins were relatively stable, and the higher running yield of corporate holdings will help benefit the Fund over the medium term.

Longer term interest rates in NZ have been under some pressure over the past 3 months as economic news has generally been on an improving trend; business and consumer confidence, GDP, inflation outcomes, and dairy prices have been improving. Interest rates are low and supportive of activity, and there will be additional spends following the recent Kaikoura earth quake. At this stage it appears we may have seen the low in yields in NZ and the sentiment bias is for higher interest rates, however with the latest move higher in yields there is now a lot of "positive economic sentiment" factored in with a higher and steeper yield curve and the market may want to see some more solid proof of improvement before taking yields higher. We expect credit to outperform lower yielding government and swap bond investments over our three year investment horizon. The accrual trade of having a higher yielding portfolio is helping to offset some of the move higher in interest rates.

The **Option Fund** performed poorly over November, falling in value by 10.16%. US interest rates increased significantly with US 10-year Treasury yields closing the month at 2.30% compared to a monthly low of 1.71% and an intra month high of 2.42%.

The majority of the moves occurred after Donald Trump's victory on the 8th of November. Large interest rate movements over a short period of time is the primary risk the Option Fund is exposed to so a down turn is to be expected however it is disappointing to report a double digit decline.

On the brighter side, with bond market volatility at elevated levels the income the Fund generates from writing options has increased significantly. Option premium income is currently approximately 2.5 to 3 times the levels received prior to Trump's victory. If US Treasury bonds trade in a more modest monthly range than seen over November and volatility stays elevated the Fund should trade well over the next 6 to 9 months.

Rising inflation expectations were a key driver of financial markets in November, which saw a further sharp increase in global bond yields. Inflation data in the US continued to gain ground adding to expectations the US Fed would be tightening monetary policy in December. The shock election of Trump as the next US President fuelled those expectations and added to the global market sell-off. Trump's policies included a major tax reform package and increased spending, including USD1 trillion on infrastructure, which would see a significant easing in US fiscal policy.

The US Fed kept policy unchanged at its November meeting, ahead of the election, but indicated that the case for a tightening had "continued to strengthen".

We have likely seen the low in longer term interest rates in this economic cycle. US interest rates have jumped on an expectation of future growth and the market is pricing in higher inflation and growth levels, only time will tell if this expectation is justified.