

Nikko AM Wholesale NZ Bond Fund

Fund manager

Nikko Asset Management New Zealand Limited (Nikko AM).

Nikko AM is Asia's premier global asset manager. In New Zealand we actively manage NZ\$5 billion of investments for a diverse group of clients, including superannuation schemes, charitable trusts, KiwiSaver scheme providers, corporations and local government along with providing services to financial intermediaries through wrap platforms.

We offer investment management services in domestic sectors (equities, fixed interest and cash) through our Auckland-based investment team and employ offshore managers to manage global sectors (global equities, global bonds and alternative investments).

Fund launch

October 2007 – a similar portfolio has been operated by Nikko AM since January 1992.

Investment objective

To construct a portfolio of authorised investments that outperform the Fund's benchmark return by 1.0% per annum over a rolling three year period before fees.

Benchmark

Bloomberg NZBond Govt 0+ Yr Index (from 1 July 2016)

Structure and taxation

The Fund vehicle is a Unit Trust and Portfolio Investment Entity (PIE) which is priced daily. Unit holders elect their own Portfolio Investor Rate. Information is provided to the IRD and unit holders on an annual basis.

Distributions

Quarterly – last week of March, June, September and December

Currency management

Investments will be in New Zealand dollars

Management fees and other charges

Investment management fees will be negotiated separately with each investor and invoiced outside the Fund. All Fund statutory and operating costs will be met directly by the Manager.

Buy/sell spread

Nil

Investment process

The Fund invests directly into tradeable capital market securities. Nikko AM's decision-making process starts with a global economic overview and then compares New Zealand's risk premium to international markets. Portfolio construction decisions follow where the government/ corporate mix and duration positions are determined.

Investment guidelines

Authorised investments are cash, deposits and debt securities issued or guaranteed by any NZ registered bank, or equivalent overseas institution, SOE, NZ and foreign Government, NZ local authority NZ and overseas corporate and derivative instruments.

Constraints:

- Duration range of the Fund is +/- 1.5 times the index duration
- A minimum of 25% of the Fund is to be invested in securities issued or guaranteed by the NZ Government or securities accepted by the RBNZ's Overnight Reverse Repo Facility.
- A minimum of 50% of the Fund restricted to issuers with a credit rating equal to or higher than NZ Government.
- Cash and cash equivalent investments must have minimum credit rating of A1 short-term and A long term.
- Up to 5% of the fund may be exposed to assets rated below A-.

Derivative counter parties must have A+ or better credit rating and all derivative exposure shall be covered by cash or physical holdings. Derivatives shall not be used to leverage the Fund – instead, utilised to implement investment strategy. The combined physical equivalent (effective exposure) of all derivative instruments must be no greater than 40% of the Fund.

For full details see investment mandate.

Trustee

Public Trust

Custodian

Public Trust as legal custodian, BNP Paribas Fund Services Australasia Pty Limited delegated as functional custodian.

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Performance (NZD gross returns)

	Fund	Benchmark	Excess
1 month	0.80%	0.93%	-0.13%
3 months	2.07%	2.15%	-0.07%
6 months	5.64%	6.10%	-0.46%
1 year	7.73%	8.04%	-0.31%
2 years (pa)	8.48%	8.31%	0.18%
3 years (pa)	6.97%	6.20%	0.76%
5 years (pa)	7.12%	5.87%	1.25%
10 years (pa)	7.24%	6.48%	0.76%

* S&P/NZX NZ Government Stock Index prior to 1 July 2016

Attribution for the quarter

Duration	0.19%
Yield curve positioning	0.03%
Spread	-0.29%
Total over/under performance	-0.07%

Fund size

NZ\$289 million

Asset allocation (% of fund)

Government stock	27.8%
SOE and local authority	16.2%
NZ registered banks	41.8%
Corporate debt	14.2%

Credit quality (S&P ratings; % of fund)

AAA	13.1%
AA	59.6%
A	22.9%
BBB	4.4%

Top 5 corporate issuers (% of fund)*

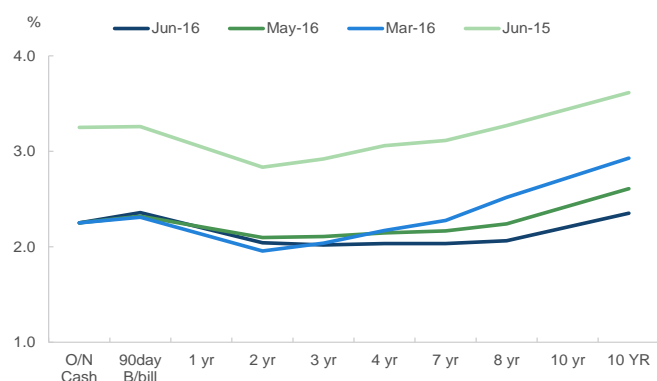
NZ Local Government Funding Authority	9.8%
Bank of New Zealand	9.1%
Rabobank	7.3%
Westpac Banking Corp	6.7%
Fonterra Co-operative Group	5.5%

* excludes central government

Duration and yield

Duration	Fund 4.0 years versus benchmark 4.43 years
Yield	Fund (gross) 3.25% versus benchmark 2.09%

New Zealand yield curve



Commentary

Over the month NZ Government bond and swap rates performed strongly as interest rates moved lower in yield. The NZ Government bond index produced a return of 0.93% for the month while the All Swap index returned 1.09% and the NZ Corporate A Index returned 0.68%.

For the month the Fund's shorter duration with higher holdings of credit detracted value. Under performance over the quarter was mainly attributed to credit as longer interest rate exposures and higher percentage holdings of government bonds and swaps performed better as New Zealand interest rates moved sharply lower in yield following the Brexit vote by the UK to leave EU membership. Before the vote the NZ Government 2033 bond had moved higher in yield (close to 3%) with expectations the UK would stay, subsequently the NZGS 2033 bond fell approximately 30 basis points in yield to 2.67% at the end of June. Similar maturities of swap rates performed better than government bonds as swap rates decreased more in yield narrowing their spread to governments. Also longer maturity bonds had greater decreases in yield outperforming shorter maturities. For example the 10-year swap rate moved 28 basis points lower in yield over the month, whereas the 2-year swap decreased by 7 basis points. The NZ yield curve has flattened significantly in shape with the 2-10 year swap spread narrowing from 64 basis points to 43 spread led by long maturities as uncertainty increases and expectations for global growth is revised downwards. An important point is that Brexit has little direct impact on NZ, however the financial markets have been relatively volatile and this may increase the likelihood of a further reduction in the NZ cash rate. The actual process of exit will develop over a period of years rather than months and market sentiment will likely have moments of complacency and bouts of overreaction as events unfold. NZ interest rates are at new historic lows, but rates are generally much lower in other developed countries. We continue to expect a reasonable amount of interest in NZ assets with attractive yields and the currency showing some stability.

Credit markets didn't perform as well as other bond sectors in the "risk off" environment, uncertainty as to where pricing should be saw two local bond issuers delaying their deals. Subsequently there have been some relatively large corporate issues globally that have received good pricing support. New issuance levels locally should offer reasonable value and we are happy continuing to extend the duration of the Fund's credit holdings to take advantage of higher credit margins. Over our 3-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.

Compliance

The Fund complied with its investment mandate during the quarter.