

Nikko AM Wholesale NZ Bond Fund

Fund manager

Nikko Asset Management New Zealand Limited (Nikko AM NZ).

In New Zealand we actively manages around 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 NZ 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 Portfolio Investment Entity (PIE) which is priced daily. Investors elect their own Prescribed Investor Rate. Information is provided to the IR and investors 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 NZ'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 corporates issuing NZ dollar debt 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 an A long term.
- A minimum of 95% of the value of the Fund must be invested in assets rated A- or better.
- Derivatives can only be transacted with counterparties listed in the Nikko AM NZ Approved Counterparty List.

The use of derivatives is limited to contracts related to Authorised Investments described in the investment mandate. 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	0.21%	-0.14%	0.35%
3 months	1.90%	0.89%	1.01%
6 months	4.01%	3.06%	0.95%
1 year	7.26%	6.63%	0.63%
2 years (pa)	8.30%	7.81%	0.49%
3 years (pa)	7.72%	6.95%	0.77%
5 years (pa)	6.83%	5.33%	1.50%
10 years (pa)	7.25%	6.42%	0.83%

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

Attribution for the quarter

Duration	0.0%
Yield curve positioning	0.15%
Spread	0.86%
Total over/under performance	1.01%

Fund size

NZ\$284 million

Asset allocation (% of fund)

Government stock	27.1%
SOE and local authority	18.7%
NZ registered banks	39.4%
Corporate debt	14.8%

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

AAA	9.8%
AA	65.9%
A	20.2%
BBB	4.1%

Top 5 corporate issuers (% of fund)*

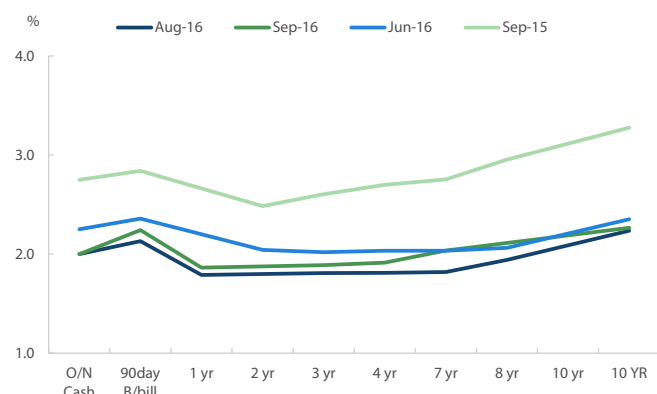
NZ Local Government Funding Authority	11.3%
Bank of New Zealand	9.3%
Rabobank	7.2%
Fonterra Co-operative Group	6.3%
Westpac Banking Corp	5.7%

* excludes central government

Duration and yield

Duration	Fund 4.8 years versus benchmark 4.7 years
Yield	Fund (gross) 3.1% versus benchmark 2.0%

New Zealand yield curve



Commentary

The Nikko AM Wholesale NZ Bond Fund returned 0.21% for the month of September. Over the month the Bloomberg NZ Government Bond Index produced a return of -0.14% for the month while the All Swap Index returned 0.06%, and the NZ Bond Corporate A Index returned 0.16%.

In summary for the month, portfolios that were positioned with shorter durations (less exposure to changes in interest rates) performed better as their prices declined less when interest rates moved higher in yield. Government bonds have been the best performing bond sector for most of the year as interest rates fell and credit margins widened, however there was some catch up from other sectors as Governments performed poorly over the month on a relative basis. The Fund outperformed as corporate bonds and swaps delivered a better return, as they didn't move higher in yield to the same extent as similar maturities of government bonds. Corporate bonds also have the advantage of a higher running yield which helps to dampen the volatility of returns. NZ interest rates were volatile intra-month with the NZ Government 2033 bond moving higher in yield by close to 40 basis points before retracing most of this move and finishing at 2.61%. For the month government bond maturities from 1 to 7 years closed approximately 10 basis points higher in yield with longer bonds less impacted. Swap margins contracted in spread to government bonds as the underlying swap rates didn't move higher in yield to the same extent as government bonds.

Over the quarter interest rates still managed to finish lower in yield despite rising in September. Government bonds were only marginally lower in yield, but swap rates performed better, falling an additional 10-15 basis points compared to similar maturities of government bonds. The shape of the NZ swap yield curve has remained relatively stable over the past three months with the 2-10 year swap spread currently at 47 basis points. Credit markets tentatively settled and (the accrual trade of) having a higher yielding portfolio is showing some benefit as the higher yield isn't eroded by widening credit margins. With a positive shaped yield curve bonds roll down the yield curve and move lower in yield as they become closer to maturity. We expect credit to outperform lower yielding government and swap bond investments over our three year investment horizon.

The New Zealand economy is performing well on a relative basis compared to other developed economies; business and consumer confidence, GDP, inflation, and dairy prices have been improving. Interest rates are low and supportive of activity with the possibility of a further rate cut. Challenges are the high level of the NZD that continues to frustrate the Reserve Bank and they would like to see house price appreciation slow. The direction of NZ short-term interest rates will continue to be influenced by local factors with low cash rates anchoring the front end of the yield curve. Bonds 5-years and longer in maturity will likely remain more heavily influenced by global events and movements in US bond rates.

Compliance

The Fund complied with its investment mandate during the quarter.