Nikko AM Wholesale NZ Bond Fund

Fund manager

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

In New Zealand we actively manage 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 years relative to 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.

Performance (NZD gross returns)

	Fund	Benchmark*	Excess
1 month	-1.40%	-1.38%	-0.02%
3 months	-0.68%	-1.37%	0.69%
6 months	2.05%	1.27%	0.78%
1 year	5.54%	5.09%	0.45%
2 years (pa)	6.92%	6.50%	0.43%
3 years (pa)	6.97%	6.28%	0.69%
5 years (pa)	6.53%	5.02%	1.50%
10 years (pa)	7.05%	6.23%	0.81%

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

Fund size

NZ$288 million

Asset allocation (% of fund)

Government stock	27.6%
SOE and local authority	18.3%
NZ registered banks	39.3%
Corporate debt	14.8%

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

AAA	13.2%
AA	63.1%
A	19.4%
BBB	4.3%

Top 5 corporate issuers (% of fund)*

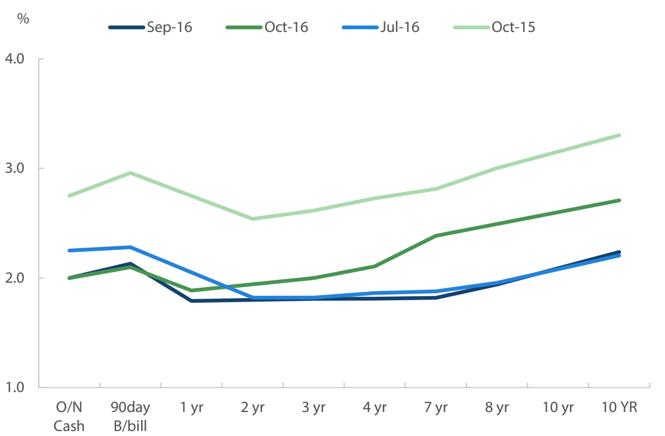
NZ Local Government Funding Agency	11.1%
Bank of New Zealand	8.6%
Rabobank	7.1%
Westpac Banking Corporation	6.7%
Fonterra Co-Operative Group	6.2%

* excludes central government

Duration and yield

Duration	Fund 4.8 years versus benchmark 4.7 years
Yield	Fund (gross) 3.42% versus benchmark 2.26%

New Zealand yield curve



Compliance

The Fund complied with its investment mandate during the month.

Commentary

Returns from the NZ bond indices were negative in October as interest rates moved higher in yield. For the month the Bloomberg NZ Government bond index produced a return of -1.38% while the All Swap index returned -1.08%, and the NZ Bond Corporate A Index returned -0.65%.

The Fund's return was negative during October as interest rates moved markedly higher in yield over the month. Shorter maturity corporate bonds were the best performing bond assets, and longer maturity governments the worst performers. Corporate bonds in general delivered a better return than NZ government bonds 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.

A combination of better economic data locally and rising US bond yields pressured NZ interest rates higher throughout the month. The shape of the NZ swap yield curve steepened - widening from a spread of 47 basis points between the 2 and 10-year swap rates to 70 basis points as longer maturity bonds experienced larger increases in yield than shorter maturities. For example; the NZ Government 2019 bond moved higher in yield by 10 basis points, the NZ Government 2021 bond was 25 basis points higher, and the NZ Government 2027 finished 44 basis points higher in yield. This rise in interest rates has taken the market back to the yield highs that we saw briefly in September when interest rates spiked before retracing most of the move before month end.

Credit markets were relatively stable, although there were some new issues of subordinated bank debt, lower rated and unrated corporate bonds that failed to receive a convincing demand response. Institutional investors typically don't have a very high capacity to hold lower rated and unrated bonds in their funds, and as a result these issuers rely more heavily on greater retail participation. Generally the better performing assets are corporate bond issuers that have strong name recognition with retail investors (for example Auckland International Airport) who often issue at slightly tighter credit spreads and receive stronger retail demand support than deals that rely more on institutional demand. Although interest rates have moved higher the accrual trade of having a higher yielding portfolio is helping to offset some of this move. With a positively 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.

NZ data has recently surprised on the positive side; business and consumer confidence, GDP, inflation outcomes, and dairy prices have been improving. Interest rates are low and supportive of activity with the possibility of a further cash rate cut. Challenges are the high level of the NZD which continues to frustrate the Reserve Bank and they would also 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.