

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 NZ domiciled 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 and 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	0.35%	0.06%	0.29%
3 months	-1.69%	-1.92%	0.23%
6 months	-2.36%	-3.26%	0.90%
1 year	2.77%	1.85%	0.92%
2 years (pa)	4.20%	3.34%	0.86%
3 years (pa)	5.99%	5.28%	0.72%
5 years (pa)	5.55%	3.89%	1.66%
10 years (pa)	6.76%	5.98%	0.78%

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

Fund size

NZ\$288 million

Asset allocation (% of fund)

Government stock	28.1%
SOE and local authority	17.6%
NZ registered banks	39.6%
Corporate debt	14.7%

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

AAA	12.6%
AA	63.1%
A	19.5%
BBB	4.8%

Top 5 corporate issuers (% of fund)*

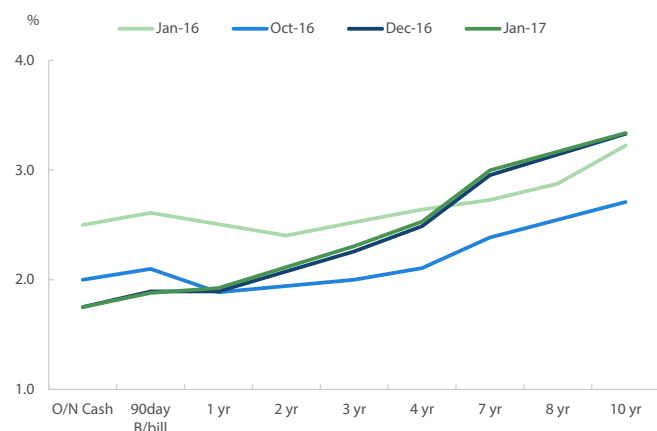
NZ Local Government Funding Agency	10.7%
Bank of New Zealand	8.3%
Westpac Banking Corporation	6.7%
Rabobank	6.6%
Fonterra Co-Operative Group	6.1%

* excludes central government

Duration and yield

Duration	Fund 4.16 years versus benchmark 4.45 years
Yield	Fund (gross) 3.8% versus benchmark 2.72%

New Zealand yield curve



Compliance

The Fund complied with its investment mandate during the month.

Commentary

The Nikko AM Wholesale NZ Bond Fund returned 0.35% for January. For the month the Bloomberg NZ Government Bond index produced a return of 0.06% while the All Swap index returned 0.07%, and the NZ Bond Corporate A Index returned 0.35%.

NZ interest rates finished January little changed, however there was a reasonable amount of volatility in interest rate movements during the month. The NZ Government 2019 bond finished higher in yield by 5 basis points (2.32%), and traded in a 20 basis point range, the NZ Government 2027 bond was unchanged (3.36%), and the NZ Government 2033 finished 3 basis points lower in yield (3.69%), after trading in a 35 basis point range over the month. Swap spreads to government bonds were relatively stable over the month with spreads inside 7 years in maturity narrowing marginally, whilst 10 year spreads widened and steepened the upward shape of the yield curve to a spread of +1.14% between the 2 and 10 year swap rates. NZ credit margins were stable to slightly narrower over the month with limited market activity due to the holiday season. A higher running yield from corporate holdings and yield curve positioning was of benefit to the fund over the month. Also of benefit the fund shortening its duration by selling its holding of NZ Government 2033 bonds at the low of the monthly range in yield and reinvested in shorter maturities which were less impacted when interest rates subsequently moved back higher in yield.

The NZ economy remains in expansionary mode, very strong immigration, tourism, and strength in other areas of the economy have picked up the slack from a weak dairy sector. Inflation appears to be recovering across a broad base and it is the first time back in the target band for some time and we expect inflation to remain contained over the near term. Given the relative strength of the NZ economy, higher growth and interest rates it is likely the NZD will continue to remain reasonably well supported, and expect dips to remain relatively shallow. With this background NZ short-term rates out to 3 years in maturity will continue to be primarily influenced by local factors and the actions of the Reserve Bank. The cash rate at 1.75% should help anchor the front end of the yield curve. The market is currently pricing an earlier start to interest rate increases than the Reserve Bank, and we believe the bank may be slower to raise interest rates as this is likely the path of least regret with uncertainties still remaining in the global economy, while inflation remains relatively benign and the NZ dollar high on a TWI basis. Longer term interest rates in NZ will likely be more heavily influenced by offshore events with the NZ 10-year interest rate following the direction of the US. There is already a reasonable amount of good news factored in with interest rates moving markedly higher over the last quarter of 2016, markets may have got ahead of actual policy in the US, and Trump will most likely continue to be a source of "surprises". The medium term directional bias is most likely upward, but we don't expect large movements higher in yield from here and expect a reasonable amount of volatility along the way.