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 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	1.25%	1.27%	-0.03%
3 months	2.68%	2.57%	0.11%
6 months	3.35%	2.82%	0.53%
1 year	3.19%	1.84%	1.35%
2 years (pa)	5.41%	4.84%	0.57%
3 years (pa)	6.32%	5.67%	0.65%
5 years (pa)	5.56%	3.82%	1.74%
10 years (pa)	7.06%	6.30%	0.76%

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

Fund size

NZ$324 million

Asset allocation (% of fund)

Government, Govt Depts & Govt guaranteed	27.9%
SOE and local authority	19.6%
NZ registered banks	37.4%
Corporate debt	15.1%

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

AAA	11.0%
AA	64.9%
A	18.7%
BBB	4.4%
Settlements	1%

Top 5 corporate issuers (% of fund)*

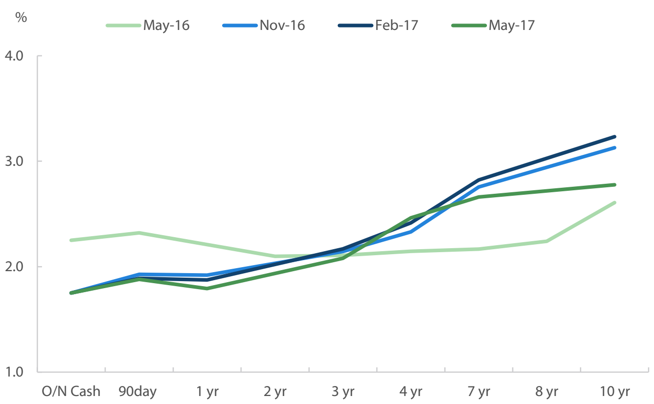
NZ Local Government Funding Agency	13.0%
BNZ	7.4%
Fonterra Co-operative	6.1%
RaboBank	5.9%
Westpac Banking Corporation	5.7%

* excludes central government

Duration and yield

Duration	Fund 3.98 years versus benchmark 4.62 years
Yield	Fund (gross) 3.30% versus benchmark 2.31%

New Zealand yield curve



Compliance

The Fund complied with its investment mandate during the month.

Fund commentary

The higher portfolio running yield and a moderate contraction in credit margins was a positive for performance. We favour credit to perform better than similar maturities of Government securities and we are currently holding closer to minimum levels of NZ Government bonds. The small underweight duration position was a slight detractor from performance.

Market commentary

The month of May continued the good performance of NZ bonds as interest rates moved lower in yield. Similar to the previous month there was a reasonably large difference in performance across the different sectors of the NZ bond market. The Bloomberg NZ Government Bond index returned 1.27%, The NZX 1-10 year swaps retuned +0.91% and the Corporate A +0.95 %.

NZ interest rates moved in line with falling global interest rates, in particular longer maturity US interest rates are now back to pre-election lows in yield. Locally, there was strong offshore demand for NZ Government bonds and fixed rate swaps. Governments were the best performers with larger falls in yield than comparative maturities of swaps, with some of the swap receiving demand offset by domestic bank paying in shorter maturities. The move lower in government bonds during May was fairly consistent along the yield curve, whereas in April longer maturity bonds had much larger falls in yield in a 'bull flattening' of the yield curve. For the month the NZ Government 2019 bond moved lower in yield by 15.5 basis points, the NZ Government 2021 bond was 24.5 basis points lower, and the NZ Government 2027 finished 29 basis points lower. Swap margins have widened and the shape of the swap yield curve which corporate bond margins are priced over flattened with the spread between the 2 and 10-year swap rate narrowing from +1.07% to +0.98%.

NZ credit margins continued to contract in spread and credit has generally outperformed similar maturities of swap and governments since the start of this year. The portfolio has benefited from having higher weightings to credit with both a higher running yield and margin contraction. We continue to have a positive view on credit and expect having a higher portfolio running yield will be one of the main attributors to outperformance over the course of this year. We prefer to hold more mid curve maturity (4-7 years) credit rather than longer government bonds that have a lower yield and greater interest rate risk. At this stage we expect movements in NZ bond yields to remain relatively muted, but we may adjust the fund duration if we see opportunities.

The NZ economy continues to perform well although forecasters expect some slowing of activity with capacity constraints in sectors such as construction. The Reserve Bank has indicated they see stable cash rates with risks evenly balanced at present, this should help anchor the front end of the yield curve at current levels. Credit/housing related excesses are being more actively curtailed, which lessens the odds of imbalances building. High immigration is growth positive, but momentum is broad based and numerous support factors remain, which should allow annual GDP growth to hover around 2.5-3% over 2017.