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	-0.41%	-0.70%	0.29%
3 months	1.62%	1.35%	0.27%
6 months	3.58%	2.72%	0.85%
1 year	1.95%	0.19%	1.76%
2 years (pa)	4.80%	4.05%	0.76%
3 years (pa)	6.26%	5.53%	0.73%
5 years (pa)	5.50%	3.72%	1.77%
10 years (pa)	7.07%	6.30%	0.76%

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

Fund size

NZ$310 million

Asset allocation (% of fund)

Government, Govt Depts & Govt guaranteed	27.8%
SOE and local authority	17.5%
NZ registered banks	28.2%
Corporate debt	26.5%

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

AAA	10.3%
AA	65.9%
A	19.2%
BBB	4.6%

Top 5 corporate issuers (% of fund)*

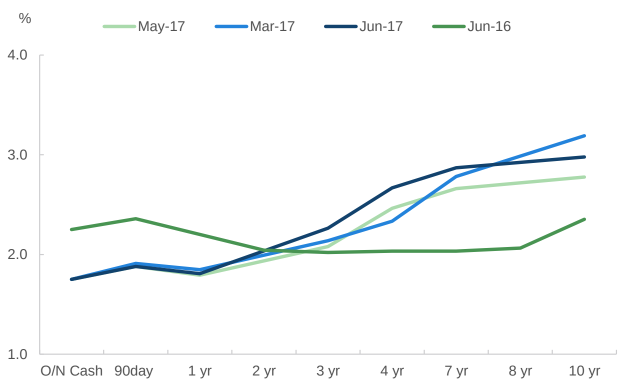
NZ Local Government Funding Agency	13.0%
BNZ	7.7%
Fonterra Co-operative	6.2%
Westpac Banking Corporation	6.1%
Rabobank	6.0%

* excludes central government

Duration and yield

Duration	Fund 4.13 years vs benchmark 4.62 years
Yield	Fund (gross) 3.50% vs benchmark 2.31%

New Zealand yield curve



Compliance

The Fund complied with its investment mandate during the month.

Fund commentary

Bonds sold off over the month, however the fund outperformed the benchmark. The underweight duration position was a positive contribution to performance. The higher portfolio running yield and a moderate contraction in credit margins also contributed to performance. We favour credit to perform better than similar maturities of Government bonds and we are currently holding close to minimum levels of NZ Government bonds.

Market commentary

The month of June saw the Government Bond Index return -0.70% points, as the NZ Government 10-year bond increased in yield by 26 points, ending the month at 2.97%. The NZX 1-10 year swaps returned -0.40% and the Corporate A -0.22%.

NZ Government bonds were a global outperformer in the first three weeks of the month. However at the end of the month the European Central Bank, the Bank of England, and to a lesser extent the US Fed, issued co-ordinated statements around the future path of interest rates and monetary conditions. In a nut shell the Central Bankers have said that they see inflation reappearing, and monetary conditions normalising in due course. This was likely in response to a global market that did not appear to believe this to be the case, as evident in the recent global bond rally. As a result of this global bonds have sold off, and the yield curve steepened out to the long end. New Zealand bonds have followed suit. Swap yields have also gone higher, but have outperformed bonds.

NZ credit margins continued to contract in spread, and credit has generally outperformed similar maturities of swap and government bonds since the start of this year. The portfolios have 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.

The RBNZ re-iterated the OCR is firmly on hold. GDP growth was 0.5% for the March quarter and below forecasts of 1.1%. The construction sector lagged, while dairy and the primary sector had a strong positive contribution. Growth per capita remains modest. It is worth noting that quarterly GDP numbers can be heavily influenced by short term movements in particular sectors, and are subject to being volatile. Consumer and business confidence are both at good levels, albeit down from recent highs. Wage inflation remains moderate, but is expected to increase due to labour market capacity constraints. The housing market, particularly in Auckland, has slowed and will likely continue to do so as we come up to the election. The main take away from this is that the economy is growing modestly, not roaring away unsustainably, and that the OCR at these levels and the RBNZ forecast of being on hold for the foreseeable seems entirely appropriate.