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	0.68%	0.51%	0.17%
3 months	0.94%	0.21%	0.73%
6 months	3.65%	2.79%	0.87%
1 year	1.62%	0.08%	1.54%
2 years (pa)	4.44%	3.43%	1.01%
3 years (pa)	6.07%	5.25%	0.82%
5 years (pa)	5.47%	3.79%	1.69%
10 years (pa)	6.97%	6.06%	0.91%

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

Fund size

NZ$323 million

Asset allocation (% of fund)

Government, Govt Depts & Govt guaranteed	28.6%
SOE and local authority	17.5%
NZ registered banks	36.9%
Corporate debt	17.0%

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

AAA	10.0%
AA	67.4%
A	18.3%
BBB	4.3%

Top 5 corporate issuers (% of fund)*

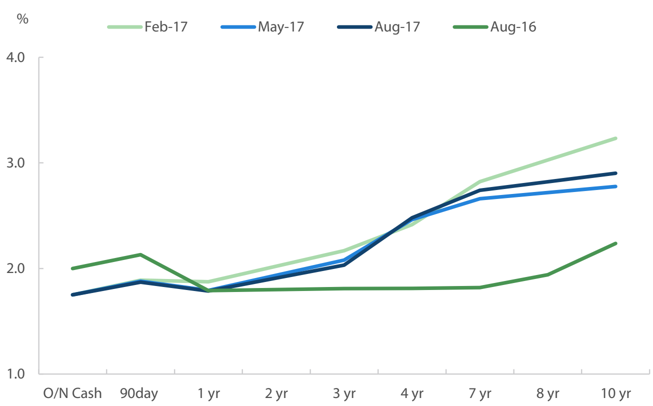
NZ Local Government Funding Agency	13.1%
BNZ	7.9%
Westpac Banking Corporation	6.8%
Fonterra Co-operative	5.9%
Rabobank	5.9%

* excludes central government

Duration and yield

Duration	Fund 4.19 years vs benchmark 4.46 years
Yield	Fund (gross) 3.10% vs benchmark 2.32%

New Zealand yield curve



Compliance

The Fund complied with its investment mandate during the month.

Fund commentary

The fund performed well over the month. Longer maturity bonds were some of the best performers through August as interest rates moved marginally lower in yield. Previously we had extended duration through switching some LGFA and bank bonds longer in maturity. Credit margins were stable but corporate bond holdings continued to add value.

Market commentary

The Bloomberg NZBond Govt 0+ Yr Index returned +0.51% for August as interest rates moved marginally lower during the month. The Bloomberg 1-10 year swaps returned +0.60% and the Bloomberg Credit Index +0.56%.

The move lower in NZ interest rates during the month of August was fairly consistent across maturities with NZ government bond rates finishing approximately 7bps lower in yield. On a sector basis similar maturities of swap performed slightly better than government bonds as swap margins contracted (1 to 5bps) relative to governments. Longer dated maturities of swap were the better performers contracting more in margin than shorter maturities. The tightening in local credit margins appears to have stalled with margins relatively stable over the month. NZ credit outperformed offshore credit where there was some widening in margins due to risk-off sentiment. With a near parallel shift lower in interest rates in the government yield curve, and some small contraction in swap margins, the best performing bonds over the month were longer dated maturities that have more price gain exposure to falling interest rates. Higher yielding maturities of credit also continued to perform well.

Interest rates have remained in a relatively narrow range so far this year and volatility in financial markets has been subdued with the events and geopolitical concerns that the market was concerned passing with little disruption. Potential “bumps in the road ahead” could be an escalation of North Korean tensions and the unwinding of the Fed’s bond buying program. At the same time financial market expectations have become increasingly positive that economies appear to be recovering. Central banks are on hold neutral, or moving closer to a slow and cautious approach for reducing stimulus. In contrast, lower than expected or dormant inflation outcomes have effectively reduced expectations for higher interest rates.

We remain happy to extend the duration of credit maturities out to mid curve through spending cash and selling shorter maturities when pricing makes sense. 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.

The RBNZ continues to maintain their view that the OCR is firmly on hold and this should help to support short to medium term bond maturities from moving much higher in yield. Longer maturity bonds will continue to be more heavily influenced by the direction of offshore markets, particularly by movements in the US 10 year bond. We don’t expect a significant impact to NZ financial markets from the upcoming election, although some investors may stay on the side-lines until there is more clarity. A change of government could lead to more government bond supply, a steeper curve and potentially reduced liquidity. Over the medium to long term there may be more potential impacts to consider depending on government policy.