

Nikko AM NZ Bond Strategy

Monthly Update 31 December 2023

Assets are held in the Nikko AM Wholesale NZ Bond Fund. The Nikko AM NZ Bond Fund (retail) invest in units in the wholesale fund, which the commentary refers to.

Market Overview

- The final quarter of 2023 was very strong for bond returns.
- Yields kept falling through November and December as the market aggressively priced interest rate cuts in 2024.
- NZ credit continues to help returns with a higher yield and stable margins supported by supply/demand dynamics.

Fund Highlights

- The fund delivered very strong positive returns benefiting from capital gains as rates moved lower.
- We have been incrementally moving the fund's duration longer and this was the main contributor to absolute and relative returns in the final quarter of 2023.
- We continue to prefer quality credit over lower yielding government bonds with the supply dynamics more supportive of credit than governments which will have ample supply in the new year.

Performance

	One month	Three months	One year	Three years (p.a.)	Five years (p.a.)	Ten years (p.a.)
Wholesale¹	3.38%	7.03%	8.15%	-1.50%	1.78%	3.93%
Benchmark²	2.84%	6.01%	6.18%	-2.39%	0.44%	2.86%
Retail³	3.30%	6.85%	7.47%	-2.13%	1.10%	3.16%

1. Returns are before tax and before the deduction of fees.
2. Current benchmark: Bloomberg NZBond Composite 0+ Yr Index. No tax or fees.
3. Returns are before tax and after the deduction of fees and expenses and including tax credits (if any).

Portfolio Manager

Fergus McDonald,
Head of Bonds and Currency



Fergus is responsible for the investment of the Bond, Cash and Currency mandates. Fergus has been actively involved in the NZ financial markets since 1981. The portfolio management team for the domestic fixed income funds includes Ian Bellew, Senior Fixed Income Manager and Matthew Johnson, Fixed Income Manager.

Overview

The fund aims to provide investors with regular income by constructing an actively managed investment portfolio of New Zealand bonds, deposits and cash with the potential for capital gain from New Zealand dollar fixed interest markets.

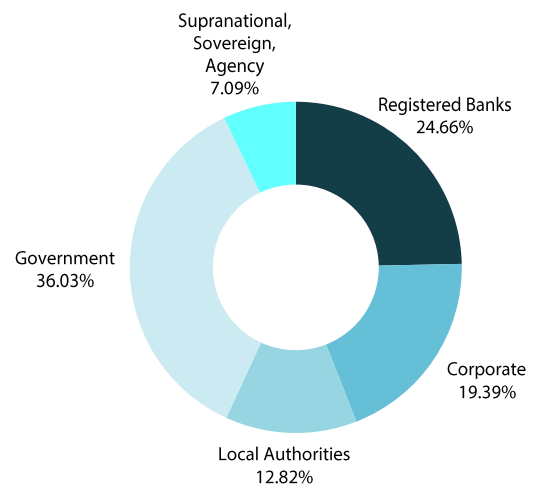
Objective

The fund aims to outperform the benchmark return by 0.60% per annum before fees, expenses and taxes over a rolling three-year period.

Five Year Cumulative Performance, \$10,000 invested^{1,2}



Sector Allocation



Top 5 Corporate Issuers*	(%)	Credit Quality	(%)	Green, sustainable and social bonds
New Zealand Local Govt Funding Agency	8.85	AAA	60.86	23.08% of the fund
Housing New Zealand	6.99	AA	19.21	Duration
Kiwibank	5.54	A	17.12	Fund 5.24 years vs Benchmark 4.48 years
Westpac New Zealand	5.11	BBB	2.81	Yield to Maturity*
Bank of New Zealand	5.04			Fund (gross) 4.8% vs Benchmark 4.66%

* Excludes NZ central government

* Excluding the inflation component of government inflation linked bonds

Market Commentary

The final quarter was very strong for NZ bonds with rates falling significantly from November through to year end as the market aggressively priced rate cuts in 2024. The move lower in interest rates was the key driver of absolute and relative returns with capital gains boosting bond returns to very respectable levels for 2023. Longer maturity bonds were the best performers as they have a higher price sensitivity to falls in rates.

It is very pleasing that the longer duration positioning has benefited the fund this year and bonds have delivered a strong return. It has been an abrupt move lower in rates with the fear of ever higher rates flipping to fear of missing out on falling rates and was exacerbated by market positioning. We agree the ultimate direction in rates is lower but doubt the pace of slowing in growth and inflation are sufficient for the RBNZ to deliver rate cuts earlier in 2024. Ultimately economic developments and the data will inform the way forward and markets may remain volatile. In terms of performance NZ bond sectors experienced similar moves lower in yield. Movements in government bond yields for the quarter were 2yr -111 bps, 5 yr -112 bps and 10 yr -99 bps. For comparison swap maturities were 2yr -108 bps, 5 yr -114 bps and 10 yr -104 bps. NZ credit has added value through a higher yield versus holding governments.

We think the RBNZ maintains a “hawkish hold” and conditions are likely restrictive enough to slow the economy and inflation, however we expect returning inflation to low levels will take time which may make market pricing look presumptuous. On a medium term view we think it makes sense locking in higher rates for longer, but rates have fallen a lot in short order and entry levels and positioning size are important so we remain patient for opportunities. We marginally reduced the fund’s long duration late December. In terms of sector allocation we prefer quality credit over governments while government bonds face supply issues in the new year.

Fund Commentary

The fund had a very strong quarter both absolute and in relative terms versus the Bloomberg NZ Composite benchmark. October was unhelpful as yields went higher but November and December produced very strong returns as interest rates kept falling. The move lower in interest rates was the main driver of both absolute and relative returns. The fund has incrementally moved to a moderate long duration position (approximately 1-year long) which was most helpful as interest rates moved a lot lower. We trimmed the long duration position late December.

Government bonds and swap had similar performances with the move lower in rates consistent along the yield curve for both sectors. Credit holdings have helped in terms of providing a higher yield while margins have been relatively stable. In terms of sectors, we continue to favour quality credit in new issuance.

We don’t necessarily expect rate cuts as early as the market is pricing but given the balance of risk, we are happy to lock in higher rates for longer when this makes sense. Again, we will remain patient and look to add value in terms of duration positioning on opportunities within the range.

Key Fund Facts

Distributions		Hedging:	Any foreign currency exposure are hedged to NZD within operational range of 95%-105%	Strategy Launch:	October 2007
Wholesale:	Calendar quarter	Exclusions:	Controversial weapons	Strategy size:	\$549m
Retail:	Calendar quarter	Restrictions:	Adult entertainment, gambling, fossil fuels, alcohol stocks, tobacco stocks. For more information, please refer to the Statement of Investment Policy and Objectives (SIPO) on our website https://www.nikkoam.co.nz/invest/retail .	Buy / Sell spread:	Click to view
Estimated annual fund changes (incl. GST)					
Wholesale:	Negotiated outside of unit price				
Retail:	0.65%, refer PDS for more details				

Compliance

The wholesale fund complied with its investment mandate and trust deed during the quarter.

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