Recommended

Product Review
Nikko AM Australian Share Income Fund

About this Review

ASSET CLASS REVIEWED	AUSTRALIAN EQUITIES
SECTOR REVIEWED	AUSTRALIAN LARGE CAP
SUB SECTOR REVIEWED	INCOME DIVIDEND FOCUSED
TOTAL FUNDS RATED	16

About this Fund

ASIC RG240 CLASSIFIED	NO
FUND REVIEWED	NIKKO AM AUSTRALIAN SHARE INCOME FUND
APIR CODE	TYN0038AU
PDS OBJECTIVE	TO PROVIDE A TAX-EFFECTIVE INCOME STREAM THAT EXCEEDS THE BENCHMARK'S DIVIDEND YIELD (GROSSED UP FOR FRANKING CREDITS) BY 2% P.A. OVER ROLLING FIVE-YEAR PERIODS, BEFORE FEES, EXPENSES AND TAX, PLUS THE POTENTIAL FOR CAPITAL GROWTH OVER THE LONG TERM
INTERNAL OBJECTIVE	AS PER PDS OBJECTIVE
STATED RISK OBJECTIVE	TRACKING ERROR IS NOT EXPLICITLY TARGETED, BUT IS MONITORED
DISTRIBUTION FREQUENCY	QUARTERLY
FUND SIZE	$189M (JUNE 2020)
FUND INCEPTION	01-11-2008
MANAGEMENT COSTS	0.85% P.A.
RESPONSIBLE ENTITY	NIKKO ASSET MANAGEMENT AUSTRALIA LIMITED

About the Fund Manager

FUND MANAGER	NIKKO ASSET MANAGEMENT AUSTRALIA LIMITED
OWNERSHIP	100% OWNED BY NIKKO ASSET MANAGEMENT CO, LTD. (NIKKO AM EQUITY AUSTRALIA LIMITED IS 50% OWNED BY THE AUSTRALIAN EQUITY TEAM AND 50% OWNED BY NIKKO AM LIMITED)
ASSETS MANAGED IN THIS SECTOR	$10.9B (30 JUNE 2020)
YEARS MANAGING THIS ASSET CLASS	30

Investment Team

PORTFOLIO MANAGER	MALCOLM WHITTEN & MICHAEL MAUGHAN
INVESTMENT TEAM SIZE	11
INVESTMENT TEAM TURNOVER	LOW
STRUCTURE / LOCATION	PM - ANALYST/SYDNEY

Investment process

STYLE	VALUE
BENCHMARK	S&P/ASX 200 INDEX (GROSS OF IMPUTATION CREDITS)
TYPICAL CAPITALISATION BIAS	MID-TO-LARGE
TYPICAL STOCK NUMBERS	40-70
STOCK POSITION LIMITS	8% ABSOLUTE
SECTOR POSITION LIMITS	20% ABSOLUTE (50% FOR FINANCIALS EX A-REITS WITH BANKS CAPPED AT 30%)

Fund rating history

JULY 2020	RECOMMENDED
AUGUST 2019	RECOMMENDED
NOVEMBER 2018	RECOMMENDED

What this Rating means

The **'Recommended'** rating indicates that Lonsec has strong conviction the financial product can generate risk adjusted returns in line with relevant objectives. The financial product is considered an appropriate entry point to this asset class or strategy.

Strengths

- The Manager has a disciplined and logical investment process, which is implemented by a highly experienced co-portfolio management team.
- The team has exhibited notable stability, despite progressing through generational change.
- Lonsec considers the investment culture to be cohesive and highly collegiate.
- The Fund has a track record in meeting its after-tax income objectives.

Weaknesses

- With the tendency to 'let winners run', the Manager's sell-discipline is considered to be less consistently driven by a stock's 'valuation' when compared to other 'value' style peers in the sub-sector.
- 'Yield' strategies are generally more sensitive to monetary policy and interest rate risk.
- Relative performance outcomes have been disappointing over recent years.

Fund Risk Characteristics

	LOW		MODERATE		HIGH
BUSINESS SUSTAINABILITY RISK		●			
CAPITAL VOLATILITY					●
SECURITY CONCENTRATION RISK			●		
SECURITY LIQUIDITY RISK	●				

Risk categories are based on Lonsec's qualitative opinion of the risks inherent in the financial product's asset class and the risks relative to other financial products in the relevant Lonsec sector universe.

BIOmetrics

Aggregated risks

	1	2	3	4	5	6	7
STD RISK MEASURE						●	

A Standard Risk Measure score of 6 equates to a Risk Label of 'High' and an estimated number of negative annual returns over any 20 year period of 4 to less than 6. This is a measure of expected frequency (not magnitude) of capital losses, calculated in accordance with ASFA/FSC guidelines.

	LOW		MODERATE		HIGH
RISK TO INCOME		●			

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Nikko AM Australian Share Income Fund

Features and benefits

	LOW		MODERATE		HIGH
COMPLEXITY		●			
ESG				●	

Fee profile

	LOW		MODERATE		HIGH
FEES VS. UNIVERSE				●	
FEES VS. ASSET CLASS			●		
FEES VS. SUB-SECTOR				●	

Fee BIOmetrics are a function of expected total fee as a percentage of expected total return.

What is this Fund?

- The primary objective of the Nikko AM Australian Share Income Fund ('the Fund') is to generate an income stream that exceeds the dividend yield of the S&P/ASX 200 Accumulation Index (grossed up for franking credits) by 2.0% p.a. over rolling five-year periods, before fees, expenses and tax. This objective is a target only and there is a risk that the yield objective may not be met in any given year. The Fund does not have a specific total return objective.
- The Fund is a long-only Australian equities investment vehicle offered by Nikko Asset Management Australia Limited ('Nikko' or 'the Manager'). Nikko has a long-standing 'relative value' fundamental investment approach, which aims to invest in companies trading at a discount to a conservative estimation of their 'intrinsic value'.
- Companies that meet the Manager's initial screens are ranked according to total expected return, which gives an indication of which companies represent the highest relative value at any given point in the market cycle. Lonsec believes Nikko takes a more 'pragmatic' approach to 'value' investing and, as a result, the Manager's style is not expected to be at the 'deep end' of the value-style spectrum relative to some peers.
- The Fund will have a combination of stocks that are attractive both in terms of 'relative value' and forecast yield, and stocks that offer lower relative value but meet the Fund's yield requirements. This is to be expected given the yield objective of the Fund. Income is targeted by placing an emphasis on companies that generate relatively high levels of franking. This is achieved by investing in stocks that offer fully franked dividends, by observing the 45-day rule for franked dividends and participation in off-market buybacks where possible.
- The Fund's guidelines allow for the use of derivative strategies to enhance income, although historically this has been a minor component of the Fund's total income. Derivatives will be used to manage exposures and not for gearing purposes.
- The portfolio is expected to be well-diversified with 40-70 stocks. Tracking error is not targeted but monitored for risk management. The Fund has a deliberate strategy of being low turnover to make it tax-effective, expected to be in the range of 40% – 80% p.a. Portfolio construction is done on an absolute basis rather than relative to a benchmark. This is a common trait of income funds. Investors should note that portfolio positioning will deviate significantly from the benchmark.
- Individual stock positions are permitted to be up to 8% of the portfolio. Lonsec observes historically that the bigger portfolio positions have tended to occur in the larger benchmark stocks such as the major banks.
- As per the Fund's PDS dated 20 November 2019, the fee disclosure for the Fund is as follows: management cost of 0.85% p.a. (including a management fee of 0.73% p.a. and administration costs & expenses of 0.12% p.a), the Fund does not charge a performance fee. Lonsec notes that the fee load is slightly at the moderate end of the broader peer group.
- During the financial year ended 30 June 2019, the net transaction costs for the Fund were estimated at 0.27% p.a. of the NAV of the Fund. Net transaction costs are costs incurred in managing the Fund (including explicit and implicit costs of buying and selling assets, the cost of hedging/protection strategies and/or when there are applications or redemptions of fund units by investors) that are not covered by the buy/sell spread. Buy/sell spreads are subject to change depending on market conditions. Please refer to the Manager for current buy/sell spreads and refer to the Fund's PDS for further details.
- Lonsec has coverage on four Nikko strategies as part of the Australian Equities – Large Cap review. The other three are:
  - The Nikko AM Australian Share Wholesale Fund, which is a core Australian equities strategy holding 20-35 stocks; and
  - The Nikko AM Australian Share Concentrated Fund, which is a more active and concentrated strategy than the core strategy, holding just 15-25 stocks.
  - The Nikko AM Australian Share Value (Ex-20) Model Portfolio, which is focused on best ideas ex-20 and is the Manager's most concentrated strategy, holding just 10-15 stocks.

Using this Fund

This is General Advice only and should be read in conjunction with the Disclaimer, Disclosure and Warning on the final page.

- The Fund is an income focused equity product. The Fund is subject to equity market risks and movements (both positive and negative) in the prices of the underlying securities in the portfolio. Investors should therefore be aware of and comfortable with the potential for the Fund to experience periods of negative returns which result in capital losses being incurred on their investment. As such, the Fund will generally sit within the growth component of a diversified investment portfolio. Lonsec recommends that equity investments are suitable for investors with an investment-time horizon of at least five years.
- Given the explicit yield and income growth objectives of the Fund, the portfolio is likely to exhibit strong sector and stock specific biases. It is therefore unlikely to provide a broad diversified exposure to the Australian Equity large cap sector alone. Absolute sector limits are used to manage these biases. Lonsec considers the Fund to be suitable to be blended with broader Australian equity funds.

ANALYST: GERALDINE GOH | APPROVED BY: SHAILESH JAIN

- Investors should note that Fund returns are primarily derived from the performance of a portfolio of Australian listed equities. This strategy is distinct from funds within the peer group that actively utilise derivative based strategies, whereby returns may reflect a combination of underlying stock and option portfolio performance.

Suggested Lonsec risk profile suitability

SECURE	DEFENSIVE	CONSERVATIVE	BALANCED	GROWTH	HIGH GROWTH
	●	●	●	●	●

For guidance on appropriate asset allocations and risk profiles, refer to the latest Lonsec Strategic Asset Allocation Review and Risk Profile Definitions on our website.

Changes Since Previous Lonsec Review

- Vincent Li was promoted to Research Analyst in March 2020.
- There have been no material changes to the investment process since Lonsec's previous review.

Lonsec Opinion of this Fund

People and resources

- Brad Potter assumed leadership of the investment team in June 2014 as Head of Australian Equities. Potter has over 26 years of investment experience and 18 years of tenure with Nikko. Potter has over 26 years of investment experience and 18 years of tenure with Nikko. Prior to Nikko, Potter worked at Westpac as a Director – Corporate Finance and at Ord Minnett as a Senior Research Analyst. Nikko's operating model sees all senior investors having not only portfolio management but also research responsibilities. Potter has analyst responsibilities for the Banking sector. Lonsec has had numerous interactions with Potter over the years and considers him to be a capable investment professional.
- Potter is supported by Johnston as the Deputy Head. Johnston began his investment career of 22 years with Nikko and Lonsec considers him a highly experienced investor. Apart from being Deputy Head, Johnston also has analyst responsibilities for the Healthcare, Agriculture and Energy sectors. Having met Johnston on a number of occasions, Lonsec is impressed with his stock knowledge and ability to articulate the investment process. Lonsec believes he is a highly capable investor and deputy.
- The Fund is co-managed by Malcolm Whitten and Michael Maughan. Whitten and Maughan both have reasonably deep investment industry experience respectively with 28 and 22 years each. Both PMs also have a high tenure, albeit Whitten has been with the firm significantly longer with 26 years of tenure compared to 13 years of Maughan. Maughan had portfolio management responsibilities in his role prior to joining Nikko. Lonsec considers Whitten to be an experienced and well-qualified investor whose past roles have included managing options strategies. Lonsec is also familiar with Maughan and considers him a capable investor. His responsibility for the Telecommunications and Transportation /Logistics industry is considered well-suited to this Fund. Whitten also has broader dealing responsibilities across Nikko's various strategies.
- Whitten and Maughan each have sole discretion for the management of 50% of the Fund's capital and this structure is a common feature of Nikko's portfolios (although the proportions may vary). A benefit of this structure is its ability to help mitigate key person risk although given the significant proportions for which Whitten and Maughan are each responsible this is to a degree moot. Despite the existence of individual responsibility, Lonsec notes that Nikko has a collegiate structure and the portfolio managers are actively encouraged to discuss portfolio activity ahead of implementing any change. Nonetheless, this can dilute accountability to investors as the relative performance of the two sub-portfolios is not disclosed.
- The investment team of 10 investors and an additional dedicated dealer is considered appropriately sized to implement the investment process. The team has historically exhibited a high degree of stability but has experienced some generational change until 2016. The investment experience levels across the team are high with an average of 21 years and an average tenure of 14 years.
- Lonsec considers communication and peer review amongst the investment team to be highly structured and robust. All team members meet multiple times throughout the week to debate and peer review stock research ideas in addition to discussing portfolio construction and broader market matters. Lonsec also considers the investment team demonstrates a high degree of collaboration relative to peers and views this favourably.
- Lonsec believes that an important factor in the stability of the team has been the opportunity for equity ownership in the franchise. Specifically, the Australian Equities business is structured as a joint venture between the investment team and Nikko. Pleasingly, Lonsec notes the high alignment of interest between the investment team and investors with all senior members of the team being equity holders. While the equity ownership structure is not unique to Nikko, the breadth of the spread of equity across the team is viewed by Lonsec to be a positive and distinguishing feature of the remuneration structure. Further, variable remuneration is based on individual performance which holds all team members to account.

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Research and portfolio construction

- Nikko seeks to identify companies that it believes exhibit fundamental intrinsic value. The philosophy gravitates towards companies that demonstrate sustainable earnings and which can capitalise these. Nikko describes their philosophy as 'value' but note that this does not necessarily mean 'cheap' value as understood from stocks trading at observable discounts (e.g. P/E or P/B) to the broader market or their history. To this end, there is an explicit cap of between four and eight years, depending on the opportunity, applying to the maximum length for which a company's franchise period that will be explicitly modelled. Lonsec highlights that the characteristics sought by Nikko, at a high level, are somewhat more consistent with growth at reasonable price ('GARP') investing. Notwithstanding, elements within Nikko's process act to control factor exposures and deliver a strategy that has exhibited 'mild value' through to more 'core' outcomes over time.
- Lonsec considers the Manager's investment process and portfolio construction to be robust and logical. The initial investment universe of the S&P/ASX 200 Accumulation Index is reduced to approximately 150 stocks after a liquidity screen is applied. To prioritise the fundamental research effort, the Manager then implements an internally generated multi-factor screen to rank companies by value, quality and combined scores before conducting the bottom-up research effort.
- Interestingly and in contrast to Nikko's concentrated strategy which has a combined growth and income objective and explicitly includes a 4% yield floor for stock eligibility, there is no such requirement in the management of this income fund. Specifically, the portfolio managers can invest in names with little or no yield provided these have successfully progressed through the research process. Lonsec considers this to be somewhat unconventional given the nature of the two strategies with both having income objectives. Nevertheless, it is important to note that this Fund's yield can be enhanced with options strategies and investments into other instruments such as hybrids.
- Analysts are accountable for their recommendations but, importantly, these are required to be peer-reviewed by the whole team. Company research includes, for instance, meeting with company management and reviewing financial disclosures. Findings are presented in a standardised report which touches on key investment factors like thesis, assumptions, risks, sensitivities, Environment, Social, and Governance (ESG) and valuation. Lonsec generally views standardised outputs as good practice helping to support consistency in an investment process.
- ESG considerations are formally incorporated into the valuation process at the stock level. This can be undertaken via a discrete estimate of the earnings impact or alternatively via a discount to the capitalisation rate. This is based on the belief that this analysis provides added insights and early signals on the 'sustainability' of returns. ESG research comes from multiple sources, including proprietary research, company information and external research providers such as MSCI. Lonsec regards this as a positive differentiating factor to other mainstream Australian equity products.
- The investment team meets on a regular basis each week to discuss the positions in each of the portfolios and to assess fresh investment ideas. Moreover, the meeting also includes in-depth discussions regarding the key quantitative inputs used in the stock valuation process. Lonsec believes this mechanism is a key strength of the investment process as it enhances the overall level of peer review.
- Nikko's financial analysis involves proprietary modelling of variables across the income and cash flow statements in addition to the balance sheet. Valuation analysis is based on a standardised Internal Rate of Return (IRR) model which has a three-year horizon. This can be cross-checked to a DCF analysis which is where the duration of a company's franchise period are explicitly curtailed. Lonsec considers that Nikko's valuation approach is reasonable and consistently applied.
- IRRs are ranked and the general aim is to invest in those companies with the greatest return profile. Portfolio construction is also largely consistent with the output of the CVA. Portfolio managers are, however, permitted to continue to hold names that drop in the IRR ranks (i.e. through price appreciation) and no longer rank highly. Nikko's rationale is that this is consistent with its belief of allowing 'winning stocks to run'. Moreover, Nikko highlights that it believes 'value' managers generally sell too early. Lonsec is sympathetic to Nikko's argument, however, believes that is also indicative of Nikko's flexible relative valuation methodology, potentially holding 'expensive' names, which is not wholly considered by Lonsec to be consistent with 'value' investing. Value investors are typically valuation driven and price-sensitive hence the general observation that they may sell too early.
- The portfolio managers each have sole discretion, subject to names having progressed through the investment process, to build their respective sub-portfolios. Each portfolio manager constructs a discrete model portfolio which is periodically optimised through BARRA. The optimisation process is used as a portfolio construction guideline for the portfolio management team, however, they retain the flexibility to impart their own qualitative views in the final portfolio in accordance with the Fund's risk constraints. Importantly, trade ideas are typically discussed between the two and Lonsec believes that this, to a degree, supports the management of the Fund as an aggregate portfolio. Further helping in this regard, the portfolio managers also have access to a range of quantitative risk tools which are used to actively monitor factor exposures at the aggregate Fund level. Additionally, there will be some differences across the sub-portfolios however these are expected to be timing and valuation-related rather than fundamental disagreements on a company's fundamentals.
- The Fund will typically consist of between 40 and 70 stocks, however, Lonsec observes the composition of the final portfolio has been at the lower end of the prescribed range in recent years.
- The Fund's use of derivatives to enhance income is selective and dependent on market conditions.

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Lonsec does not expect this aspect of the strategy to be a significant driver of the Fund's income or total return. The Fund can also invest in hybrids but there have been no such investments to date.

ESG Integration

- As a firm, Nikko has articulated a commitment to the integration of ESG within their investment processes supported by responsible investment policies (including engagement and proxy voting), some of which are publicly available. Lonsec views the strength of this commitment and disclosure of responsible investment policies to be above peers.
- As aforementioned, Lonsec also observes a notable level of ESG integration within the Nikko's research and portfolio construction process where Nikko shows a willingness to moderate position weights or stock valuations upon identifying material ESG risks it believes could adversely impact Fund performance. Nikko has also demonstrated active ownership through proxy voting and company engagement activities, however, Lonsec notes Nikko does not publicly disclose the outcomes of these activities. Overall, on a peer relative basis, Lonsec considers the degree of ESG integration within this Fund to be 'Moderately-High'.

Risk management

- The Fund will be nearly fully invested and risk is managed in a relative sense versus the benchmark. Lonsec believes that the Manager has sufficient risk controls in place to effectively manage the risks within the portfolio (such as stock and sector exposures). These are overseen by a dedicated Investment Risk Manager. Given the Fund is relatively concentrated in the number of stocks it holds, Lonsec views risk management as a vital element of the investment process.
- The Manager has hard absolute limits on both stock and sector constraints. Stocks are managed to an absolute limit of 8%. Absolute sector constraints are 20% for all GIC sectors excluding financials ex A-REITs which is subject to a 50% limit with banks capped at 30%. The Manager will also typically not hold over 10% of a company's issued capital and will generally invest only in companies with a market capitalisation greater than $300 million.
- Risk management is also considered to be largely inherent in the Manager's investment process, focused on quality companies with earnings certainty. The Manager considers these attributes to be vital for a fund with an income objective that is linked to dividend yield.
- Further, risk management is also considered to be embedded in the research process, with optimisation and 'scenario analysis' undertaken as part of portfolio construction. Tracking Error is not targeted due to the income nature of this product but is regularly monitored.

Funds under management (FUM)

- Nikko had approximately $9.3 billion in FUM across its Australian equities strategies as at March 2020. Nikko's most recent capacity analysis was conducted on 28 February 2019 and determined that a hard close would be appropriate at 0.75% of the S&P/ASX200 market capitalisation (currently equivalent to c. A$13 billion). Based on current FUM and market size, a soft close would occur at approximately A$12 billion.
- There are positives and negatives to low or high levels of FUM; however, on balance Lonsec believes managers with smaller FUM are better placed to add value. Larger fund managers typically have better access to key decision-makers (e.g. CEOs) and may gain better execution pricing and preferential access to IPOs and secondary offerings. Conversely, managing a large pool of money means that a manager may confront liquidity issues and is likely to be less nimble in the market as it takes longer for a position to be established or sold down.
- Lonsec notes Nikko is nearing its pre-defined capacity limit at current levels of FUM but views the Fund's mid-large market cap bias and relatively low portfolio turnover as mitigating factors to capacity constraints risk. That said, Lonsec will continue to monitor for Nikko's scale in FUM and assess the ongoing impact on Fund performance.

Performance

- The Fund seeks to deliver a tax-effective income stream that exceeds the dividend yield of the S&P/ASX 200 Accumulation Index ('the Benchmark') which has been grossed-up for franking credits by 2% p.a. (gross fees) over rolling five years. There is no explicit excess return objective, however, the Fund states that it offers the potential for capital growth over the long-term.
- Notably, for the five years to 30 June 2020, the Fund delivered an excess grossed-up yield, relative to its benchmark, of 3.4% p.a. (gross of fees) and has, therefore, met its investment objective. The Fund, however, posted a growth return of -3.7% p.a. over the same period. Over the same period, the Fund generated a total return of 3.7% p.a. and underperformed the Benchmark by 2.3% p.a. while performing in line with income dividend-focused peer median.
- Over the shorter one year period to June 2020, the Fund delivered an excess grossed-up yield, relative to its benchmark, of 4.4% (gross of fees). Over the same time frame, the Fund generated a total return of -13.2% and underperformed the benchmark by 5.5%. Lonsec notes the Fund's underperformance is partially attributed to heightened market volatility between February and April 2020 as a result of knock-on impacts from the novel coronavirus (COVID-19) pandemic. Lonsec is cognisant of the Fund's disappointing relative performance in recent years and seeks to observe a sustained turnaround in performance.
- Key contributors to Fund performance over the 12-months to 30 June 2020 include positions in Coles, James Hardie and Nurfarm. Key detractors include positions in Oil Search, CSL and Boral. Notably, the Fund's volatility of returns (as measured by Standard Deviation) was higher than the Benchmark and peer group median across all time frames.
- While Lonsec acknowledges the Manager's established track record in meeting its after-tax income objectives, Lonsec is cognisant of the Fund's disappointing relative performance in recent years and seeks to observe a sustained turnaround in

performance to maintain its current conviction in the Manager.

Overall

- Lonsec has maintained the Fund's **'Recommended'** rating at its most recent review. The rating is underpinned by the Manager's experienced investment team along with its longstanding disciplined and logical investment process.
- That said, Lonsec is mindful of the Manager's flexible relative valuation methodology which has challenged sell-discipline. While Lonsec acknowledges the Manager's established track record in meeting its after-tax income objectives, Lonsec highlights the Fund's disappointing relative performance in recent years and seeks to observe a sustained turnaround in performance to maintain its current conviction in the Manager.

People and Resources

Corporate overview

Nikko Asset Management Australia Limited (NAML) is owned by Nikko Asset Management Co. Ltd (NAM Group), a Tokyo-based asset management group with more than US$205.2 billion in FUM (as at March 2020). NAML's Australian Equity business was responsible for $10.9 billion as at June 2020.

The Australian Equity business is structured as a joint-venture between NAML and the investment team with each group owning 50% of the operating entity (Nikko AM Australian Equities Pty Limited).

NAML is the Fund's Responsible Entity and additionally offers a range of other strategies domestically, e.g. fixed income and global equities. The Australian business is based in Sydney with overseas offices located in Edinburgh, London, New York and Singapore. NAM Group entered the Australian market via its acquisition of Tyndall Investment Management in 2011 from Suncorp Metway Ltd and subsequently re-branded the organisation.

Size and experience

NAME	POSITION	EXPERIENCE INDUSTRY / FIRM
BRAD POTTER	HEAD OF AUSTRALIAN EQUITIES	26 / 18
TIM JOHNSTON	DEPUTY HEAD OF AUSTRALIAN EQUITIES, PORTFOLIO MANAGER & SENIOR ANALYST	22 / 22
JASON KIM	PORTFOLIO MANAGER & SENIOR ANALYST	28 / 19
MALCOLM WHITTEN	PORTFOLIO MANAGER & SENIOR ANALYST	28 / 26
MICHAEL MAUGHAN	PORTFOLIO MANAGER & SENIOR ANALYST	22 / 13
CRAIG YOUNG	SENIOR RESEARCH ANALYST	24 / 24
MICHAEL WARD	SENIOR RESEARCH ANALYST	22 / 4
STEFAN HANSEN	SENIOR RESEARCH ANALYST	19 / 4
JAMES NGUYEN	PORTFOLIO MANAGER & SENIOR ANALYST	16 / 12
VINCENT LI	RESEARCH ANALYST	6 / 4
DAVID THOMS	DEALER	16 / 10
AVERAGE (N=11)	-	20 / 14

The team is led by Brad Potter, with Tim Johnston being his back-up as Deputy Head of Equities. The investment team comprises 10 equity investors and one dealer. All members of the investment team have stock research responsibilities (c. 15 to 20 stocks each) and six of the most senior members have additional portfolio management duties. The specific responsibilities are as follows for the team:

- Brad Potter – Banks;
- Tim Johnston – Healthcare, Energy;
- Jason Kim – Insurance;
- Michael Maughan – Telecommunications, Transportation/Logistics;
- Craig Young – Banks, Retail and Food & Beverage, Telecommunications;
- James Nguyen – Diversified Financials, Gaming and Utilities, Infrastructure;
- Michael Ward – Building Materials, Contractors, Metals;
- Stefan Hansen – Mining, Energy;
- Vincent Li – A-REITS, Industrials; and
- David Thoms and Malcolm Whitten – Dealing.

Remuneration / alignment of interests

The remuneration principle is to pay a market salary plus attractive short-term incentives (plus long-term incentives via shares in the Joint Venture Company). All established investment personnel in the Australian Equities team retain equity ownership. This serves the purpose of providing the investment team with access to profit sharing. Lonsec notes that equity can only be on-sold to another member of the equities team. In addition, there are financial penalties if a team member joins a competitor.

Variable remuneration is based primarily on the overall outperformance achieved by the Fund, team and

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individual. Bonuses (which are based on rolling two year performance) are adjusted positively or negatively at the analyst level to reflect individual performance contributions. To facilitate this, the Manager uses an internal analyst attribution model, which monitors performance on one and two year rolling periods.

Research Approach

Overview

INVESTMENT STYLE	INTRINSIC VALUE (INCOME – DIVIDEND YIELD FOCUS)
NO. OF STOCKS IN UNIVERSE	200 (S&P/ASX 200 ACCUMULATION INDEX)
NO. OF STOCKS FULLY MODELED	150
UNIVERSE FILTERING	LIQUIDITY SCREEN: 90-DAY MEDIAN DAILY TURNOVER
RESEARCH INPUTS	FUNDAMENTAL ANALYSIS – FINANCIAL STATEMENTS, COMPANY MEETINGS, ETC.
USE OF BROKER RESEARCH	CONSENSUS EARNINGS USED FOR SCREENING
VALUATION OVERVIEW	PE RELATIVE WITH DCF CROSS CHECK

Nikko seeks to identify companies that it believes exhibit fundamental intrinsic value. The philosophy gravitates towards companies that demonstrate sustainable earnings and which can capitalise these.

The Manager operates a research process referred to as Comparative Value Analysis (CVA). Those stocks remaining after the screening process (approximately 150) are then subjected to in-depth fundamental research.

The universe for idea generation comprises all names in the S&P/ASX 200 Index. Research is prioritised through the use of proprietary quantitative screens that screen/rank based on a range of criteria (liquidity, value, quality and momentum):

- Value (forecast one year);
- Price/Earnings;
- Dividend Yield;
- Enterprise Value multiples;
- Accounting Accruals;
- Retained Earnings/Assets; and
- EBIT/Total Assets.

Those names which screen well are candidates for further fundamental due diligence and research. This typically numbers c. 130 names. The Manager's fundamental research has a focus on EBIT drivers, profitability, cash flow and the structure of the company's balance sheet (to try and find value in non-capitalised assets).

The key inputs into the research process include broker reports; company reports; company visits; 'one on one' meetings with management; and other sources.

Research output is standardised. Additionally, the research is updated on an ongoing basis, with the Manager producing forecasts for P&L statements, Balance Sheets, Cash Flow Statements, as well as Ratio Analysis. Proprietary stock models are generally revisited bi-annually (when company results are released) and when warranted by a specific event. This includes the calculation of a three year internal rate of return (IRR) for each stock.

All research is subject to team-wide peer review before being completed. Peer review is facilitated through regular analyst meetings held three times per week. Additionally, the Manager conducts Portfolio Construction Meetings each week which provide a 'sounding board' for the Portfolio Managers which is attended by all team members.

Valuation

The formulation of a three-year IRR is a requirement for all stocks considered within Nikko's investment process. The IRR ranks are a key factor driving a stock's relative attractiveness within Nikko's process.

To enhance the consistency of the valuation output, the Manager utilises standardised inputs (such as beta, risk-free rate of return and gearing) when calculating the weighted average cost of capital for its discounted cash flow models.

Additionally, stock valuations can be cross checked against an alternative valuation model, usually a DCF, and adjusted for significant developments (such as acquisitions). Other valuation metrics considered include: earnings per share (EPS), dividends per share (DPS) and grossed up dividend yield (GUDY).

Portfolio Construction

Overview

FUND BENCHMARK	S&P/ASX 200 ACCUMULATION INDEX (GROSSED UP FOR FRANKING CREDITS)
RETURN OBJECTIVE (INTERNAL)	TO EXCEED THE GROSSED UP DIVIDEND YIELD OF THE BENCHMARK BY 2% P.A. OVER ROLLING FIVE YEAR PERIODS, BEFORE FEES, EXPENSES AND TAX.
RISK OBJECTIVE (INTERNAL)	NONE STATED
PORTFOLIO APPROACH	ABSOLUTE RETURN BASIS
PORTFOLIO DECISIONS	MALCOLM WHITTEN & MICHAEL MAUGHAN (50/50)
STOCK SELECTION	>90%
TOP-DOWN INFLUENCE	<10%
TYPICAL NUMBER OF HOLDINGS	40-70
MARKET CAPITALISATION BIAS	MID-TO-LARGE
EXPECTED PORTFOLIO TURNOVER	40-80% P.A. (TYPICALLY 55% P.A.)
OBSERVED ACTIVE SHARE	60.0% (JUNE 2020)
PORTFOLIO EXPOSURE IN TOP 10 HOLDINGS	43.8% (JUNE 2020)

The Manager generally aims to produce a portfolio of 40-70 stocks and with the Fund comprising two sub-portfolios which are separately managed by two different Portfolio Managers. Turnover is expected at 40% – 80% p.a.

From the fully researched universe of approximately 150 stocks, a dividend yield screen is applied to identify companies with the highest forecast dividend yield (grossed up for franking credits).

The process also considers the IRR of these securities but this is regarded as secondary measure for identifying suitable opportunities in the management of the Fund. For example, stocks that rank highly based on dividend yield and IRR are typical buy candidates for the portfolio. This contrasts with Nikko's other strategies which tend to be led by the IRR ranks.

The qualitative element of the process allows the Manager to factor in market dynamics and insight gained from bottom-up analysis in constructing the portfolio. There is no general IRR which is considered particularly attractive (e.g. minimum acceptable hurdle) with the Manager noting this depends on the prevailing market opportunities. The Co-Portfolio Managers may also select stocks that have capital structures where special dividends, off market buy backs or capital returns are likely.

This can also encompasses the use of a potential discretionary element, which allows the Portfolio Manager to hold up to 7.5% of the portfolio in stocks that do not rank highly on IRR terms. The Manager's rationale for this component is that it allows 'winning' stocks to 'run', believing that a trap which other value managers sometimes fall into is to sell down profitable positions too early. Nikko has noted that this has not been applied in this portfolio.

Additionally, this flexibility is further included in the acceptance that the three-year IRR method may miss alpha opportunities in special circumstances (e.g. corporate targets, thematic shifts, successful acquirers, capital raisings and a quick response to changed fundamentals).

Importantly, however, Portfolio Managers must also determine milestones for the performance of these stocks and if they are not met, they are forced to reconsider the position at the Portfolio Construction meetings. In addition, such a position will also be reviewed should it start underperforming the market on a quarterly basis. So far, Lonsec understands that the Manager's usage of this discretionary element has been relatively minor to date.

BARRA is used as a quantitative tool in the portfolio construction process. The Manager believes it is particularly useful to both help assess the risks within the portfolio and for portfolio optimisation. The optimisation process is based on an efficient frontier of expected Tracking Error and expected Excess Return.

Price and earnings momentum are also considered in the portfolio construction process, with the primary objective being to optimally time stock entries and exits. Price and earnings momentum signals are also used to help identify potential 'value traps'.

The portfolio is 'stress tested' monthly through scenario analysis that allows the Manager to test the portfolio against potential market events.

Finally, the portfolio is assessed against value criteria to ensure that it is 'true to label' (e.g. idiosyncratic stock risk is driving the portfolio). The Manager relies on both BARRA output for this assessment and on its internal software.

Once implemented the portfolio is subject to ongoing review, with key 'flags' (such as a new stock entering the Top 20 IRR ranking, the stock weighting deviating more than 30% from the model portfolio target, or the stock closing in on 'fair value') used as triggers for investigation.

Derivative application

The Portfolio Managers have been afforded the flexibility to use derivatives where required to manage the effective exposures within the portfolio and to manage risk. It is important to note that the Fund is not designed to be a 'buy-write' product or to rely heavily on derivatives for income generation. The Manager has indicated that the primary source of income generated by the Fund will be dividend yield.

Risk Management

Risk limits

SEPARATE INVESTMENT RISK MONITORING	YES
STOCK LIMIT	8% ABSOLUTE (INITIAL MAXIMUM IS 6%)
SECTOR LIMIT	20% ABSOLUTE (50% FOR FINANCIALS EX A-REITS WITH BANKS CAPPED AT 30%)
CASH	MAXIMUM 20%
FUTURES CONTRACT EXPOSURE	MAXIMUM 20%
PURCHASED EQUITY OPTION PREMIUMS	MAXIMUM 10%
SOLD OPTION PREMIUMS	MAXIMUM 10%

The Fund is permitted to use derivatives for the purposes of managing tax exposures and risk, and as a means of generating income. Derivatives are not used for gearing purposes.

Risk monitoring

All of the Fund's trades are monitored on a pre- and post-trade basis and its stock positions are also monitored on a daily basis. Lonsec observes a clear separation of duties between investment management and risk management, with compliance reports sent out on a daily basis to all Portfolio Managers, the dealer, the Head of Australian Equities and a separate compliance team. Futures and options activity and position reports are prepared at least weekly.

Risks

An investment in the Fund carries a number of standard investment risks associated with investment markets. These include performance, liquidity, counterparty, market and tax risks. These and other risks are outlined in the PDS and should be read in full and understood by potential investors. Lonsec considers the following to be the major risks:

Equity market

Investments in equity markets are subject to numerous factors which may have an impact on the performance of an investment (both positive and negative). Unexpected changes in economic, technological, structural, regulatory or political conditions can have an impact on the returns of all investments within a particular market.

Derivatives

There is scope in the PDS to implement various derivative strategies. However, Lonsec does not expect derivatives to be a widely used given that these are not the intentions of the Manager. Derivatives are not intended to be used to speculate and the Fund does not intend to borrow.

Nikko AM Australian Share Income Fund

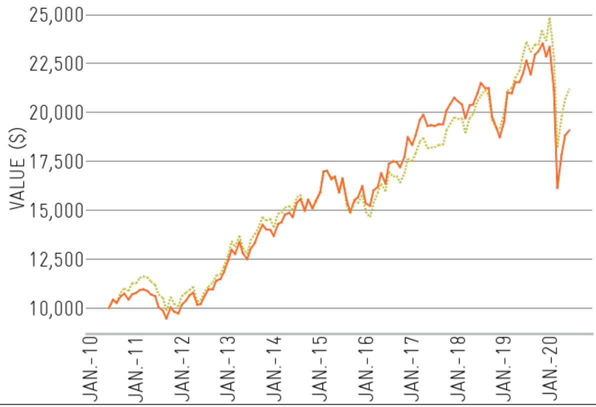
Quantitative Performance Analysis - annualised after-fee % returns (at 30-6-2020)

Performance metrics

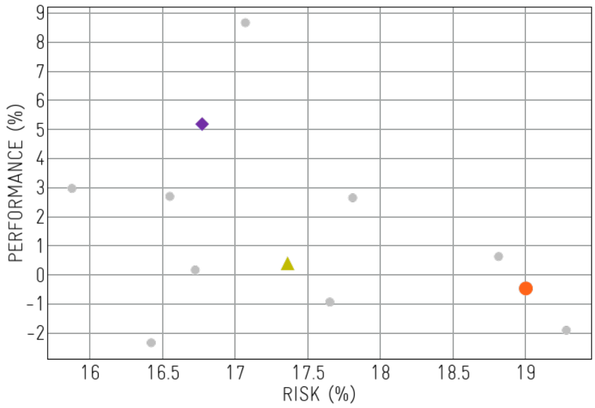
	1 YR		3 YR		5 YR		10 YR	
	FUND	PEER MEDIAN	FUND	PEER MEDIAN	FUND	PEER MEDIAN	FUND	PEER MEDIAN
PERFORMANCE (% PA)	-13.17	-10.85	-0.46	0.40	3.69	3.69	6.69	6.69
STANDARD DEVIATION (% PA)	30.24	26.98	19.00	17.36	16.64	15.39	13.89	13.49
EXCESS RETURN (% PA)	-5.49	-3.17	-5.65	-4.78	-2.26	-2.26	-1.12	-1.37
OUTPERFORMANCE RATIO (% PA)	41.67	41.67	33.33	37.50	46.67	43.33	49.17	47.50
WORST DRAWDOWN (%)	-31.30	-28.87	-31.30	-29.02	-31.30	-28.87	-31.30	-29.18
TIME TO RECOVERY (MTHS)	NR	NR	NR	NR	NR	NR	NR	NR
SHARPE RATIO	-0.46	-0.44	-0.11	-0.06	0.12	0.13	0.29	0.29
INFORMATION RATIO	-0.88	-0.88	-1.23	-1.15	-0.53	-0.70	-0.31	-0.67
TRACKING ERROR (% PA)	6.27	3.61	4.60	3.77	4.28	3.60	3.66	3.05

FUND: NIKKO AM AUSTRALIAN SHARE INCOME FUND
LONSEC PEER GROUP: AUSTRALIAN EQUITIES - AUSTRALIAN LARGE CAP - INCOME DIVIDEND FOCUSED
BENCHMARK USED: S&P/ASX 200 TR INDEX AUD
CASH BENCHMARK: BLOOMBERG AUSBOND BANK BILL INDEX AUD
TIME TO RECOVERY: NR - NOT RECOVERED, DASH - NO DRAWDOWN DURING PERIOD

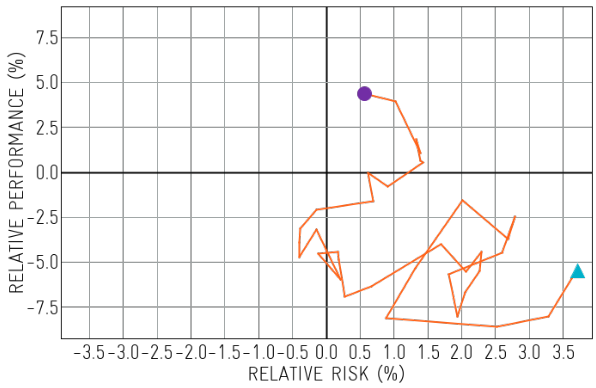
Growth of $10,000 over 10 years



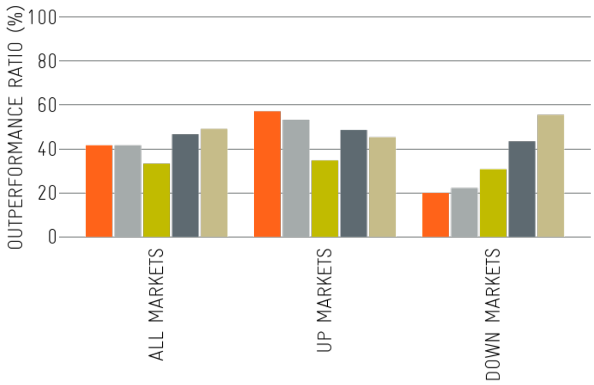
Risk-return chart over three years



Snail trail



Outperformance consistency



ANALYST: GERALDINE GOH | APPROVED BY: SHAILESH JAIN

Nikko AM Australian Share Income Fund

Glossary

Total return 'Top line' actual return, after fees

Excess return Return in excess of the benchmark return

Standard deviation Volatility of monthly Absolute Returns

Tracking error Volatility of monthly Excess Returns against the benchmark (the Standard Deviation of monthly Excess Returns)

Sharpe ratio Absolute reward for absolute risk taken (outperformance of the risk free return (Bank Bills) / Standard Deviation)

Information ratio Relative reward for relative risk taken (Excess Returns / Tracking Error)

Worst drawdown The worst cumulative loss ('peak to trough') experienced over the period assessed

Time to recovery The number of months taken to recover the Worst Drawdown

Snail Trail A trailing 12-month relative performance and relative risk measurement over the benchmark. The trail is generated using a 12-month rolling window over the specified period

About Lonsec

Lonsec Research Pty Ltd (Lonsec) is an investment research house with specialist areas of expertise, that was originally established in 1994 and the current entity was registered on 23 June 2011. From 1 July 2011, Lonsec became a fully owned subsidiary of Lonsec Fiscal Holdings Pty Ltd, a privately owned entity with a multi-brand strategy of providing leading financial services research and investment execution. Lonsec believes that professional financial advisers need informed opinions on the best investment strategies and financial products to provide real value for their clients. To meet this need, Lonsec has in place an experienced research team, which draws on a robust research process to undertake in-depth assessment of managed fund products.

Analyst Disclosure and Certification

Analyst remuneration is not linked to the research or rating outcome. Where financial products are mentioned, the Analyst(s) may hold the financial product(s) referred to in this document, but Lonsec considers such holdings not to be sufficiently material to compromise the rating or advice. Analyst holdings may change during the life of this document. The Analyst(s) certify that the views expressed in this document accurately reflect their personal, professional opinion about the matters and financial product(s) to which this document refers.

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