8th May 2017

Retail Harbour Income Fund: Amendments to Investment Guidelines effective 19th June 2017

In light of our experience in managing the retail Harbour Income Fund ('the Fund'), we are making amendments to the Investment Guidelines of the Fund with the objective of improving investor outcomes. The amended investment guidelines will be effective from 19th June 2017.

The key purpose of the Fund will remain the same. The objective of the Fund is still to generate a favourable level of income. Returns will continue to be predominately driven by core holdings of New Zealand fixed interest securities and dividend-paying Australasian equities.

The main changes to the Investment Guidelines are as follows:

1. To introduce additional income-generating asset classes, allowing some allocation into well-researched non-investment grade corporate bonds and loan products.

2. To enable more active management, by widening the allowable asset allocation ranges.

3. To allow the Fund to hold a broader range of types of securities and instruments, to implement these strategies.

We believe that these changes will provide a better overall experience for clients. In particular, the addition of other income-generating asset classes will help lift the running yield and expected return of the Fund, while providing diversification benefits. In addition, widening the allowable asset allocation ranges creates greater scope to reduce exposures to asset classes where we identify significant downside risks.

As a result of these amendments, we are changing the return objective of the Fund from the Official Cash Rate (OCR) plus 2% to the OCR plus 3.5%. Our modelling suggests that, with these changes, the return volatility of the Fund will remain below that of a typical Balanced Fund.

We are also pleased to confirm that the management fee for this Fund will, effective 19th June 2017, reduce from 77 basis points to 63 basis points. We believe this will deliver better value for investors.

We have fully engaged with the Fund's Supervisor, Trustees Executors Limited, throughout the entire process. They are supportive of these Fund investment guideline amendments. The attachments with this letter provide more detail to the background and rationale for these changes, as well as the new Statement of Investment Policy and Objectives (SIPO) which will be effective from 19th June 2017.

Action required

If you are comfortable with the investment guideline amendments, no action is required by you. Harbour will continue to manage the Fund on your behalf, with the new investment guidelines coming into effect on 19th June 2017.

If you are unsure of the impact of the investment guidelines on your investment, we recommend that you consult your financial adviser.

Conclusion

In light of our experience in managing the Harbour Income Fund, we plan to refine the way the Fund is managed. While underlying income generating objective of the Fund will remain the same, it does require amendments to the Investment Guidelines as set out in the SIPO, which is currently available on Harbour's website at www.harbourasset.co.nz and on the scheme register for the Harbour Investment Funds available at www.business.govt.nz/disclose (**Disclose**).

This letter is to inform you of these changes to the Investment Guidelines, and confirm that these changes will be effective from 19th June 2017. The updated version of the SIPO reflecting these changes will be available on the Harbour website and on Disclose from this date.

Christian Hawkesby

Executive Director,
Head of Fixed Income & Economics
Harbour Asset Management

Jody Kaye

Executive Director,
Chief Operating Officer & Head of Client Servicing
Harbour Asset Management

Attachment

Background

The retail Harbour Income Fund was first launched in October 2015.

Since inception, the neutral allocation of the Fund has been 67% in New Zealand corporate bonds and 30% in Australasian equity income. This has been implemented through holdings in Harbour's underlying funds for these asset classes: the Harbour NZ Corporate Bond Fund, and Harbour Australasian Equity Income Fund. The Fund has been run with relatively narrow +/- 15% asset allocation ranges, with the Harbour NZ Short Duration Fund used as a way to allocate defensively into cash.

In light of our experience in managing the Fund, we will be amending the Fund's Investment Guidelines. These changes fall into three categories, each discussed below.

1. **Additional income generating asset classes**

We will enable the Fund to hold additional income-generating asset classes, such as non-investment grade corporate bonds and loan products, and include these in the Fund's neutral asset allocation. In addition, we plan to augment holdings of Australasian dividend-paying equities with a small core allocation to Harbour's buy-rated Australasian growth focused equities.

The net effect of these amendments is to help lift the running yield and expected return of the Fund, while providing benefits from diversification.

As a result of these changes, we expect the margin on the average running yield over 6 month term deposits rates to rise from 0.75% to 1.10%.

The table below compares the neutral asset allocation of the Fund.

Table 1. Neutral asset allocations

Asset Class	Neutral allocation (old)	Neutral allocation (new)
Cash	3%	8%
Investment grade fixed interest	67%	40%
Non-investment grade fixed interest	0%	5%
Loan products	0%	15%
Australasian equity – dividend paying	30%	27%
Australasian equity – growth focus	0%	5%
Global equity income	0%	0%

2. Widening allowable asset allocation ranges

We will also widen the allowable asset allocation ranges within the Fund.

A key motivation for this change is to create greater scope to reduce exposures to asset classes where we identify significant downside risks. For example, in the extreme, it would allow the Fund to reduce the allocation to equities to 0% if this was deemed an unattractive asset class. Furthermore, depending on relative valuation signals, there is greater ability to move the allocation to equities between Australasian dividend-paying equities, Australasian growth focused equities, and global equities with an income focus.

Consistent with this more active approach to managing downside risks, the new Investment Guidelines also incorporate wider ranges for other key exposures. While the neutral duration for fixed interest securities in the portfolio will be 4 years, the allowable range is from - 2 years to + 8 years. Similarly, the foreign currency position of the Fund is able to range from 90% to 110% hedged to NZ dollars.

Table 2. Asset allocation ranges

Asset Class	Allocation ranges (old)	Allocation ranges (new)
Cash	0-20%	5-40%
Investment grade fixed interest	55-85%	20-90%
Non-investment grade fixed interest	0%	0-20%
Loan products	0%	0-30%
Australasian equity income	15-45%	0-40%
Australasian equity focus	0%	0-15%
Global equity income	0%	0-20%
Total loans and non-investment grade fixed interest		*Max 30%*
Total equity		*Max 40%*

To manage the exposure of the Fund to illiquidity risk, there will be a maximum exposure of 30% of the Fund in the combination of loans and non-investment grade fixed interest. In addition, at least 5% of the must be held in Highly Liquid securities, defined as New Zealand Government securities with less than 5 years maturity, cash, and other cash equivalents. The core holding in New Zealand investment grade corporate bonds also helps ensure the Fund has strong liquidity across a range of market environments.

3. **A broader range of types of securities and instruments.**

Since inception, investments by the Harbour Income Fund have been implemented primarily through allocations to Harbour's underlying funds for respective asset classes.

Under the new Investment Guidelines, Harbour will have greater scope to implement the active investment strategy through holding direct securities and derivative instruments. We believe that this is a more efficient and effective approach.

In practice, around 50% of the underlying assets held by the Fund will continue to represent exposures to New Zealand fixed interest.

The table below lists some key hedging instruments.

Table 3. Instruments and tools

Instruments and tools
Foreign exchange forwards
Interest rates swaps and futures
Credit and equity derivatives
Inflation index-linked bonds

In addition, the new Investment Guidelines will permit Harbour the ability to appoint external managers to oversee a portion of the Fund. For example, this could include an allocation to a global absolute return strategy, if this enhanced the overall risk-return characteristics of the Income Fund. This is not part of a neutral benchmark allocation.

Investment resources

We are also taking this opportunity to re-organise the investment team managing the Income Fund.

With the introduction of the new Investment Guidelines, Mark Brown will formally become the Portfolio Manager of the Income Fund. Mark is currently the Head of Fixed Income Portfolio Management, and has around 30 years' experience managing active portfolios in fixed interest, foreign exchange and income.

Since inception, Simon Pannett has been the Portfolio Manager of the Income Fund, as part of his role co-ordinating Harbour's multi-asset strategies. Simon will remain an integral part of the investment team for the team, but his focus will shift primarily to asset allocation and the credit analysis required for investing in corporate bonds and loan product.

In addition to drawing on Simon's credit analysis, Mark will also draw on input from Craig Stent, the Portfolio Manager of the Harbour Australasian Equity Income Fund, and Shane Solly, the Portfolio Manager of the Harbour Australasian Equity Focus Fund. In practice, the direct holdings of Australasian equity in the Harbour Income Fund will mirror these underlying Harbour equity funds.