

NIKKO AM OPTION STRATEGY

Applies to: Nikko AM Wholesale Option Fund and Nikko AM Option Fund (retail) and Nikko AM KiwiSaver Option Fund

Market Overview

- US 10-year US Treasury bond interest rates moved in a modest 12 basis point range, trading between 2.62% and 2.74% over February.
- The Federal Reserve will be patient when deciding on any future interest rate moves but further rate rises are still likely.
- There are signs US economic activity is moderating, trade tensions and US politics continue to create uncertainty but the risk of extreme outcomes have lessened.

Fund Highlights

- The fund returned 1.17% in February. After a turbulent close to 2018 the interest rate market has settled over the start of 2019 which led to a more normal pattern of returns occurring.
- The investment strategy of investing in NZ bank bonds and selling short term option contracts on 10-year US Treasury bonds remains unchanged.
- If US interest rates stabilise around current levels, premium income received from selling option contracts will benefit the fund.

Performance

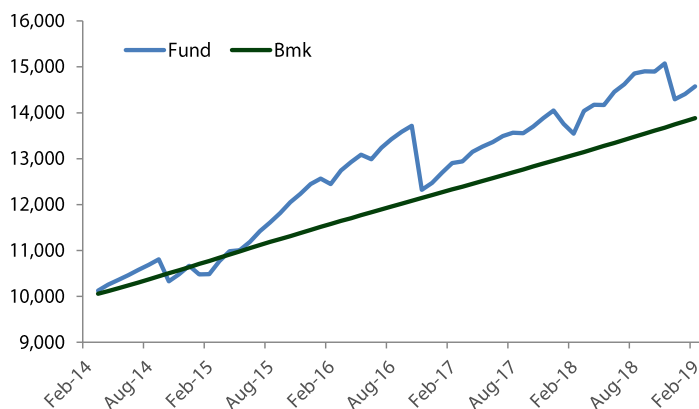
	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale ¹	1.17%	-3.31%	7.62%	5.41%	7.83%	10.31%
Benchmark ²	0.48%	1.49%	6.11%	6.24%	6.78%	6.90%
Retail ³	0.61%	-3.66%				
KiwiSaver ³	0.69%	-3.37%				

1>Returns are before tax and before the deduction of fees

2. Benchmark: Bloomberg NZBond Bank Bill Index plus 4.0% per annum. No tax or fees.

3. Returns are before tax and after the deduction of fees and expenses and including tax credits (if any)

Five Year Cumulative Performance^{1,2}



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, Fixed Income Manager and Matthew Johnson, Fixed Income Manager.

Overview

The strategy invests in cash and fixed interest investments, and undertakes a leveraged trading strategy based on selling options on global government bonds.

This fund is a specialist investment strategy and is suitable only for experienced investors who have an investment time frame of three years or longer and are comfortable to accept short sharp periods of high volatility

The fund uses a leveraged trading strategy and the impact of interest rate volatility is magnified by the use of leverage. For every \$1 in the fund, up to \$6 of call options and \$6 of put options can be sold. The options are sold in pairs, each comprising a call and a put option with the same expiry date. Accordingly, the effective leverage of the fund is 6 times the value of the fund.

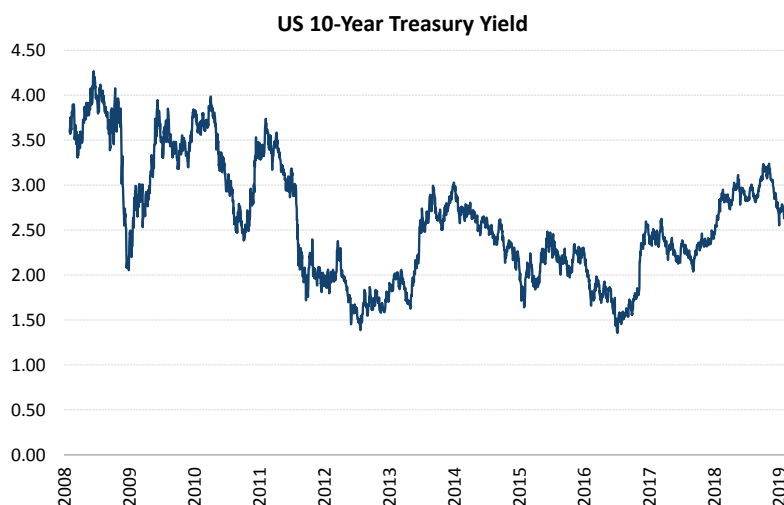
In times of increased interest rate volatility it is likely the fund will receive a higher stream of income as new options sold will have higher income.

Objective

The fund aims to earn a return of the benchmark before fees, expenses and taxes over a rolling three year period.

Market Commentary

In a move that surprised markets by the extent of the change in stance, the Federal Reserve delivered a likely move towards a neutral monetary policy stance and away from their previous path of scheduled rate rises over 2019 and beyond. The Fed said it will be patient on any future interest rate moves and signalled flexibility on the path to reducing the size of its balance sheet. These statements were a significant move away from its bias toward higher borrowing costs. The Federal Open Market Committee “will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support” a strong labour market and inflation near 2%. In a separate statement the Fed said it is prepared to adjust any of the details for completing the balance sheet normalisation in light of economic and financial developments. The central bank also said it would be ready to alter the balance sheet size and composition if the economy warrants a looser monetary policy than the federal funds rate could achieve on its own. With less pressure on interest rates from the Fed likely over 2019 the extent of any increase in longer term rates is also diminished. From the Fed’s statements it looks like it is now safer for investors to go back into risk assets as liquidity and interest rate risk is now diminished and being underwritten by the US Federal Reserve. We have seen a strong rebound in the price of US equity markets and other risk assets since the Fed’s announcements earlier in the year. If prices stabilise at these higher levels and global trade risks diminish further it is likely in our view the Fed revisits its decision to halt rate rises and delivers one, possibly two 0.25% rate rises in the second half of 2019.



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Fund Commentary

The US 10-year bond yield traded in a modest 12 basis point range over the month, moving between a high of 2.74% and a low of 2.62% before closing the month at 2.72%. US interest rates have fallen quickly from their recent high point of 3.25% in November. With the Fed’s recent change in the policy stance to having a more neutral stance on future rate rises it is difficult to see US 10-year yields rising significantly over the near term. With intra month interest rate movements being small we have seen the income received from selling options on the US Treasury Bond falling. The lower level of income has been compensated by a low level of options being ‘struck’ resulting in an acceptable level of returns over the past month. If current levels of volatility are maintained, income generated by the fund should remain at satisfactory levels however the speed and magnitude of yield changes in the US 10-year Treasury bond will continue to determine the total return of the fund in the months ahead.

Key Fund Facts

Distributions

Wholesale fund: generally does not distribute
Retail fund: generally does not distribute
KiwiSaver fund: does not distribute

Estimated annual fund charges

Wholesale: negotiated outside of unit price
Retail: 1.20%, refer PDS for more details
KiwiSaver: 1.15%, refer PDS for more details. Fee waived until 31/3/2019

Hedging

Any foreign currency exposures are hedged to NZD within an operational range of 98.5% to 101.5%

Buy / Sell spread

0.00% / 0.00%

Strategy size

\$75.6m

Strategy Launch

October 2007

Compliance

The Fund complied with its investment mandate and trust deed during the month.

Contact Us

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