

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 Treasury bond interest rates moved lower over the month, starting at 2.53% reaching 2.57% before closing the month at 2.13%
- The Federal Reserve will continue to be patient when deciding on future interest rate moves however the escalation of trade tensions and the potential to slow economic growth makes a rate cut more likely.
- The US economy remains healthy but risks to the outlook are growing. The Federal Reserve is under political pressure to cut interest rates and resume bond purchases as a means to stimulate the economy further.

Fund Highlights

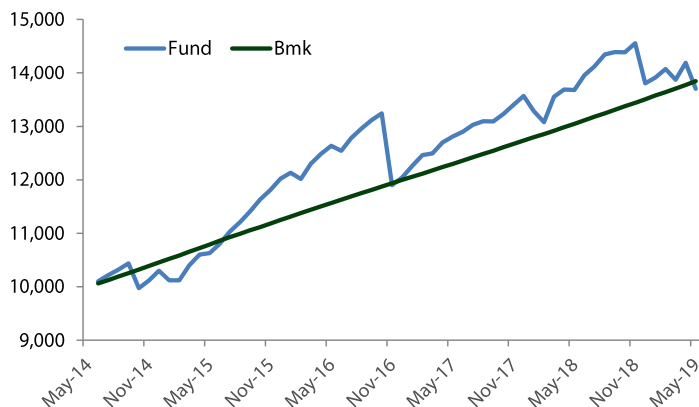
- The fund lost value over May. Interest rates fell quickly towards the end of the month as a result of President Trump expanding the scope of his controversial trade strategy. The fall in rates means that a number of the fund's sold call options were struck resulting in a loss.
- The investment strategy of investing in NZ bank bonds and selling short term option contracts on 10 year US Treasury bonds remains unchanged.
- As a result of increased volatility in financial markets we have seen a sharp rise in the income the fund receives from selling short dated options on US Treasury bonds.

Performance

	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale ¹	-3.43%	-2.63%	0.17%	2.74%	6.51%	9.66%
Benchmark ²	0.50%	1.49%	6.10%	6.18%	6.72%	6.86%
Retail ³	-1.30%	-0.68%	0.93%			
KiwiSaver ³	-1.20%	-0.36%	2.43%			

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, \$10,000 invested^{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 a 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

Financial market turbulence surged over recent weeks as President Trump ramped up his 'trade war' strategy. This turbulence resulted in a fall in equity markets and a flight to quality assets such as US Treasury bonds as investors reassessed the prospects for global growth in a world that possibly retreats into smaller trading blocs and more protectionism.

The flight to quality resulted in strong buying and a significant fall in yield on the 10-year US Treasury bond.

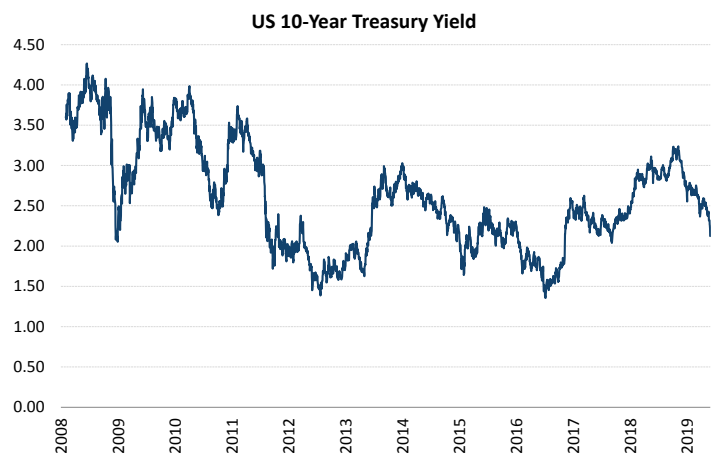
Federal Reserve Chairman Jerome Powell signalled an openness to cut interest rates if necessary, pledging to keep a close watch on fallout from a deepening set of disputes between the US and its largest trading partners.

Referring to trade negotiations and other matters Powell said "we do not know how or when these issues will be resolved".

The Fed will be closely monitoring the implications of these developments for the US economic outlook and will act as appropriate to sustain the expansion, with a strong labour market and inflation near the 2% objective.

It seems Governor Powell is walking a tightrope of wanting to stay optimistic on the US growth prospects but remain willing to cut interest rates if needed. Investors have increased their bets that the Fed will indeed cut rates this year with cuts viewed as even more likely after President Trump intensified trade tensions when he threatened to impose new tariffs on Mexico unless it stemmed migrant flows to the US.

As mentioned in previous commentaries, with short term interest rates more likely to fall than rise the extent of any increase in longer term rates is also diminished. 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.



Fund Commentary

The fund lost value over May down -3.43% (gross). Interest rates fell quickly towards the end of the month as a result of President Trump expanding the scope of his controversial trade strategy. The fall in rates means that a number of the fund's sold call options were struck resulting in a loss. The US 10-year bond yield traded in a 44 basis point range over the month, moving between a high of 2.57% before closing the month on its 2.13% lows. The trading range is larger than we have seen over recent months and follows on from steady falls in the yield on US Treasury bonds. The lift in rates from March's levels saw the yield on 10-year bonds move away from some of the fund's option contract levels and helped restore value to the portfolio.

Income levels generated from selling options has increased significantly as a result of greater volatility and uncertainty pervading financial markets. If volatility remains elevated for an extended period the income generating potential of the fund looks attractive.

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 (incl GST)

Wholesale: negotiated outside of unit price
Retail: 1.22%, refer PDS for more details
KiwiSaver: 1.17%, refer PDS for more details. Fee waived until 30/9/2019

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

\$78.7m

Strategy Launch

October 2007

Compliance

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

Contact Us

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