

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 fell sharply over the month following on from the downward trend so far in 2019.
- The Federal Reserve Chairman Powell restated that downside risks to the US economy have increased, reinforcing the case for lower rates but not as quickly as President Trump demands.
- The Fed's overarching goal to sustain the US economic expansion remains intact.

Fund Highlights

- Fund returns fell over the past month with the past year being a difficult one for the fund. US 10-year Treasury bond rates fell close to their Global Financial Crisis low points as investors fretted about lower economic growth. While additional rate cuts to short term rates are still data dependent it seems likely the Fed will deliver further rate cuts to help support the economy.
- 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 the rise in the income the fund receives from sell short dated options on US Treasury Bonds being maintained however the past month has seen the frequency and costs of option contracts being struck increase sharply.

Performance

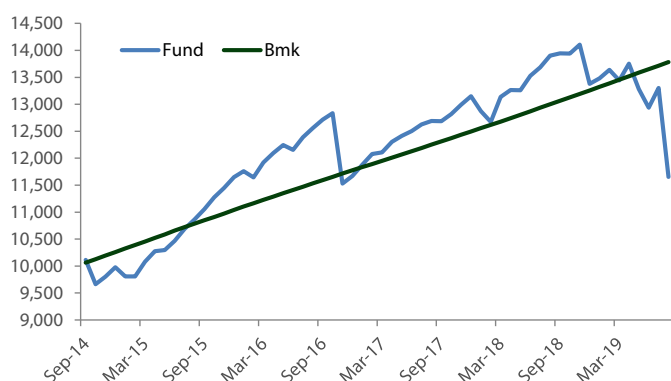
	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale ¹	-12.40%	-12.26%	-16.19%	-2.47%	3.11%	6.83%
Benchmark ²	0.48%	1.44%	6.03%	6.12%	6.63%	6.83%
Retail ³	-12.21%	-14.13%	-16.89%			
KiwiSaver ³	-12.18%	-13.98%	-15.96%			

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

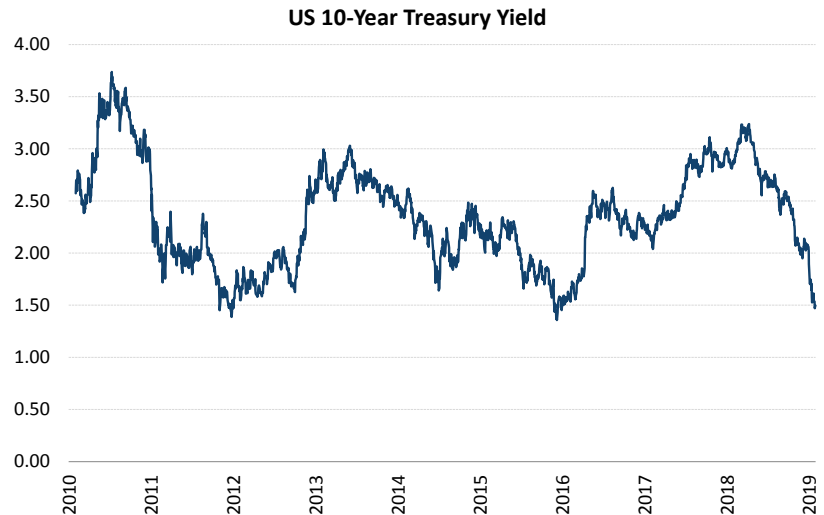
The fund aims to earn a return of the benchmark before fees, expenses and taxes over a rolling three year period.

Market Commentary

The August fall in interest rates on sovereign bonds around the globe was arguably the broadest this decade. Rates on 10-year bonds fell across all 24 developed markets over August, something last seen in July 2015. In addition, this is the first time all markets fell by 10 basis points (bps) or more. US rates fell by 51bps. Relentless quantitative easing and a new round of global rate cuts have turned the global bond market into a one-way bet. Diversity and differentiation has almost gone with Greek rates threatening to fall below those in the US and Italian rates well below those on offer in the US.

Part of the reason for the rally in rates is the large hoard of government bonds that are held by the G-3's combined \$14 trillion balance sheets and the large holdings of sovereign bonds banks are required to hold as part of their high quality liquid asset portfolios.

The current fall in rates seems justified given the increased uncertainty over trade that is dragging down global growth potential and heightening the risk that businesses will cut or defer investment. This is forming a feed-back loop that reinforces the likelihood of further Central Bank rate cuts. There are plenty of reasons for gloom - an explosion of tariffs, Brexit uncertainty, Hong Kong, Italian politics and tensions in Kashmir however investment sentiment could turn for the better if there were signs of a tangible progress in trade talks. Perhaps most of the bad news is being priced into bonds already.



Fund Commentary

Fund returns fell over the past month with the past year having being a difficult one for the fund. 10-year US Treasury bond rates fell close to the lows experienced during the global financial crisis as investors fretted about lower economic growth. While additional rate cuts to short term rates are still data dependent it seems likely the US Federal Reserve will deliver further rate cuts to help support the economy. The US 10-year bond yield traded in a 61bps range over the month, moving between a high of 2.05% and a low of 1.44% before closing the month at 1.50%. The fall in rates is larger than we have seen over recent months, however it follows on from steady falls in the yield on US Treasury bonds. US 10-year Treasury bonds have fallen from a high point of 3.25% in November last year to a low of 1.44% in August 2019.

Income levels generated from selling options has increased as a result of greater volatility in Treasury bond interest rates and uncertainty pervading financial markets. If volatility remains elevated for an extended period the income generating potential of the fund looks attractive. 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. The frequency and cost of options being struck will also determine the total return of the fund.

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

\$72.34m

Strategy Launch

October 2007

Compliance

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

Contact Us

www.nikkoam.co.nz | nzenquiries@nikkoam.com

This document is issued by Nikko Asset Management New Zealand Limited (Company No. 606057, FSP No. FSP22562), the investment manager of the Nikko AM NZ Investment Scheme, the Nikko AM NZ Wholesale Investment Scheme and the Nikko AM KiwiSaver Scheme. This information is for the use of researchers, financial advisers and wholesale clients. This material has been prepared without taking into account a potential investor's objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this document, who are not wholesale investors (in accordance with Schedule 1, Clause 3 Financial Markets Conduct Act 2013), or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement. Past performance is not a guarantee of future performance. While we believe the information contained in this presentation is correct at the date of presentation, no warranty of accuracy or reliability is given and no responsibility is accepted for errors or omissions including where provided by a third party. For full details on the fund, please refer to our Product Disclosure Statement on nikkoam.co.nz.