

NIKKO AM OPTION STRATEGY

Assets are held in the Nikko AM Wholesale Option Fund. The Nikko AM Option Fund (retail) and Nikko AM KiwiSaver Option Fund invest in units in the wholesale fund, which the commentary refers to.

Market Overview

- Over the month volatility of US 10-year bond rates declined from recent highs and financial markets remained relatively stable.
- With the US Federal Reserve indicating they are on hold and will be taking their direction from future economic and market developments it seems likely the US 10-year bond could remain more constrained.
- The prospects of improving global growth look more promising than in the recent past however new flash points in the geopolitical environment are never too far away.

Fund Highlights

- The Fund had a steady month returning 1.11% as the US 10-year bond remained in a moderate range and no options were exercised during the month.
- Volatility has declined from its recent highs, but the income the fund receives from selling short dated options still remains supportive of generating good returns.

Performance

	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale ¹	1.11%	4.77%	-5.57%	2.67%	4.83%	6.74%
Benchmark ²	0.43%	1.29%	5.75%	5.99%	6.45%	6.77%
Retail ³	0.79%	4.34%	-6.91%			
KiwiSaver ³	0.81%	4.38%	-6.08%			

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).

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

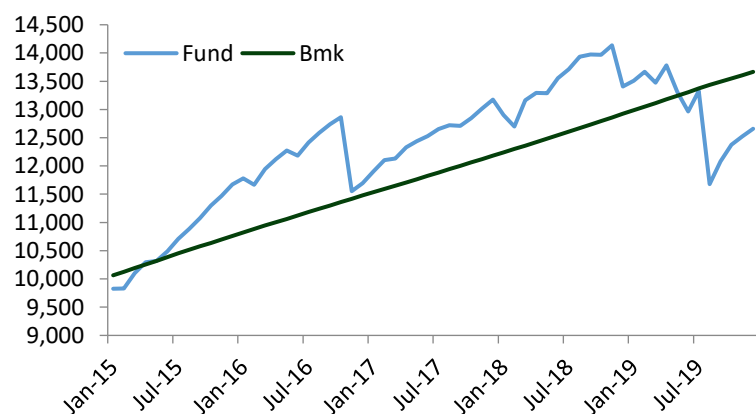
The fund uses a leveraged trading strategy and the impact of interest rate volatility is magnified by the use of leverage. For every \$1 in the fund, up to \$6 of call options and \$6 of put options can be sold. The options are sold in pairs, each comprising a call and a put option with the same expiry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

Five Year Cumulative Performance, \$10,000 invested^{1&2}



Market Commentary

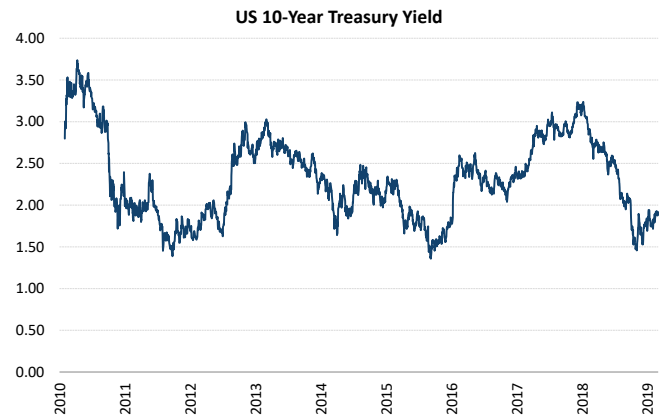
Over the month volatility of US 10-year bond rates declined from recent highs and financial markets remained relatively stable. The US 10-year bond traded in a constrained 26 basis point band, ranging between a high point of 1.95% and a low of 1.69% before closing the month at 1.92%.

With the US Federal Reserve indicating they are on hold and will be taking their direction from future economic and market developments it seems likely the US 10-year bond could remain more constrained inside its recent trading range of 1.50% to 2% well into the first quarter of 2020.

Federal Reserve Chairman Jerome Powell has left no doubt that US cash rates are on hold for a prolonged period. He said on December 11 that the current level will likely remain appropriate unless the Fed’s favourable outlook for the economy sees a material reassessment. He spoke after policy makers kept rates steady in a 1.5% to 1.75% target range following three consecutive cuts. The Fed also published forecasts showing 13 of 17 officials projecting no changes in rates over 2020. If correct that would keep them on hold during the presidential election year.

Global risks remain elevated, yet the past few months has seen a partial thawing of trade tensions between China and the US. The prospects of improving global growth look more promising than in the recent past however new flash points in the geopolitical environment are never too far away. The ebbs and flow of market and investor sentiment should ensure competition remains robust between the buyers of the options we sell, and the income received should remain at a reasonable level supporting returns.

The stable outlook for short term interest rates is likely to limit any sustained movement in longer term interest rates. The speed and magnitude of yield changes in the US 10-year Treasury bond will continue to determine returns in the months ahead.



Fund Commentary

The fund has produced quite strong returns over the past 3 months and option income levels have been good, however the past year has been a difficult one for the fund following a poor month in August when large movements in the US 10-year bond occurred. The range in US rates has been significant with US 10-year Treasury bonds falling from a high point of 3.25% in November 2018 to a low of 1.43% in September 2019 before increasing to current levels, around 1.9%, as market sentiment improved.

Income levels generated from selling options has increased over the past year and remains above its medium term average 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, however, 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.

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

\$79.8m

Strategy Launch

October 2007

Compliance

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

Contact Us

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