

# 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

- The interest rate on the US 10-year Treasury bond fell significantly for a third month in a row.
- US 10-year bonds traded in a volatile manner. Within the month yields hit a high point of 1.27% and traded as low as 0.31%.
- Markets were focused on the economic and financial market impact of COVID-19. The impacts have been greater than anticipated as has the Governmental and Central Bank response.

## Fund Highlights

- The fund posted a significant negative return over the month as bond yields dropped to record lows and the global economic impact of widespread social distancing became more apparent.
- The impact COVID-19 will have on economic activity is unknown, all we know at this stage is the impact will be large and unfavourable. Even though governments and central banks are providing unprecedented levels of stimulus and support it is unlikely economic activity will return to pre-virus levels quickly.
- Volatility has increased significantly and we are seeing a corresponding increase in the level of income the fund receives from selling short dated options.

## Performance

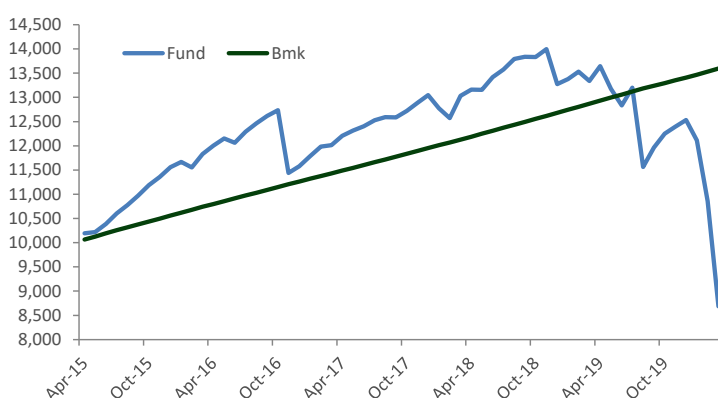
	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale <sup>1</sup>	-20.01%	-30.71%	-34.89%	-10.25%	-2.78%	2.04%
Benchmark <sup>2</sup>	0.47%	1.37%	5.63%	5.95%	6.33%	6.74%
Retail <sup>3</sup>	-32.08%	-37.45%	-41.37%			
KiwiSaver <sup>3</sup>	-29.52%	-35.09%	-38.81%			

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<sup>1&2</sup>



## 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

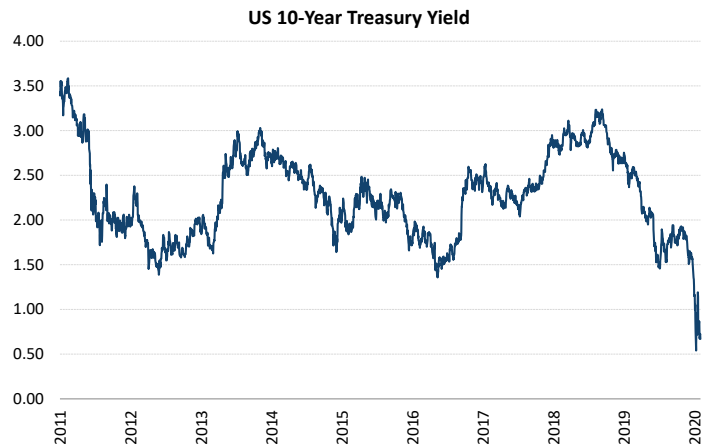
The strategy invests in cash and fixed interest investments, and undertakes a leveraged trading strategy based on selling options on global government bonds. This fund is a specialist investment strategy and is suitable only for experienced investors who have an investment time frame of three years or 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

Initially we saw a ‘flight to safety’ and large scale bond buying as the impact upon economic activity from wide spread quarantining became more apparent. After trading as high as 1.94% in January this year, yields plummeted to an intraday low of 0.31% on the 9th of March. Even in the depths of the Global Financial Crisis (GFC) bond yields didn’t fall to this extent with the previous low point being close to 1.3%, however the excitement wasn’t over with just yet. Within a matter of days yields had climbed back to 1.27% as the prospect of large scale bond issuance from most governments around the globe weighed heavily on investor’s minds. Large government stimulus packages will need to be funded and the first port of call is to issue more bonds. The question of who would buy all these new bonds was answered when central banks embarked on a range of new Quantitative Easing programmes which include large scale bond purchase schemes.



From an economic and financial market perspective the enduring impact of the coronavirus will be much higher levels of government debt around the globe and the need to finance this debt for many years ahead. Governments and central banks are now incentivised to keep rates low to help the economic recovery and to keep financing costs manageable. The short term impact on economic activity is almost impossible to quantify. What is known is that growth rates are going to plummet in the second quarter of 2020 before hopefully rebounding by year end but not enough to stop most countries recording negative GDP growth this calendar year. Investors may look through these poor numbers and have their eyes fixed on the strength of the recovery however volatility and uncertainty will be continue for many months ahead.

## Fund Commentary

The fund posted a large negative return over the month as US 10-year US Treasury bond yields dropped significantly as the implications of the coronavirus became more apparent. The large fall in 10-year US Treasury bond yield pushed the fund returns steeply negative over the month as bond yields traded through call option strikes and volatility increased markedly. The speed and magnitude of yield changes in the US 10-year Treasury bond combined with the income received from selling options determines the total return of the fund.

Income levels generated from selling options has increased over the past few months however the income have been swamped by the cost of options being struck. Income levels remain well above its medium term average as a result of greater volatility in Treasury bond interest rates and uncertainty pervading financial markets. This elevated income will over time help restore the value of the fund. 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. Unfortunately, in recent times, the cost of options being struck has far exceeded income received.

### 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

\$57.1m

#### Strategy Launch

October 2007

## Compliance

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

## Contact Us

[www.nikkoam.co.nz](http://www.nikkoam.co.nz) | [nzenquiries@nikkoam.com](mailto:nzenquiries@nikkoam.com)

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