

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

- US 10-year bonds traded in a less volatile manner as the initial reaction to the economic shock caused by COVID-19 continued to subside. Within the month yields hit a high of 0.74% and a low of 0.58%. The historical low point in 10-year Treasury bonds was recorded in March this year when bonds traded at a yield of 0.31%.
- Markets continue to be 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 positive return over May after some months of disappointing returns. Bond yields dropped to record lows in March however financial markets have subsequently been calmed by significant central bank and governmental intervention.
- Volatility has also reduced as central bank and government spending programmes continue to support economies and financial markets. Income the fund receives from selling short dated options has decreased over the month but still remains elevated compared to pre-COVID levels.

Performance

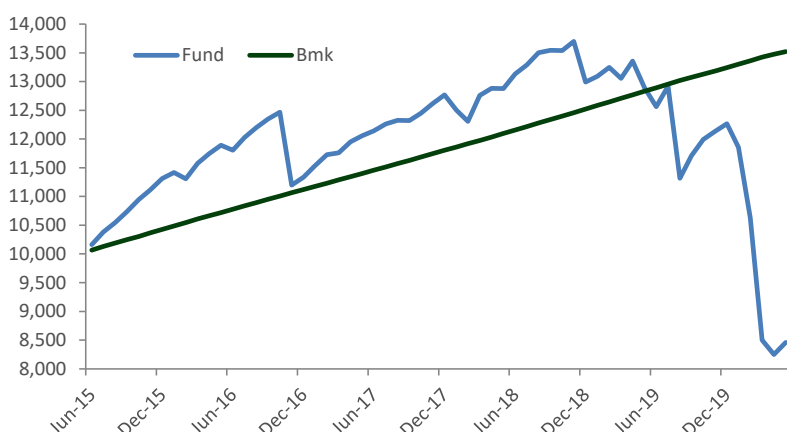
	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale ¹	2.57%	-20.39%	-34.40%	-11.13%	-3.29%	2.70%
Benchmark ²	0.36%	1.22%	5.37%	5.86%	6.22%	6.70%
Retail ³	1.45%	-29.78%	-40.39%			
KiwiSaver ³	2.59%	-25.41%	-36.45%			

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.

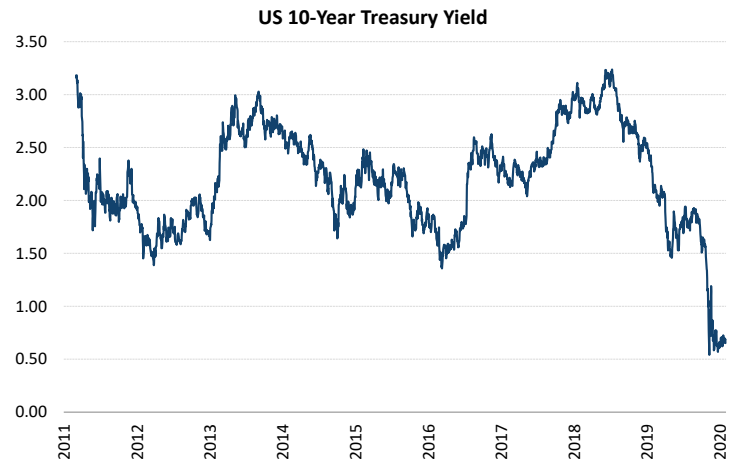
Market Commentary

Interest rates on US 10-year Treasury bonds traded in a modest range over the month as the initial reaction to the economic shock caused by COVID-19 continued to subside. US bonds traded in a less volatile manner than seen over recent months with yields hitting a high of 0.74% and a low of 0.58% during May. The historical low point in 10-year Treasury bonds was recorded in March this year when bonds traded at a yield of 0.31%.

Federal Reserve Chairman, Jerome Powell stated that the US economy faces unprecedented risks from the coronavirus if fiscal and monetary policy makers don't rise to the challenge. Powell and his colleagues at the Fed have taken dramatic measures to shelter the US economy during the virus pandemic. They have cut their benchmark cash rate to close to

zero, engaged in open ended bond buying and begun rolling out emergency lending programmes as US unemployment soars to levels not seen since the 1930s Great Depression. The US unemployment rate is likely to be significantly higher than 20%, more than double the GFC peak of 10% in 2009. With the labour market hurting this badly it is difficult to see a time when the Fed will start to reverse their low interest rate stance.

Amid such a gloomy outlook, some investors are of the view that the Fed may follow other central banks and take rates into negative territory in an attempt to spur spending and investment. Powell acknowledged the speculation but said such a move was not being considered, although he stopped short of completely ruling out negative rates as a policy option in the future. With large scale fiscal and monetary policy stimulus required to support US economic activity and jobs for the foreseeable future interest rates are likely to remain low across all maturities and volatility in interest rate markets will moderate after the dislocation we have seen so far in 2020.



Fund Commentary

The fund posted a positive return over May after some months of disappointing returns. Bond yields dropped to record lows in March however financial markets have subsequently been calmed by significant central bank and governmental support.

The precise impact COVID-19 will have on economic activity is unknown however what we do know is the impact will be large and unfavourable. Earlier than anticipated opening up of economies from stringent lock downs is causing optimism to rise. Time will tell if this is the correct response.

Volatility has reduced as central bank and government spending programmes continue to support economies and financial markets. As a consequence of lower volatility, the income the fund receives from selling short dated options has decreased over the month but still remains elevated compared to pre-COVID levels.

If volatility remains at current levels the income generating potential of the fund looks attractive however the frequency and cost of options being struck will also determine the total return.

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: 1.15%, 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

\$59.1m

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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