

Factsheet 31 July 2020

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

- Interest rates on US 10-year Treasury bonds continued to trade in a modest range over the month. Any increases in yields are currently seen as a buying opportunity as COVID-19 infection rates continue to climb.
- The Federal Reserve left interest rates near zero and vowed to use all its tools to support the recovery from an economic downturn that Chairman Jerome Powell called the most severe in our lifetime.
- Markets continue to be focused on the economic and financial market impact of COVID-19. The impact has been greater than anticipated with the full impact difficult to quantify.

Fund Highlights

- The fund posted a positive return over July after the fund recorded a period of disappointing returns earlier in the year. Bond yields dropped to record lows in March however financial markets have subsequently been calmed by significant central bank and governmental support.
- Volatility has 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 remains attractive compared to many investment alternatives.

Performance

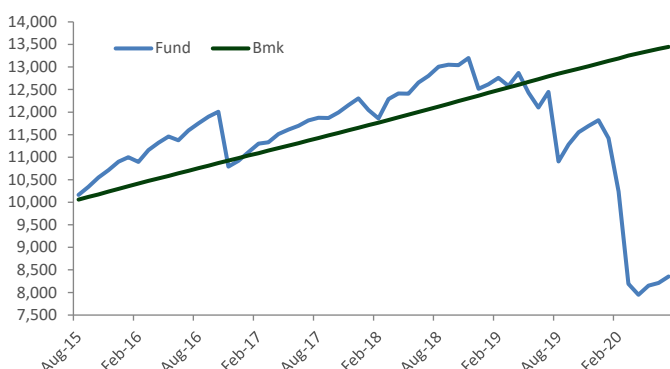
	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale ¹	1.76%	5.12%	-32.88%	-10.91%	-3.53%	2.29%
Benchmark ²	0.36%	1.07%	5.12%	5.76%	6.10%	6.66%
Retail ³	1.82%	4.93%	-36.97%			
KiwiSaver ³	1.85%	5.25%	-33.44%			

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. Increases in yields have been viewed as a buying opportunity as infection rates continue to climb.

US 10-year bonds traded in a narrow range over the month with yields steadily falling. July saw yields hit a high of 0.71% before closing near the monthly low of 0.52%. The historical low point in 10 year Treasury bonds was recorded in March this year when bonds traded at a yield of 0.31%.

The Federal Reserve left interest rates near zero and vowed to use all its tools to support the recovery from an economic downturn that Chairman Jerome Powell called the most severe in our lifetime. The path forward is very uncertain. Powell is reported as sounding a dour tone about how long the road is ahead to get back to where the US was only months ago and noted that more fallout from the virus still lies ahead. Powell said that not all sectors of the economy were weakening, citing housing as one bright spot but on balance the economy seems to be slowing in the pace of recovery. Investors have pounced on any sell off as a buying opportunity, keeping yields in check and pushing them lower after they fell 125 basis points in the first quarter of 2020.

The grim outlook among bond investors is starkly contrasted with the positive outlook from equity investors. Share prices have risen strongly over the past quarter on expectations for a rebound in business activity however optimism may fade somewhat amid a surge of infections and moves by some states to delay re-openings. The end result is that Treasuries will likely remain the haven for investors seeking protection from the risk of another drop off in economic growth and another dose of central bank monetary accommodation.

The labour market remains the area of most concern. The deep damage done there is likely to see the jobless rate remain highly elevated from the 3.5% seen in February. The Federal Reserve is likely to continue pumping stimulus into the US economy until jobs recover. In an interview Fed Chairman Powell said “we’re not even thinking about raising rates” and followed up by saying “we are strongly committed to using our tools to do whatever we can for as long as it takes”

Monetary policy is a powerful tool but there are limits to what it can achieve on its own. Fiscal policy is also required to help support the recovery. The Fed Chairman agrees saying that the recovery needs support from both monetary and fiscal policy and urging lawmakers and the Trump administration to renew taxpayer support before the current assistance packages run out.

Taking these comments at face value, unless an efficient vaccine is discovered over the next few months, we are not expecting a sustained rise in US interest rates any time soon.

Fund Commentary

The fund posted a positive return over July after the fund recorded a period of disappointing returns earlier in the year. 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, what is known is that the impact will be large and unfavourable. Earlier than anticipated opening up of economies from stringent lock downs caused optimism to rise. Time will tell if this is the correct response as global infection rates continue to rise. Volatility has 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 remains attractive compared to many investment alternatives. If volatility remains at current levels the income generating potential of the fund looks attractive however the frequency and cost of options being struck also determines the total return.

US 10-Year Treasury Yield



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

\$62.8m

Strategy Launch

October 2007

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

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