Factsheet 31 August 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 traded in a modest range over the month with any increases in yields seen as a buying opportunity as a quick global economic bounce back from the COVID-19 induced slow down seems more remote.
- Federal Reserve Chair Jerome Powell unveiled a new approach to setting US monetary policy, letting inflation and employment run higher in a shift that will likely keep interest rates low for years to come. 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 but being most keenly felt in the labour markets.

Fund Highlights

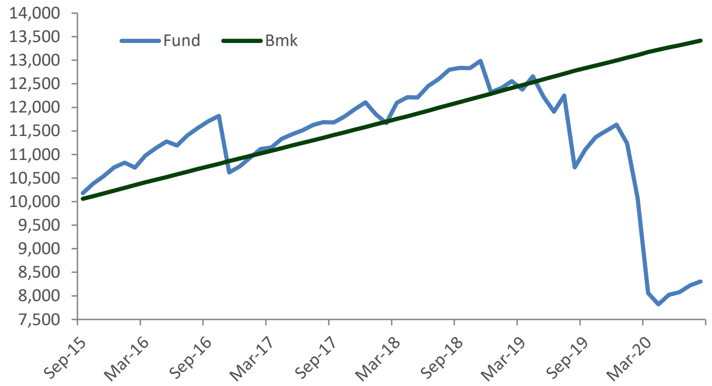
- The fund posted a positive return over August. Bond yields dropped to record lows in March however financial markets have subsequently been calmed by significant central bank and governmental support.
- Volatility has reduced as central bank and government spending programmes support economies and financial markets. Income the fund receives from selling short dated options has decreased from earlier in the year 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]	0.99%	3.50%	-22.61%	-10.77%	-3.65%	2.74%
Benchmark[2]	0.36%	1.07%	5.00%	5.71%	6.05%	6.63%
Retail[3]	0.64%	4.09%	-27.74%			
KiwiSaver[3]	0.66%	3.27%	-23.71%			

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

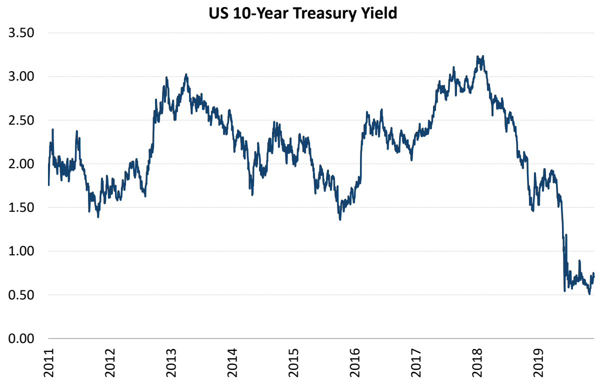
The fund uses a leveraged trading strategy and the impact of interest rate volatility is magnified by the use of leverage. For every $1 in the fund, up to $6 of call options and $6 of put options can be sold. The options are sold in pairs, each comprising a call and a put option with the same expiry 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 with any increases in yields seen as a buying opportunity as a quick global economic bounce back from the COVID-19 induced slow down seems more remote.

August saw yields hit a high of 0.77% and a low of 0.50%. 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 Chair Jerome Powell unveiled a new approach to setting US monetary policy, letting inflation and employment run higher in a shift that will likely keep interest rates low for years to come. Following a more than year-long review, the Fed will seek inflation that averages 2% over time, implying the Fed will allow prices pressures to overshoot after a period of weakness. It also adjusted its view of full employment to permit labour market improvements to reach more workers especially for many in the low and moderate income communities.

The new strategy is being undertaken to tackle years of too low inflation. It hands the Fed flexibility to let the job market run hotter and price pressures move higher before taking action as it may have previously done.

The Fed's change in stance may see other central banks follow suit and over time may provide higher growth and employment levels than seen before. However, achieving an overshoot of inflation will be difficult. Unemployment is above 10% and the economy is still recovering from the shock of the virus shutdowns that inflicted the steepest recession on record. Even though a new strategy has been adopted it doesn't mean the Fed has given up being vigilant on inflation. Powell noted the risk, if excessive inflationary pressures were to build or inflation expectations were to ratchet above levels consistent with reaching the Fed's goals the central bank would not hesitate to act.

As mentioned above the labour market remains the area of most concern. The deep damage done to the labour market 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 earlier this year 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 and labour markets quickly improve, we are not expecting a sustained rise in US interest rates any time soon.

Fund Commentary

The fund posted a positive return over August 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 support economies and financial markets. Income the fund receives from selling short dated options has decreased from earlier in the year 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.

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	Strategy size	Strategy Launch
0.00% / 0.00%	$64.1m	October 2007

Compliance

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

Contact Us

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