

Factsheet 30 September 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 with any increases in yields seen as a buying opportunity as a quick global economic bounce back from the COVID-induced slow down seems more remote.
- US Federal Reserve officials held interest rates near zero and signalled they would stay there for at least three years, vowing to delay tightening until the US gets back to maximum employment and 2% inflation.
- 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. The Fed sees rates staying low through to 2023.

Fund Highlights

- The Fund posted a positive return for the quarter, continuing to recover from 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.

Performance

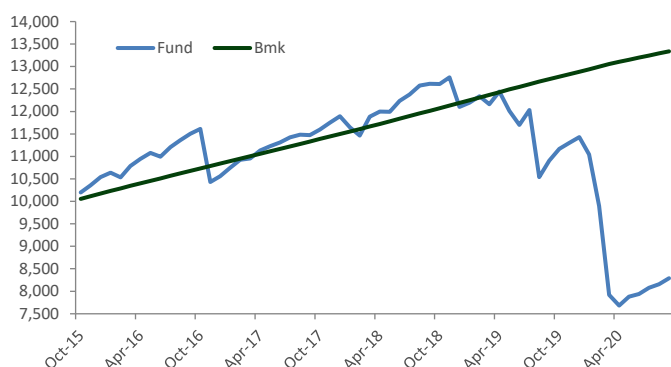
	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale ¹	1.60%	4.41%	-24.02%	-10.28%	-3.69%	2.61%
Benchmark ²	0.35%	1.06%	4.85%	5.58%	5.93%	6.56%
Retail ³	1.65%	4.16%	-28.60%			
KiwiSaver ³	1.70%	4.27%	-24.70%			

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.

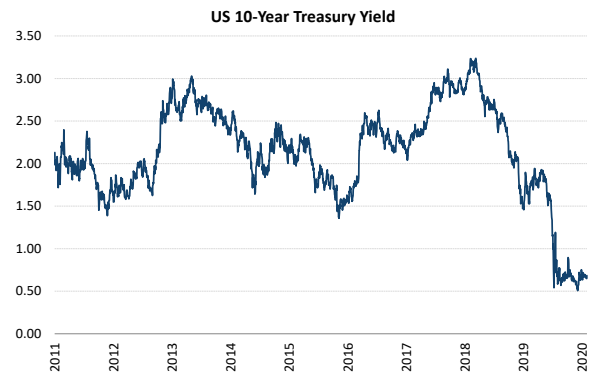
Objective

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 continued to trade in a modest range with any increases in yields seen as a buying opportunity as a quick global economic bounce back from the COVID-induced slow down seems more remote. September saw yields hit a high of 0.72% and a low of 0.60%. The historical low point in 10-year Treasury bonds was recorded in March this year when bonds traded at a yield of 0.31%.

US Federal Reserve (Fed) officials held interest rates near zero and signalled they would stay there for at least three years, vowing to delay tightening until the US gets back to maximum employment and 2% inflation. The Federal Open Market Committee expects to maintain an accommodative stance until these outcomes are achieved. This guidance goes hand-in-hand with a new long-term policy framework to allow inflation to overshoot the Fed’s 2% target after periods of underperformance. The Fed 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 deep damage done to the US labour market is likely to see the jobless rate remain highly elevated from the 3.5% seen in February. The new strategy is 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 Federal Reserve is likely to continue pumping stimulus into the US economy until the job market recovers. 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. Even though a new strategy has been adopted it doesn’t mean the Fed has given up being vigilant on inflation. Fed Governor 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. In the mid-month statement he stated that the recovery has progressed more quickly than generally expected while also cautioning that the pace of activity will likely slow and the path ahead remains highly uncertain. 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”.



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 for the quarter and continues to recover after 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 continues to be unknown - what is known is that the impact will be large and unfavourable. Earlier than anticipated opening up of economies from stringent lock downs and further progress on the development of a vaccine 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 support economies and financial markets. The 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. Unfortunately, over the past year, the cost of options being struck has exceeded income received. If this trend is reversed the fund is well placed to generate an acceptable level of returns.

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

\$65.2m

Strategy Launch

October 2007

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

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