Nikko Asset Management

Factsheet 31 October 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 bond yields moving higher on the prospect of an increased economic stimulus package being announced soon.
- Markets continue to focus on the economic and financial market impact of COVID-19 and the help a large fiscal stimulus package may deliver. The Fed sees rates staying low through to 2023 to help the economy and especially the labour market recover.

Fund Highlights

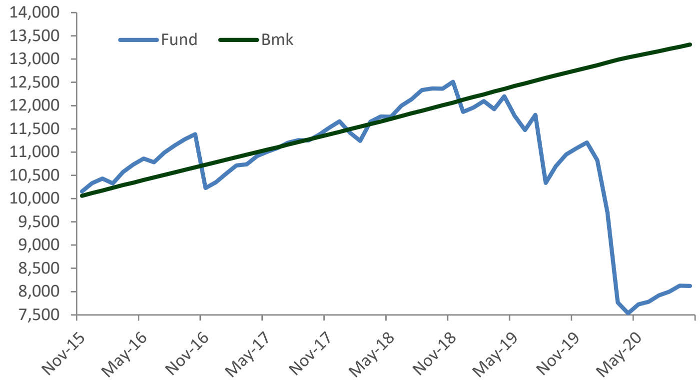
- The fund return was flat over October. The fund recorded a period of disappointing returns earlier in the year. Bond yields dropped to record lows in March however financial markets have subsequently been calmed by significant Central Bank and Governmental support.
- The fund reduced the level of option selling during the month as the US elections date nears.
- Volatility has recently increased after a period of dampened activity. Income the fund receives from selling short dated options has increased from earlier in the year and is 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]	-0.03%	2.57%	-25.82%	-10.60%	-4.07%	2.35%
Benchmark[2]	0.35%	1.06%	4.77%	5.53%	5.89%	6.53%
Retail[3]	0.08%	2.38%	-29.81%			
KiwiSaver[3]	0.13%	2.50%	-25.94%			

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

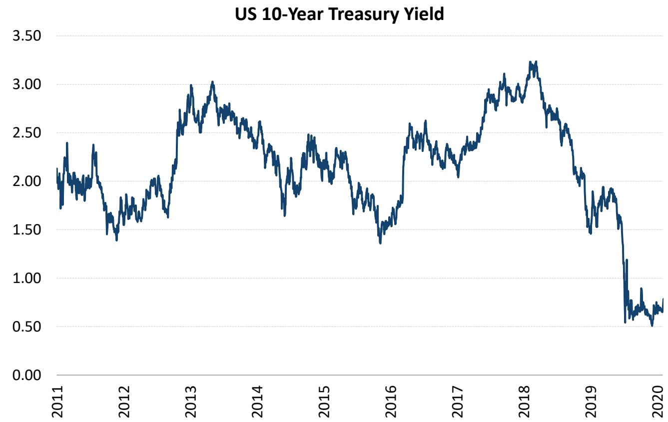
The fund uses a leveraged trading strategy and the impact of interest rate volatility is magnified by the use of leverage. For every $1 in the fund, up to $6 of call options and $6 of put options can be sold. The options are sold in pairs, each comprising a call and a put option with the same expiry 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 bond yields moving higher on the prospect of an increased economic stimulus package being announced soon.

Yields peaked at 0.87% during October and reached a low of 0.64%. 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 officials continue to hold 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 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. Even though a new strategy has been adopted it doesn't mean the Fed has given up being vigilant on inflation. Federal Reserve 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.

Early November will be an interesting period that spans a presidential election, a Federal Reserve meeting and the latest snapshot on the US labour market. An election result where there is no immediate clear winner will be the worst outcome as markets dislike uncertainty. Importantly, whether the Democrats manage to take the Senate which is currently held by the Republicans. It is possible that a united Democrat controlled presidency, Senate and House of Representatives would put the most upward pressure on interest rates.

Fund Commentary

The fund posted a positive unit price return over October 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.

With the outcome of the November US elections uncertain we have reduced the level of option selling as the US elections date nears. Option selling will recommence when the outlook becomes clearer. The fund has less exposure to sold options that span the election period than it would have in more normal times. This strategy may reduce the fund's income in the short term but will produce less volatile price movements.

Investment market volatility has recently increased after a period of dampened activity. Income the fund receives from selling short dated options has also increased from earlier in the year. 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

$49m

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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