

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. Bond yields had some short-term volatility around the US election but soon settled as no significant change to the economic outlook is likely.
- Markets continue to focus on the economic and financial market impact of COVID-19 and the help that a large fiscal stimulus package and a vaccine roll out 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 posted a positive unit price return over November 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 fund reduced the level of option selling at the beginning of the month as the US elections date drew nearer.
- Volatility declined after the US election as the results were largely as expected.
- Income the fund receives from selling short dated options remains attractive compared to many investment alternatives.

Performance

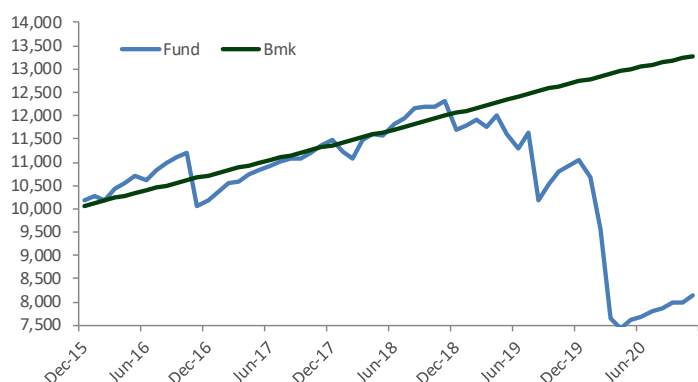
	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale ¹	1.78%	3.38%	-25.39%	-10.47%	-4.02%	2.20%
Benchmark ²	0.35%	1.06%	4.71%	5.49%	5.84%	6.51%
Retail ³	1.32%	3.07%	-30.06%			
KiwiSaver ³	1.41%	3.27%	-26.15%			

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. Bond yields had some short-term volatility around the US election but soon settled as no significant change to the economic outlook is likely.

Yields peaked at 0.97% during November and traded at a low of 0.72%. 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 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 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 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.

Federal Reserve Chair Jerome Powell cautioned that the US economy remains in a damaged and uncertain state despite progress made in the development of COVID-19 vaccines. ‘Recent news on the vaccine front is very positive for the medium term. For now, significant challenges and uncertainties remain, including timing, production and distribution and efficacy across different groups’. Powell also pointed with concern to the resurgence of the virus across the US and the world. He gave no indication how the central bank may respond to those concerns when it conducts its next policy meeting scheduled for December 15 and 16 although he did reiterate that it would use all of its tools to help the economy recover.

Early November was an interesting period that spanned a presidential election, a Federal Reserve meeting and a snapshot on the US labour market. After an uncertain period, Biden has claimed the presidency however which party controls the Senate is yet to be resolved. Since the Senate will not have a strong majority for either party any significant policy changes will be difficult to enact.

Fund Commentary

The fund posted a positive unit price return over November 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 fund reduced the level of option selling at the beginning of the month as the US elections date drew nearer with option selling recommencing later in November as the outlook became clearer.

Volatility declined after the US election as the results were largely as expected. Even though income levels have declined, income the fund receives from selling short dated options 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. As the US economy gradually recovers from the COVID induced recession it is possible longer-term bonds trend higher in yield however we believe upside to yields will be limited as the Fed remains committed to keeping interest rates low. If the interest rates on US treasury bonds don’t have large movements over a short time period, the fund should be able to generate acceptable returns.

Key Fund Facts

Distributions		Estimated annual fund charges (incl. GST)	
Wholesale fund:	generally does not distribute	Wholesale: negotiated outside of unit price	
Retail fund:	generally does not distribute	As of 1 December 2020, the retail and KiwiSaver Option Funds were closed to new investors.	
KiwiSaver fund:	does not distribute		
Hedging		Buy / Sell spread	Strategy size
Any foreign currency exposures are hedged to NZD within an operational range of 98.5% to 101.5%		0.00% / 0.00%	\$49.9m
			Strategy Launch
			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

This document is issued by Nikko Asset Management New Zealand Limited (Company No. 606057, FSP No. FSP22562), the investment manager of the Nikko AM NZ Investment Scheme, the Nikko AM NZ Wholesale Investment Scheme and the Nikko AM KiwiSaver Scheme. This information is for the use of researchers, financial advisers and wholesale clients. This material has been prepared without taking into account a potential investor’s objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this document, who are not wholesale investors (in accordance with Schedule 1, Clause 3 Financial Markets Conduct Act 2013), or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement. Past performance is not a guarantee of future performance. While we believe the information contained in this presentation is correct at the date of presentation, no warranty of accuracy or reliability is given and no responsibility is accepted for errors or omissions including where provided by a third party. For full details on the retail and KiwiSaver funds, please refer to the relevant Product Disclosure Statement on nikkoam.co.nz.

