

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 in the short term.
- Markets continue to focus on the economic and financial market impact of COVID-19 and the help 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 return over December after the recording a period of disappointing returns earlier in 2020. 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 prior to the US election, activity levels have increased again as the outcome became clearer.
- Volatility has declined after the US election as the results were largely as expected. Income the fund receives from selling short dated options has also declined however remains attractive compared to many investment alternatives.

Performance

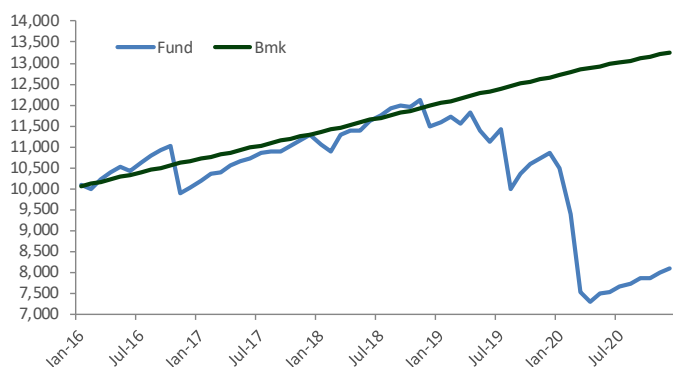
	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale ¹	1.19%	2.96%	-25.33%	-10.48%	-4.13%	2.63%
Benchmark ²	0.35%	1.06%	4.63%	5.44%	5.79%	6.48%
Retail ³	0.99%	2.40%	-29.92%			
KiwiSaver ³	1.08%	2.64%	-25.95%			

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

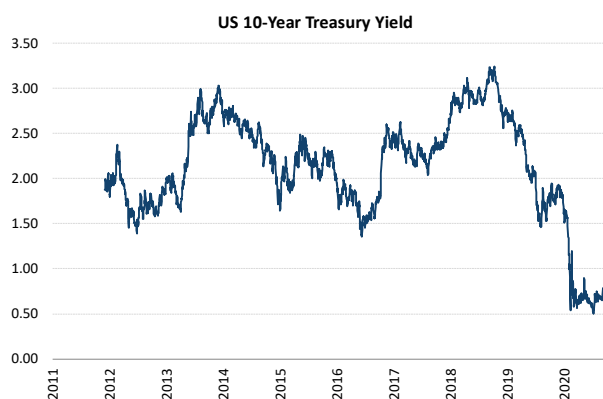
Interest rates on US 10-year Treasury bonds traded in a modest range over the month. Bond yields had some short term volatility around the US election but soon settled as no significant change to the economic outlook is likely in the short term.

Yields peaked at 0.98% during December and traded at a low of 0.83%. The historical low point in 10-year Treasury bonds was recorded in March 2020 when bonds traded at a yield of 0.31%.

The Federal Reserve strengthened its commitment to support the US economy, promising to maintain its large asset purchase programme until it sees substantial further progress in employment and inflation. The Fed expects it will also be appropriate to maintain the federal funds target rate in a range of 0 - 0.25% until the labour market conditions have reached a level that would support full employment and inflation has risen to 2% and is on track to stay at or exceed that level for a sustained period.

The Fed is still far away from their goals, in addition to the economic support the Fed is bringing to the table, Governor Powell has repeatedly called on Congress to pass a further round of fiscal stimulus to help the US economy through its winter of discontent. The unemployment rate stood at 6.7% in November while inflation remains below 2%.

Even though the Fed has remained relatively down-beat, financial markets have been buoyant as investors eye the prospect of steady growth in 2021 as more people are vaccinated, pent up consumer demand is released, low interest rates remain and another round of fiscal stimulus looks likely. The S&P 500 index set a record in December while yields on corporate bonds are trading at pre-COVID lows. On the negative side non-farm payrolls slowed and retail sales dropped more than forecast.



Fund Commentary

The fund posted a positive return over December after recording a period of disappointing returns earlier in 2020. 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 prior to the US election, activity levels have increased again as the outcome became clearer with a Biden presidency and a Democratic party majority in the Senate. Volatility has declined after the US election as the results were largely as expected. Income the fund receives from selling short dated options also declined however remains attractive compared to many investment alternatives.

As the US economy gradually recovers from COVID and the Democrats have a freer hand to enact their policies 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. 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 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
As of 1 December 2020, the retail and KiwiSaver Option Funds were closed to new investors.

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

\$54.2m

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

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