

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 over the month. The US election has passed however the bond market is still taking its lead from politics, namely the size of the stimulus package and its timing. Until this is clearer and the vaccine roll out is more advanced no significant change to the economic outlook is likely but optimism about the future is increasing.
- 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 January after the fund recorded 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 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

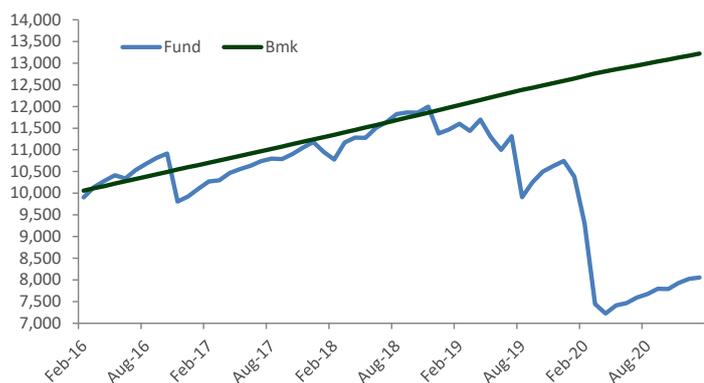
	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale ¹	0.41%	3.41%	-22.41%	-9.73%	-4.23%	2.24%
Benchmark ²	0.35%	1.05%	4.54%	5.39%	5.74%	6.46%
Retail ³	0.65%	2.99%	-27.63%			
KiwiSaver ³	0.53%	3.05%	-23.61%			

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 over the month. The US election has passed however the bond market is still taking its lead from the politics, namely the size of the stimulus package and its timing. Until this is clearer and the vaccine roll out is more advanced no significant change to the economic outlook is likely but optimism about the future is increasing.

Yields peaked at 1.18% during January and traded at a low of 0.90% early in the month. 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 made it clear the US Central Bank was nowhere near exiting massive support for the economy during the ongoing coronavirus pandemic. At the FOMC meeting in late January officials left their benchmark interest rate unchanged near zero and flagged a moderating US recovery.

The Bank repeated it would maintain its bond buying programme at the current pace of \$120 billion of purchases per month until “substantial further progress” towards its employment and inflation goals has been made. Their goals remain unchanged; to maintain an environment that supports full employment and have inflation rising to 2% and on track to maintaining or exceeding that level for a sustained period.

Powell went on to say “the whole focus on exit is premature” noting the US was a long way from full recovery and the Fed would take care to communicate early to make sure no one was taken by surprise of what he promised would be a gradual taper of purchases when the time came. Powell however did comment that the widespread availability of vaccines were grounds for optimism noting several developments point to an improved outlook later this year. Investors have certainly taken this optimism to heart pushing long dated bond yields higher and lifting many equity indices to record highs. As the US economy gradually recovers from the COVID inspired recession 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 rate movements on US treasury bonds are moderate or trend higher or lower over time the fund should be able to generate acceptable returns over the following year.



Fund Commentary

The fund posted a positive unit price return over January after the fund recorded 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 declined after the US election as the results were largely as expected and has now stabilised. Income the fund receives from selling short dated options also declined however 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 first quarter of 2020, the cost of options being struck exceeded income received. As this event recedes the fund is well placed to provide acceptable level of returns once again.

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

\$54.3m

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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