Factsheet 31 January 2022

NIKKO AM OPTION STRATEGY

Assets are held in the Nikko AM Wholesale Option Fund.

Market Overview

- US 10-year Treasury bond yields traded higher over the month as the Federal Reserve signalled it will start raising rates soon.
- Yields moved within a 37 basis point range – a low point of 1.53% and high point of 1.90%, with 10-year yields closing the month at 1.78%.
- Yields have moved a long way from the historical low point of 0.31% recorded in March 2020 and have been threatening to breach the psychologically important 2% level.
- Even with the Omicron spread the Fed's programme to taper bond purchases will be brought forward. Multiple rises in the Fed Funds Rate over 2022 looks to be a certainty as the US faces a longer period of elevated inflation and an improving labour market.

Fund Highlights

- The fund recorded a small fall over January as bond yields increased and, in some cases, moved through option strike levels.
- Income and volatility levels remained at attractive levels with data releases and central bank statements that kept markets on edge.
- Uncertainty surrounding the strength and longevity of the US economic recovery, the resulting inflationary impact and the Fed's response will likely keep bond market volatility and option income at attractive levels.

Performance

	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale[1]	-0.33%	4.47%	4.43%	-9.81%	-3.60%	3.03%
Benchmark[2]	0.40%	1.18%	4.48%	4.87%	5.34%	6.18%

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.

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.

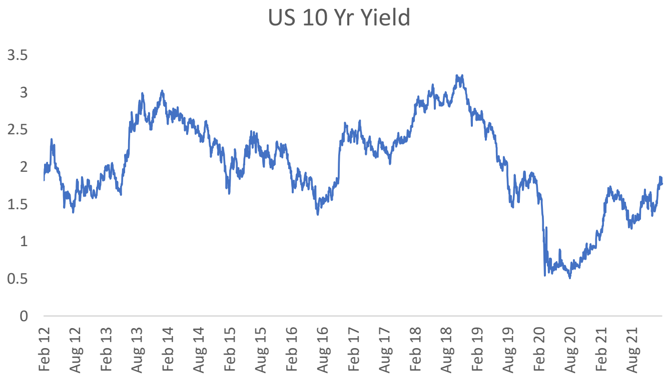
Objective

The fund aims to earn a return of the benchmark before fees, expenses and taxes over a rolling three-year period.

Five Year Cumulative Performance, $10,000 invested[1&2]

Market Commentary

The Federal Reserve signalled it will start raising interest rates soon and shrink its bond holdings after lift-off has begun, moving toward ending ultra-easy pandemic support to fight the hottest inflation in a generation. In a FOMC statement they said, “with inflation well above 2% and a strong labour market, the committee expects it will soon be appropriate to raise the target range for the federal funds rate”. In a separate statement they said they expect the process of balance sheet reduction will commence after the rate rises have begun. All this occurring as consumer price inflation has hit 7%, the most since the 1980s, and a tight labour market that’s pushed unemployment down faster than anticipated to almost pre-pandemic levels.



At the time of these statements a 0.25% increase is priced in for the March Fed meeting with a total of 1% of tightening by the end of 2022. A rate hike will be the first since 2018. The Fed is prepared to be nimble so that they can respond to the full range of plausible outcomes. Governor Powell said, we will remain attentive to risks, including the risk that high inflation is more persistent than expected, and are prepared to respond as appropriate. The US economy is on track to expand at a robust pace over 2022 and the employment market is making rapid progress towards maximum employment levels. Supply and demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation, however Fed officials have now sent a loud and clear message to markets, they are serious about controlling inflation and are willing to hike rates faster and higher to achieve their goals. Acting earlier rather than later on their tightening programme and going hard and early gives the Fed a greater chance of regaining control of inflation and will mean the peak in the interest rate cycle will likely be lower than if stimulus was retained. If the Fed did not act now, it would make their job to rein in inflation and inflation expectations even harder and, at a later date the Fed response would likely need to be more aggressive than if they acted sooner.

As the US economy recovers from the COVID inspired recession it is likely longer term bond yields trend higher. We believe however that upside in yields will be moderate as we have already seen increases in long bond yields over the past year and short-term interest rates will likely remain low compared to historical levels even when they move off levels close to zero.

Fund Commentary

The fund recorded a small fall over January as bond yields increased and, in some cases, moved through option strike levels. This detracted from returns, however much of this negative movement are the result of unrealised losses that may accrue back to the fund over the coming month. Income and volatility levels remained at attractive levels over the past month as we continued to see data releases and central bank statements that kept markets on edge. Uncertainty surrounding the strength and longevity of the US economic recovery, the resulting inflationary impact and the Fed’s response will likely keep bond market volatility and option income at attractive levels. If US Treasury market volatility remains at current levels the income generating potential of the fund looks attractive however the frequency and cost of options being struck will also determine the total return. If the incidence of large yield movements over a short time period remains modest the fund is well placed to provide acceptable level of returns.

Key Fund Facts

Distributions	**Estimated annual fund charges (incl. GST)**		
Hedging	**Buy / Sell spread**	**Strategy size**	**Strategy Launch**
Any foreign currency exposures are hedged to NZD within an operational range of 98.5% to 101.5%	0.00% / 0.00%	$44.8m	October 2007

Compliance

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

Contact Us

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