Nikko Asset Management

Factsheet 31 May 2022

NIKKO AM OPTION STRATEGY

Assets are held in the Nikko AM Wholesale Option Fund.

Market Overview

- US 10-year Treasury bond yields continued to trade in a volatile fashion over the month as the market fluctuated between worrying about inflation and the impact on economic growth resulting from the Federal Reserve's aggressive tightening policy.
- Hawkish Fed statements and inflation concerns drove bond yields to a high of 3.2% early in the month before falling to a low of 2.71% as investors fretted about dimming economic growth prospects.
- Multiple rises in the Fed Funds Rate over 2022 looks to be a certainty as the US faces elevated inflation and a strong labour market. Rate rises will eventually reach a level that slows economic activity, the Fed is confident of delivering a soft economic landing however many believe they are treading a fine line and a hard may be the result.

Fund Highlights

- The fund fell May as bond yields spiked to 3.2% before retreating again. These sharp movements saw yields move through option strike levels and creating losses for the fund.
- Income and volatility levels remain at attractive levels as we continue to see central bank statements, data releases and geo-political events keep markets on edge.
- Uncertainty surrounding inflation and growth levels will likely keep bond market volatility and option income high. The elevated level of option premium income will benefit the fund and help insulate it from further losses should large short-term yield movements in bonds continue.

Performance

	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale[1]	-1.75%	-14.15%	-9.30%	-14.12%	-7.49%	1.18%
Benchmark[2]	0.46%	1.31%	4.78%	4.79%	5.28%	6.12%

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.

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.

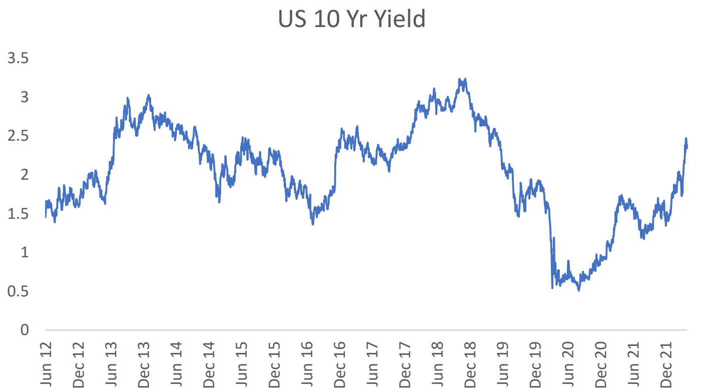
In times of increased interest rate volatility, it is likely the fund will receive a higher stream of income as new options sold will have a higher income.

Objective

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

Market Commentary

The Federal Reserve delivered the biggest interest rate increase since 2000 and signalled it would keep hiking at the same pace over the next couple of meetings, unleashing the most aggressive policy action in decades to combat soaring inflation. The Federal Open Market Committee voted unanimously to increase the benchmark rate by 0.5%. It will also begin to allow its holdings of Treasuries and mortgage-backed securities to decline in June at an initial combined monthly rate of $47.5billion, stepping up over three months to $95 billion. There is a broad view amongst committee members that additional 0.5% increases should be on the table for the next couple of meetings. Treasury and equity markets rallied after the announcement as Governor Powell dashed speculation the Fed was considering an even larger 0.75% shift in the months ahead.



The Fed funds rate is now in a range of 0.75% to 1.0%, the May increase followed a 0.25% increase in March which ended two years of near zero rates which helped cushion the US economy against the initial blow from COVID. The Fed is trying to curb the hottest inflation surge since the early 1980s. Back then Fed Chair, Paul Volker, raised rates as high as 20% and crushed both inflation and the broader economy in the process. The Fed is hoping that this time around that the combination of higher borrowing costs and a shrinking balance sheet will deliver a soft economic landing that avoids recession while dampening down inflation. Statements from the Fed suggest they see strong fundamentals in the economy and see a low near-term risk of recession. It is also possible that inflation has peaked or is going to soon, as lower demand has driven down prices in core goods sectors, however the Fed's decision makers will need more data points before taking these disinflationary signs on board and tempering their tightening path. It is clear that markets are swinging from fearing inflation to having a growth scare. Uncertainty has grown and volatility looks likely to remain elevated for some months to come.

Fund Commentary

The fund fell over May as bond yields spiked to 3.2% before retreating again. These sharp movements saw yields move through option strike levels and creating losses for the fund. The income generated by the fund was strong but not sufficient to fully offset the option exercise costs. Income and volatility levels remain at attractive levels as we continue to see central bank statements, data releases and geo-political events keep markets on edge. Uncertainty surrounding inflation and growth levels will likely keep bond market volatility and option income high. The elevated level of option premium income will benefit the fund and help insulate it from further losses should large, short term yield movements in bonds continue.

Key Fund Facts

Distributions	**Estimated annual fund charges (incl. GST)**		
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** $37m	**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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