

NIKKO AM OPTION STRATEGY

Assets are held in the Nikko AM Wholesale Option Fund.

Market Overview

- US 10-year Treasury bond yields traded in a volatile fashion as the market contemplates whether the Fed may temper their aggressive tightening policy.
- At first glance, restrictive monetary policy should keep 10-year US Treasury yields high however the Fed has begun to reduce the size of hikes to mitigate downside risks to the economy.
- Multiple rises in the Fed Fund's Rate were expected over 2023 and had been priced into the US yield curve however markets are now anticipating when the tightening cycle may end. The Fed will be wary of unwarranted loosening of financial conditions as this would hurt efforts to achieve price stability.

Fund Highlights

- The fund's unit price increased strongly over the past month. Bond yields reached a high of 3.83% at the beginning of the month before closing January at 3.51%. The month's low point was 3.32%.
- Bond yields moved through a small number of option strike levels however elevated income levels ensured January performance was strong.
- Income and volatility levels remained at high levels as central bank policy settings, data releases and geo-political events kept markets on edge however we are seeing signs that volatility levels are declining.

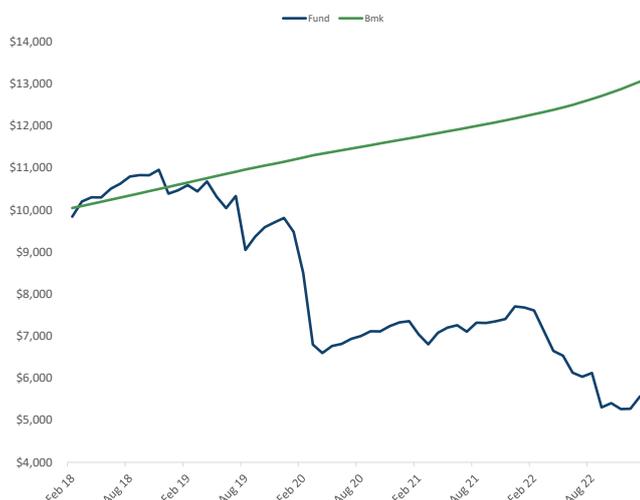
Performance

	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale ¹	5.61%	2.97%	-27.52%	-16.26%	-11.05%	-1.52%
Benchmark ²	0.71%	2.04%	6.75%	5.25%	5.48%	6.17%

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.

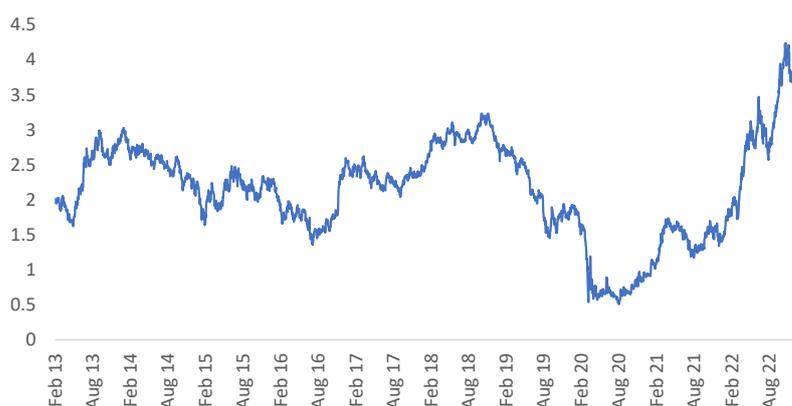
Market Commentary

The Federal Reserve slowed its drive to rein in inflation and said further interest rate hikes are in store as officials debate when to end their most aggressive tightening of credit in four decades.

The market correctly anticipated the Fed lifting their targeted benchmark rate by 0.25% to a range of 4.5% to 4.75% in early February. The smaller move followed a 0.5% increase in December and four 0.75% hikes prior to that.

Even though the rate hike was smaller than recent moves, Governor Powell said “we think we’ve covered a lot of ground...even so, we have more work to do”.

US 10 Yr Yield



With a lower peak in US cash rates likely and possibly the end of the hiking cycle in sight, bond investors were happy to buy longer term bonds, pushing yields lower. Future rate rises will depend on a variety of factors including perhaps the most important which is determining the economic impact of the cumulative hikes so far.

Restoring price stability will likely require maintaining a restrictive stance for some time. While recent readings on price pressures are encouraging it would be premature to declare victory. We feel the Fed will err on the side of caution and keep rates elevated until it is certain inflation falls and importantly, will stay down. The Fed remains hopeful they can achieve a soft landing for the US economy, bringing down inflation without pushing the US into recession however private sector economists aren’t quite so optimistic. A Bloomberg survey conducted in January amongst a group of forecasters put the probability of a contraction over 2023 at 65%.

With the end of the tightening cycle in sight and an economic contraction likely it is not surprising US Treasuries and bonds in general are back on investors radars. We have likely already seen the peak in longer term bond yields however yields will continue to be volatile for some time however as the outlook becomes clearer some of this volatility can be expected to subside.

Fund Commentary

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Uncertainty surrounding how long the Fed maintains tight policy settings, inflation outcomes and economic activity levels will likely keep bond market volatility and option income up into the new year. The elevated level of option premium income is helpful however large, short-term movements in 10-year bond yields will ultimately determine the future performance of the fund.

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 \$31.3m	Strategy Launch October 2007

Compliance

The wholesale fund complied with its investment mandate and trust deed during the month, except that an error has been identified where the value of specific options were incorrectly accounted for in the net asset value of the fund on certain days. We are working through the details and will advise the affected clients when the impact analysis is complete later in February.

Contact Us

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