

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 manner as a political stalemate over the US debt ceiling raised the possibility of the government running out of money to pay their obligations.
- After a rapid rise in cash rates the Fed may now have reached the end of their tightening cycle.
- Inflation has fallen from its peak but is still elevated indicating it may be too soon to think of rate cuts.

Fund Highlights

- The fund delivered a strong return over May. Bond yields reached a high of 3.86% prior to the resolution of the US debt ceiling impasse.
- Bond yields moved through a 57 basis point range, with yields trading as low as 3.29% before closing the month at 3.66%.
- The option exposure in the portfolio reduced to zero by month end as the fund prepares to close.

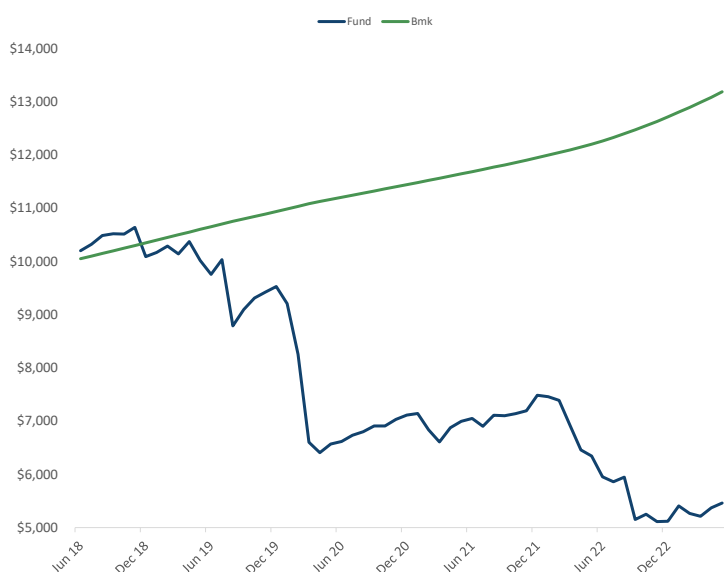
Performance

	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale ¹	1.68%	3.73%	-13.91%	-5.97%	-11.39%	-1.75%
Benchmark ²	0.79%	2.28%	8.06%	5.70%	5.69%	6.25%

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

Federal Reserve officials are signalling they plan to keep interest rates steady in June while retaining the option to hike further in coming months should economic data come in hotter than expected.

The FOMC has raised rates by 5% in the past 14 months to curb inflation which was running at more than double their 2% target. With their benchmark rate now in a 5% - 5.25% target range following a 0.25% increase in early May, Governor Powell has said that policy makers could afford to watch the data and the evolving outlook.

The case for a suspension of hikes rests on the idea that monetary policy works with a time lag, so the impact of past rate hikes have yet to fully weigh on the economy and labour market. In addition, recent bank failures have resulted in tighter financial conditions which may reduce credit availability by an uncertain amount, making the outlook even more uncertain.



While goods prices have shown improvement and housing prices seem poised to ease later this year, other services prices are likely to be sticky and continue to rise in the face of a labour market that still seems to have heat.

The Fed remains hopeful the US avoids a recession or if one occurs that it is mild. It will be a great achievement if the Fed can navigate all the various pit falls and deliver such an outcome.

Fund Commentary

The fund delivered a strong return over May. Bond yields reached a high of 3.86% prior to the resolution of the US debt ceiling impasse before moving lower as a resolution became more likely.

Yields moved through a 57 basis point range, with yields trading as low as 3.29% before closing the month at 3.66%. Income earned by the fund was strong and more than offset some small losses due to some option positions being struck.

The option exposure in the portfolio reduced to zero by month end as the fund prepared to close.

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

\$30.8m

Strategy Launch

October 2007

Compliance

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

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