

Nikko AM Wholesale Option Fund

Fund manager

Nikko Asset Management New Zealand Limited (Nikko AM NZ).

In New Zealand we actively manage around NZ\$5 billion of investments for a diverse group of clients, including superannuation schemes, charitable trusts, KiwiSaver scheme providers, corporations and local government along with providing services to financial intermediaries through wrap platforms. We offer investment management services in domestic sectors (equities, fixed interest and cash) through our Auckland-based investment team and employ offshore managers to manage global sectors (global equities, global bonds and alternative investments).

Fund launch

April 2007 – a similar portfolio has been operated by Nikko AM since September 2003.

Investment objective

To invest the portfolio in the authorised investments such that the portfolio earns a gross return of Bloomberg NZBond Bank Bill Index plus 4.0% per annum over a rolling three year period before fees.

Benchmark

Bloomberg NZBond Bank Bill Index plus 4.0% per annum (from 1 July 2016)

Investment process

The Fund invests into cash deposits and bank bills with highly rated financial institutions. The assets are then used as collateral security for derivatives, in particular, selling options on long-term NZ, US, UK, Euro bloc or Australian government stock.

Most options are written for one month and provide the institutional purchaser with a payout if interest rates move by more than a prescribed margin in one particular direction. The Fund earns a premium for writing (selling) the options. The Fund will write options on government bonds with maturities between 5 and 15 years.

Structure

The Fund vehicle is a NZ domiciled Portfolio Investment Entity (PIE) which is priced daily. Investors elect their own Prescribed Investor Rate. Information is provided to the IR and investors on an annual basis.

Distributions

Generally does not distribute but may do so at Nikko AM NZ's discretion.

Currency management

All premium income is converted into NZD upon receipt and any currency margin deposits are hedged to NZD within an operational range of 98.5% to 101.5%.

Management fees and other charges

Investment management fees and performance fees will be negotiated separately with each investor and invoiced outside the Fund.

All Fund statutory and operating costs will be met directly by the Manager.

Buy/sell spread

Nil

Trustee

Public Trust

Custodian

Public Trust as legal custodian, BNP Paribas Fund Services Australasia Pty Limited delegated as functional custodian.

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Performance (NZD gross returns)

	Fund	Benchmark*	Excess
1 month	1.78%	0.50%	1.27%
3 months	-7.45%	1.54%	-9.00%
6 months	-4.11%	3.15%	-7.26%
1 year	1.03%	6.58%	-5.56%
2 years (pa)	10.06%	7.06%	3.00%
3 years (pa)	8.53%	7.25%	1.28%
5 years (pa)	10.12%	7.10%	3.02%

* S&P/NZX Bank Bills 90 Day Index plus 4.0% per annum prior to 1 July 2016

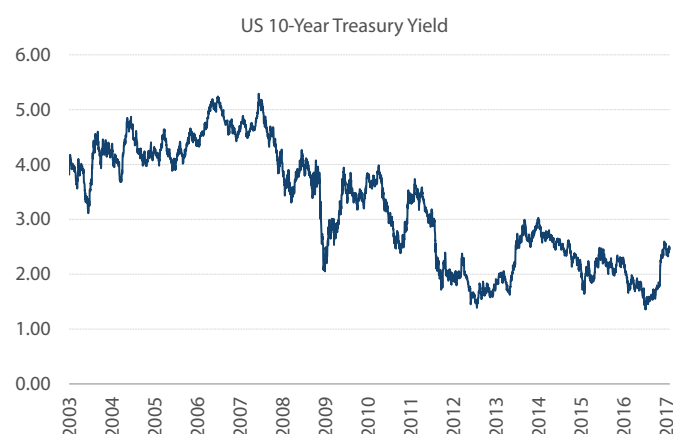
Fund size

NZ\$176 million

Compliance

The Fund complied with its investment mandate during the month.

Commentary



The Option Fund returned 1.78% for January. The US 10-year government bond rate finished January unchanged at 2.45%, and traded in a 24 basis point range over the month. The Fund coped well with the modest level of volatility through the month and the options have now been reset around what appears to be the new range in yield for the US 10-year government bond. Premium income has remained at reasonable levels and counterparties have been happy to buy options as a fair amount of uncertainty remains in the US around what the Trump presidency will mean for the economy and financial markets.

Large interest rate movements over a short period of time is the primary risk the Option Fund is exposed to. The US 10-year bond has been more range bound to start the new year and there is already a reasonable amount of good news factored in with interest rates moving markedly higher in the US over the last quarter of 2016, markets may have got ahead of actual policy in the US, and Trump will most likely continue to be a source of “surprises”. The market consensus has the medium term directional bias as likely upward, but we don’t expect large movements higher in yield from here near term, and expect a reasonable amount of volatility along the way.

The US Fed held few surprises as they left rates on hold and said “measures of consumer and business sentiment have improved of late”. The Fed reiterated risks to the outlook are “roughly balanced” and officials would continue to “closely monitor inflation indicators and global economic and financial developments”. The Fed also highlighted “inflation increased in recent quarters but is still below the committee’s 2% longer-run objective”. More importantly, the Committee reiterated its intention to move “gradually” with respect to rate hikes this year. In particular, the policy statement gave no reason to think that a March rate hike was any more probable than it was prior to this meeting.