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.

Performance (NZD gross returns)

	Fund	Benchmark*	Excess
1 month	1.00%	0.50%	0.50%
3 months	2.62%	1.50%	1.12%
6 months	6.30%	3.02%	3.29%
1 year	1.93%	6.26%	-4.33%
2 years (pa)	8.70%	6.63%	2.07%
3 years (pa)	8.45%	7.06%	1.40%
5 years (pa)	10.00%	7.02%	2.98%

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

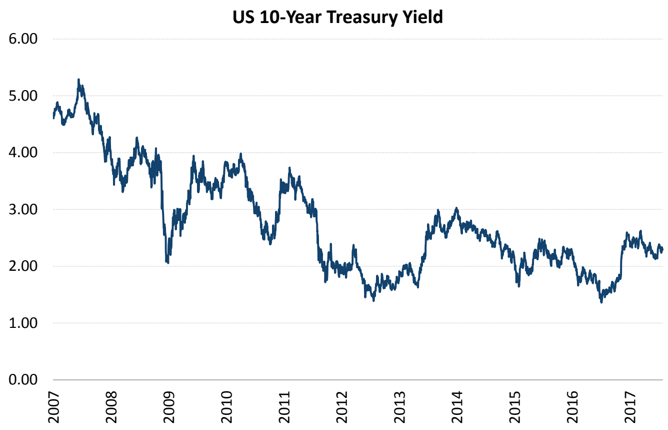
Fund size

NZ$180 million

Compliance

The Fund complied with its investment mandate during the month.

Treasury yield



Fund Performance

The Option Fund returned 1.0% over July. Interest rate movements on US 10-year Treasury Bonds continue to be modest with a 17bp range occurring as yields traded between 2.39% and 2.33% before closing the month at 2.27%. Short term volatility is at very low levels in bond and equity markets. We do note however the income available from selling options with expiry dates of six to eight weeks is significantly higher than the income from writing three to four week options even when taking into account the longer time period. The Fund has recently been extending the tenor of the options to take advantage of the higher income opportunities. Options are still being written with a 50bp band around the market yield of the 10-year bond.

Market Commentary

The broadly based global economic recovery supported financial market sentiment, seeing global equities reach record highs and volatility indices falling to their lowest levels since 1993. Bond market movements also continued to be modest. In the US the Consumer Price Index undershot market expectations for a fourth consecutive month and wage inflation continued to be low. Midway through the month Fed Chair Janet Yellen's testimony before Congress was interpreted as mildly dovish and the FOMC statement acknowledged inflation was declining. This statement would indicate the Federal Reserve is in no hurry to increase interest rates.

After lifting the federal funds rate four times the market is currently pricing in less than a 50% probability of a further rate rise in 2017. We have seen an abrupt slowdown in America's service industries which doesn't help the US economy breakout of its growth rut.

Political risk continues to weigh on investor sentiment in the US. Market optimism that was once very evident continues to decline. There are serious questions over policy goals in light of messy health care reform, and other issues reflecting badly on the administration's ability to push its agenda and stimulate economic activity.