Factsheet 31 July 2021

NIKKO AM OPTION STRATEGY

Assets are held in the Nikko AM Wholesale Option Fund.

Market Overview

- US 10-year Treasury bond yields continued to fall from this year's high point. Optimism for a strong economic recovery has been dented as the COVID Delta variant outbreak causes concern. The market continues to see buyers emerge around current levels as higher growth and inflation numbers are seen as transitory.
- Yields reached a high of 1.48% in July with each month recording a lower high since the 1.77% peak in March 2021. July's low point in yield was 1.13% giving a 35 basis point yield range over the month. Yields have moved a long way from the historical low point in 10-year treasury bonds of 0.31% recorded in March 2020, this may help explain some of the buying support over recent months.
- The Federal Reserve is moving closer to when they can start reducing massive support for the US economy, though Chair Jerome Powell said there is some way to go.

Fund Highlights

- The fund's unit price fell in July as bond yields continued to fall and move through some option call strikes. After recent falls, yields may stabilise around current levels as the market has experienced five successive months of falling rates on 10-year US treasury bonds.
- Income and volatility levels have increased from recent months and are higher than levels experienced over most of the past year.
- Uncertainty surrounding the strength and longevity of the US economic recovery and the resulting inflationary impact will likely keep bond market volatility and option income levels at attractive levels compared to many other investment alternatives.

Performance

	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale[1]	-2.11%	0.39%	2.49%	-12.55%	-5.88%	0.45%
Benchmark[2]	0.35%	1.06%	4.30%	5.10%	5.50%	6.29%

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.

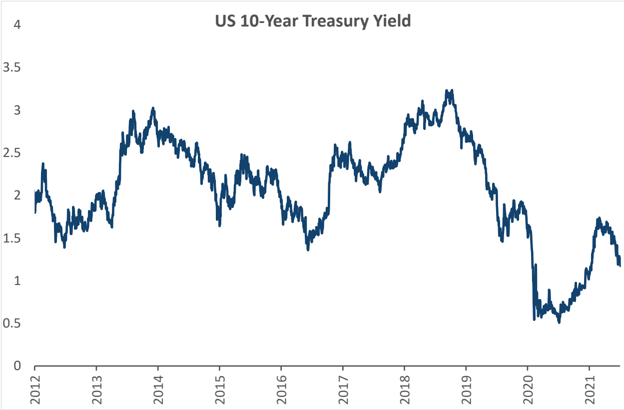
In times of increased interest rate volatility, it is likely the fund will receive a higher stream of income as new options sold will have a higher income.

Objective

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

Market Commentary

US 10-year Treasury bond yields continued to fall from this year's high point. Optimism for a strong economic recovery has been dented as the COVID Delta variant outbreak causes concern. The market continues to see buyers emerge around current levels as higher growth and inflation numbers are seen as transitory and US interest rates remain high compared to many other parts of the world. A further period of low short-term rates is likely to limit the extent of longer term US rates rises even though the Fed is now closer to raising rates or at least is thinking about reducing US economic stimulus.



The Federal Reserve is moving closer to when they can start reducing massive support for the US economy, though Chair Jerome Powell said at a press conference that there is some way to go and "we're not there and we see ourselves as having some ground to cover to get there". This was said after the Fed held interest rates in a range close to zero and maintained asset purchases at $120 billion a month until substantial further progress has been made on employment and inflation.

Consumer prices are rising at their fastest pace since 2008 as the economy reopens and Americans renew spending after a year of lockdowns. At the same time, the spreading Delta variant has jolted investors who worry it could threaten the economic recovery. "As long as COVID is running loose out there, as long as there is time and space for the development of new strains, no one is finally safe" Powell said. Even so, it is clear the Fed is considering the time when stimulus could be reduced starting with tapering their bond buying activity.

Yields reached a high of 1.48% in July with each month recording a lower high since the 1.77% peak in March 2021. July's low point in yield was 1.13% giving a 35 basis point yield range over the month. Yields have moved a long way from the historical low point in 10-year Treasury bonds of 0.31% recorded in March 2020 and this may help explain some of the buying support over recent months.

As the US economy recovers from the COVID inspired recession, stimulatory monetary and fiscal policies remain in place it is possible longer term bonds trend higher in yield. We believe however, that any upside in yields will be modest as we have already seen a significant increase in long bond yields. Short-term interest rates will likely remain low compared to historical levels even when they move off levels close to zero. If the interest rate movements on US treasury bonds are moderate or trend higher or lower over time, the fund should be able to generate acceptable returns over the coming year.

Fund Commentary

The fund's unit price fell in July as bond yields continued to fall and move through some option call strikes. After recent falls, yields may stabilise around current levels or rise somewhat as the market has experienced five successive months of falling rates on 10-year US treasury bonds. Adding to the positive outlook, income and volatility levels have increased from recent months and are higher than levels experienced over most of the past year.

Uncertainty surrounding the strength and longevity of the US economic recovery, and the resulting inflationary impact will likely keep bond market volatility and option income levels at attractive levels.

If the incidence of large yield movements over a short time period remains modest and volatility remains at current levels the income generating potential of the fund looks attractive, however the frequency and cost of options being struck also determines the total return.

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** $40.9m	**Strategy Launch** October 2007

Compliance

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

Contact Us

www.nikkoam.co.nz | nzenquiries@nikkoam.com