Factsheet 31 August 2021

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 narrow range over August as the market looked for signs of the Federal Reserve's response to rising US growth, employment and inflation numbers. The market continues to see buyers around current levels as higher growth and inflation numbers are viewed as transitory, and the Fed remains cautious in removing stimulus too soon.
- Yields reached a high of 1.37% in August with each subsequent month recording a lower high since the 1.77% peak in March 2021. August's low point in yield was 1.13% giving a 24 basis point 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 continues to say there is some way to go.

Fund Highlights

- The fund's unit price rebounded in August as bond yields stabilised after the market experienced a string of months where interest rates on 10-year US treasury bonds kept on falling.
- Income and volatility levels stabilised over the past month, however, are higher than levels experienced over most of the past year.
- Uncertainty surrounding the strength and longevity of the US economic recovery, the resulting inflationary impact and the Fed's response, will likely keep bond market volatility and option income 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]	3.01%	1.63%	4.54%	-12.15%	-5.58%	4.25%
Benchmark[2]	0.38%	1.08%	4.33%	5.06%	5.47%	6.27%

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.

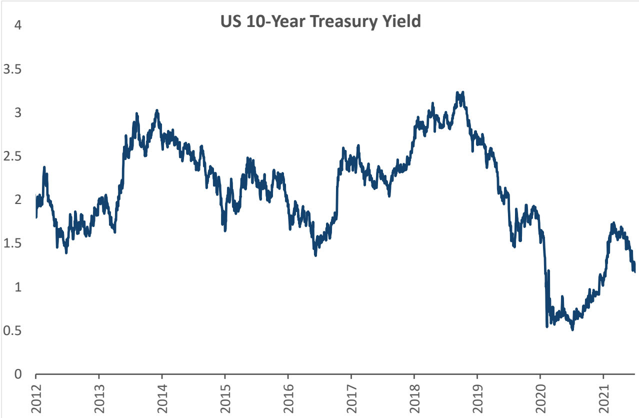
In times of increased interest rate volatility, it is likely the fund will receive a higher stream of income as new options sold will have a higher income.

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 traded in a narrow range over August, as the market looked for signs of the Federal Reserve's response to rising US growth, employment and inflation numbers. The market continues to see buyers around current levels as higher growth and inflation numbers continue to be viewed as transitory, and the Fed remains cautious in removing stimulus too soon.



Fed Chair Jerome Powell said the central bank could begin reducing its monthly bond purchases this year, though it won't be in a hurry to begin raising interest rates thereafter. According to Powell, the economy has now met the test of "substantial further progress" towards the Fed's inflation objective, that is a precondition for tapering the bond buying while the labour market has also made "clear progress". If the economy evolves as the Fed expects it may lead to a reduction in the pace of asset purchases this year. Although July's employment report was strong, the spread of the Delta variant is another set of risks that may impact incoming data over the months ahead and impact the Fed's plans to reduce economic stimulus.

The market took the tapering news in its stride, avoiding any hint of the so-called taper tantrum when the Fed surprised markets in 2013 by unexpectedly announcing it would pare back asset purchases. The Fed is currently buying $120 billion a month of bonds. It is likely policy makers would finish their purchasing programme before they started to raise rates. Powell stated, "we will continue to hold the federal funds rate at its current level until the economy reaches conditions consistent with maximum employment, and inflation has reached 2% and is on track to exceed 2% for some time". He also stated, "we have much ground to cover to reach maximum employment and time will tell whether we have reached 2% inflation on a sustainable basis". In summary, future interest rate moves are data dependent and don't expect a move in the Fed funds rate in 2021.

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As the US economy recovers from the COVID inspired recession and stimulatory monetary and fiscal policies remain in place, it is possible longer term bonds trend higher than current yields. We believe however, that any upside in yields will be modest, as we have already seen a significant increase in long bond yields over the past year, and 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 rebounded in August, as bond yields stabilised after the market experienced a string of months where interest rates on 10-year US treasury bonds kept on falling. Income and volatility levels stabilised over the past month, however, are higher than levels experienced over most of the past year. Uncertainty surrounding the strength and longevity of the US economic recovery, the resulting inflationary impact and the Fed's response will likely keep bond market volatility and option income at attractive levels. If 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. If the incidence of large yield movements over a short time period remains modest, the fund is well placed to provide an acceptable level of returns.

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** $43m	**Strategy Launch** October 2007

Compliance

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

Contact Us

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