Factsheet 31 October 2021

NIKKO AM OPTION STRATEGY

Assets are held in the Nikko AM Wholesale Option Fund.

Market Overview

- US 10-year Treasury bond yields pushed higher in yield over October as inflation fears worried markets.
- Yields reached a high of 1.7% in October as the prospect of the Fed starting to taper bond purchases became more evident as concern over persistently high inflation intensified.
- October's low point in 10-year yields was 1.45% giving a 25 basis point yield range over the month.
- Yields have moved a long way from the historical low point of 0.31% recorded in March 2020 however remain below the 2021 highpoint of 1.77% reached in March.

Fund Highlights

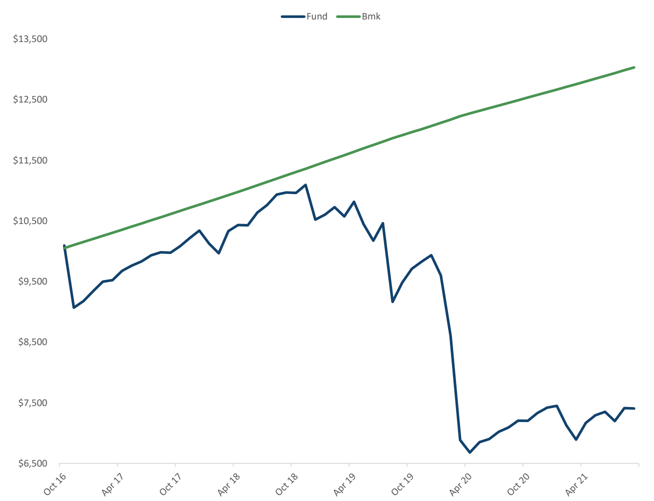
- The fund's unit price increased over October as bond yields traded in a modest range. The overall trend was for rates to rise.
- Income and volatility levels have edged up over the past month, we are continuing to see periods of market activity that are keeping markets on edge.
- Uncertainty surrounding 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]	0.55%	3.46%	3.37%	-12.10%	-5.91%	3.62%
Benchmark[2]	0.37%	1.10%	4.34%	4.98%	5.41%	6.23%

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.

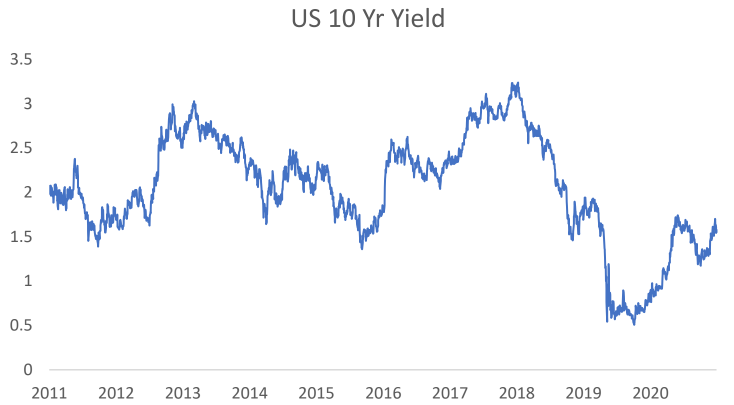
In times of increased interest rate volatility, it is likely the fund will receive a higher stream of income as new options sold will have a higher income.

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 Chairman, Jerome Powell sounded a note of heightened concern over persistently high inflation as he made clear the central bank will start tapering its bond purchases shortly but remain patient on raising interest rates. The risks are now skewed towards longer and more persistent bottlenecks and therefore to higher inflation, with longer term rates moving higher the market seems to be pricing in this scenario. Cash rate rises however still seem some way away. Powell said, "I do think it's time to taper and I don't think it's time to raise rates". The Fed is expected to announce the beginning of the wind-down of their pandemic inspired bond purchase programme at their November meeting.



Currently the Fed is buying $120 billion of securities each month and the coming reduction in the pace of purchases will mark the central bank's first steps toward exit from the monetary support measures that were rolled out in 2020 to support the economy from the worst impacts of the pandemic. If the current level of monetary stimulus was retained, it would risk the current elevated levels of inflation getting embedded into wages and prices. This would make the Fed's job to rein in future inflation and inflation expectations even harder and the Fed's response would need to be more aggressive. It's important to note that for now the Fed's most likely scenario is that inflation will come down as supply-chains ease "as they eventually will". If however, the Fed was to see inflation move to persistently higher levels they would certainly use all their tools, including raising rates, to preserve price stability while also taking into account the implications for their maximum employment goal.

As noted above, we are seeing Fed officials becoming more hawkish. Complicating the picture somewhat is that Powell's term as Fed Chair expires in February 2022 and in the US fall, President Biden will decide whether to nominate him again for another four-year term. As the US economy recovers from the COVID inspired recession and stimulatory monetary and fiscal policies remain in place for the time being it is possible longer term bonds trend higher. 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.

Fund Commentary

The fund posted a positive return for October - bond yields moved higher as the month progressed but not at a pace rapid enough to hurt the fund significantly. Some of the fund's option contracts were 'struck' however the cost of this was not material compared to the monthly income generated by selling options. Activity to reduce portfolio risk also benefited the fund over the month. Income and volatility levels have edged up over the past month and we are continuing to see periods of activity that keeps markets on edge. Continued uncertainty surrounding the strength and longevity of the US economic recovery, supply chain disruptions, debate around the transitory nature of elevated inflation levels and the Fed's response to all of this will likely keep bond market volatility and option income from falling. If US Treasury market volatility remains at current levels the income generating potential of the fund looks attractive however the frequency and cost of options being struck will also determine the total return. If the incidence of large yield movements over a short time period remains modest the fund is well placed to provide 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** $43.1m	**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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