Factsheet 28 February 2022

NIKKO AM OPTION STRATEGY

Assets are held in the Nikko AM Wholesale Option Fund.

Market Overview

- US 10-year Treasury bond yields traded higher over the month as the Federal Reserve signalled it will start raising rates soon in response to growing inflation concerns.
- Yields moved within a 34 basis point range, reaching a high of 2.08%. The low point was 1.74% recorded early in February. By month end, 10-year yields partially retraced their move higher closing at 1.83%.
- Yields have moved a long way from the historical low point of 0.31% recorded in March 2020 and have breached the psychologically important 2% level before retreating.
- Multiple rises in the Fed Funds Rate over 2022 look likely as the US faces a longer period of elevated inflation and an improving labour market, the wild card is the impact on global growth and market sentiment from the Ukraine invasion.

Fund Highlights

- The fund fell over February as bond yields increased and, in some cases, moved through option strike levels.
- Income and volatility levels remain at attractive levels as we continue to see data releases, central bank statements and geo-political events 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.

Performance

	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale[1]	-0.92%	2.74%	8.12%	-10.44%	-4.09%	2.67%
Benchmark[2]	0.40%	1.19%	4.53%	4.85%	5.32%	6.16%

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.

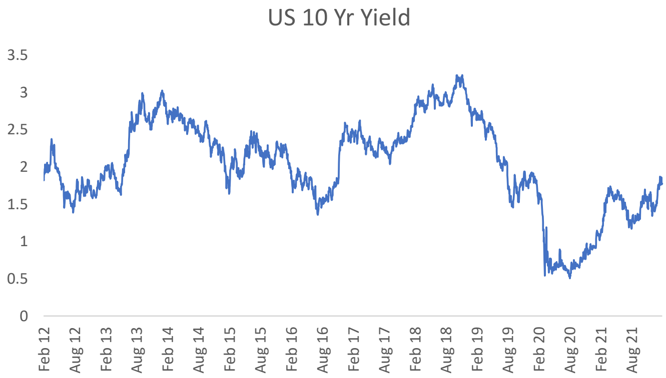
In times of increased interest rate volatility, it is likely the fund will receive a higher stream of income as new options sold will have a higher income.

Objective

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

Market Commentary

The international response to Russia's invasion of the Ukraine created safe haven buying of US Treasury bonds late in the month. The Fed is still expected to start raising rates in March however may find itself constrained by tightening financial conditions even as surging commodity prices threaten more inflation. Traders have started to reduce their expectations of rate rises however 1% of Fed tightening is still priced in to occur by July.



Ukraine and inflation will likely figure prominently in the Fed's thoughts however it seems a 50 basis point hike to start the tightening cycle seems unlikely in this volatile environment. Uncertainty remains on how far the Fed goes with their tightening given the global back drop. Fed Chair Jerome Powell must strike a delicate balance as he aims to reassure Americans the central bank will confront high inflation at the same time as the war in the Ukraine clouds the economic outlook.

Rising energy prices in the wake of the invasion have spurred higher inflation expectations however for now safe haven demand is helping the bond market more than other macro factors are hurting it. It remains to be seen how long this will last.

The US economy is on track to expand at a robust pace over 2022 and the employment market is making rapid progress towards maximum employment levels. Supply and demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation, however Fed officials have now sent a loud and clear message to markets, they are serious about controlling inflation and are willing to hike rates faster and higher to achieve their goals. The market must now grapple with the question of how much geo-political issues will temper the Fed's plans.

Acting earlier rather than later with their tightening programme and going hard early gives the Fed a greater chance of regaining control of inflation and will mean the peak in the interest rate cycle will likely be lower than if stimulus was retained. If the Fed did not act now it would make their job to rein in inflation and inflation expectations even harder and at a later date the Fed response would likely need to be more aggressive than if they acted sooner.

Fund Commentary

The fund recorded a negative return over February as bond yields increased and, in some cases, moved through option strike levels. Income and volatility levels remain at attractive levels as we continue to see data releases, central bank statements and geo-political events 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.

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** $43.5m	**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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