Factsheet 31 March 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 said it will take the "necessary steps" to get inflation down.
- Yields moved within a wide 88 basis point range as markets continued to worry about inflation and the consequences of a war in Europe. Hawkish Fed statements drove bond yields to a high of 2.55% after trading as low as 1.67% early in March as uncertainty surrounding the Ukraine invasion intensified.
- Multiple rises in the Fed Funds Rate over 2022 looks to be a certainty as the US faces a longer period of elevated inflation and an improving labour market. Rate rises will eventually reach a level that slows economic activity across the economy.

Fund Highlights

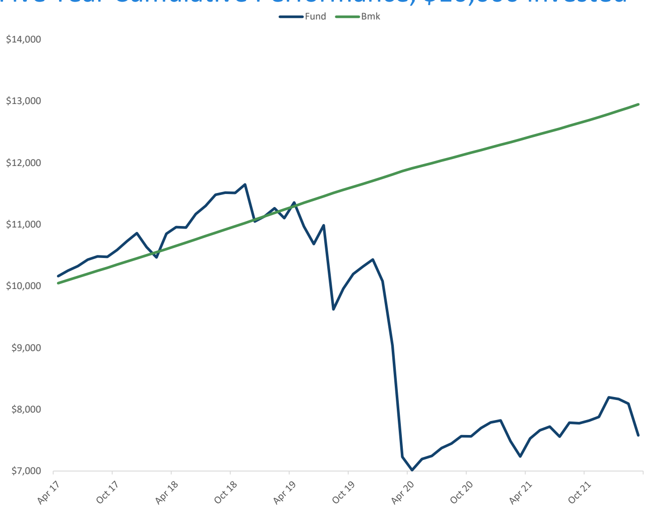
- The fund recorded a significant fall over March as bond yields fell sharply before soaring to over 2.5%. These sharp movement saw yields move through option strike levels and creating losses for the fund.
- Income and volatility levels remain at attractive levels as we continue to see data releases, central bank statements and geo-political events keep 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. The elevated level of option premium income will benefit the fund and help insulate it from further losses should large, short-term yield movements in bonds continue.

Performance

	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale[1]	-6.34%	-7.51%	4.75%	-11.95%	-5.39%	2.07%
Benchmark[2]	0.42%	1.22%	4.60%	4.82%	5.30%	6.15%

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.

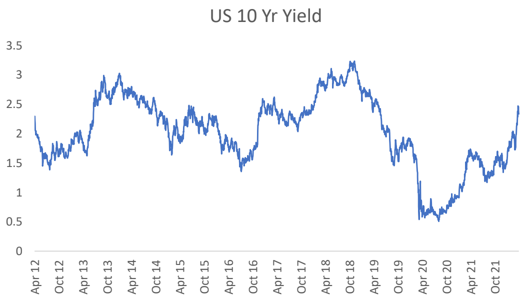
Objective

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

Market Commentary

The Federal Reserve Chair Jerome Powell said the central bank will take the necessary steps to get inflation down even if it means increasing interest rates more rapidly than anticipated and eventually to levels that will slow the broader economy.

The Fed raised their benchmark lending rate by 0.25% at their March meeting. This was the first increase since December 2018 and signalled six similar hikes over 2022. The rate is projected to reach 2.8% in 2023, this would be beyond the neutral rate which is perceived to be 2.4%. The neutral rate is a level that neither speeds up or slows down economic activity. Half a percentage point moves cannot be ruled out as the Fed signalled, they are prepared to be more aggressive in their tightening if it is required.



Powell said that Russia's invasion of Ukraine is aggravating inflation pressures by boosting prices on food, energy and other commodities at a time of already too high inflation. He went on to say that central banks typically look through event-driven commodity price shocks. But this time won't necessarily be typical. The risk is rising that an extended period of high inflation could push longer term expectations uncomfortably higher which underscores the need for the Fed to move expeditiously. These statements suggest the Fed sees even higher inflation as a greater risk to the economy than any near-term slowdown resulting from consumption due to higher fuel costs and rising uncertainty. Powell describes the economy as "very strong" and well positioned to handle higher interest rates even as Russia's invasion of the Ukraine has thrown new risks into the mix. The Fed is forecasting economic growth of 2.8% over 2022 and the Fed remains optimistic that the economy can have a soft landing.

As mentioned in previous commentaries, acting earlier rather than later, on 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 of reining in inflation and inflation expectations even harder in the future and their response would likely need to be more aggressive if they wait rather than if they act now.

Fund Commentary

The fund recorded a significant fall over the quarter and March as bond yields fell sharply before soaring to over 2.5%. These sharp movement saw yields move through option strike levels and creating losses for the fund. Income and volatility levels remain at attractive levels as we continue to see data releases, central bank statements and geo-political events keep 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. The elevated level of option premium income will benefit the fund and help insulate it from further losses should large, short term yield movements in bonds continue. 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 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 acceptable level of returns.

Key Fund Facts

Distributions	**Estimated annual fund charges (incl. GST)**		
Hedging	**Buy / Sell spread**	**Strategy size**	**Strategy Launch**
Any foreign currency exposures are hedged to NZD within an operational range of 98.5% to 101.5%	0.00% / 0.00%	$39.4m	October 2007

Compliance

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

Contact Us

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