Factsheet 30 June 2022

NIKKO AM OPTION STRATEGY

Assets are held in the Nikko AM Wholesale Option Fund.

Market Overview

- US 10-year Treasury bond yields continued to trade in a volatile fashion over the month. The market fluctuated between worrying about inflation and worrying about the impact on economic growth resulting from the Federal Reserve's aggressive tightening policy.
- Hawkish Fed statements and inflation concerns drove bond yields to a high of 3.5% early in the month before closing at 3.0% as investors fretted about dimming economic growth prospects.
- Multiple rises in the Fed Funds Rate over 2022 looks to be a certainty as the US faces elevated inflation and a strong labour market. Rate rises will eventually reach a level that slows economic activity, the Fed is confident of delivering a soft economic landing however appear less certain of this than they once were.

Fund Highlights

- The fund recorded a fall over June as bond yields spiked to 3.5% before retreating again. These sharp movements 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 central bank statements, data releases and geo-political events keeping markets on edge.
- Uncertainty surrounding inflation and economic growth levels will likely keep bond market volatility and option income high. The elevated level of option premium income will benefit the fund and help insulate it from losses should large short-term movements in bond yields continue.

Performance

	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale[1]	-6.17%	-14.00%	-15.56%	-15.18%	-8.79%	0.23%
Benchmark[2]	0.50%	1.39%	4.94%	4.81%	5.29%	6.12%

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.

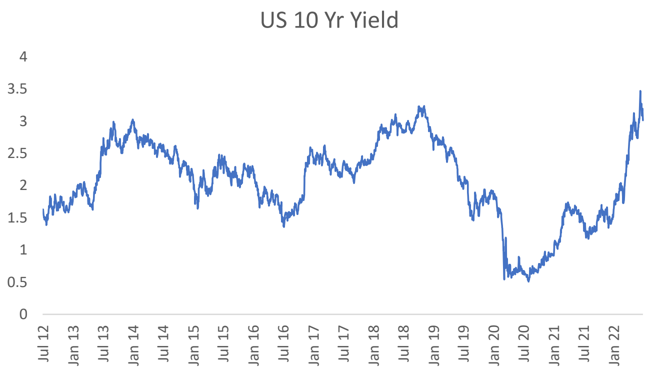
Objective

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 US economy is in strong shape and that the Central Bank can reduce inflation to 2% while maintaining a solid labour market, even though that task has become more challenging in recent months.

He also vowed to ensure rapid price increases don't become entrenched, saying that "we will not allow a transition from a low inflation environment to a high inflation environment". The Fed remains hopeful that growth will remain positive - believing that overall the US economy is well positioned to withstand tighter monetary policy. The Fed continues to think they can raise interest rates without sparking a recession, many investors in the financial markets however are not so confident that this outcome can be achieved.



The Fed raised interest rates by 0.75% on 15 June, the biggest increase in three decades. Powell also signalled another 0.5% to 0.75% increase is on the table when they meet again in late July. This would quickly move rates into restrictive territory acting to restrain rather than to spur economic activity. Powell and his colleagues have pivoted aggressively to fight the hottest inflation in 40 years amid criticism that they left monetary policy too easy for too long as the economy recovered from COVID19. They have raised cash rates by 1.5% this year and are forecasting a further 1.75% of tightening by year end. The Fed message is clear, they are more concerned about getting inflation down than they are about the possibility of causing a recession.

In addition to aggressively raising rates US money supply is being reduced at the same time. The Fed's holdings of treasuries and mortgage-backed securities started to decline in June at an initial combined monthly rate of $47.5billion, stepping up over three months to $95 billion. This "quantitative tightening" will join interest rates as another head wind for economic activity as money supply is put on more restrictive settings. It is clear that for a number of reasons markets are swinging from fearing inflation to having a growth scare. Only time will tell how severe the downturn will be however in the meantime uncertainty has grown and volatility looks likely to remain elevated for some months to come.

Fund Commentary

The fund recorded a fall over June as bond yields spiked to 3.5% before retreating again. These sharp movements saw yields move through option strike levels and creating losses for the fund. The income generated by the fund was strong but not sufficient to fully offset the option exercise costs. Income and volatility levels remain at attractive levels as we continue to see central bank statements, data releases and geo-political events keeping markets on edge.

Uncertainty surrounding inflation and economic growth levels will likely keep bond market volatility and option income high. The elevated level of option premium income will benefit the fund and help insulate it from losses should large short-term movements in bond yields continue.

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** $33.3m	**Strategy Launch** October 2007

Compliance

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

Contact Us

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