Factsheet 31 July 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 as the market fluctuated between worrying about inflation and worrying about economic growth.
- Hawkish Fed statements and inflation concerns drove bond yields to a high of 3.1% before closing at a yield of 2.67%. Investor concerns about a slowing economy were confirmed with US GDP contracting for the second quarter in a row.
- 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. The speed of rate rises may slow if economic data remains soft however the Fed does need to win the inflation battle.

Fund Highlights

- The fund's unit price fell over July as bond yields remained volatile with yields moving through some 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 keep 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 eventually benefit the fund and help insulate it from further 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]	-1.55%	-9.24%	-15.08%	-16.40%	-9.25%	-0.09%
Benchmark[2]	0.54%	1.50%	5.14%	4.83%	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.

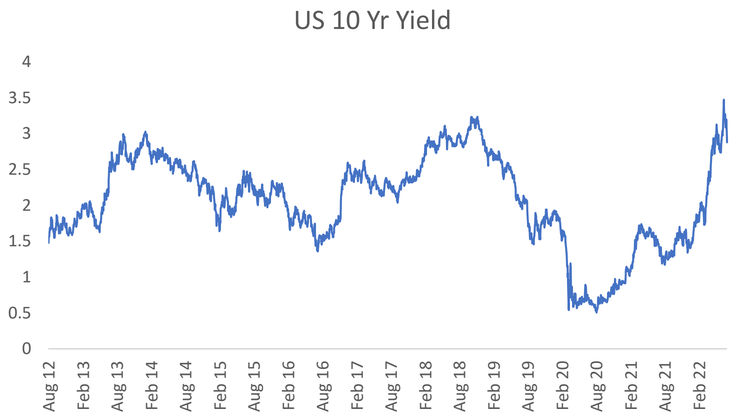
The fund uses a leveraged trading strategy, and the impact of interest rate volatility is magnified by the use of leverage. For every $1 in the fund, up to $6 of call options and $6 of put options can be sold. The options are sold in pairs, each comprising a call and a put option with the same expiry 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

Treasury yields fell on the last day of the month as investors pared expectations for how much policy tightening the Federal Reserve will do based on a weak estimate of the US economy's performance in the second quarter of 2022. The GPD measure of economic growth fell an annualised 0.9% following on from a decline in the March quarter. The GDP report illustrates how inflation has undercut Americans' spending power and tighter monetary policy has weakened interest rate sensitive sectors such as the housing market.



Market pricing now suggest traders expect the Fed Funds rate to peak around 3.25% before the end of 2022, less than 1% above current levels. The move follows a drop in rates following the Fed's decision to hike rates by 0.75% to a range of 2.25%-2.5% and comments that were taken as more dovish by the market however it may be an error to suggest that this means the Fed will change direction on their interest rate policy even when faced with a softening economic outlook. Reducing inflation and inflation remains their primary objective. The market seems to be suggesting that "bad news is good news". When an economy is slowing, inflation measures tend to fall. That brings the tightening cycle closer to a conclusion and both bond and equity markets will like that. Also frontloading rate rises, as has occurred, will likely mean the peak in rates will be lower and the rate of increases may also start to reduce soon.

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 head winds 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's unit price fell over July as bond yields remained volatile with yields moving through some 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. The income generated by the fund is strong but not sufficient to fully offset the option exercise costs. 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 eventually benefit the fund and help insulate it from further 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** $32.6m	**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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