

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 the Federal Reserve's aggressive tightening policy's impact on economic growth.
- Hawkish Fed statements, UK policy mis-steps and the likelihood of an elevated period of restrictive policy stance drove 10-year US Treasury yields to a high of 4.01%. It was one way traffic for the bond market with the lows seen on the first day of the month.
- Multiple rises in the Fed Funds Rate over 2022 and into 2023 are priced into the US yield curve. The speed of rate rises may slow if economic data is softer however the Fed does need to win the inflation battle.

Fund Highlights

- The fund's value decreased over September as bond yields increased significantly and market volatility spiked. Bond yields moved through option strike levels resulting in losses for the fund.
- Income and volatility levels increased as 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 benefit the fund eventually however the large monthly rate rises in 10-year bonds is unhelpful in the short term.

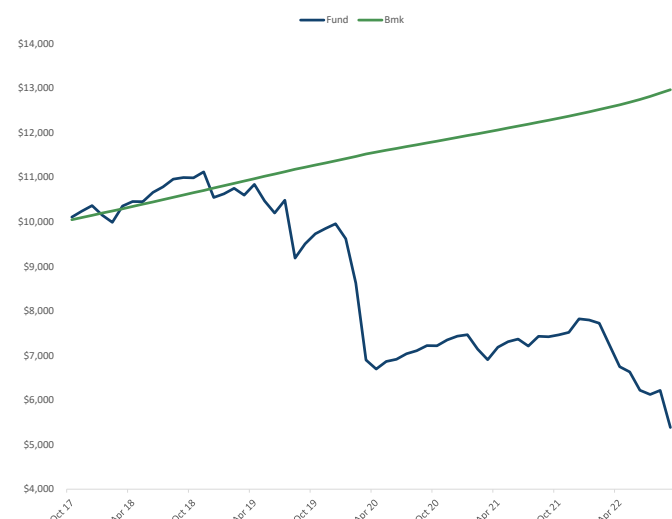
Performance

| | One month | Three months | One year | Three years (p.a) | Five years (p.a) | Ten years (p.a) |
|------------------------|-----------|--------------|----------|-------------------|------------------|-----------------|
| Wholesale ¹ | -13.40% | -13.47% | -27.46% | -17.26% | -11.65% | -1.52% |
| Benchmark ² | 0.58% | 1.70% | 5.57% | 4.92% | 5.33% | 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

Federal Reserve Chair Jerome Powell said officials were determined to curb inflation after they raised interest rates by 75 basis points for a third straight time to a range of 3% to 3.25% and signalled a more aggressive than expected path of rate hikes to come. The 3% to 3.25% range is the highest since the 2008 financial crisis and up from near zero at the start of the year.

“We are moving our policy stance purposefully to a level that will be sufficiently restrictive to return inflation to 2%”. Officials forecast rates will reach 4.4% by the end of this year and 4.6% in 2023, this was an increase from the previous forecast path.

Inflation as measured by the US consumer price index peaked in June at 9.1% but it has so far failed to come down as quickly as hoped, in August it was still 8.3%. Job growth has remained robust and the unemployment rate at 3.7%, is still below levels most Fed officials consider to be sustainable in the longer run. The failure of the labour market to soften has added to the impetus for a more aggressive tightening path at the Fed. The Fed action is taking place against the backdrop of tightening at other central banks. Collectively about 90 have raised rates this year with about a half of them delivering at least 75 basis points in one shot.

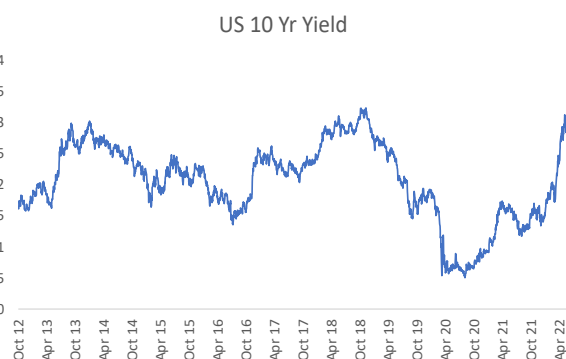
The US Central Bank is likely to keep raising interest rates and leave them elevated for a while to stamp out inflation and the Fed has pushed back against the idea the Fed would soon reverse course. Powell is on record as saying, “the historical record cautions strongly against prematurely loosening policy”.

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 economic downturn will be however in the meantime uncertainty has grown and volatility looks likely to remain elevated for some months to come.

Fund Commentary

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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% | \$29.2m | October 2007 |

Compliance

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

Contact Us

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