Factsheet 30 November 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 swung from worrying about inflation in the first half of the month to worrying about the economic impact of the US Federal Reserve's aggressive tightening as the month progressed.
- At first glance, an elevated period of restrictive monetary policy should keep 10-year US Treasury yields high however the case is building for the Fed to reduce the size of hikes to mitigate downside risks to the economy.
- Multiple rises in the Fed Funds Rate over 2022 and into 2023 continue to be priced into the US yield curve however markets are anticipating when this tightening cycle may end.

Fund Highlights

- The fund's value decreased over November. Bond yields increased from 4.06% at the beginning of the month to a high of 4.24% before closing November at the monthly low of 3.6%. Bond yields moved through a number of option strike levels resulting in losses for the fund which were not fully covered by option income.
- Income and volatility levels are remaining at high levels as central bank policy settings, 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 however large movements in 10-year bond yields are 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]	-2.61%	-14.02%	-28.91%	-18.43%	-12.19%	-1.97%
Benchmark[2]	0.62%	1.84%	6.10%	5.06%	5.39%	6.14%

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.

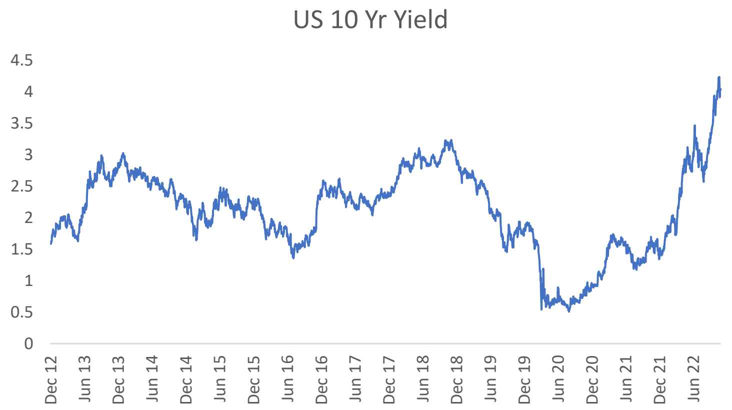
The fund uses a leveraged trading strategy, and the impact of interest rate volatility is magnified by the use of leverage. For every $1 in the fund, up to $6 of call options and $6 of put options can be sold. The options are sold in pairs, each comprising a call and a put option with the same expiry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

US Federal Reserve Chair, Jerome Powell, signalled the Fed will slow the pace of interest rate increases next month while at the same time stressing borrowing costs will need to keep rising and remain restrictive for some time to tame inflation. His comments likely cement in expectations for the Fed to raise interest rates by 50 basis points when they next meet on December 13-14, following four straight 75 basis point moves. Powell also said that “given our progress in tightening policy, the timing of the moderation in rate increases is far less significant than the question of how much further we will need to raise to control inflation, and the length of time it will be necessary to hold policy at a restrictive level.”



There hasn’t been enough strong evidence to make a convincing case that inflation will decelerate soon and the path ahead for inflation remains highly uncertain. Despite the Fed’s actions in raising the benchmark rate from near zero to the 3.75% to 4% range and slower growth over the past year there has not been clear progress on slowing inflation. The Fed’s tightening has been the most aggressive since the 1980s.
The labour market remains tight, showing only tentative signs of cooling while wage increases are well above levels consistent with 2% inflation over time.

Many economists see a recession in the US over the next 12 months as more likely than not, Powell’s view is that a soft landing or a “softish” landing remains very plausible and still achievable although he did acknowledge the path to such an outcome is narrowing. So, despite higher borrowing costs, the US economy continues to grow amid sustained demand and steady hiring. That resilience despite stubbornly high inflation points to the need for ongoing rate increases. Even though cash rates will move higher the bond market is looking forward to the time when the economy slows under the weight of higher interest rates and reduced spending heralding in the end of the Fed’s policy current tightening cycle.

Fund Commentary

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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** $29.4m	**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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