nikko am
Nikko Asset Management

Factsheet 28 February 2023

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. The market is considering the timing of when interest rate hikes will stop and when they do, how long restrictive monetary policy settings will continue for, especially as some economic indicators continue to be uncomfortably strong.
- At first glance, restrictive monetary policy should keep 10-year US Treasury yields high however the Fed has begun to reduce the size of hikes to mitigate downside risks to the economy. The problem is that inflation is still high and not falling quickly enough for the Fed officials.
- Further rises in the Fed Funds Rate are expected over 2023 and have been priced into the US yield curve however markets are trying to anticipate when the tightening cycle may end.

Fund Highlights

- After a strong start to the year the fund gave back some of the gains made in January. Bond yields reached a high of 4.0% at the beginning of the month before closing February at 3.95%. The month's low point was 3.33% giving a wide 0.67% trading range over the month.
- Bond yields moved through a number of option strike levels over the month creating losses in the fund which were greater than the income generated from selling options on Treasury bonds.
- Income and volatility levels remained at high levels as central bank policy settings, data releases and geo-political events kept markets on edge however we are seeing signs that volatility levels may be lower over 2023 than experienced over recent years.

Performance

	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale[1]	-2.60%	2.98%	-28.74%	-13.91%	-11.24%	-1.97%
Benchmark[2]	0.68%	2.09%	7.04%	5.33%	5.52%	6.18%

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.

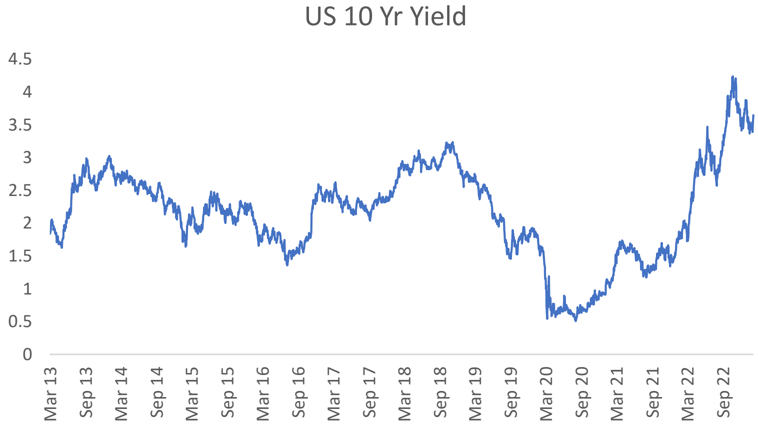
The fund uses a leveraged trading strategy, and the impact of interest rate volatility is magnified by the use of leverage. For every $1 in the fund, up to $6 of call options and $6 of put options can be sold. The options are sold in pairs, each comprising a call and a put option with the same expiry 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 officials said interest rates will need to increase further and stay elevated into next year to curb US inflation that's showing few signs of abating despite the central bank's most aggressive monetary tightening in a generation. Higher rates will allow tighter policy to filter through the economy and ultimately bring supply and demand into better balance and thus lower inflation.
The Fed is not seeing much sign of interest rate increases slowing the services sector of the economy and wage growth is too high to be consistent with their 2% inflation target.
Financial markets are pricing in a 5.5% peak in the Fed Funds rate which is similar to what the Fed is signalling.



Several recent reports have shown inflation accelerated more than forecast in January, a surprising pivot after prices had cooled in the last three months of 2022. The labour market also remained tight at the beginning of the year, with employers adding a large 517,000 jobs in January. History has taught us that if central banks ease up on inflation before it is thoroughly subdued, it can flare up again with sometimes disastrous results.

Bringing down inflation remains the Fed's number one priority. While the US economy is not in recession, history also shows that tighter monetary policy usually leads to one. Typically, when a central bank has caused a recession by raising rates the bounce back can be very fast however the Fed would not be wanting to crash land the US economy unless they are forced to do so by high and persistent inflationary pressures.

With the end of the tightening cycle in sight and an economic contraction likely it is not surprising US Treasuries and bonds in general are back on investors radars however a prolonged period of high cash rates looks probable. We have also likely seen or are close to the peak in longer term bond yields however yields will continue to be volatile for some time. As the outlook becomes clearer some of this volatility can be expected to subside.

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** $30.4m	**Strategy Launch** October 2007

Compliance

The wholesale fund complied with its investment mandate and trust deed during the month, except that an error has been identified where the value of specific options were incorrectly accounted for in the net asset value of the fund on certain days. We are working through the details and will advise the affected clients when the impact analysis is complete in March.

Contact Us

www.nikkoam.co.nz | nzenquiries@nikkoam.com