Factsheet 28 February 2021

NIKKO AM OPTION STRATEGY

Assets are held in the Nikko AM Wholesale Option Fund.

Market Overview

- Interest rates on US 10-year Treasury bonds broke out of their recent trading range. Optimism increased as vaccine programmes were rolled out and lock downs eased that a wave of pent up consumer spending will propel the US economy into a strong recovery.
- Yields spiked to 1.61% late in February, the low point for yields was 1.07% seen at the start of the month. Yields have moved a long way from the historical low point in 10-year Treasury bonds of 0.31% recorded in March 2020.
- The Fed sees short term rates staying low through to 2024 to help the economy and especially the labour market recover.

Fund Highlights

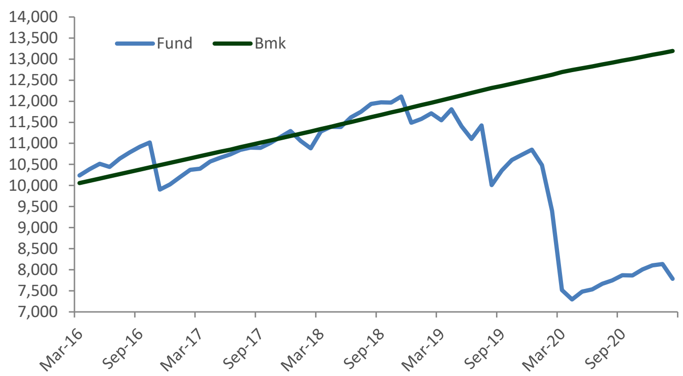
- The fund posted a negative return over February as bond yields moved higher late in the month. Yields have retraced some of their upward move in early March.
- Income and volatility levels have increased to the highest levels seen over the past year.
- Uncertainty surrounding the strength of the US economic recovery will likely keep bond market volatility and option income levels elevated.

Performance

	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale[1]	-4.31%	-2.78%	-17.18%	-10.57%	-4.89%	1.75%
Benchmark[2]	0.35%	1.05%	4.44%	5.35%	5.70%	6.43%

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.

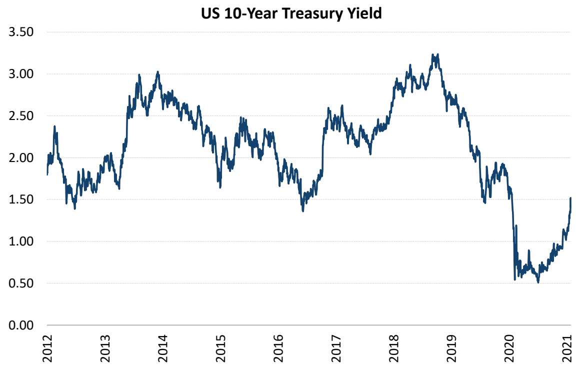
The fund uses a leveraged trading strategy and the impact of interest rate volatility is magnified by the use of leverage. For every $1 in the fund, up to $6 of call options and $6 of put options can be sold. The options are sold in pairs, each comprising a call and a put option with the same expiry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



Interest rates on US 10-year Treasury bonds broke out of their recent trading range. Optimism increased as vaccine programmes were rolled out and lock downs eased that a wave of pent up consumer spending will propel the US economy into a strong recovery. The concern for bond investors is that along with growth will come renewed inflation pressures. An additional issue is the size of the Democratic party's stimulus package, if passed in full this would see an additional layer of spending power to the consumer who are already likely wanting to go on a spending spree after enduring various severities of lock downs.

As a result of better economic prospects ahead and the fear that inflation may become a problem yields spiked to 1.61% late in February, the low point for yields was 1.07% seen at the start of the month. Yields have moved a long way from the historical low point in 10-year Treasury bonds of 0.31% recorded in March 2020 but still remain low in many people's eyes. As a counter to the rise in bond yields the Fed sees short term rates staying low through to 2024 to help the economy and especially the labour market recover. If short term rates stay low it makes no sense to continually push bond yields higher.

Federal Reserve Chair Jerome Powell signalled that the central bank was nowhere close to pulling back on its support for the pandemic damaged economy even as he voiced expectations for a return to more normal, improved activity later this year. He also played down concerns of an inflationary out break from another big fiscal stimulus package or from unleashing pent up demand as a growing number of Americans are vaccinated against the virus. He also said the run up in bond yields could be viewed as a vote of confidence of a return to a more normal economy. Any increase in inflation is seen as temporary and unlikely to be large as the economy recovers from depressed levels.

Powell commented that the high level of joblessness has been especially severe for lower paid workers and for African Americans, Hispanics and other minority groups. He reiterated the Fed's pledge to keep short term rates near zero until the labour market has reached maximum employment and inflation has accelerated to 2% and is on track to moderately exceed that level for some time.

As the US economy recovers from the COVID inspired recession and the Democrats have a freer hand to enact their stimulatory policies it is possible longer term bonds trend higher in yield however we believe upside to yields will be limited as the Fed remains committed to keeping interest rates low. If the interest rate movements on US treasury bonds are moderate or trend higher or lower over time the fund should be able to generate acceptable returns over the coming year.

Fund Commentary

The fund posted a negative return over February as bond yields moved higher late in the month, moving close to and through some of the fund's option strike rates. Yields have retraced some of their upward move in early March.

Income and volatility levels have recently increased to close to the highest levels we have seen over the past year as uncertainty surrounding the strength of the US economic recovery and the possibility of higher inflation kept bond market volatility and option income levels elevated.

If volatility remains at current levels the income generating potential of the fund looks attractive however the frequency and cost of options being struck also determines the total return. If the incidence of large yield movements over a short time period remains modest the fund is well placed to provide an acceptable level of returns once again.

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** $48.3m	**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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