Factsheet 31 December 2021

NIKKO AM OPTION STRATEGY

Assets are held in the Nikko AM Wholesale Option Fund.

Market Overview

- US 10-year Treasury bond yields traded in a modest range over the month as inflation fears were pushed aside somewhat as the Omicron variant threatened to dampen economic and employment growth.
- Yields moved within a 22 basis point range, reaching a high of 1.54%. The low point in yields was 1.32% recorded early in December. 10-year yields closed the month at 1.49%.
- Yields have moved a long way from the historical low point of 0.31% recorded in March 2020, however, remain below the 2021 highpoint of 1.77% reached in March.
- Even with the Omicron spread the Fed's programme to taper bond purchases looks likely to be brought forward. Rises in the Fed Funds Rate over 2022 also looks to be a certainty as the US faces a longer period of elevated inflation and an improving labour market.

Fund Highlights

- The fund increased 5.4% over the quarter as bond yields traded in a modest range.
- Income and volatility levels remain heightened, as we continued to see data releases that keep markets on edge.
- Uncertainty surrounding the strength and longevity of the US economic recovery, the resulting inflationary impact and the Fed's response will likely keep bond market volatility and option income at attractive levels.

Performance

	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale[1]	4.04%	5.39%	5.20%	-9.48%	-3.19%	3.32%
Benchmark[2]	0.39%	1.15%	4.43%	4.91%	5.36%	6.19%

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.

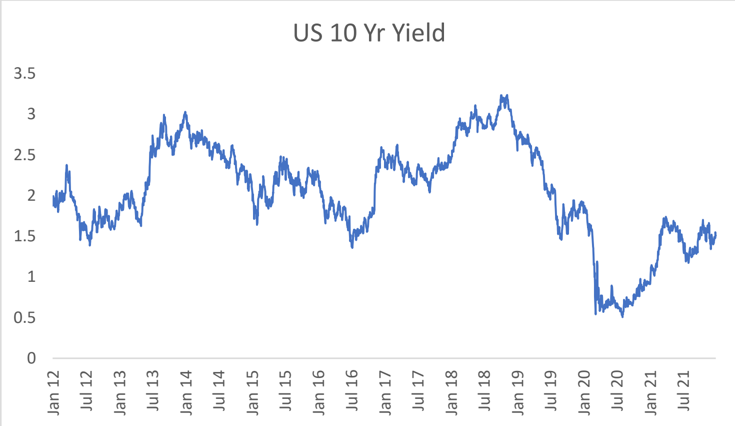
The fund uses a leveraged trading strategy, and the impact of interest rate volatility is magnified by the use of leverage. For every $1 in the fund, up to $6 of call options and $6 of put options can be sold. The options are sold in pairs, each comprising a call and a put option with the same expiry 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 intensified their battle against the hottest period of inflation since the 1970s by shifting to end their asset buying programme earlier and, signalling they favour raising short-term interest rates in 2022 at a faster pace than expected. The Fed is now on track to end their purchases of Treasuries and Mortgage-Backed Securities early in 2022 rather than mid-year as initially planned. In addition, the Fed is now projecting three 0.25% increases in the benchmark federal funds rate after holding borrowing costs near zero since March 2020. Governor Powell was reported as saying "economic developments and changes in the outlook warrant this evolution of monetary policy...the economy has been making rapid progress toward maximum employment". The quicker pullback in asset purchases puts Powell in a position to raise rates earlier than previously anticipated to counter price pressures, even as the pandemic poses an ongoing challenge to economic recovery. The Fed doesn't anticipate raising rates before ending the tapering process but could hike before the economy reaches full employment. The new interest rate projections represent a major shift from the last time forecasts were updated in September, when officials were evenly split on the need for any rate increases at all in 2022. The new projections also showed that in addition to the three increases in 2022, a further three increases are seen as appropriate in 2023 and two more in 2024 bringing the Fed funds rate to 2.1% by the end of that year.

The US economy is on track to expand at a robust pace over 2022 and the employment market is making rapid progress towards maximum employment levels. Supply and demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation, however Fed officials have now sent a loud and clear message to markets indicating they are serious about controlling inflation and willing to hike rates faster and higher to achieve their goals. Acting earlier rather than later, on their tightening programme and going hard early gives the Fed a greater chance of regaining control of inflation and will mean the peak in the interest rate cycle will likely be lower than if stimulus was retained. If the Fed did not act now it would make their job to rein in inflation and inflation expectations even harder and the Fed response would have to be more aggressive. As the US economy recovers from the COVID inspired recession it is likely longer term bond yields trend higher. We believe however, that upside in yields will be moderate as we have already seen increases in long bond yields over the past year and short-term interest rates will likely remain low compared to historical levels even when they move off levels close to zero. If the interest rate movements on US treasury bonds are moderate or trend in either direction, the fund should be able to generate acceptable returns over the coming year.

Fund Commentary

The fund increased 5.4% over the quarter, as bond yields traded in a modest range. Interest rates moved up with 10-year Treasury bond yields closing the year at 1.49%. Income and volatility levels remain at attractive levels over recent months as we continued to see data releases that kept markets on edge. Uncertainty surrounding the strength and longevity of the US economic recovery, the resulting inflationary impact and the Fed's response will likely keep bond market volatility and option income at attractive levels. If US Treasury market volatility remains at current levels the income generating potential of the fund looks attractive, however the frequency and cost of options being struck will also determine the total return.

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%	$45.2m	October 2007

Compliance

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

Contact Us

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