Factsheet 30 April 2022

NIKKO AM OPTION STRATEGY

Assets are held in the Nikko AM Wholesale Option Fund.

Market Overview

- US 10-year Treasury bond yields traded higher over the month as the Federal Reserve signalled support for further aggressive tightening to curb inflation.
- Yields closed the month 0.6% higher. Hawkish Fed statements drove bond yields to a high of 2.97% after trading as low as 1.67% early in March as inflation concerns intensified.
- Multiple rises in the Fed Fund Rate over 2022 looks to be a certainty as the US faces a longer period of elevated inflation and a strong labour market. Rate rises will eventually reach a level that slows economic activity however the Fed is treading a fine line between delivering conditions that create a hard rather than a soft landing.

Fund Highlights

- The fund fell over April as bond yields increased to close to 3%. These sharp movements saw yields move through option strike levels creating losses for the fund.
- Income and volatility levels remain at attractive levels as we continue to see central bank statements, data releases and geo-political events keep markets on edge.
- Uncertainty surrounding the strength and longevity of the US economic recovery, how long the spike in inflation will last and what the Fed's response to high inflation will be, will likely keep bond market volatility and option income high. The elevated level of option premium income will benefit the fund and help insulate it from further losses should large short term yield movements in bonds continue.

Performance

	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale[1]	-6.71%	-13.43%	-6.07%	-14.61%	-7.00%	1.26%
Benchmark[2]	0.43%	1.25%	4.68%	4.81%	5.29%	6.13%

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.

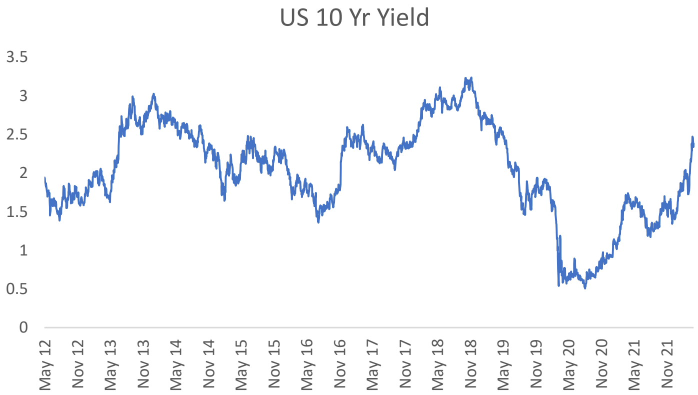
The fund uses a leveraged trading strategy, and the impact of interest rate volatility is magnified by the use of leverage. For every $1 in the fund, up to $6 of call options and $6 of put options can be sold. The options are sold in pairs, each comprising a call and a put option with the same expiry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



The Federal Reserve Chair Jerome Powell continues to endorse aggressive action to contain rampant inflation and return it to the 2% level. Powell blessed a half-point interest rate hike at the Fed's May meeting and signalled support for further tightening to curb inflation by noting that he sees merit in front-end loading policy moves. He went on to say "we are really committed to using our tools to get 2% inflation back".

It seems the Fed Chair and his colleagues want to lift rates quickly to a neutral level over 2022, a level that neither stimulates nor restrains growth, deemed to be around 2.5%, and then slow the pace of tightening. A risk to this strategy is that the Fed may have to move rates even higher to contain economic activity and inflation heightening the risk this triggers a recession, however Powell is confident in the Fed's ability to pull off a soft landing that brings inflation close to 2% without stalling the economy. The Fed's priority is price stability, and they are prepared to raise rates above neutral to more restrictive settings if that is what is required to tame price rises. The Fed is also planning to start shrinking their $9 trillion dollar balance sheet in May, quickly moving to a maximum run-off pace of $95 billion per month.

Current market pricing is above the Fed's current projections of the cash rates which top out at 2.8%. Perhaps this reflects the Fed's cautiousness once rates move up through neutral levels. Global events could provide a head wind to US growth. Russia's invasion of Ukraine and China's latest round of virus lock downs could both slow global growth and further snarl up supply chains, creating more scarcity and pushing up prices. At the same time, slowing growth in China and Europe could create disinflationary forces. Some Bloomberg analysis indicates that a 4% decline in the level of GDP in China could lead to a 30% reduction in oil and commodity prices, potentially off-setting the inflationary effects of Europe's potential oil embargo on Russia. Risks to both higher and lower inflation exist. Through all of this the US labour market remains robust and while this continues to be the case the chance of the Fed delivering a soft landing for the US economy looks promising.

Fund Commentary

The fund recorded a significant fall over April as bond yields increased to close to 3%. These sharp movements saw yields move through option strike levels and creating losses for the fund. Income and volatility levels remain at attractive levels as we continue to see central bank statements, data releases and geo-political events keep markets on edge. Uncertainty surrounding the strength and longevity of the US economic recovery, how long the spike in inflation will last for and what the Fed's response to high inflation will be will likely keep bond market volatility and option income high. The elevated level of option premium income will benefit the fund and help insulate it from further losses should large short term yield movements in bonds continue.

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%	$37m	October 2007

Compliance

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

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