Factsheet 31 October 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 fluctuated between worrying about inflation and worrying about the Federal Reserve's impact on economic growth.
- An elevated period of restrictive monetary policy is likely to keep 10-year US Treasury yields high however the case is building for the Fed to calibrate hikes to mitigate economic downside risks.
- Multiple rises in the Fed Funds Rate over 2022 and into 2023 continue to be priced into the US yield curve. The speed of rate rises may slow if economic data is softer however the Fed does need to win the inflation battle.

## Fund Highlights

- The fund increased over October. Bond yields increased from 3.83% at the beginning of the month to a high of 4.34% before closing October at 4.05%. Bond yields moved through a number of option strike levels resulting in some losses for the fund however these were covered by option income.
- Income and volatility levels are being maintained 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] | 1.93% | -10.41% | -26.46% | -17.38% | -11.49% | -1.53% |
| Benchmark[2] | 0.63% | 1.79% | 5.85% | 4.99% | 5.36% | 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.

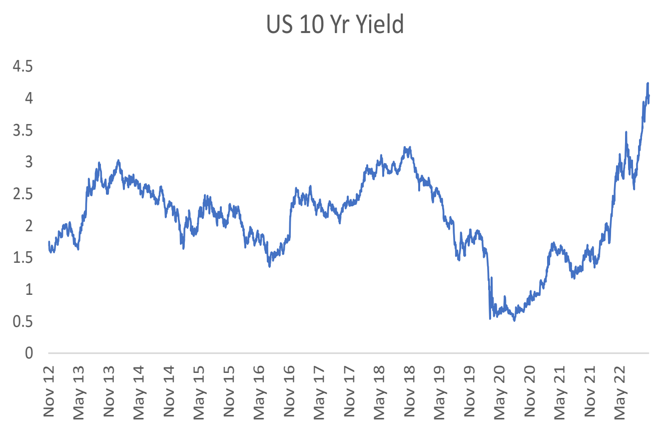
## Objective

The fund aims to earn a return of the benchmark before fees, expenses and taxes over a rolling three-year period.

## Market Commentary

Federal Reserve officials are committed to raising interest rates to a restrictive level in the near term and holding them there to curb inflation, however a number of officials said it would be important to calibrate hikes to mitigate risks. According to the minutes of the Fed's last meeting, several FOMC members noted that, especially in the current highly uncertain global economic and financial environment, it would be important to calibrate the pace of further policy tightening with the aim of mitigating the risk of significant adverse effects on the economic outlook.

During that meeting they agreed to raise the benchmark lending rate 75 basis points for the third straight time, lifting it to a target range of 3% to 3.25% as they combat stubborn inflation pressures. The talk of calibrating the pace of increases is a sign that perhaps the Fed is contemplating the time when further rate rises are no longer required. Mitigating this is the Fed emphasising that the cost of taking too little action to bring down inflation likely outweigh the cost of taking too much action.




Slammed by critics for being slow to respond to mounting price pressures, the Fed has unleashed the most aggressive tightening campaign since the 1980s. Starting with rates nearly at zero in March. It has hiked by 300 basis points and signalled more is to come. Fed officials expect to raise rates to 4.4% by the end of 2022 and 4.6% in 2023. That will come at an economic cost, higher borrowing costs are expected to slow growth to 1.2% next year and raise unemployment. Given the varying messages coming from the Fed it is unsurprising the market is not pushing bond yields significantly higher or lower and uncertainty prevails.

## Fund Commentary

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## Key Fund Facts

| | | | |
|---|---|---|---|
| **Distributions** | **Estimated annual fund charges (incl. GST)** | | |
| **Hedging**<br>Any foreign currency exposures are hedged to NZD within an operational range of 98.5% to 101.5% | **Buy / Sell spread**<br>0.00% / 0.00% | **Strategy size**<br>$30.2m | **Strategy Launch**<br>October 2007 |

## Compliance

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

## Contact Us

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