Nikko Asset Management

Factsheet 31 December 2022

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 volatile fashion as the market swung from worrying about rampant inflation to worrying about the economic impact of the Fed's aggressive tightening policy.
- 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.
- Multiple rises in the Fed Fund Rate over 2022 and into 2023 have been priced into the US yield curve however markets are anticipating when this tightening cycle may end. Unwarranted loosening of financial conditions would hurt the Fed's efforts to achieve price stability.

Fund Highlights

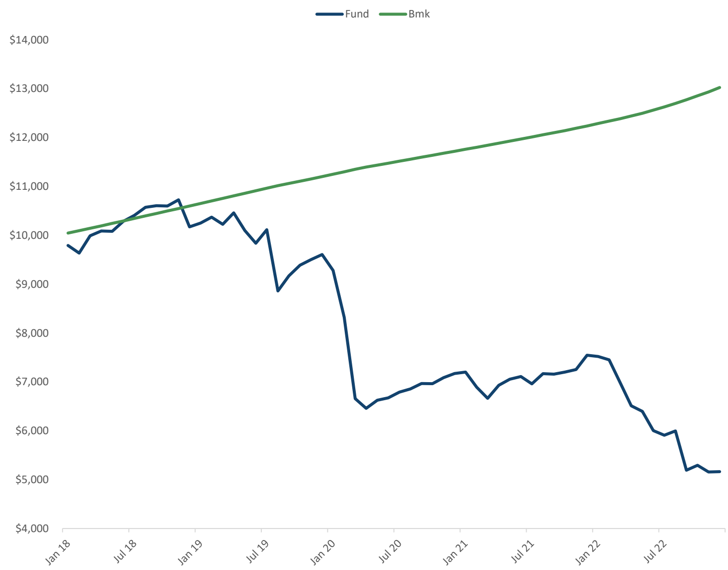
- Bond yields increased from 3.8% at the beginning of the quarter to a high of 4.34% in October before closing the year at 3.88%. Bond yields moved through a number of option strike levels resulting in losses for the fund over the quarter which were not fully compensated for by option income.
- Income and volatility levels remained at high levels as central bank policy settings, data releases and geo-political events kept markets on edge.
- Uncertainty surrounding inflation and economic growth levels will likely keep bond market volatility and option income high into the new year. 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]	0.11%	-0.62%	-31.60%	-18.70%	-12.39%	-2.04%
Benchmark[2]	0.69%	1.96%	6.42%	5.15%	5.43%	6.15%

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.

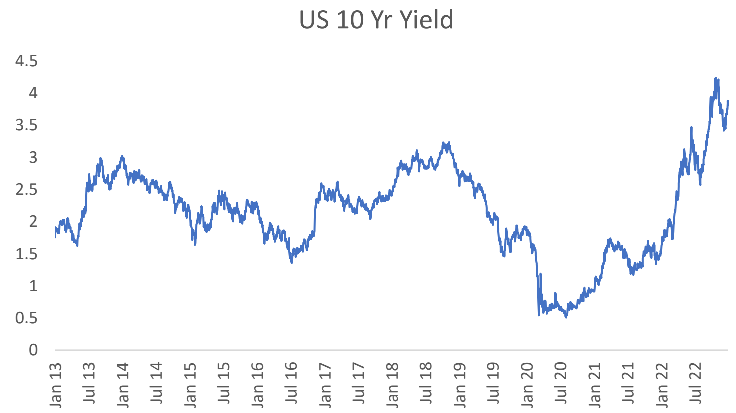
Objective

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

Market Commentary

US Federal Reserve officials reaffirmed their resolve to bring down inflation, cautioning that an unwarranted loosening of financial conditions would hurt their efforts to achieve price stability. Going into the December FOMC meeting, markets were pricing in interest rate cuts in the second half of 2023. In the Fed's view this is too soon.

US central bankers raised the benchmark lending rate by 0.5% at their latest meeting, slowing down after an aggressive string of four straight 0.75% increases. Officials also delivered a hawkish tilt with more hikes projected in 2023 than expected by investors. Fed officials also reinforced their intent to lower inflation back toward their 2% target even at the risk of rising unemployment and slower growth. The Fed's actions last month extended its most aggressive tightening cycle since the 1980s. Starting at close to zero in March 2022, the Fed have raised their benchmark lending rate through successive meetings to a target range of 4.25% to 4.5%, the highest since 2007.



The latest quarterly economic estimates show rates rising to 5.1% in 2023 up from 4.6% in the prior update. A recession is now a plausible outcome according to the Fed. Fed Governor, Jerome Powell, also described the labour market as "out of balance" and "extremely tight" and warned that restoring stable prices is likely to result in softening in the job market.

Sluggish growth in real private domestic spending, a subdued global economic outlook and persistently tight financial conditions are tilting the economic risks to the downside. Restrictive conditions are expected to lift the unemployment rate to 4.6% by the end of the year. Even though unemployment is forecast to rise and inflation to fall, it is too soon for the Fed to allow investors to start pricing in rate cuts before the Fed has finished rate rises. We expect the Fed continue to talk tough, even though the Fed may soon reach the top of the cash rate cycle and their focus will switch to thinking about how long the restrictive settings will last. Only the data outcomes will determine the timing for central banks to err on the side of caution and keep conditions tighter than needed to ensure both inflation and inflation expectation fall.

Fund Commentary

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Income and volatility levels remained at high levels as central bank policy settings, data releases and geo-political events kept markets on edge. Uncertainty surrounding inflation and economic growth levels will likely keep bond market volatility and option income high into the new year. 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.

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** $29.5m	**Strategy Launch** October 2007

Compliance

The wholesale fund complied with its investment mandate and trust deed during the quarter, 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 later in January.

Contact Us

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

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