Clime Australian Income Fund

Quarterly Update - December 2018

Investment Objective

The Fund's objective is to provide a level of income of 2% to 3% p.a. above the RBA cash rate and to grow capital in line with inflation. It seeks to deliver a strong risk-adjusted total return and is expected to have a level of volatility of returns significantly less than traditional equity indices.

Investment Strategy

The Clime Australian Income Fund seeks to provide an income stream above the RBA cash rate from a portfolio of Australian listed and over the counter (OTC) unlisted securities, with a strong view towards capital preservation. The portfolio will invest in select high quality individual investments which in aggregate create a best ideas portfolio for income generation. Portfolio yield is likely to be incrementally enhanced via franking credits.

Performance and Volatility of Return (31/12/18)

	Portfolio Return**	*Income*	*Capital Growth*	Franking
1 month	0.16%	0.82%	-0.65%	-
3 months	-1.14%	0.82%	-1.93%	-
6 months	0.56%	1.55%	-0.97%	-
1 year	0.53%	3.95%	-3.29%	0.18%
2 years*	4.35%	3.92%	0.42%	0.24%
3 years*	6.04%	3.96%	2.00%	0.26%
Since Inception*	6.10%	3.62%	2.39%	0.22%

Note: Compound (geometric) returns are used in the above table's segmentation of Income and Capital Growth. This may result in small differences when compared with a simple addition of Income and Capital Growth components.
*1 July 2015. Performance figures for more than 1 year are annualised, calculated after all applicable fees and taxes.
**Portfolio return is based on the change of the unit price including distributions but excluding franking credits. Franking credits will enhance portfolio returns and historically, have added about 0.22% pa to Fund returns as shown in the last column of the table above.

We have tabulated the volatility of the fund over 1, 2 and 3 years and since inception and compared this with the ASX200 index below. The volatility of the Income Fund is far less than the equities market, with the ratio at about 0.30 (or 30%) of the ASX200 over the measured period. This is consistent with the Fund's objective of providing capital stability while generating regular quarterly income.

Volatility^^			
	CAIF	ASX200	Ratio of CAIF/ASX200
1 year	2.67%	8.94%	0.30
2 year	2.52%	8.79%	0.28
3 year	3.19%	11.16%	0.29
Inception	3.31%	11.86%	0.28

^^Volatility is the annualised standard deviation of the NAV/unit and ASX200 as measured on a weekly basis.

For those who prefer to visualize this price stability, we provide the weekly unit price compared with the ASX200 (normalized from the Fund's inception date) as shown below. Clearly the price stability of the Fund is superior to that of the ASX200 where the variability of the unit price is noticeably smoother. This price stability is clearly demonstrated in the last quarter of 2018 when the market was sold off by around 10% while the Fund maintained relative price stability.

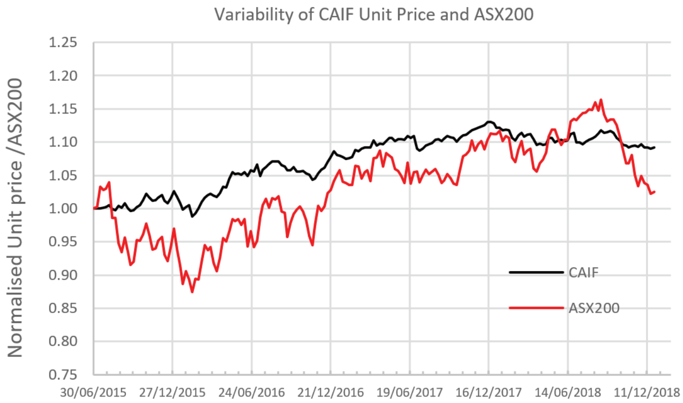
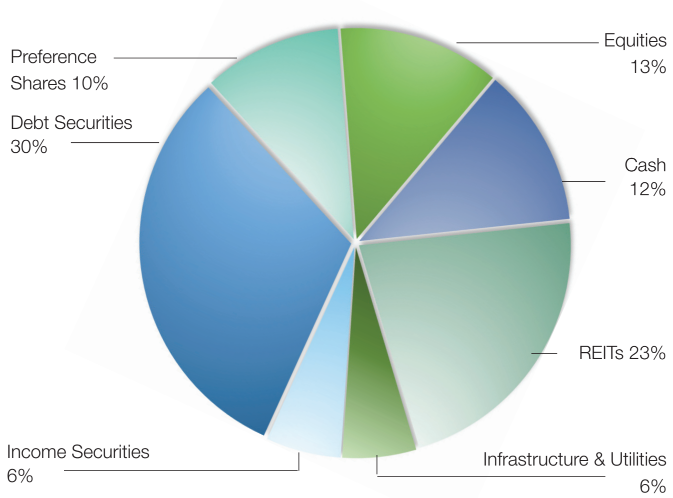


Chart 3 - The variability of the Fund's and ASX200 weekly prices since inception. The CAIF's unit price shows much less variation and represents a demonstrably higher risk-adjusted return.

Asset Allocation



Distributions

Period Ending	Wholesale Units (cents per unit)
31 December 2018	0.8859
30 September 2018	0.8045
30 June 2018	1.8352 +0.2025 franking credits
31 March 2018	0.7455
31 December 2017	0.7602
30 September 2017	0.6015
30 June 2017	1.8451 +0.3189 franking credits
31 March 2017	1.0082
31 December 2016	0.9706
30 September 2016	0.5123
30 June 2016	2.1483 +0.3153 franking credits
31 March 2016	0.8246
31 December 2015	0.2390
30 September 2015	0.5383

Top 5 Holdings

Security	Weight %
Multiplex SITES	2.9%
National Income Securities	2.7%
Macquarie Income Securities	2.7%
Elanor 7.1% Bond	2.6%
Centuria Diversified Property Fund	2.6%

Investment Commentary

At 31 December 2018, the Clime Australian Income Fund was diversified across six underlying sub-asset classes: Domestic Debt, Income & Preferred Securities; REITs; Utilities & Infrastructure (U&I); Equities; and Cash. Note REITs and U&I are technically equities, but they are normally classified as a sub-set of the equity asset class. The underlying security weights in the portfolio ranged from around 0.5% to 3.0%.

In our 3-year letter to CAIF investors distributed in September 2018, we noted that one of the things we aim to do better is to increase interim distributions, as well as overall distributions, in any rolling 12-month period. However, interest rates remain very low, and the RBA is unlikely to be increasing rates in the next 12 months, perhaps not until 2020. Moreover, if the global economy peaked in 2018, the RBA might not be able to hike in this cycle.

In recent quarters, within the Fund we have:

- Increased exposure to bonds, selectively focusing on stable non-cyclical businesses and / or investment grade bonds;
- Continued to actively reduce our exposure to Banks' T1 capital notes (CNs) by taking profits on above par CNs and adding to below par ones and / or switching to its ordinary equities;
- Selectively introduced holdings in good quality direct property assets when the opportunities arose, although there is a limit to how much we will hold these assets due to liquidity risk.

In this quarter, we added more income generating debt securities, with credit rated Banks' T2 FRN's (AMP and BEN T2) and a new series Centuria 4.5-year senior secured bond. We also topped up on our entitlement for the Elanor Commercial Fund when the Fund bought a QLD Government tenanted building.

Outlook

The global economy may have peaked in 2018, and there are several major risks surfacing at present. We name a few below:

1. US-Sino trade tensions will likely be a prolonged issue that lingers well beyond 2019.
2. China's economy is slowing, and this will impact global growth. While the probability of a US recession is low, the Eurozone is weak and will be adversely affected by Brexit.
3. The US Fed Fund rate is at 2.25% to 2.50% and has crept up at a time when corporates have borrowed heavily to buy back their shares instead of borrowing to invest for the future. This will have a negative impact on growth.
4. The ECB has ended their QE program may look to raise rates post the northern summer of 2019.
5. Locally, we face uncertainty from the NSW and Federal elections in the first half of 2019. This will amplify the negativity of consumer sentiment on a highly geared household, falling house prices and low savings ratio. These issues will not go away until at least the State and Federal elections are out of the way.

On the positive side, employment in the US and locally continues to be robust while inflation remains low globally. As long as we have strong employment and low inflation, it is possible to maintain an orderly soft landing.

In our December 2017 quarter commentary, we were steadfast in our view that inflation will remain low. This has proven to be correct. Unfortunately, returns for the Fund were disappointing with capital losses over the last 12 months almost completely negating income returns. Nevertheless, we are comforted by the fact that we have:
a) improved on the short-term income component of the Fund, now at an annual income yield of 3.95%;
b) maintained relative price stability over the last quarter given the market was down close to 10%.

What about 2019? We believe it will be challenging for most asset classes except for high quality defensive securities, high credit rated FRNs and cash. Volatility will increase from the recent past.

In reality, markets are moving back to more normal behaviour.

That said, we believe the local equity market has mainly priced in this slower growth, given that the index has dropped by -9% over the past 3 months, and -15% from the peak to bottom in the recent sell off. Short of a recession (not our base case although the risk is increasing), we think there is value in the equity market, but we need to focus on yield and quality lower risk securities as we navigate these uncertain times.

Overseas, we remain cautious on US equities. The Federal Reserve is aiming to increase rates twice in 2019, and it is simultaneously reducing liquidity in the market by shrinking its balance sheet by US$50B per month. We think this will have a similar but opposite effect on US equity markets compared with the period when it introduced QE during the GFC, when cheap money drove the market up strongly.

Some of these negative impacts will be transported globally, including to our local market (as we witness now through higher funding costs). In addition, we note that with the yield for US 2y bonds around 2.50% (which is higher than US inflation), investors have an alternative to park their funds with the safest paper asset class. To make things worse, the ECB ended its QE programmes in December 2018 and look set to raise rates within the next 6 months.

All these changes will exacerbate market uncertainty. The primary objectives of the Fund remain to provide regular income in the short term, steady capital growth in line with inflation over the midterm, while maintaining low volatility of returns. We will take advantage of market volatility to accumulate high quality low risk securities with good yields.

Additional Information

For more information and to download information and application forms, please visit the Clime website at: www.clime.com.au/caif

Or call a Clime Client Director on:

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