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Clime Australian Income Quarterly Investment Report March 2019

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Market Commentary

While the rate of growth moderated during the month of March, with the S&P/ASX200 Accumulation Index up 0.7%, the first quarter of 2019 has come as a welcome relief for growth asset investors. Following the sharp pullback last November and December, global investor sentiment and market prices have recovered some of their optimism, largely off the back of a more dovish US Federal Reserve.

The reversal of fortunes in risk assets has come despite generally disappointing macro data across Europe, the US and China and the tempering of corporate earnings forecasts globally. The rally in global equities to date in 2019 has not been driven by expectations for better growth and rising corporate profits, but by reassurance that global central banks would temper their inflation-fighting objective and seek instead to sustain the post-GFC recovery.

Another factor supporting the equity market recovery has been the sense that the sell-off late last year was overdone. The near 30% de-rating in global equity PE ratios from end-January 2018 to end-December 2018 was both brutal and unexpected, given that the world's largest economy, the US, was growing strongly and experiencing a buoyant year for corporate earnings. But of course, markets are forward-looking, and fears of "peak earnings", a Sino-American trade war, a hard landing in China and a Federal Reserve determined to "normalise" rates sapped confidence and soured the mood. The fact that many of these fears have proved either unfounded or exaggerated has supported the rebound.

Now that the first quarter is over, we must assess whether that rebound is either warranted or sustainable. Over the course of the first 3 months of 2019, the S&P/ASX200 has risen 10.9% while global markets have enjoyed similarly impressive quarterly returns. A good part of those figures may be making up the losses from the quarter before that, but it remains for the market to be tested for the most critical factor, which is value.

The likelihood of material further upside for equity markets in the short term is, in our view, now dependent on central banks allowing financial conditions to remain loose, policymakers stimulating activity through prudent infrastructure spending and fiscal relief for households, the successful conclusion to trade talks, the US economy remaining reasonably strong and some sparking of growth in the European and Chinese economies.

In particular, we highlight the effectiveness or otherwise of the broad range of measures implemented by the Chinese authorities to cushion their growth slowdown. The Chinese consumer is the "single most important (factor) in the world economy", said Jim O'Neill, former Goldman Sachs chief economist. "The next 40 years of global growth might be about the Chinese consumer. It is very unlikely that any other country could step in to drive global consumption." China has contributed around 30% of the global economy's growth since 2013, compared to 11-13% from each of India, the European Union, and the United States. The strength of China's economy is critical.

A key support to developed economies (the US, the Eurozone and Japan) remains consumption growth backed by solid labour markets and continued wage growth. To date, the absence of wage growth has been the disappointing factor in the recovery that we saw during last year, and this has been a spur to the growth of populism in many countries. A pause in the central banks' rate rising program and a well-targeted stimulus from China should provide the basis for global growth a little below trend. Resolution in trade conflicts would no doubt also reduce uncertainty and support global growth.

In an environment where economic risks are building and global growth is slowing, careful assessment of investment opportunities is required. The change in tone from the US Fed, and its increased sensitivity to growth and the financial cycle, has led to a fundamental reassessment of risks and opportunities in many financial markets, as the "lower for longer" thesis on interest rates reasserts itself. At the same time, while trade talks between the US and China seem to be progressing, the Brexit imbroglio and many other political risks remain heightened. However, these risks and changes in economic growth expectations present opportunities and an argument for active management and active asset allocation.

Clime's base case is that overall global equity returns in the medium term are likely to be positive but more muted than investors have been used to for most of the post-global financial crisis period. Nonetheless, we expect that late cycle volatility and macro-thematic market drivers combined with company-specific opportunities will provide a satisfactory set of portfolio alternatives for patient investors.

Thank you for your continued support of Clime.

Adrian Ezquerro
Head of Investments

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Investment Objective

The Fund's income objective is to provide regular meaningful income above the RBA cash rate in the form of quarterly cash distributions. 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. The Fund's risk objective as defined by the annualised standard deviation is 4.0% ± 1.0% over a rolling 12 months with the relative risk to the ASX200 index of less than 40%. In order to maximize the chance of achieving these objectives, the recommended investing time frame is 3 to 5 years.

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) securities, with a view to price stability. The portfolio will invest in selected high quality individual securities 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 (31/03/2019)

	Portfolio Return**	Income	Capital Growth	Franking
1 month	1.2%	0.7%	0.5%	-
3 months	4.0%	0.7%	3.3%	-
6 months	2.9%	1.6%	1.3%	-
1 year	6.3%	4.0%	2.3%	0.2%
2 years*	5.2%	3.8%	1.4%	0.2%
3 years*	7.2%	4.0%	3.2%	0.3%
Since Inception	6.8%	3.6%	3.2%	0.2%

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 0.2% pa to Fund returns as shown in the last column of the table above.

We have tabulated the volatility of the Fund over 1 - 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, less than 3.3% in absolute terms and less than 30% of the ASX200 over the measured period, well within the Fund objectives.

The Fund's March quarter distribution is 0.8096 cent / unit, and the rolling 12-month income generation is 3.98%. This is consistent with the Fund's income investment objective of providing meaningful income above the RBA cash rate.

	Volatility^^		
	CAIF	ASX200	Ratio of CAIF/ASX200
1 year	2.5%	9.5%	0.26
2 year	2.4%	9.5%	0.26
3 year	2.8%	10.6%	0.26
Since Inception	3.2%	11.8%	0.27

^^Volatility is the annualised standard deviation of the NAV/unit 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) below. Clearly the price stability of the Fund is superior to the ASX200 and the variability of the unit price is noticeably smoother.

The portfolio's price stability is evident when the market sold off in the last quarter of 2018 by more than 10% and rallied back in the March quarter. Thus we believe in the merits of investing in a multi-asset income focused portfolio which has the ability to deliver moderate capital growth and consistent income from a low volatility portfolio.

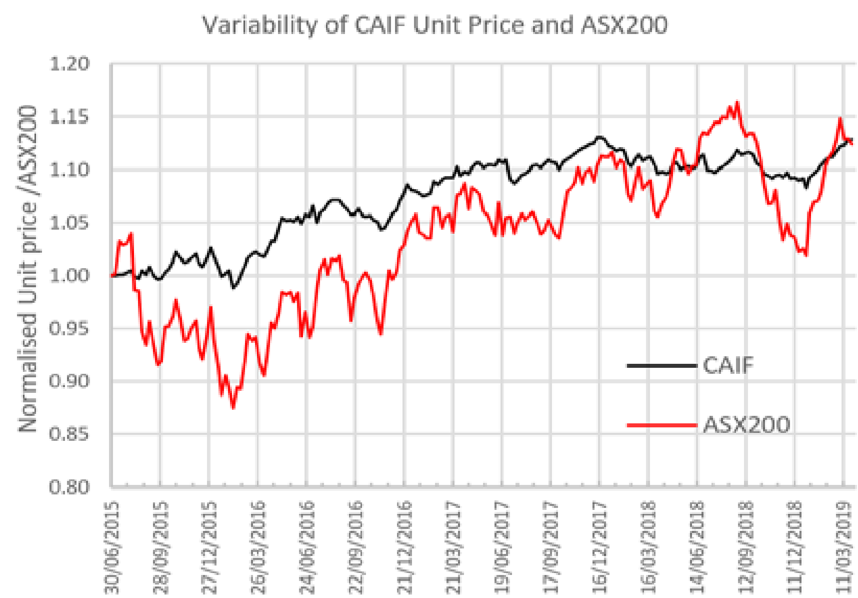

Chart 4 - The variability of the Fund's and ASX200 weekly prices since inception. The CAIF's unit price is smoother, representing a relatively more stable capital price, while generating regular income.

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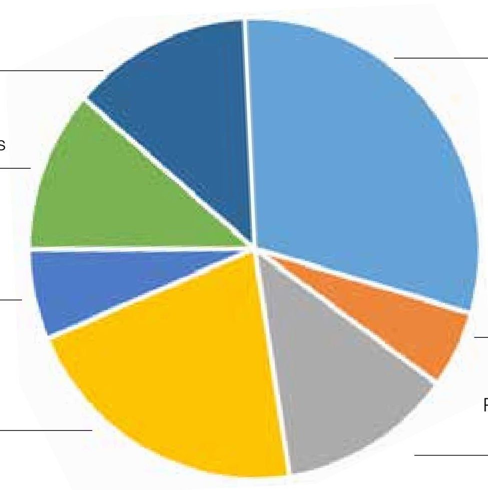
Asset Allocation



Top 5 Holdings

Security	Weight %
Multiplex SITES	3.0%
National Income Securities	2.8%
Macquarie Income Securities	2.7%
Elanor 7.1% Bond	2.3%
Centuria Diversified Fund	2.3%

Distributions

Period Ending	Wholesale Units (cents per unit)
31 March 2019	0.8096
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

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Investment Commentary

At 31 March 2019, 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 the March quarter, the Fund's strategic asset allocation (SAA) and tilts within each asset classes included:

- Increased exposure to credit rated Floating Rate Notes (FRNs),
- Positioning the Fund to fixed rate debt securities with midterm maturities to lock in fixed rates;
- Selectively accumulating quality equities;
- Selectively increasing exposure to attractive REITs but also taking profits at the individual security level due to the strong rally of bond prices (and declining yields) in late March;
- Slowing our reduction of capital notes begun in 1H18. We may participate in new issuance if they are priced attractively.

During the quarter, we added income generating debt securities, including credit rated senior debt paper via CUA senior 3-year FRNs and IAG MTN Subordinate debts. Both were heavily over-subscribed, even though re-priced due to heavy demand. Peet Limited (ASX: PPC) issued another bond, an OTC 5-year, 3-year NC bond at 6.75% fixed rate (also over-subscribed). Macquarie Group Limited (MQG) issued a new capital note (MQGPD) priced at 4.15%, in which we participated. Due to strong demand, all the debt securities and capital note we participated in during the March quarter were scaled back. Lastly, we introduced Iress Limited (IRE) in the equity bucket when the ASX decided to sell off their stake in February 2019.

We exited AMP Limited (AMP) at a loss but to offset this, we took profits in Australian Unity Office (AOF). We will wait for an opportunity to re-introduce exposure in AOF at a later date when the price becomes more attractive.

Outlook

A string of economic data in March resulted in less positive outlooks from the ECB and US Fed. With these weaker data, both the ECB and US Fed reversed the direction of interest rates and announced the following:

- The ECB announced a new two-year bank funding package (Long Term Refinancing Operations) to start on September 2019. Second, the forward guidance on when the ECB might begin diverging from the path of negative interest rates was changed from "after the summer (northern) of this year" to "at least until 2020".
- The US Fed announced a pause in rate hikes this year (from two increases anticipated previously) and sees only one hike in 2020. The Fed will reduce its balance sheet reduction programme from $30bn to $15bn per month from May and end the process completely by September.

Post these announcements, the US 3m and 10-year treasuries inverted. We do not read too much into this, although historically an inverted yield curve is a strong leading indicator of recession.

As a result, the market is now pricing in a cut in the US fund rate by the end of 2019, even though the US Fed has only signalled a pause in rate hikes. The Australia 10-year Bond breached the all-time low in 3Q2016 but closed at 1.80% for the March Quarter.

In our December 2017 quarter commentary, we were steadfast in our view that inflation would remain low and yields would remain the important part of the total return over the medium term. This has proven to be correct. For the Fund, we will try

1. to improve on the income component. The annual income yield of 31 March 2019 is 3.98%, which is well above the RBA cash rate of 1.50%.
2. to maintain strong price stability of the unit price.
3. to take advantage of market volatility to accumulate high quality, lower risk, yield-focused securities across the entire capital structure.
4. to take profit at the security level if any individual security runs too hard.