# Clime Australian Income Fund

Quarterly Update - September 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 CPI. It seeks to deliver a strong risk-adjusted total return and is expected to have a level of total volatility of returns of significantly less than the 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

| | Portfolio Return^ | *Income* | *Capital Growth* | *Franking* |
|---|---|---|---|---|
| 1 month | -0.10% | 0.73% | -0.82% | - |
| 3 months | 1.72% | 0.73% | 0.98% | - |
| 6 months | 3.37% | 2.41% | 0.93% | - |
| 1 year | 4.21% | 3.81% | 0.39% | 0.19% |
| 2 years (p.a.)* | 6.39% | 3.96% | 2.34% | 0.24% |
| 3 years (p.a.)* | 7.65% | 3.76% | 3.75% | 0.26% |
| Since Inception | 7.14% | 3.64% | 3.20% | 0.24% |

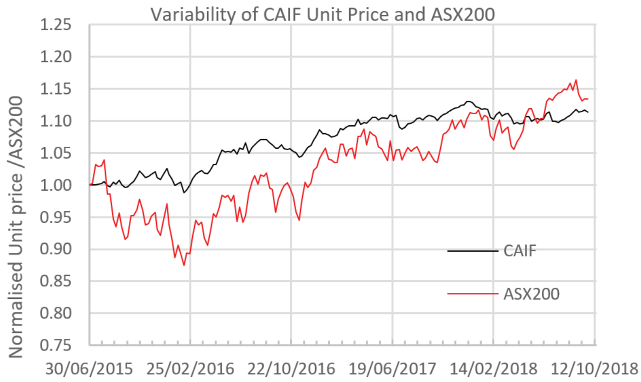
Note: Compound (geometric) returns are used in the above table's segmentation of Income and Capital Growth. This may result in small differences when compared with a simple addition of Income and Capital Growth components.
*1 July 2015. Performance figures for more than 1 year are annualised, calculated 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 0.25% 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 with 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 entire 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 | 2.65% | 8.37% | 0.305 |
| 2 year | 2.82% | 10.55% | 0.267 |
| 3 year | 3.45% | 12.33% | 0.280 |

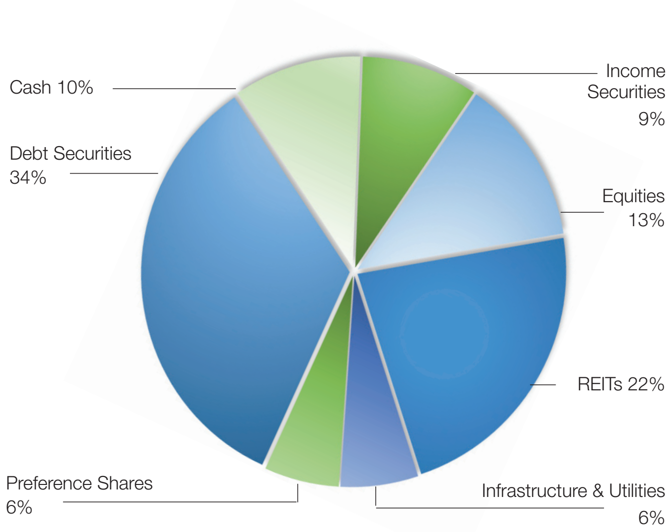
^^Volatility is the annualised standard deviation of the NAV/unit and ASX200 as measured on a weekly basis.

For those who prefer to visualize this price stability, we provide the weekly unit price compared with the ASX200 (normalized from Fund's inception date) as shown below. Clearly the price stability of the Fund is superior to the ASX200 where the variability of the unit price is noticeably smoother over the entire period.




*Source: Clime Asset Management, IRESS*
Chart 4 - The variability of the Fund's and ASX200 weekly prices since inception. The CAIF's unit price is much smoother, which represents a relatively more stable capital price.

## Asset Allocation




## Distributions

| Period Ending | Wholesale Units (cents per unit) |
|---|---|
| 30 September 2018 | 0.8045 |
| 30 June 2018 | 1.8352<br>+0.2025 franking credits |
| 31 March 2018 | 0.7455 |
| 31 December 2017 | 0.7602 |
| 30 September 2017 | 0.6015 |
| 30 June 2017 | 1.8451<br>+0.3189 franking credits |
| 31 March 2017 | 1.0082 |

| | |
|---|---|
| 31 December 2016 | 0.9706 |
| 30 September 2016 | 0.5123 |
| 30 June 2016 | 2.1483<br>+0.3153 franking credits |
| 31 March 2016 | 0.8246 |
| 31 December 2015 | 0.2390 |
| 30 September 2015 | 0.5383 |

## Top 5 Holdings

| Security | Weight % |
|---|---|
| National Income Securities | 3.2% |
| Macquarie Income Securities | 3.1% |
| Elanor 7.1% Bond | 3.0% |
| Multiplex SITES | 2.9% |
| CBA Capital notes | 2.3% |

## Investment Commentary

At 30 September 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. The underlying security weights in the portfolio ranged from around 0.5% to 3.2%.

In our 3year letter to CAIF investors distributed recently, we said 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 until 2H 2019. Moreover, with the increased trade tension between the US and China, in the unlikely event this escalates into something more serious, the RBA may not be even be able to hike in this cycle.

You may ask how we intend to increase yield in our portfolio yet not increase risk (volatility) significantly as this is one of our two objectives. The simplified schematic below should assist with the visualisation of our strategy. We termed this a two-step "operation twist" whereby we will increase our risk slightly by increasing our asset allocating towards equities as we reduced our preference shares and capital notes holdings. For example, the banks' equities are paying a much higher fully franked dividend than its banks' capital notes but with a higher risk. In the second step process, we reduce our risk to the portfolio by increasing our exposure to bond (debt) so that the overall portfolio risk remains about the same.

| |
|---|
| Senior debts + cash in bank (lowest risk) |
| Subordinate debts (including Bank's T2) |
| Convertible notes |
| Preference shares (including banks Capital notes - T1) |
| Regulated utilities and infrastructure securities |
| REITs |
| Ordinary shares - excluding REITs, U&I (highest risk) |

In other words, in the recent quarters, 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 profit on above par ones and then 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.

Over the past quarter, we have topped up WBC and MYS. In exchange, we have exited IAGPD, taking advantage of the higher price in these securities.

We are active in the OTC by participating in the Zenith Energy and Maurice Blackburn fixed interest rate bonds. They were priced at 7.55% and 7.45% respectively and both pay interest quarterly.

We also participated in one direct commercial property asset – 80 Grenfell Street in Adelaide. We like this asset due to the strong tenant and long WALE (Adelaide Bank's headquarter for the Bendigo and Adelaide Bank). It has a higher yield compared to ASX listed commercial property after accounting for liquidity risk and higher gearing on a risk adjusted basis.

As the result of these changes over the past few quarters, the September's 2018 quarter distribution is 33% higher than September 2017. We aim to maintain this momentum over the coming quarters.

The 10-year Australian bond yield finished at 2.67% in the September quarter 2018 after starting the quarter at 2.637%. In the September FOMC meeting, as expected, the US Fed hiked again by 0.25% and stated they intended to increase rates one more this calendar year. Next calendar year, there will likely be 3 more increases and by then, the cash rate will be at or slightly higher than the long-term rate. Significantly, they have removed the word "accommodative" in their latest release suggesting that they no longer believe cash rates are now very low, giving further signs that the normalisation of the rate is getting closer to the end.

## Outlook

The US economy has further improved from three months earlier with the unemployment rate at 3.7%. There are strong indications the US economy is growing at a good pace, likely caused by President Trump's tax cuts. The US central bank will continue to raise rates as they are keen to normalise. Local short-term borrowing costs have moved up due in part to the fact that domestic banks tend to borrow from overseas for a major proportion of their funding. In the FY18 results, we note that the A-REIT sector reported the average cost of debt had gone up. We believe the task of managing the cash rate has suddenly got a lot more challenging for the RBA. Despite this, the local economy appears fine with infrastructure and mining appearing to be resilient, resulting in employment growth. Given this backdrop, we continue to be cautiously optimistic about the rest of this year.

Over the midterm, there are several known challenges including:

- Slowing in the Chinese economy as they are keen to reduce debt, but this is complicated by US-Sino trade tensions.
- Trump administration accelerating trade war with China. In the near term, we believe this is not going to have a major impact on the underlying assets in the fund but a full-blown trade war would impact not only the Australian economy but would have a material impact globally.
- Financial tightening conditions in the US causing USD strength and creating unintended consequences in emerging markets.
- US Fed tightening in conjunction with the trade tension with China will eventual slow the US economy and that will present further risk at a time when US equities are at record levels.
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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 at all times. We will take advantage of market volatility to accumulate high quality low risk securities with good yields.