Integrity Transparency Conviction

Clime Australian Income Fund

Quarterly Investment Report - March 2018

Clime Asset Management Pty Limited
Level 7, 1 Market Street Sydney NSW 2000

PO Box Q1286, QVB
Sydney NSW 1230

Phone 1300 788 568
www.clime.com.au

Investment Objective

The Fund's objective is to provide a level of income of 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 less than half 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 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.

Fund Profile

Investment Manager	Clime Asset Management Pty Limited
Investments	The Fund's goal is to select high quality individual investments that allow the creation of a best ideas portfolio for income generation.
Fund Size - Wholesale Inception Date	A$16.7million 1 July 2015
Income Distributions	Quarterly. Unless otherwise requested, distributions are automatically re-invested.
Management Fee	1.03% p.a.
Contribution Fee	Nil
Minimum initial investment	$200,000
Minimum additional investment	$10,000
Expenses	0.21% p.a.
Withdrawal Fee	Nil
Benchmark	Achieve a return of 3% p.a. above the RBA cash rate and to grow capital in line with CPI with volatility of return less than half ASX200 Index.
Investment Horizon	Minimum 3 years

Performance and Volatility of Return (31/03/18)

	Portfolio Return^	Income	Capital Growth	Franking	Volatility**
1 month	-0.77%	0.68%	-1.44%	-	-
3 months	-1.62%	0.68%	-2.29%	-	-
6 months	0.81%	1.36%	-0.54%	-	2.74%
1 year	4.07%	3.64%	0.42%	0.29%	2.49%
2 years*	7.71%	4.04%	3.53%	0.30%	3.00%
Inception*	6.97%	3.42%	3.44%	0.22%	3.50%

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.

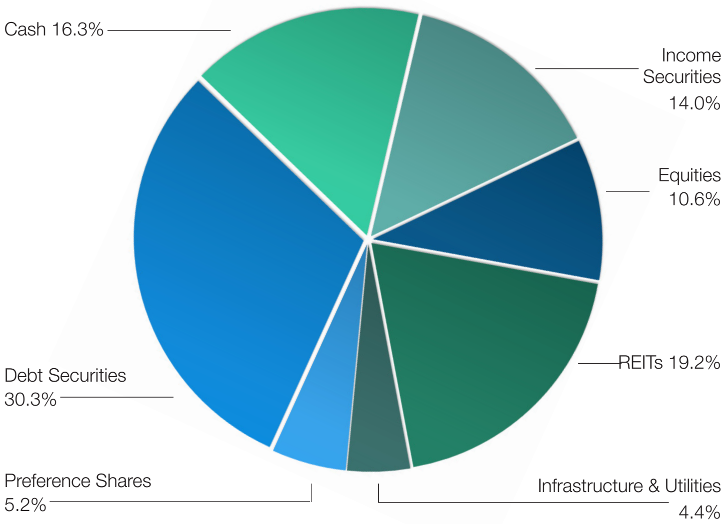
^Portfolio return is based on the change of the unit price including distributions but excluding franking credits. Franking credits will enhance this portfolio return, and historically this has added about 0.30% pa to the return of the Fund.

*Inception: Wholesale Units: 1 July 2015. Performance figures for more than 1 year are annualised, calculated after all applicable fees and taxes. Performance figures compare unit price to unit price for the given period. The returns do not include the benefit of franking credits.

** Volatility is based on the annualised standard deviation of weekly price movements.

The 1 year volatility of the ASX200 is 9.8% over the same weekly measurement period; placing the Clime Australian Income Fund volatility significantly below that of the ASX200 Index. This is consistent with the Fund objective of providing capital stability while generating regular quarterly income.

Asset Allocation



Wholesale Units - Monthly Returns (since inception*)

Financial Year	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	CAIF FYTD	Franking
2015 - 16	0.5%	0.6%	-1.3%	2.5%	-0.6%	1.5%	-1.6%	-0.3%	2.5%	1.3%	1.7%	0.7%	7.6%	0.3%
2016 - 17	2.5%	-0.0%	-0.3%	-0.7%	0.8%	2.7%	-0.3%	1.5%	1.2%	0.9%	0.1%	0.3%	9.0%	0.3%
2017 - 18	0.4%	1.1%	0.4%	0.9%	1.06%	0.5%	-0.5%	-0.4%	-0.8%				2.7%	TBA ^

*Inception date as at 1 July 2015 (Wholesale) at which point the Fund's units NAV was struck at an inception price of AUD 1.00.

^To be announced 30 June 2018

Note: FYTD represents net return for the given financial year, calculated after all applicable fees and taxes. Performance figures compare unit price to unit price for the given period.

Distributions

Quarter Ending	Wholesale Units (cents per unit)
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%
Elanor 7.1% 171022 Bond	3.16%
Macquarie Perp Notes	3.14%
National Bank NABHA FRN	2.98%
WPCPE FRN 311249	2.71%
Challenger Life Float	2.42%

Quarterly Investment Commentary

At 31 March 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 3.3%.

In view of interest rate movements, to minimise material increase in volatility in the portfolio over the short term, we took action to rebalance the asset classes. As described in the previous quarterly commentary, we have:

- reduced our exposure to REITs, albeit in a selective manner (elucidate below),
- selective switching in of the Banks' T1 capital notes; paying attention to below par papers, while taking profit on above par ones
- selective accumulation of utilities and infrastructure assets.

We reduced retail sub-sector REITs because it faces twin structural (e-commence) and cyclical (high household debt) challenges. We exited Carindale (ASX: CDP), Hotel Property Investment (ASX: HPI), Viva Energy REIT (ASX: VVR) and lowered Vicinity (ASX: VCX) weight slightly to reduce our overall retail REITs exposure. Furthermore, we took profit on GOZ because its peers look more attractive on a risk adjusted return basis. In the table below, we provide several parameters we believe are important in this environment. As this is a lower risk income focused portfolio, the key parameters revolve around risk which implies the ability to continue to distribute a regular income stream irrespective of possible macro shocks, at least over the short to midterm.

	Income Fund	ASX 300 REIT Sector
WALE (yrs.)	7.8	5.5
Gearing (%)	30.2%	28.3%
Occupancy (%)	98.3%	97.2%
Debt to maturity (yrs.)	4.6	5.5
Interest cover ratio	4.9	4.8
Yield	**6.1%**	**5.5%**

Source: Clime Asset Management, IRESS

Why are these risk parameters important?

WALE:
WALE represents the weighted average lease expiry for all the properties owned by the REIT security. We believe the higher the number, the more comfort one has over the certainty of this income over the period. In the case for Income Fund, note that the WALE is almost 8 years of secured leases compared to 5.5 years for the REITs sector

Gearing:
We believe gearing between 25% and 35% is ideal in the current environment for REITs. One may recall the period leading up to the GFC, when the REIT average gearing was in the mid-to high 40% and some securities having gearing in excess of 50%. These highly geared REITs were well supported because investors were attracted by the higher yield – but they neglected to properly consider the risk. One may recall that interest rates were very low then, and some property managers were aggressively funding property purchases with cheap debt. They were able to revalue their assets up as aggressive managers were chasing assets to buy with more debt until the GFC hit. When the GFC occurred, some of these securities faced the double headwinds of falling asset prices as they are forced seller of the assets in order to repay debt because they have breached their gearing and interest cover covenants. Quite a few of these highly geared REITs with poorer assets (~50% gearing or higher) collapsed as a result.

Since the lessons learnt from the GFC, one finds that there are now few if any ASX listed REITS with gearing higher than 40%, with the weighted average at around 30% as shown in the table above. This is unlike those in the unlisted direct property space where gearing of 50% or higher is once again common. That said, some of these unlisted direct assets are very high quality with strong tenants and long WALEs.

Occupancy:
Ideally, we would like occupancy rates of 100% implying that every lettable space is leased. However, in a multi-premise multi-tenanted asset, having 100% leased also implies that there is no room for improvement. After all, one requires a bit of down time to make improvements to the premise so value can be added. In this manner, the property owner has better bargaining power to increase rents or more favourable rental review et. al. can be negotiated. Thus, depending on whether it is office, industrial or retail sub-sector REITs, an occupancy in the range of 95% to 99.0% is ideal. On this measure, we note the weighted occupancy on the Income Fund is 1% higher than the average for the sector although the average sector weight is well within the range we viewed as acceptable.

Debt to Maturity:
Debt to maturity is the average duration in years that the debt is coming up to maturity. A good property manager will start re-negotiating loan terms with their creditors well before the term matures. Ideally we like the debt to maturity as long as possible but the longer the term, the higher the cost would be because this is a function of the term structure of interest rate.

If the debt to maturity is too short, management must be vigilant about interest rate movements and this may make it difficult to forecast and plan cash distributions. To have some certainty, the minimum term should be at least 3 years. However, this implies there is little margin of safety should the economy take a drastic turn or if interest rates move sharply up (if the debt is not hedged). Thus we believe debt to maturity of 5 years (give or take one year) is ideal. In this case, we note that the weighted average for the REIT held in the Income Fund is slightly below 5 years but still within the 4 to 6 years we believe is acceptable. At Clime, we take the opportunity to communicate to the management of individual securities held in the Fund to lengthen their debt to maturity profile whenever possible.

Interest Cover:
Interest cover ratio (ICR) is a good rule of thumb for indicating how many times the interest is covered by their earnings, in this case predominantly rental income. We believe a ratio of 3 times is adequate for REITs, but given the low interest environment and coupled with conservative gearing profiles in the listed REIT space post GFC, ICR have generally been higher than our desired level for the past several years. However, this may change as interest rate moves up.

Based on our experience gained from multi-decades of observations and investing in REITs, we view the two most critical risk measures are WALE and gearing, followed closely by the remaining three in the table above in our selection process. Having considered these key risk parameters, the average yield we expect to achieve is 6.1% compared to the REITs average of 5.5%. We conclude that our selected REIT portfolio has been well optimised for higher yield compared to the REIT sector, while having superior risk measures to withstand any anticipated short to midterm macro shocks.

Due to the lower exposure in the utility and infrastructure asset class, we introduced AGL Limited (ASX: AGL) in the portfolio leading up to its dividend, taking advantage of weakness in the sector during the quarter.

In a general rebalancing in Banks' T1 capital notes, we introduced two below par Basel III T1 capital notes: CBAPD and WBCPE. In other words, they are trading below face value of the capital notes and have about 4 years to run before its optional call. This is part of our general strategy of switching out of above par longer dated capital (e.g. ANZPG) notes into shorter dated ones.

We have also incrementally increased existing holdings in income securities (i.e. NABHA, MBLHB) with fund inflow. These older style T1 capital do not comply with Basel III and their classification as capital are only transitionary and being well below face value provides added attractiveness in these papers.

In this quarter, we disposed of two subordinated debts; being AGLHA as its yield to call is below 4%. We took the opportunity to switch into its headstock AGL which is yielding more than 7% on a pre-tax basis. We have also exited WBCHB, a T2 capital of WBC.

In the OTC market, we participated in the Newcastle Permanent 5y senior debt. They are priced at 140bp over 90-day. To replace the interest payment gap from the disposal of WBCHB, we participated in the DBS Bank's 5 year non-call 10 year maturity T2 FRN, priced at 158bp over the 90 day BBSW. We participated in the DBS's T2 FRN because we seek to diversify away from the domestic major four banks' ADI. DBS bank is one of Singapore's three premier banks and is rated AA- for their senior debt, similar to the major four banks here in Australia.

The 10-year Australian bond yield finished at 2.60% in March quarter 2018 after starting the quarter at 2.63%. This relative flatness masked a big swing as it peaked at over 2.90% in mid-February - which saw a major selling of REITs and other interest rate sensitive securities. While the 10y bond yield has rallied back since the low in mid-February, we note that REITs and other interest sensitive securities have not followed. As a result, the Income Fund had a negative return in the March Quarter 2018. Despite this, the Fund's 12m volatility has maintained at 2.5%, which is well below the ASX200 volatility of 9.8%. Furthermore, with the selloff in interest sensitive securities, we believe these sectors are increasingly attractive when viewed from a mid-term prospective and we will look at reshaping of the portfolio shortly.

In the March FOMC meeting, as expected, the US Fed hiked interest rates by 0.25%. While it is likely that we will have further rate hikes going forward in the US, we still believe the rate increases will be gradual.

Outlook

We have previously updated different possible trajectories for the Fund and refer unitholders to the December 2017 quarterly update for more detail. Nevertheless, we highlight that we believe we are now at the tail end of a multi-decades low to ultra-low interest rate era.

That said, we do not think interest rates will move sharply up from here because inflation will continue to be relatively tame (which we attribute to structural forces). What has changed in our opinion is that central banks are resigned to the fact there is a need to re-calibrate interest rate after two decades of low to very low interest rates post the bursting of dot.com in March 2000, the event of 9/11 in 2001 and ultra-low interest rates post the GFC. After multi-decades of low to ultra-low interest rate policies set by central banks, all it essentially has achieved is the inflating of asset values while ordinary living expenses (rents, utilities, healthcare, and insurances et. al.) have gone up higher than the official inflation rate - to the detriment of many social-demographics. We believe central bankers are now behind the curve and there is a need to gradually normalise in preparation of the next downturn. After all, the current expansion in the US is about 9 years old, and we are possibly due for a slowdown.

Going forward, we expect volatility to increase because

- there is a need to re-calibrate interest rates with the US Fed hiking rates, this is equivalent to reducing liquidity, i.e. debts are getting a bit more expensive;
- the US Fed is shrinking its balance sheet; this also implies the US Fed is withdrawing liquidity from the economy.

Both of these will increase volatility. Coupled with the strong rhetoric of a possible trade tensions between the US and China, the market has become more volatile. After decades of globalisation, the global trade network is connected by multi-dimensional nodes joining together. It is not easy to launch a unilateral trade war without hurting allies (friends) as well. In this case, it would hurt the US economy as well as others. We believe the risk of a global slowdown materialising, while still low, has gone up.

With the primary objectives of the Fund to provide regular income in the short term, steady capital growth in line with inflation over the midterm, while maintaining a lower volatility profile of return, our strategy for Clime Australian Income Fund is unchanged. We will be taking advantage of the higher volatility of the market to switch and accumulate high quality low risk securities while holding a reasonably high cash level.

Nevertheless, if we believe a US-China trade war is materialising with risks accelerating sharply (not our base case at this stage), and US Fed continues to hike with a concomitant shrinking of its balance sheet, we would not hesitate to increase cash levels to preserve capital. In such circumstances, the probability of stagflation and/or recession in the US and other developed nations including Australia would increase