Integrity Transparency Conviction

Clime Australian Income Fund

Quarterly Investment Report - December 2017

Clime Asset Management Pty Limited
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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 credits.

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$14.4 million 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 returns less than half ASX200 Index.
Investment Horizon	Minimum 3 years

^The Australian Income Fund is currently in the incubation phase and at this time the manager is not charging the full management fee. With effect from 1 January 2018, the management fee was revised to 0.871% pa, which will be reviewed on a quarterly basis.

Performance and Volatility of Return (31/12/17)

	Portfolio Return^	Income	Capital Growth	Volatility**
1 month	0.50%	0.68%	-0.17%	-
3 months	2.48%	0.68%	1.79%	-
6 months	4.36%	1.22%	3.09%	1.67%
1 year	8.32%	3.89%	4.27%	2.15%
2 years*	8.91%	3.97%	4.75%	3.40%
Inception*	8.41%	3.48%	4.76%	3.48%

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.

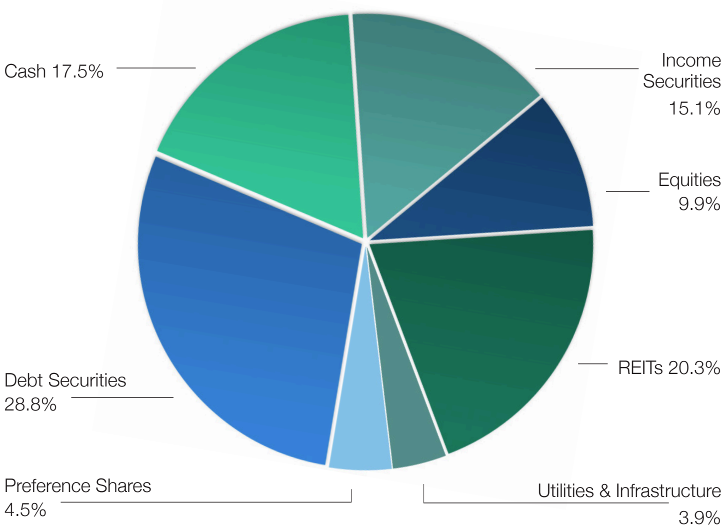
^Portfolio return is based on the change of the unit price including distributions but excluding franking credits. Franking credits will enhance this portfolio return, and historically this has added about 0.30% pa to the return of the Fund.

*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 9.4% 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
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%**
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%**
2017 - 18	0.4%	1.1%	0.4%	0.9%	1.06%	0.5%							**4.4%**

*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.

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 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	3.5%
Macquarie Perp Notes	2.6%
National Bank NABHA FRN	2.5%
National Australia Bank Limited	2.4%
Australia & New Zealand Banking Group	2.4%

Quarterly Investment Commentary

As at 31 December 2017, the Clime Australian Income Fund was diversified across seven underlying sub-asset classes: Domestic Debt, Income Securities, Preferred Securities; REITs; Utilities & Infrastructure (U&I); Equities; and Cash. The underlying security weights in the portfolio ranged from around 0.04% to 3.5%.

During the quarter, we have incrementally added to NAB and ANZ ahead of dividends which also provide an additional income benefit via franking credits.

We increased our position in REITs sector by increasing our preferred sub-sectors in REITs (metro office, child & age care properties and REIT which owns premium / quality assets) by accumulating AOF, ARF, FET GPT and SCG in the Fund. This strategy paid off for the December quarter as the REITs sector got a momentary boost due to the announced takeover of Westfield Corporation (WFD) by the mega French shopping mall owner, Unibail Rodamco, in December 2017 for a part script part cash bid. Since Clime Australian Income Fund owns WFD, the fund also received a further slight boost in performance for the quarter. However, towards the end of December, there was weakness in the sector possibly due to highly anticipated US tax cut; as investors abandoned income securities such as REITs to chase growth sectors. It provided us a second tail wind to accumulate our preferred REITs securities at more attractive prices just prior to the bulk of the REITs going ex-distribution. For the record, despite the selloff in late December 2017, REIT sector outperformed the ASX200 slightly during the December quarter, positively reinforcing our strategy that we have adopted at the end of the September quarter.

Due to the underweight position in the utility and infrastructure asset class, we have decided to introduce AusNet Services Limited (AST) in the portfolio leading up to its dividend. We have also incrementally increased existing holdings in income securities (i.e. NABHA, MBLHB) with fund inflow.

We have added one new income generating security in December quarter 2017: BENPG by participating in the Bendigo Bank (BEN) Capital Notes offering. These Capital Notes were heavily subscribed with a massive scale back, resulting in the Fund having to go into the market to buy more when it listed. The new capital notes have an optional call date over 6 years and are priced as 3.75% margin over the 90 day BBSW. During the quarter, we exited AMPPA with an average price close to $10 above the face value, crystallising ~$10 of capital gain while we switched the proceeds to BENPG at or near face value.

We have also added one debt security, Clime Capital Convertible Notes (CAMG). Clime Capital Limited (CAM) issued a 4y debt paper at 6.25% paying quarterly. Since the conversion / redemption rights rest in the hands of the note holder and there is no senior debt in the capital structure, we view this is a very secure interest paying debt security. Since it was listed, the yield on this debt has compressed to below 6%.

Lastly in the listed space, one of the REITs we held in the Fund, you may recall in the previous update, Asia-Pacific Data Centre (ASX: AJD) was subject to a takeover. We have cashed out on our position and realised a large capital gain which is an unexpected bonus as the Fund's major objective is income and capital stability. This marks the second takeover of security held in the Clime Australian Income Fund in 2017 calendar year as we have accepted the takeover offer of Duet Group (ASX: DUE) in the June quarter and realised a huge capital gain for the Fund in FY17. Given that the Board of WFD has unanimously supported this Unibail Rodamco's takeover deal, we believe it is likely to get up and would be the third takeover in the Income Fund portfolio in recent times.

In the OTC market, we bought more AMP B3 T2 FRN with fund flow as an earlier B2 T2 issuance was called back on 22 December 2017. We have participated in a 3y senior debt paper of ME Bank Limited and 5y senior debt paper of Macquarie Group Limited, Challenger Limited B3 T2 FRN, ME Bank Limited T1 Capital Notes and Elanor Investor Group 7.1% fixed rate 5y bond offering. All these will provide a stable income stream for the fund over the next 3 to 6 years. Lastly in the unlisted space, we have participated in the Australian Unity Healthcare REITs Funding Units and during the course of the next 18 months, these Australian Unity Healthcare REITs Funding units will be gradually converted into Australian Unity Healthcare REITs securities over three separate conversion tranches. When they are fully converted into Australian Unity Healthcare REITs, it should yield an income of ~7% to 7.5% with projected distribution growth thereafter, paying quarterly.

The 10-year Australian bond yield finished at 2.63% in December quarter 2017 after starting the quarter at 2.84%, implying that the bond price has rallied in the December quarter. Moreover, both the yield curve here and that of the US have flattened since the start of the quarter. Under normal conditions, this would usually indicate slowing growth but in our opinion, whilst the global economy is not necessary robust, we do not think the global economy is heading towards a major slowdown in the near future either. Rather, we believe this flattening should be interpreted as the imminent hike in the US rates (short end moving up) to be followed by a local rate hike sometime further down the track.

We provided an update (figure 1) on the spread between US 10y treasuries and the 10y Aussie which at the end of the September quarter, was 55bp and we attributed the widening to the increased tension between US and North Korea. We note that the spread is now back below 20bp similar to when the tension began to accelerate in mid-June.

In the December FOMC meeting, as expected, the US Fed raised interest rates by 0.25%. While it is likely that we will have further rate hikes going forward, we believe these will be gradual. This is because we believe inflation will remain low in the near to midterm for reasons we discuss below.

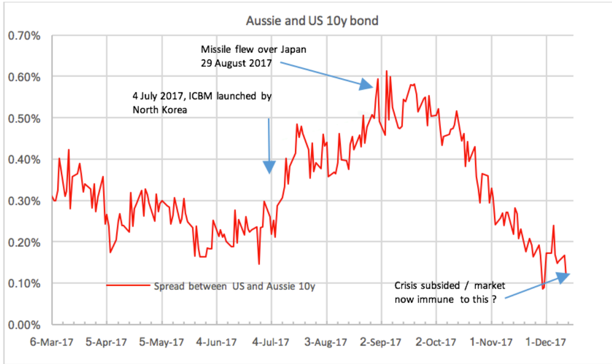


Figure 1. Source: IRESS and Clime Asset Management

Outlook for the year ahead

We believe the consensus is more bullish than our view which implies that income or yield sensitive securities will most likely underperform during the first half of the year. This may imply that the Fund may not exhibit any capital growth in the interim, resulting in income generation as the only compensation for the total return in this period.

In the second half, if inflation indeed picks up as Central Bankers like the Fed have been suggesting for well over the past 12 to 18 months, it is likely that long bond will be sold-off more aggressively. This implies the equity market valuations may be challenged. This signifies our worst case scenario for the Income Fund and any other assets classes (equity, bond et. al.) in general for the year ahead.

However, if inflation does not pick up and remain relatively tame, it is likely that bonds will rally and income securities and other equities securities will rally with it. Under this scenario, the Income Fund will most likely achieve its target of income generation with moderate capital growth.

In summary, after a good 2 years of consistently beating the Fund's objectives, i.e. annualised return of over 8.9% pa for the past 2 years compared to ~ 6.75% pa targeted return and annualised volatility in the low 3% compare to more than 12% for the ASX200 with quarterly distributions over the same period, we believe the year ahead for the Income Fund will be a year of consolidation. To perform better than our base case for this year, we need to take selected opportunities when they arise. That said, we intend to stay the course and adhere to our investment process and below we will elucidate our reasoning.

Predicting is hard especially if it is about the future (commonly attributed to the Physics Nobel Laurate, Niels Bohr). Aside from the unknowable "Black Swan" events, while we are not attempting to make any prediction of the future here, we like to think future trends for the midterm to longer term are not as hard to identify.

For example:

- We have an ageing population in the western developed world, most of this demographic will require income for their retirement, thus yield securities will likely be sought after until the relative size of the ageing cohort is replenished by a bigger youthful working cohort or some alternative solutions are found. In our opinion, this would be a while yet (i.e. many years). An ageing cohort is very deflationary.
- The Governments of most developed nations are heavily in debt and no major deleveraging has occurred for the 10 years post GFC. In Australia, the main problem is historically high household debt. Regardless of what type of debt (Government, corporate or household), it has to be paid with interest. The higher the portion of household income is channelled to pay interest, the less a typical household has the ability to spend on other goods and services. This will result in lower economic growth implying lower pressure on inflation, particularly discretionary goods and services.
- Global ecommerce for example has created a new environment where sellers have the ability to reduce costs significantly while online buying has given ordinary consumers for the first time the ability to have new consumer power. Consumers are aided by the enormous number of fellow anonymous online shoppers' reviews / rating and form a view before buying products from sellers' sites, similar to rating agencies, albeit from a consensus approach. These are enormous powers which ordinary consumers never had previously and this will keep sellers competitive at all times.
- Further advancement of technology will lower the cost of doing business in every sector. We believe we are at the cusp of strong productivity increases as new technology, from physical to biotechnology science applications, penetrate or are being continuously introduced into the (global) economy at an ever faster rate, inflation will be kept relative low,
- Global value chains through globalisation will put pressure on inflation at least in the near term to possibly midterm. This area was investigated by R. Auer, et. al[1]. recently.

For the Clime Australian Income Fund, we steadfastly focus on capital protection and regular income generation at much reduced risk. However, the general consensus is more focused on the short term and at this moment, the majority of investors, financial commentaries and major central banks are of the view that inflation is just around the corner. This will likely result in the selling of income sensitive asset classes and the buying of growth securities in preparation for stronger global growth and higher inflation.

For example:

- The latest unemployment rate in US is 4.1% which is low by historical standards, implying that spare capacity is probably getting very tight. Locally, unemployment has stabilised and now sitting at 5.5%; lowest in 4 years.
- Unlike weighted averages, on the simple average, we suggest that wage growth is likely to be higher than the official data when we look at the younger cohort, i.e. recent graduates, younger skilled and unskilled workers. They are likely to have a higher pay rise in percentage terms compared to senior employees who have worked for many years because young workers tend to have lower starting wages.
- The US tax-cut late last year may result in bigger earnings for US Corporations. This will be felt globally in due course.

Thus shorter term investors have some fundamental motivations to conclude that higher inflation is imminent because higher economy growth will resume.

Nevertheless, we are more convinced that inflation will be relatively tame for the near to midterm future due to the trends we described above. However, it is possible that we may not get the timing perfectly right.

Given the circumstance this year and the primary objectives of the Fund are to provide regular income generation in the short term, steady capital growth in line with inflation over the midterm, while maintaining a lower volatility profile of return at all times, the strategy that Clime Australian Income Fund will be adopting for the year ahead is:

1. Best to err on the side of caution and continue to manage the Fund in a measured approach while holding sufficient cash as working capital for selected opportunities. After all, if shorter term investors are buying growth securities and reducing their income stocks, we believe this will present the Fund with better buying opportunities in the year ahead.
2. Maintain the same to slightly reduce REITs asset class weight but stay focused on preferred sub-sectors and quality top tier assets with lower gearing and continue to switch within the sub-sector given opportunity.
3. Remain underweight in Utilities and Infrastructure asset class as a whole but be selective to accumulate good quality assets if they continue to weaken over the year since the Fund is underweight this asset class.
4. Tilt towards floating rate notes in the event that inflation does indeed pick up and central banks in the short term, including our own RBA hike rates more aggressively.
5. We may also consider reducing the portfolio weight in longer dated fixed rate bonds and switch the proceeds into floating rate notes. At this stage, we are comforted by the fact that we have positioned the portfolio to underweight this sub-group of fixed interest securities earlier on and therefore not in any urgency to action this in the near term.

1 "The Globalisation of Inflation: The Growing Importance of Global Value Chains", R. Auer, C. Borio and A. Filardo, a CSIRO working paper No. 6387, category 7: Monetary Policy and International Finance, March 2017.