Integrity Transparency Conviction

Clime Australian Income Fund

Quarterly Investment Report

September 2019

Integrity Transparency Conviction

Market Commentary

September 2019 Report

Introduction

Markets were volatile over the last quarter, reflecting investor concerns about the US-China trade war and slowing global growth. The mood of the global economy and financial markets is deteriorating: globalization and international trade is under threat; geopolitical risks are rising; negative real interest rates are advancing; and fears of recession are growing. In our view, a recession in the next year or two is far from inevitable, but the risks are greater than at any time since the GFC, and rates are likely to remain at ultra-low levels for a protracted time. For investors, this probably means lower expected returns from their investment assets.

The global economy has been patchy at best: the US and China have slowed to around-trend growth, but Germany, the world's fourth largest economy and the manufacturing powerhouse of Europe, is struggling. Unemployment rates in advanced economies are generally at decade lows, but there are few signs of any inflationary pressures. Markets see accommodative monetary policy as the only solution: cheap money is the means by which "the can is kicked down the road", putting off structural problems until tomorrow. With central bank policy rates so low, advanced economies will be poorly-equipped to counter a recession if one does occur. With the prices of risk assets up over the year, patience has proven to be a virtue so far, and risk taking has been rewarded. However, while we remain steadfast in our view that judicious stock picking will continue to add value, we expect broader asset returns will be below their long-term historical averages over the next few years.

Manufacturing sector struggling

Manufacturing activity is contracting across advanced economies, pointing to the impact of President Trump's trade policies. In the US, a key indicator measuring manufacturing activity in September recorded its lowest level in more than a decade, while global data showed the sector was declining amid fears that trade tensions will escalate further. Output was lower than a year earlier across all 36 advanced economies and sentiment indicators suggest the most geographically widespread manufacturing downturn for seven years.

The global Purchasing Managers' Index in September recorded its fifth month below the 50 mark, the level that divides expansion from contraction. This is the longest period that indicator has been so low since 2012. The PMI for the eurozone fell to 45.7 last month, its lowest reading since October 2012. The Institute for Supply Management index of US manufacturing activity fell more than expected to 47.8, its worst reading since June 2009.

As noted above, Germany is already confronting recessionary conditions, being the most vulnerable large economy to international trade. Germany's leading economic research institute has cut their forecast for economic growth for this year and next, blaming in part "the falling worldwide demand for capital goods." German GDP growth for the year is now forecast at just 0.5%. It can be argued that German industry is now in recession, and this will start to impact the service providers catering to those companies.

In the face of uncertainty and the unpredictability of President Trump, many companies are putting off investment decisions. Others are reckoning with the consequences of higher costs. Although manufacturing is only a small part of the global economy, it is one of the most volatile sectors and often acts as a leading indicator of global economic swings. The World Trade Organization has halved its estimate for trade growth this year, blaming "escalating trade tensions" for the cuts which it said would leave world trade volumes growing only 1.2% this year.

Financial markets

Financial markets have been rattled over the escalating trade war between the US and China as both imposed tariffs and counter-tariffs on imports. Yet despite that, the lack of income returns from cash or fixed deposits has mostly kept shareholders in the markets. Investors' search for "safety" has pushed bond yields to unprecedented low levels, with the yield on 30-year German Bunds turning negative for the first time ever. The US yield curve inverted once again, with yields on 2 year bonds briefly rising above those on 10 year bonds.

There are three factors markets are monitoring. First, markets abhor policy uncertainty, and geopolitical risk is on the rise: President Trump is a wild-card for markets, and inherently unpredictable; and events such as Brexit and the attack on Saudi oilfields are unsettling. Second, the risk of the trade war morphing into a more widespread global currency war is increasing as the US and China compete for global hegemony. And third, political pressures on central banks are mounting. The Federal Reserve has delivered a rate cut and ended quantitative tightening, but President Trump continues to pressure Chairman Powell to do more. Clearly Trump will want rates as low as possible, and the markets as high as possible, at least until the November 2020 Presidential Election.

Investment implications and central banks

What are the investment implications of these various factors? The fall in bond yields is concerning. The capital markets are being supported by ultra-dovish central banks, determined to do whatever they can to extend the economic cycle. To date, expectations of aggressive monetary easing have limited equity market downside in this highly uncertain environment: perhaps this could be called "the Powell Put".

Central banks might help to extend the cycle, but the power of any new measures, such as further lowering rates to almost zero, or purchasing ever more quantities of government bonds, will be less potent than in the past. Eventually, the artificially low cost of capital will either create bubbles in asset prices (we see it in bond markets already) or distort the behaviour of financial markets in ways we do not yet fully understand.

After a decade, central banks are still not observing the inflation they have targeted. Quantitative easing's boost to asset prices has quite possibly become counterproductive – widening wealth disparities, reducing yields and further lowering inflation. All this has been seen before – in Japan, which remains caught up in a decade-long deflationary spiral.

Global equity valuations look attractive when compared with the returns available from cash or bonds, but not when compared with their long term average earnings multiples. Using traditional valuation measurements such as earnings or cashflow multiples suggest equities are mildly overpriced, particularly if the global economy faces further risks of slowing. And yet even though equity valuations are "short of compelling", there are few alternatives that look attractive in this environment.

Market Commentary

Is more easing making the world weaker?

Cutting interest rates from already very low levels might suppress demand rather than stimulate it. In the decade since the GFC, central banks have implemented unprecedented monetary stimulus, both conventional and unconventional, in an effort to boost demand. However, these latter efforts have been largely ineffective and may even have been counterproductive.

On the positive side, lower rates make it cheaper to borrow, thus encouraging investment. Higher asset prices create a wealth effect, which encourages consumption. On the negative side, lower rates reduce income for savers. There are also psychological effects: businesses and consumers worry that if central banks keep lowering rates, there must be a recession in the offing, which undermines confidence. If potential borrowers anticipate further rate cuts down the line, they will defer their borrowing to a later date, thus the lowering of rates can be self-defeating.

On balance, it could be argued that further monetary easing may make the global economy weaker rather than stronger. Because of these offsetting effects, the overall impact of monetary stimulus is difficult to measure. In the US, for example, the shrinking importance of the manufacturing sector - which has fallen from 30% of jobs in the 1950s to 9% today - has reduced the benefit of lower rates in promoting capital spending.

Federal Reserve easing can help boost American exports by pushing the US dollar down, but this does not work if other central banks are trying to do the same thing. Note that the RBA Governor gave as one of his reasons for cutting Australian cash rates the importance of matching overseas cuts in order to keep the AUD from rising and compromising our export competitiveness.

The Australian economy is growing - slowly

The Australian economy is still growing – but very slowly, as evidenced by recent gross domestic product data. In fact, GDP growth is now the weakest since the GFC. Were it not for a big jump in exports due to the high iron ore price and strong government spending, the results would have been worse. The RBA's Governor Lowe remains optimistic that the growth rate will improve, yet he still felt it necessary to lower rates three times this year, justifying the cuts by pointing to the following factors:

• The Australian economy has been going through a soft patch. Over the year to June, GDP grew by just 1.4%, the slowest year-ended growth for some years. The RBA was surprised by the extent of this slowdown.
• While Australia has been less directly affected by the US-China trade disputes than some other countries, there is an indirect effect through slower global growth and increased global uncertainty.
• Over the past year, there has been no growth in consumption per person - unusual when employment is strong. Household disposable income has been increasing only slowly, reflecting subdued wage increases and growth in taxes.
• Slow growth in household income has led people to reassess their spending on discretionary items, which has been weak.
• As housing prices have fallen, there has been a sharp decline in housing turnover to the lowest level in 20 years. With fewer people moving homes, spending on furniture and household appliances has been soft.
• The drought has contributed to slower growth. In some areas, conditions have been the driest on record. Farm output in Australia has fallen for the past two years and there has been a sharp drop in farm income as farmers try cope with increased costs for feed and water.
• Over the past year, the Wage Price Index increased by just 2.3%. This is a pick-up from recent years, but the lift in wages growth has stalled recently.
• Low wages growth is one of the factors contributing to low inflation. Over the year to June, inflation was 1.6%, in both headline and underlying terms.

Continued jobs strength is somewhat surprising, given the soft economic conditions, weak retail indicators and fundamental headwinds, particularly in the construction sector. The lack of improvement in unemployment adds voice to the call for even further RBA rate cuts by the end of the year. However, the RBA may prefer to receive more data on how the stimulus to date is being received, alongside an update of their forecasts before moving rates again.

Oil shock quickly reversed

The attacks on 14 September on Saudi Arabia's oil facilities have put the oil market back in focus for investors and policy makers alike. The event was reported to have been the largest single supply disruption in the oil market for half a century, crippling half of Saudi oil production and temporarily halting production of approximately 5% of global oil production.
Surprisingly, the supply shock caused by the attacks had a relatively muted impact on the major equity and fixed income markets, and it remains to be seen what long-term impact, if any, the Saudi attacks will have on oil prices. At one end of the spectrum, the 1974 and 1990 oil price shocks had enormous long term consequences on inflation, interest rates and markets. This time, the response seems to have been amazingly short-lived and prices quickly reversed.

Concluding words

Your Manager is responding to the issues discussed above by adjusting portfolios and mitigating potential harm in many different ways. We are generally holding somewhat elevated levels of cash in most portfolios as a risk mitigation tactic, as well as to take advantage of volatility to invest in attractive stocks at discounts to value, should such discounts materialise over time. Our asset allocation and stock selection strategies will ensure that portfolios are well guarded against global market volatility. Furthermore, we are still finding ample opportunities to invest in high quality companies with sustainable competitive advantages – companies that we expect to grow and perform well through the economic cycle.

Bear markets generally coincide with recessions for good reason: during recessions, corporate earnings fall and investor appetite to embrace risky equities reduces. Yet in a world with such low rates available on savings, some argue that there is no alternative to investing in the capital markets.

In any event, and few can be confident in predicting the future, there are practical, sensible solutions to ensure investment portfolios are resilient. Strategies such as diversifying across asset classes, including cash (even if the return from cash is only marginal); ensuring asset allocation is fit for purpose; by focusing on high quality companies; and maintaining a focus on sustainable yield. These strategies have stood the test of time and will continue to do so in the future.

Adrian Ezquerro
Head of Investments

Integrity Transparency Conviction

Clime Australian Income Fund

Investment Objective

The Fund's return objective is to provide regular meaningful income above the RBA cash rate in the form of quarterly cash distributions, and aims to achieve a return of at least the RBA cash rate + 3.0% pa. It seeks to deliver a strong risk-adjusted total return and is expected to have a level of volatility of returns significantly less than equity indices, and it aims to maintain unit price stability along the way. The Fund's risk objective as defined by the annualised standard deviation is 4.0% ± 1.0% and a rolling 12 months relative risk measure of less than 40% of the S&P/ASX 200 Index. In order to maximize the chance of achieving these objectives, the recommended investing time frame is at least 3 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 with consistent income generation. Portfolio yield is likely to be incrementally enhanced via franking credits and is likely to be the bulk of the portfolio return.

Performance and Volatility of Return (30/09/2019)

	Portfolio Return	Income	Capital Growth	Franking
1 month	0.5%	0.5%	-	-
3 months	1.5%	0.5%	1.0%	-
6 months	4.2%	2.8%	1.4%	-
1 year	7.1%	4.3%	2.7%	0.23%
2 years (pa)*	5.7%	4.1%	1.5%	0.21%
3 years (pa)*	6.6%	4.1%	2.5%	0.24%
4 years (pa)*	7.5%	3.8%	3.6%	0.25%
Since Inception (pa)*	7.0%	3.8%	3.1%	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 0.2% pa to Fund returns as shown in the last column of the table above.*

The Fund's recent short-term returns are relatively modest, caused by the sell-off of long bonds globally after peaking in early September 2019. The bond sell-off was caused by a confluence of events, including major US corporations issuing huge amounts of long dated 30-year debt at around 3%, which coincided with a large US Treasury monthly auction of ~US$78B (to fund its US$1T deficit) and the toning down of the anticipated ECB stimulus package flagged earlier. In addition, a somewhat concessionary tone from US and Chinese negotiators on the trade talk front boosted growth equities at the expense of more defensive securities.

The portfolio is overweight income sensitive securities such as REITs and U&I, which were sold off in line with rising bond yields in early September. Equity investors switched to growth stocks, presumably taking the view that central banks, including the RBA, will continue to cut rates.

The Fund is a goal-based investment where we target a certain level of income (higher than the RBA cash rate) and risk (lower than the equity market). We encourage investors to look beyond the short term and focus on the longer-term income generating capacity of the Fund. Historically, the return over 2 years or longer, and since inception, has been in the range of 5.6% to 7.0% pa, with the majority of the return derived from income.

The current September quarter distribution of 0.5160 cent /unit is lower than we were aiming for, mainly attributed to the timing of cash flows. A higher distribution was paid in the June 2019 quarter. Investors should note that the June quarter distribution is usually the highest of the year, due to the timing of cash flows and the distribution of realised capital gains and franking for the financial year (if any). As such, investors should plan cash flow requirements accordingly.

In the Table below, we tabulate the risk (as measured by the annualised standard deviation) of the Fund over 1 to 4 years, and since inception, and compare this with the S&P/ASX 200. The risk of the Fund is less than 3.3% in absolute terms, and less than 30% of the S&P/ASX 200 since inception. These risk outcomes are well within the Fund's objectives of absolute risk of 4.0% ± 1.0% and relative risk of less than 40% of the S&P/ASX 200 Index. This demonstrates our strong risk management processes and the achievement of unit price stability while generating quarterly income returns.

The absolute and relative risk on a 12m rolling basis are plotted in Figure 1 below. From these charts, we see that the absolute risk has not breached the 5% maximum risk since inception. On a relative basis, the rolling 12m relative risk is below 40% of the S&P/ASX 200 over the entire period. Thus, whether you consider it over a longer fixed period or on a rolling 12-month basis, risk has been well managed, while generating attractive regular income with modest unit price appreciation along the way. Figure 2 shows the total return on a cumulative return basis, compared with the RBA cash rate + 3.0% pa return objective. This has resulted in a superior Sharpe ratio (discussed below).

	Volatility^			
30/06/2019	CAIF	ASX 200	Ratio of CAIF/ ASX 200	Sharp Ratio ^^
1 year	3.0%	11.3%	26.6%	1.9
2 year	2.8%	9.9%	28.1%	1.5
3 year	2.7%	10.1%	27.1%	1.8
4 year	3.3%	11.4%	28.6%	1.7
Since Inception	3.3%	11.8%	27.6%	1.5

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

^^Sharpe Ratio is calculated on a monthly basis.

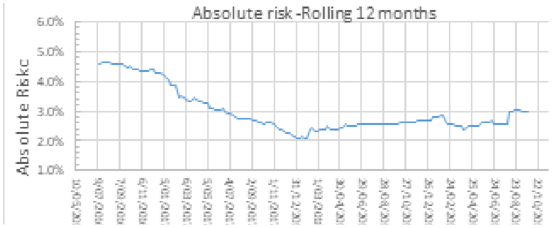
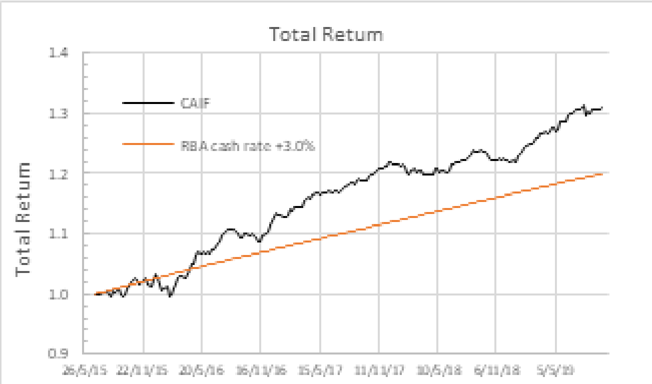


Figure 1 The absolute risk (top) and relative risk (to the S&P/ASX 200 Index) of the Fund using weekly prices since inception. The Fund has shown superior absolute and relative risk attributes since inception.



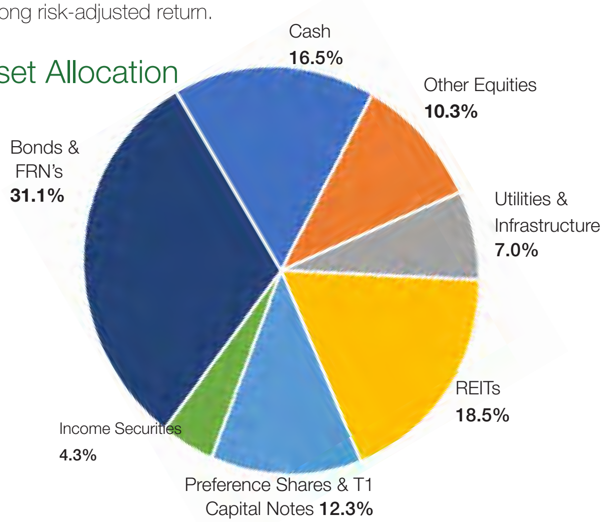
Source: Clime Asset Management and RBA

Figure 2 Total Return of the Fund since inception. The orange line represents the minimum return that the Fund is aiming for, namely the RBA cash rate + 3% pa.

The Sharpe ratio was developed by Nobel laureate William F. Sharpe and is used to help investors understand the return of an investment compared to the risk undertaken to achieve the return. The ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk.

The Sharpe ratio tabulated above has been consistently positive over the entire period. A positive number (above zero) indicates that we have added value by taking the additional risk to achieve a return above the risk-free rate. A positive number close to or above 1.0 is considered to be a strong risk-adjusted return.

Asset Allocation



Distributions

Period Ended	Wholesale Units (cents per unit)
30 September 2019	0.5160
30 June 2019	2.5854 (+0.2533 franking credits)
31 March 2019	0.8096
31 December 2018	0.8859
30 September 2019	0.8045
30 June 2018	1.835 (+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	2.55%
GPT Group	2.37%
Commonwealth Bank PERL VII	2.36%
Macquarie Income Securities	2.23%
UBS 5 AT1	2.20%

Investment Commentary

At 30 September 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 also equities, but they are normally classified as a sub-set of the equity asset class as they tend to have a lower volatility under normal conditions. The underlying security weights in the portfolio ranged from around 0.5% to below 3.0%.

During the quarter, we maintained the course in terms of the Fund's strategic asset allocation (SAA). Tilts within each asset class included:

• Increased exposure to credit rated Floating Rate Notes (FRNs),

• Where possible, positioning the Fund to include fixed rate debt securities with short to midterm maturities (to lock in fixed rates as we expect rates have further to fall);

• Selectively increasing exposure to attractive REITs but also taking profits at the individual security level due to the strong rally of bond prices that began in March;

• We tilted towards the Utilities & Infrastructure asset class by selectively topping up existing securities in the portfolio.

We participated in the following FRNs / Bond issuance in the primary market:

• UBS OTC AT1 5y non-call capital notes;

• WBC subordinated T2 FRNs.

These papers were in high demand and closed over-subscribed. During the quarter, we bought Suncorp OTC T2 debt in the secondary market and exited Nufarm Notes (NFNG).

On a positive note, Brookfield Multiplex confirmed the redemption of the Multiplex SITES (MXUPA) at $100.00. This is positive for the Fund because this will provide a solid realised capital gain once redeemed on 31 December 2019. We have commenced incrementally replacing this regular income by increasing weights in existing securities in the portfolio and bringing in new income generation ideas.

In the equity basket (including REITs and U&I), we topped up AusNet (AST), introduced RIO and AMC, and reduced exposure to Wesfarmers (WES) as its valuation is somewhat stretched.

Outlook

We see geopolitical risk increasing, and slower growth with muted inflation in the mid-term. The bond market is clearly signalling expectations of subdued economic growth and low inflation for the foreseeable future. We reiterate that investors should lower their expectations of high returns over the mid-term.

The RBA cut the cash rate twice (from 1.50% to 1.00%) in the September quarter, and cut once again on 1 October 2019 to a historical low of 0.75%. It has signalled that further cuts to 0.50% are possible. Globally, we have seen central banks turning dovish and signalling further stimulus / cuts in the future. The US Federal Reserve cut twice in the September quarter (to 2.0%) while the European Central Bank eased by 10 bp to -0.50%. In addition, the ECB resumed bond purchases (QE) starting in November 2019 at €20B / per month indefinitely.

Over the quarter, the Australian 10y bond price rallied sharply from 1.32% to 1.01% (yield moves in the opposite direction to price) after touching an all-time low of 0.86% in early September 2019.

Similarly, US 10y Treasuries were at 2.01% at the beginning of the quarter and finished at 1.68%. During the quarter, the 10y and 3m US Treasury yield curve remained inverted (since March 2019), and the 10y and 2y yield curve inverted briefly but currently remains flat. Historically, this latter yield curve has been one of the better indicators of a US recession 4 to 5 quarters ahead, implying the possibility of recession in 2020 or 2021.

As we write, the Australia 10y Bond remains below 1.0%. In the near term, it is likely to trade around ± 0.30% with respect to the current level. Our view is that if bonds are sold off abruptly, then income sensitive securities such as REITs and U&I in the portfolio will be negatively impacted. As the Fund targets longer term returns, we are not overly concerned with short-term volatility. Instead, we remain focused on achieving regular income generation from the Fund whilst minimising risk.

The global economy is stuck in a low growth environment. We think this is caused by several structural factors, summarised here:

• The US-Sino trade tensions will take longer to resolve. We see further downside risks as rivalry between the top two economic powers for technology supremacy ratchets up. This will take many years to "play out";

• High debt levels amongst public and private sectors;

• Negative demographics;

• Changing climate patterns disrupting the economy;

• With ultra-low interest rates, central banks have little room to cut in the event of slower growth using conventional monetary policy. In addition to QE, more unconventional monetary policies may be deployed, increasing the risk of unintended consequences;

• The divergence between the privileged rich and the poor, eroding the fabric of society.

Investing in such an environment requires extra care. These macro themes inform our asset allocation decisions. We actively tilt our asset allocation to maximise returns while minimising risk in a dynamic manner while focused on the goal of income returns.

Given this backdrop, is the Australian economy heading towards a major slowdown or recession? It depends on two major factors: fiscal policy and China. Over the last 3 months, the Australian economy has slowed, but is not contracting. Similarly, Chinese economic data has shown some sluggishness.

Australian economic data appear to indicate that the tax cuts for lower income individuals and households have not predominantly been spent to boost the economy; instead most recipients have chosen to pay down debt. While this is positive for the longer term, in the short term this will be negative for economic growth. The Government has yet to initiate any major infrastructure spending as they opt instead to protect the surplus and Australia's credit rating.

The RBA under Governor Philip Lowe is increasingly being forced to consider unconventional monetary policies (like QE) to meet its inflation and unemployment targets, similar to the US Fed, and the European, UK and Japanese central banks. In reality, we have already had a preview of this over the past 6 months when our bank term deposits rates began to drop sharply as they anticipated further RBA rate cuts.

For the Fund, we will adhere to the aim of generating meaningful income higher than the RBA cash rate, yet doing this with relative price stability. Furthermore, we will seek to:

(a) Maintain or improve on the income component. The annual income yield of 30 September 2019 is 4.3% (excluding franking), which is well above the RBA cash rate of 0.75% (as of 1 October 2019). That said, it is likely that the RBA will cut rates further. Investors should adjust their expectations to a lower yield environment accordingly;

(b) Maintain price stability of the unit price;

(c) Take advantage of market volatility to accumulate high quality, low risk, yield-focused securities across the capital structure;

(d) Take profits at the security level if any individual security trades beyond value so that realised capital gains can be distributed to all unitholders, augmenting the income component of the Fund's distribution.

Vincent Chin
Portfolio Manager

Snapshot

Portfolio Return (Month) Wholesale	Recent Distribution (Wholesale)	Income (Annual) Wholesale	Fund Size (Wholesale) (Cum)
0.5%	0.5160 (cents per unit)	4.3%	$27.2m

Performance and Volatility of Return (30/09/19)

	1 month	3 months	6 months	1 year	2 years	3 years	Inception
Portfolio Return Wholesale	0.5%	1.5%	4.2%	7.2%	5.7%	6.6%	7.0%
Income	0.5%	0.5%	2.8%	4.3%	4.1%	4.1%	3.8%
Capital Growth	-	1.0%	1.4%	2.7%	1.5%	2.5%	3.1%
Volatility**	-	-	-	3.0%	2.8%	2.7%	3.3%

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 wholesale 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.