Clime Fixed Interest Fund

Fund Performance - March Quarter 2020

The Clime Fixed Interest Fund's primary objective is capital preservation. It aims to generate income returns above the RBA cash rate in the form of monthly income distributions. Its return objective is to outperform the benchmark of the RBA cash rate +2.0% p.a. The Fund's risk objective is set at 1.5% ± 1.0%, as defined by the weekly change of the annualised standard deviation of the unit price movement.

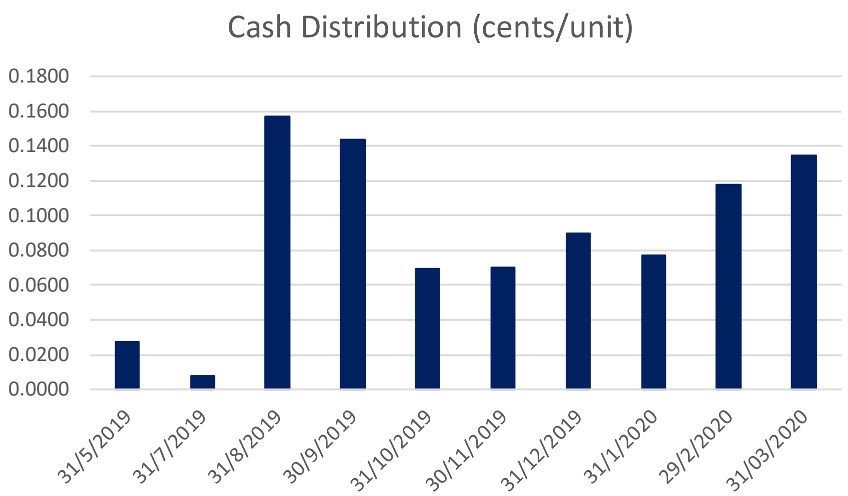
Porfolio Quarter Net Return	Portfolio 6-Month Net Return	Portfolio Net Return Inception p.a.	Fund Size
-2.7%	-2.2%	-0.7%	$17.3m

	1 month	3 months	6 months	FYTD	Since Inception*
Portfolio Net Return**	-3.5%	-2.7%	-2.2%	-1.6%	-0.7%
Risk	-	-	-	2.2%	2.1%

*Inception date: 17 April 2019
**Portfolio return is based on the change of the unit price including distributions and franking.
^The volatility of return is based on the change in the weekly unit price. Since the Fund is less than 6 months old, it is likely that risk indicated here is only an approximation.

Distributions

The Fund distributes income monthly on a cash basis (if available). For the March quarter, we distributed a total of 0.3301 cent / unit, with the latest distribution of 0.1349 cent / unit for the month of March 2020. The chart below shows the monthly distribution profile since inception. After the initial irregular distributions during the formative stages of the Fund, distributions should be more consistent in the future now that we are fully invested.



Fund Facts

Portfolio Manager	Dr Vincent Chin
Fund Inception	April 2019
Fund Size	$17.3m
Cash Distributions	Monthly

Performance & Volatility of Return (31/03/2020)

When we set up the Fund, we followed the standard financial guideline that one in roughly 40 years negative return is a very low to low risk event. Based on this framework, the Fund would be calibrated in the upper medium end of a low risk domain. The suggested time frame for this investment is 2 to 3 years. We have completed empirical modelling and are thus confident that the risk return objectives are achievable based on historical movements of financial markets over the last 30 to 40 years.

In view of the COVID-19 pandemic now sweeping across the world and normal economic activities being significantly curtailed, we acknowledge that it is unlikely that the investment strategy can, at least in the next 12 months, achieve its risk return goals. This is because we believe the seriousness of this pandemic is a 1 in 100 years event.

As we write, more than 2.0m confirmed cases have been recorded worldwide with more than 120k fatalities. There are two crises, i.e. a health crisis and an economic crisis, and both will weigh on the public purse. Governments, Central Bankers and other authorities are working to both save lives and to sustain the economy with the multiple emergency / relief packages announced. It is a fine balance because if the economy is put into hibernation for too long, there is the potential that we may spiral into a deep recession (or worse, a depression) but if they ease off too soon, the human cost would be extremely high.

The Fund achieved a return of -2.7% in the March 2020 quarter and -0.7% since inception in April 2019. We are now fully invested. The negative return is disappointing; this is primarily due to the massive jump in credit spreads by close to 200bp (see chart below). This is likely to be the fastest movement of credit spreads since the GFC. As bond prices move inversely to yield, bond prices have reduced and volatility sharply increased. Consequently, most of the bonds in the Fund are priced below par (face) value at present, resulting in negative returns.

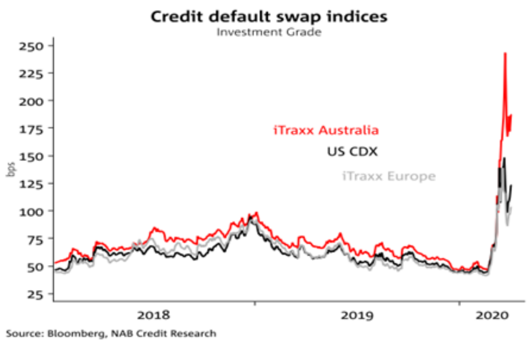


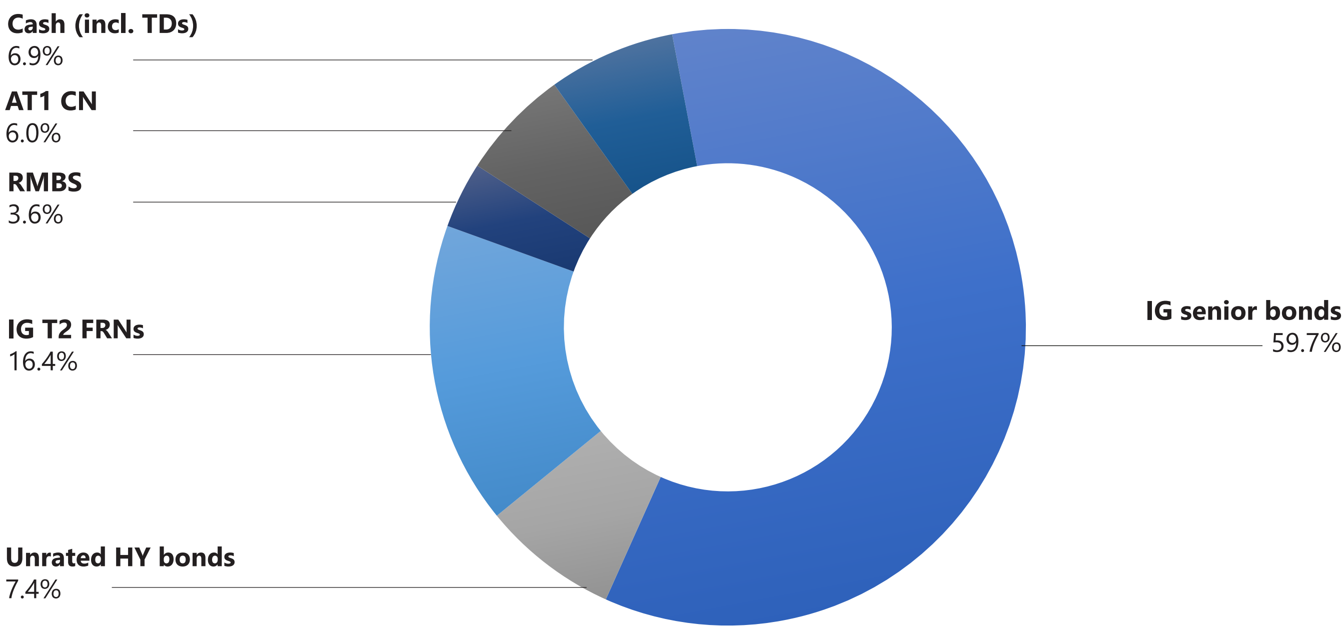
Figure 1 Australia and US credit default swap indices.

If it is any comfort, the equity market as measured by the ASX200 total return index fell by -20.7% in the month of March 2020 and -15.5% since 17 April 2019 (inception date for the Fund). Whilst there is always room for improvement, we believe we have navigated these extremely challenging times reasonably well in the circumstances.

The RBA have further cut the cash rate to a low of 0.25% and indicated that it will remain very low for an extended period. In addition, the RBA has for the first time introduced QE to Australia and intends to keep parts of the yield curve low (which is expected to assist bond prices to stabilise).

As the Fund is less than 12 months old, we have estimated that the risk as defined by the annualised weekly change in the unit price is 2.2% for FYTD and 2.1% since inception. This spike in volatility is a direct result of the sharp spike in credit spreads, resulting in the drop in bond prices alluded to above.

Asset Allocation



Portfolio Commentary

At 31 March 2020, the Clime Fixed Interest Fund was diversified across investment grade (IG) senior and IG subordinated debt, high yield bonds, RMBS and AT1 Capital Notes / Hybrids. We have yet to invest in income notes or asset backed securities. The highest portion of the portfolio is in investment grade FRNs and fixed rate bonds at around 76.2%. This is core to our investment strategy as this will likely provide the capital preservation / price stability required by the Fund while earning interest above that of the cash rate. The objective of these coupons is to provide steady and regular monthly income distributions.

During the quarter but before the spike in the COVID-19 cases globally (i.e. up to late February and early March 2020), we invested mainly through primary issuance. In anticipation of rates dropping further, primary issues were in high demand and spreads tightened due to strong demand. However, that changed when the coronavirus pandemic hit in early March 2020.

Until early March, we shunned other bonds and participated in senior rated bonds only. They are:

- Liberty Financial 4.5-year senior FRN. It was priced at 2.35% over the BBSW.
- Members Bank 3-y senior FRN priced at 0.93% over the BBSW.
- Newcastle Permanent 5-y Senior FRN, priced at 1.14% over the BBSW.
- Sumimoto Bank 2.5y senior FRN, priced at 0.66% over the BBSW

We bought a small parcel of AMP Bank Limited senior debt maturing in less than 1.5 years below par as it became available. Similarly, we bought Ausgrid 5-year senior debt when it became available.

During the quarter, the Fund exited Multiplex Preference shares (it was redeemed at par) and we received the last coupon with the redemption. In mid-March, as Australian Unity 2026 bond (AYUHD) was still holding up, we exited the holding in the Fund prior to the price falling off. We will look at re-purchasing these bonds at a lower level if they are available.

Asset Type	Average Duration (years)
IG Senior Bonds	3.6
IG Tier 2 FRN's	4.2
Unrated HY bonds	2.6
RMBS	2.8
AT1 Capital Notes	7.2

From the table above, we have kept the duration short with the exception of the AT1 CN asset class. However, the Fund has less than 6% exposure in this AT1 asset class, of which more than 5% of the 6% are issued by major leading banks.

Figures below show the breakdown of the credit rating of the IG senior debt. As seen, more than 68% of senior debts are in the high investment rated paper category (BBB+ or higher).

Rating	Allocation
AA	3.1%
AA-	9.2%
A+	3.0%
A	11.1%
A-	1.5%
BBB+	38.3%
BBB	15.6%
BBB-	6.1%
BB	2.1%
NR	10.0%

Since the Fund was set up, we have been fairly risk averse. Capital preservation remains a primary focus. We intend to maintain a cautious stance in the current environment, staying predominantly with highly rated securities. We will keep the duration short. This is because as long as the corporations that issue them are solvent, they would be expected to meet their interest obligations, and when the bond matures, it would be expected to be redeemed at par. Thus, we anticipate that over time the Fund return should increase. In the interim, we expect to be able to continue to pay monthly interest as normal.

Outlook

The world has certainly changed since the abrupt acceleration of the COVID-19 health crisis. We are increasingly hearing terms like "BC and AC" – before and after coronavirus to describe this tragic event. As we know, this health crisis is also an economic crisis as economic activities essentially grind to a halt while resources and effort are switched to combating the disease. It is estimated that up to 1m Australians applied to Centrelink to get unemployment benefits within 2 weeks and similar drastic job losses have occurred overseas. We expect more job loses worldwide in the weeks and months ahead.

Having learnt many lessons from the GFC 12 years ago, central banks and Governments have swiftly rolled out unconventional monetary policies and massive fiscal programs to help cushion the deteriorating economic outlook.

Over the next 2 to 3 quarters, it is likely that we will move into a global recession, which includes Australia, despite the vast amounts of emergency funds being "thrown" at the global economy.

Due to the vast amounts of fiscal stimulus, extremely low interest rates (expected for many more years) and ongoing QE, it will take future generations many years to pay back the accumulated debts. There will probably be tax hikes and less social security benefits. These consequences are not very encouraging, and we anticipate that GDP growth will remain weak for some time.

Our immediate concern is to navigate the portfolio through these crises with minimum damage. Our near-term concern is that until there is a credible vaccine, it is likely that we will get a second wave if social distancing rules are relaxed too early. This is because:

1. There are now community spread with unknown source.
2. COVID-19 has a long incubation time and is asymptomatic.
3. COVID-19 is highly infectious.

These are worrying times. That said, it is possible that the market will rally once infection cases are seen to have peaked. It is not possible to predict this as it depends on many factors, including how quickly Government relaxes social distancing rules.

Ultimately, we believe that until the medical scientists find an effective vaccine or until the bulk of the population is tested for COVID-19 and most unknown cases resolved, we are not secure from further outbreaks and thus it seems difficult for the economy to be back on a sustainable path to recovery.

We reiterate that investors should lower their expectations of high returns over the medium-term.

For the Fund, we adhere to our goal-based investment strategy of generating regular monthly income and capital preservation and expect to continue to do so.

Finally, we ask for your understanding and patience. You can be confident that we will do our best to safeguard your investment in these challenging times.

Please stay safe and thank you for your on-going support.

Sincerely,

Vincent Chin, Portfolio Manager - Multi-Asset Income Strategies

Market Commentary

It will come as no surprise that the COVID-19 pandemic has had a shocking effect on the world's investment markets. Most global markets have experienced their worst quarter since the Global Financial Crisis 12 years ago, with unprecedented volatility as investors try to gauge the implications of large parts of the world's population being caught up in lockdowns of varying intensity.

As renowned investor Howard Marks writes, "The trade-off between the health costs and the economic costs will be a major challenge for every government. The inescapable fact during this pandemic is that what's good for the economy is bad for public health and vice versa." Countries that open too early will face secondary outbreaks, while those that leave it too long risk damaging their economy more than necessary.

Governments and central banks around the world have made emergency interest rate cuts and announced support measures of extraordinary size and scope to sustain economic activity at a reduced level – until we get to "the other side" of the crisis. Companies continue to withdraw their profit guidance, and many have been forced to raise fresh capital in order to bolster balance sheets ahead of the uncertain period in front of them.

As we write this report, some rare good news is that Australia may be past the worst of the health crisis in that "the curve" of new Covid-19 cases appears to be "flattening". Furthermore, the Australian Government's response has been swift and decisive.

The Government has put in place three economic stimulus packages, with total expenditure and revenue measures of $194 billion (9.7% of GDP) through Financial Year 2023-24, the majority of which is to be executed in FY20 and FY21. Measures include sizable wage subsidies (6.7% of GDP), income support to households, cash support to businesses, investment incentives and targeted measures for affected regions and industries.

Other measures include loan guarantees between the Commonwealth Government and the banks to cover the immediate cash flow needs of small and medium size businesses (up to $20 billion). The Government is allocating up to $15 billion to invest in residential mortgage backed securities (RMBS) and asset backed securities to help funding for small banks and non-bank financial institutions.

The Reserve Bank of Australia has cut the official cash rate twice (on 3 March and 19 March) to 0.25%, and announced yield targeting on 3-year government bonds at around 0.25% through purchasing of government bonds in the secondary market. APRA announced on 30 March that it is deferring its scheduled implementation of the Basel III reforms by one year to January 2023.

All these responses will be crucial in managing the response to the pandemic. But of course, the scale of the economic and financial costs remains unknown. In the US, both the world's largest economy and now the epicentre of the virus, a decline in GDP of between 15% and 30% is expected, while estimates of earnings of S&P 500 companies range from -10% to -100%. We can expect something broadly similar in Australia.

Fortunately, there are some positives: the speed with which China has managed to get back to a semblance of normality is encouraging; the monetary and fiscal responses around the world have been truly enormous and will allow many businesses to survive the "hibernation" period; banks are better capitalised and probably carry less risk than they did at the time of the GFC; and markets have adjusted to the extent where many high quality and resilient businesses are now available for investment at more attractive prices.

Philosophical thoughts - Investing with a focus on quality and value

There's no better time to reiterate one's investment philosophy than in a time of crisis. We remain focused on investing in quality companies while maintaining strong valuation discipline.

It's human nature to perceive threats more urgently than the opportunities that lie in wait on or over the horizon. At the same time, pessimism holds an allure that will often present those propagating it as the 'wise sage', perhaps in contrast those proffering a case for long term optimism.

While we acknowledge the significant near term uncertainty, we maintain the view that equities will offer genuine long term investors the ability to generate sound returns, over time. Firstly though, we must be positioned to endure a tougher environment; 'In order to succeed, you must first survive'. Thus, our resolve to focus on high quality companies with strong balance sheets, those companies with true staying power, has only solidified.

The ever calming voice of Warren Buffett wrote in his recent annual letter to investors; 'We constantly seek to buy businesses that meet three criteria. First, they must earn good returns on the net tangible capital required in their operation. Second, they must be run by able and honest managers. Third, they must be available at a sensible price.' He continued; 'Berkshire's assets are deployed in an extraordinary variety of wholly or partly-owned businesses that, averaged out, earn attractive returns on the capital they use.' Who are we to disagree with such sound principles?

Despite market volatility, Clime retains its focus on highly profitable business (as measured by return on equity and return on invested capital): hence you see a diverse portfolio that contains the likes of CSL Ltd (CSL), Appen (APX), Bravura Solutions (BVS), Electro Optic Systems (EOS) and Jumbo Interactive (JIN) to name just a few. Finally, on this note, we also agree with Warren Buffett that 'Reinvestment in productive operational assets will forever remain our top priority'.

The 'All Cap' Appeal

Investors can often seek affirmation and the safety of the crowd. However, in order to achieve above average long term investing results, one must think a little differently. Indeed, investing is a field that demands at least a degree of contrarian thinking. In part, this is one reason why we are so passionate about active management and 'All Cap' quality investing; allowing investors to take advantage of deep insights through meeting more than 500 companies annually and accessing high quality opportunities right across the market cap spectrum.

Exclusively corralling yourself into large cap equities will likely reduce drawdowns in periods of excess stress, but will ultimately converge longer term returns to that of the index. So, while some small caps will be tested during periods of market panic as we've seen in the March quarter, finding and allocating some capital to high quality emerging small and mid-cap companies will reward the patient, diligent investor. Of course, this is provided such an endeavour is done with reference to portfolio balances and the investor's specific needs and objectives such as cash requirements from the portfolio.

Portfolio repositioning

Extraordinary circumstances often call for decisive action. While we maintain a focus on long term horizons, portfolio repositioning in the face of elevated risk remains prudent. In turn, this affords scope to perhaps better deploy capital into superior risk-adjusted opportunities in the months to come.

Thus, in the face of the developing crisis, the first step for us was to dispassionately reassess those companies that we believed were acutely exposed to a significant downturn. This activity impacted companies that largely fell into two buckets: (1) Travel related businesses and retailers dependent on foot traffic, and (2) Leveraged businesses.

The likelihood of near term revenue either being impaired or ceased altogether for companies involved in the travel and bricks-and-mortar retail sectors was rising rapidly so the decision was made to remove these exposures from the portfolio during the quarter. This included our positions in Helloworld (HLO), Seek (SEK) and Webjet (WEB). While we rate these businesses and respective management teams highly, at the time of divestiture, we felt deeper discounts were likely to transpire in the weeks to follow. This indeed occurred, with WEB forced into a deeply dilutive capital raising late in the quarter.

It's a simple concept, but no business has ever died by having too much cash. Plenty of businesses have disappeared off the back of too much debt, however. Leveraged businesses, including leveraged financials, can be severely tested during downturns. As a result, we reassessed our investment theses for our positions in Afterpay (APT), Amcor (AMC) and Credit Corp (CCP). Similarly, we remain attracted to each of these businesses and may well revisit in the future, but felt the prudent course was to de-risk significant geared exposures in such an environment. Concurrently, we maintained a significant underweight position in the banking sector.

At the same time, to a smaller extent, we have utilised the degree of opportunity to initiate positions in a range of high quality companies that we indeed hope to own for many years from this point. Thus, the likes of Altium (ALU), Goodman Group (GMG), Breville (BRG), Technology One (TNE), REA Group (REA) and several other securities were introduced at 'starter' weights within portfolios during the quarter, which allows us to incrementally wade into these positions during weaker periods. We explore the investment theses for many of our new positions in the subsequent Portfolio Commentary section.

When coupled with the range of high quality businesses we already hold, we now believe we own the vast bulk of the portfolio constituents we will move forward with for the foreseeable future (based on our current thoughts for the path forward). It is our intention to buy more of these stocks, thereby adding to portfolio weights, should markets fall back to retest recent lows in the coming months.

What about earnings?

The longer term average P/E for the ASX200 is about 14.5x, which approximates the current P/E for the Australian market. However, it is notable that this only incorporates average company earnings downgrades of just -7% thus far: an improbably meagre figure given the scale of economic dislocation already evident. We therefore still see material downside to near term earnings forecasts, with the spectre of extended shutdowns and equity raisings only adding further pressure to earnings profiles.

Courtesy of UBS, since 1972, earnings per share (EPS) have fallen by 32% during an average recession. By sector, Resources EPS (-44%) has historically fallen the most on average, followed by the Financials (-27%) and the Industrials ex Financials (-25%). This provides useful context when assessing the relative optimism still embedded in current earnings forecasts. Furthermore, while EPS revisions have not yet gathered much steam, the number of ASX 200 stocks with downward EPS revisions is at record highs. We can readily observe that most ASX200 constituents that have provided guidance have either withdrawn or reduced their guidance since February.

While the above provides for a more circumspect outlook on equity performance, there remains several factors to support higher P/Es in today's environment. This includes enormous fiscal stimulus, record low interest rates, including ostensibly limitless QE funded buying of Government bonds, and a potentially faster recovery.

The Outlook

Looking ahead, a great many uncertainties remain, but we are confident that the portfolio is well positioned with a diverse range of financially strong, high quality businesses. While we do not know the tenure of the crisis, history suggests that high quality financially strong companies tend to power out of downturns, and this is how we are now positioned. Cash reserves are healthy at quarter end and afford us opportunity to incrementally add to target holdings with a view to holding and expanding these positions over the long term as market conditions turn more favourable.

Looking forward the approach for growth equity portfolio management is dictated by the following principles:

1. The portfolio will hold elevated levels of cash that will rise and fall according to opportunity and/or new updated significant information;
2. The portfolio will be generally more weighted to larger companies, with better market liquidity, identified by quality overlays and valued conservatively;
3. The portfolio's exposure to small capitalisation companies has been reduced to a level commensurate with a more risk averse environment focused on liquidity; and
4. The elevated cash holding is expected to be partly utilised by capital raising opportunities by companies that are challenged by the current environment but meet our quality analysis.

The current situation is dynamic, and our approach is to be active, nimble and open-minded to rapidly changing circumstances.

Thank you for your ongoing support.

Adrian Ezquerro
Head of Investments

Fund Information

Investment Objective

The Fund's main objective is capital preservation. In addition, we aim to generate income returns above the RBA cash rate in the form of monthly income distributions, with a target of 2% over the RBA cash rate (including franking if available). The Fund's risk objective is set at 1.5% ± 1.0%, as defined by weekly changes of the annualised standard deviation, which is substantially lower than the equity market. In order to maximize the chance of achieving these objectives, the recommended investing time frame is at least 2 years.

Investment Methodology

The Clime Fixed Interest Fund seeks to provide an income stream above the RBA cash rate by investing mainly in the over the counter (OTC) market from a range of investment grade senior and subordinated debts, high yield bonds, asset backed securities, RMBS, income notes, capital notes and other fixed income / hybrids securities with a strong capital preservation focus. The portfolio will invest in selected high-quality individual debt and hybrid securities with consistent income generation.

Portfolio Manager

Dr Vincent Chin

Vincent joined Clime in February 2009. He has a wide range of investment experience spanning fixed income to equity. He has more than 10 years of portfolio construction and managing risk across multi-asset classes. Before joining Clime, he gained his investment experience in the late 1990s to 2000s at Ausbil Dexia and Maxim Asset Management (now wholly subsidiary of Charter Hall) where he has developed multi-factors quantitative models for stock selections and attribution performance analysis. Vincent is passionate about ethical investment across any assets including alternate investments. Prior to this, Vincent worked in semiconductor device and material research in academia and industry for more than 15 years. His research spanned III-V and IV groups semiconductor materials and its application. He specialised in transport properties (numerical modelling and characterisation) in these semiconductors for devices and solar cells applications. He has published about 50 international refereed scientific publications and co-edited a proceeding in opto-electronics.

Fund Information

Name	Clime Fixed Interest Fund	**Investor Eligibility**	Wholesale
Structure	Managed Investment Scheme	**Minimum Investment**	100,000
Investment Universe	< 90 to 95% over the counter (OTC) in the capital debt market, AUD denominated only	**Liquidity**	Weekly Unit Pricing Applications and Redemption
Benchmark	Return : RBA cash rate + 2.0%; Risk : 1.5% ± 1.0%	**Fees**	0.41%
Fund Size	$17.3m	**Admin**	Mainstream Fund Services Pty Ltd
APIR Code	CLA0724AU		

Contact Information

Investor information
Clime Asset Management
Ph: 1300 788 568
Email: info@clime.com.au

Administrator
Mainstream Fund Services
Ph: 1300 133 451
Email: registry@mainstreamgroup.com