MEMO FROM:

John Morgan

DATE: **12 February 2018**

SUBJECT: **More calm before the storm**

Fund Commentary

Capital Protection Trust #1 (CP1)
The CP1 aim is to deliver a consistent margin over the Australian inflation rate through investment in a portfolio of defensive assets that offer a diversified risk weighted return superior to the Australian inflation rate. CP1 has been designed to provide an efficient and effective mechanism for investors to gain access to the broad range of defensive investment opportunities that include Australian and international deposit products, corporate debt, Sovereign Bonds and mortgages secured by real estate assets.

CP1 delivered a return to investors of 0.86% for the quarter to 31 December 2017 and 4.14% for the 2017 year. Since inception, the fund has returned 4.46% p.a. to investors. The fund continues to outperform its target and benchmarks.

Growth Trust #1 (G1)
G1 is a high conviction absolute return fund that allocates capital to a small number of high quality domestic and international investment opportunities designed to deliver superior risk-weighted returns over a three to five-year period. The G1 investment universe includes Australian and international equities, alternative investments, listed and unlisted domestic and international real estate, high yield debt and private equity opportunities. As an absolute multi-asset fund, G1 is not designed to track or outperform any specific global or domestic market index, but to deliver long-term stable growth at lower levels of risk than equities markets.

G1 realised a return to investors of 4.24% for the December quarter and a return of 6.28% for the 2017 year. While the impact of currency movement on the quarterly performance was minimal, the AUD appreciated against the USD by 7.8% during the 2017 year. A material portion of the G1 portfolio is denominated, or listed, in the US and as such this had a drag on the performance of the fund for the year.

G1 made three new investments during the quarter. In addition to their individual risk-weighted return profiles, these investments were chosen for their low correlation with listed equity markets, where we continue to see macro valuation downside risk.

High Yield Trust (HYT)
HYT is designed to provide investors with a secured regular income significantly greater than that offered by deposit and other debt products through access to a portfolio of Australian based loans primarily secured by first registered mortgage over Australian real estate assets. HYT's investment objective is to achieve this through:

- investment in primarily Australian credit assets that offer a risk weighted return materially superior to the Australian CPI;
- a high level of downside protection gained through first ranking mortgage security over Australian real estate assets at conservative loan to value ratios;
- development of a portfolio of assets with balanced maturities that creates opportunities for liquidity, but delivers high yield returns; and
- investment in wholesale and institutional investments that would not ordinarily be available due to the magnitude of the investment or the level of due diligence and expertise required.

The fund realised a return to investors of 1.80% for the December quarter and a return of 3.14% for the six months to 31 December 2017. This was achieved with average loans to total funds ratios of 14% and 58% for the September and December quarters respectively. These results are in line with our targets, yet we would expect to see an improvement in these results as HYT becomes fully invested and broadens its loan portfolio.

Market and Economic Commentary

Global Growth

Global growth continued its positive trajectory with major economies registering positive GDP results for the past quarter. Recently, the IMF upgraded its global growth forecasts for both 2018 and 2019 to 3.9% from 3.7%. This is the second upgrade to 2018 and 2019 estimates in the past 3 months.

The Australian Economy

Australia remains an economy with conflicting stories. On the positive side, on the back of uniform global growth and continued growth from China, commodity prices, especially iron ore continue to perform well. Housing prices, particularly in Sydney and Melbourne are off their highs, to date, in orderly fashion and the unemployment rate fell to a near-five-year low of 5.4%. This is all contributing to GDP numbers that are amongst the best in the developed world, due in a large part to those real estate prices.

Yet, against this and despite good employment numbers, consumer confidence and wage growth remain low and consumer debt is at record highs. Possibly attributable to this low confidence and poor retail spending, inflation remains below RBA targets, which exacerbates the high debt risk.

Where to from here for Australia is the proverbial $64 million question. Will global growth create continued trade benefits that flow into the Australian economy boosting consumer confidence and leading to a retail revival? Or, will growth taper off, housing prices continue to fall and debt continue to restrict the nation, leading to declining GDP and more problems for consumers across a set of fronts?

The Rest of the World

The world is experiencing its third quarter of uniform growth. China, despite concerns over housing prices, the restrictive effects of environmental issues and the overhang of the banking crisis, reported growth of 6.9% for the year. Albeit, there is some cynicism about Beijing's continuing ability to beat economist expectations by the slimmest of margins. The US economy continues to lead the world in economic recovery despite a small dip in GDP in the December quarter. US consumer confidence increased in early 2018 to an almost 17-year high thanks to increased optimism about the economy and record low unemployment. And, while their long-term benefit remains a topic of debate, the Trump tax cuts seem, at least, to be increasing business confidence.

Eurozone health continues to improve with increased discussion of terminating ECB stimulation and the unemployment rate falling to 8.7 percent in November: the lowest level since early 2009.

Add to this the fact that, for the moment at least, geopolitical risk seems lower than it has been for some while and the world appears, from an economic standpoint, to be in improving to good health.

Markets

And don't the markets know it. In 2017, the Australian and US markets grew by 11.8% and 19.6% respectively in an accumulated sense. Similarly, EU, Japanese and UK markets all experienced double-digit gains. And this was against repeated calls at the beginning of the year that growth was likely to be in the low single digits. As markets progressed calls for a correction became louder and louder, especially as interest rate markets started to seriously consider the end of a 30-year bull market and the likelihood that the US would lead the interest rate reversal from historic lows. Yet, in 2017, nothing happened and markets volatility reached all-time lows. Finally, in early February, global markets led by the US markets had a material correction which fell by 7% in just a few days. The drop was sparked by U.S. wage data that pointed to quickening inflation and the rising US 10-year bond yield, which touched 2.85%, a level it has not seen since January 2014. The stock price decline has many wondering if this is the correction that has been long anticipated. However, it is worth noting that, such were the gains in January, that as at 8 February, the markets were back in positive territory for 2018. Equities should not be viewed as short term investments. Corrections occur from time to time and are healthy over time.

That said, we have been, and remain, cautious of downside risk in equities and fixed interest debt and discuss the measures taken to manage these risks in the "Impact on Our Funds" below.

Interest Rates
At the time of writing this note, the benchmark U.S. 10-year Treasury yield rose above 2.8% for the first time since 2014 contributing in part to the equities rout. This has caused a level of nervousness in global equity markets as seen in a substantial increase in expected volatility, a situation which is most likely to continue for some time as investors weigh up the long-term risk-free rate.

The US Fed tightened by another 0.25% in December and has signalled that it sees three rises in 2018, which will take the US Fed Funds rate to 1.75-2.00%. The recent wage data has the markets, that were expecting fewer than three rises, now wondering if in fact the Fed may raise rates four times this year. Only time will provide an answer, but increased volatility is likely.

Weighed against this, the markets consider that there is a better than even chance of one rate rise in the Australian RBA rate in 2018.

Currencies
Despite the US rate rise in December and the fact that that it is expected that the US Fed will raise rates by more than any other developed market, the USD is experiencing a period of sustained weakness. There are many arguments behind what may be contributing to this, including the current USD federal debt position; the likelihood that the new tax regime will only exacerbate that problem; the US protectionism talk; possible redirection of investment funds to improving markets including Europe and Japan; and the revolving door policy in the White House. From a trade weighted perspective, the USD is now at its lowest point since December 2015.

Of greater interest to CTE and our investors is the relationship between the AUD and the USD and to a lesser extent other currencies. For AUD/ USD pair, it was again a volatile quarter with the pair ranging between 0.7506 and 0.7912 for the quarter, yet, despite this volatility, at 31 December the AUD settled only 0.29 cents lower at USD 0.7800, meaning that for the first time since the inception of the G1, currency played only a limited role. However, in terms of annual performance, the AUD finished 7.8% higher against the USD for the year, which detracted from G1 performance.

Impact on Our Trusts

Last update, we spoke about the risks associated with fixed-rate interest debt investments. The chart below shows the yield on 10-year US Govt. Bond for the past 5 years.

10-year US Bond yield

Source: Bloomberg

As can be seen, at 2.8% the current yield is the highest it has been since January 2014. This increase in the rate has two effects: the first is a negative effect on the market price of issued fixed-rate debt; and the second, specifically associated with the 10-year bond yield, as a proxy for the risk-free rate, is that by increasing the discount rate asset values fall.

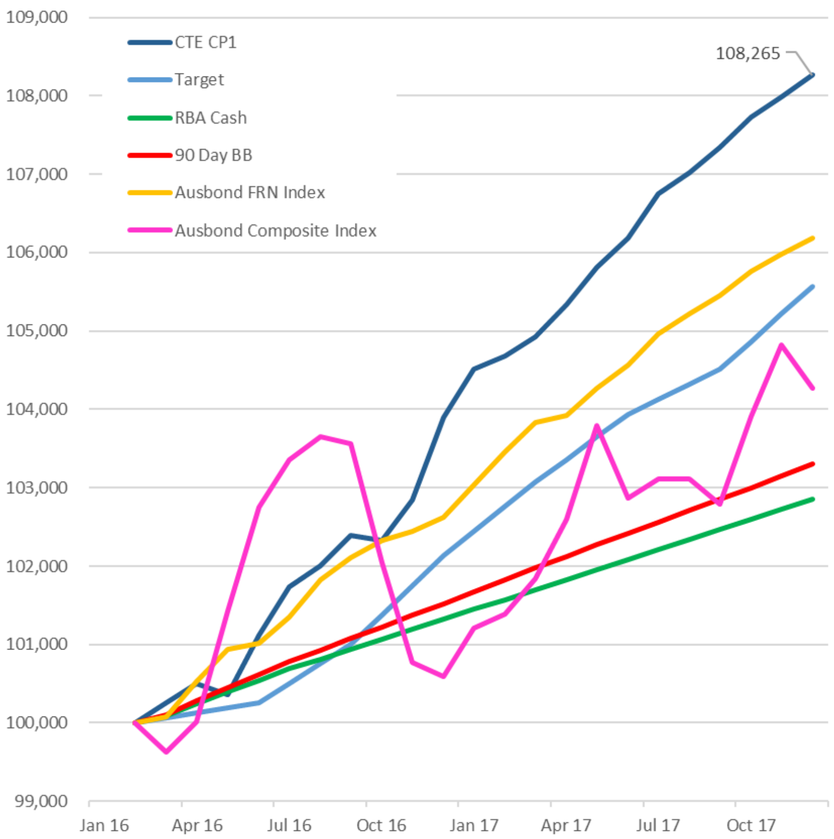
There is little doubt that we are in a medium-term trend of increasing interest rates. The big questions are: what are the new stable sovereign rates? and how long will it take to reach that stability level? While central banks, especially in Australia and the US have provided guidance on the first question, there are many views, but little consensus on the second and as a result, we are likely to see significant volatility and potential capital loss in both debt and equity markets in the medium term.

We discuss how this impacts each of our funds below.

CP1

In the case of CP1 we have avoided fixed-rate debt for two years and we will continue to favour floating-rate assets for as long as this uncertainty remains. The chart below highlights the performance of the CP1 fund against floating and fixed-rate indices since the fund's inception. Despite no movement in the RBA Official Rate since August 2016, the return of the fixed rate Ausbond Composite index (the pink line) has been negligible at 0.6%. For the same period, the return of the floating rate Ausbond FRN index (the orange line) at 4.29% has been materially better. This floating rate return out performance has also been achieved with materially less volatility than its fixed-rate counterpart.

Return on $100,000 invested in March 2016



Notes: *Returns calculated after all fees and expenses and based on NAV price and reinvestment of distributions.*
The Bloomberg AusBond Credit FRN 0+ Yr Index is engineered to measure the market of floating rate credit securities issued in the Australian debt market.
The Bloomberg AusBond Composite 0+ Yr Index is engineered to measure the Australian debt market and is a composite of Treasury, Semi-Govt, Supra/Sov, and Credit indices.
Past performance is not a reliable forecast of future performance. Returns are not guaranteed.
Returns greater than 1 year are annualised.

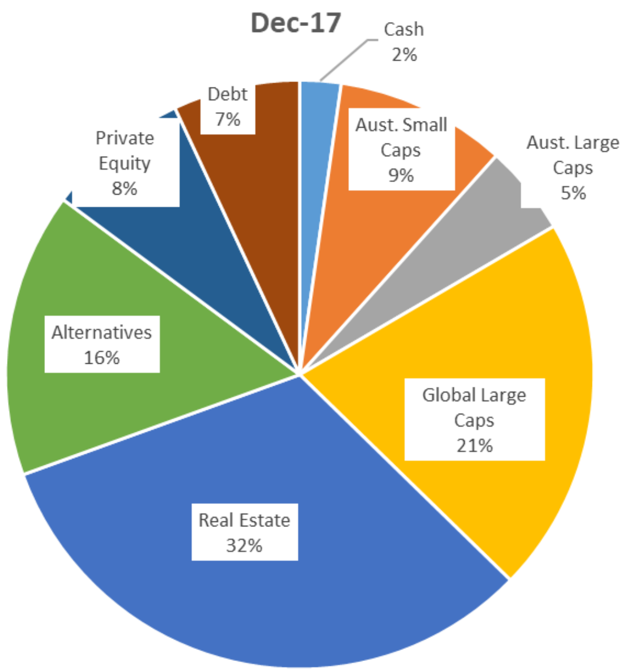
Source: *RBA, Bloomberg, CTE Analysis*

Our view looking forward remains unchanged. As long as acceptable returns can be found in the floating-rate market at lower risk levels and with the most likely direction in global rates being up, we feel it prudent to continue our policy of primarily investing in floating rate instruments.

G1

The G1 portfolio contains three strategies to counter the risk posed by rising interest rates and their potential to lead to a material decline in listed equity prices: With only 35% of the fund invested in listed equities, G1 is underweight in this asset class compared to most multi-asset portfolios (See pie chart below). As such, we are exposed to a range of assets with lower correlation to equity markets that we expect will not experience the same impact in the event of a market shock. Secondly, as we highlighted in our September update, 7% of G1 is invested in assets specifically designed to materially outperform in the event of a downturn in equities. And finally, the portfolio has more than 50% in foreign investments. Historically, the AUD performs poorly in times of high risk, which should provide some protection for Australian investors.

CTE Investments G1 asset allocation



Source: RBA, Bloomberg, CTE Analysis

HYT

As outlined in the CP1 discussion above, we favour floating rate over fixed rate exposure. In the case of HYT, all our current loans are at fixed rates. However, our policy is to not enter any loans with a term of more than two years and the current weighted average life of the loan book is 14.5 months. In this way we minimise any long-term mark-to-market losses resulting from rate changes.

2018 Outlook

Those readers familiar with our early updates will remember that while we used to do an outlook section, we also lay down caveats like the saying below:

> *"The only function of economic forecasting is to make astrology look respectable." - J.K. Gailbraith.*

And, while we do not participate in card reading, we share the views of noted technologist Paul Saffo

> *"The goal of forecasting is not to predict the future but to tell you what you need to know to take meaningful action in the present" – Paul Saffo.*

As such, we share below the dominant views behind our current investment strategy:

View	Impact
1. Floating rate debt offers a superior risk reward profile to fixed rate debt	➢ CP1 will remain with a very high weighting (>85%) to floating rate debt. ➢ Fixed rate investments will be limited to shorter durations.
2. Don't race up the risk spectrum chasing yield	➢ Despite some yield compression in CP1 over the past 6 months, we continue to invest in investment grade debt.
3. Equity markets are likely to offer risk weighted return opportunities, but Volatility is likely to be a significant factor in 2018 in both equity and debt markets	➢ Remain underweight equities ➢ Continue to hold assets with downside protection ➢ Invest in the dips
4. Given the demand/ supply dynamics, Australian residential real estate prices are unlikely to crash but may plateau or come off their highs especially in Sydney	➢ Continue to invest in real estate lending opportunities with appropriate security buffers but avoid Australian residential real estate
5. Global equites are likely to outperform Australian equities	➢ Overweight Global equities in comparison to Australian equities
6. US equities are more likely to underperform compared to EU and developed Asia	➢ We have shifted our international exposure to have a greater weight in EU and developed Asian markets and are likely to increase this position during the year

To our investors, I thank you for your continued support and as always, I welcome all comments and questions.