MEMO FROM:

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DATE: **10 May 2018**

SUBJECT: **Welcome Back Vol**

Fund Commentary

Capital Protection Trust #1 (CP1)
The CP1 aim is to invest 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 -0.42% for the quarter to 31 March 2018. Since inception, the fund has returned 3.86% p.a. to investors.

While the fund continues to outperform its target and benchmarks over the long run it had its first negative quarter since inception. We spent considerable time analysing the drivers of this negative short-term performance and the changes that we can make to minimise the risk of this occurring in the future. Our view is that the primary contributors to the negative return in March (the primary driver of the negative quarterly return) were the correlation between the downturn in equities and hybrid securities combined with a substantial increase in the supply of debt securities in February and March. The matter was not helped by inferences by the Labor Party that franking credits would no longer be refundable in pension phase Superannuation Funds.

The effect of this was to drive prices of these securities down. By way of example, the ASX hybrids index has fallen by 1.50% since 31 January. The corollary of this has been to drive yields on these products particularly some of the ones in CP1, well above stable levels. The yield to maturity on one of CP1's products increased by 0.75% in March.

We understand that the supply of hybrid debt will dry up significantly for the rest of 2018 and we hold the view that the sell down was an over shoot. As such, we expect that yields should stabilise reversing losses to floating rate bond and hybrid prices. This has been partially proven up by performance in April and early May with the ASX hybrids index up 0.91% since the end of March and prices in our other bonds have also improved significantly.

We conducted extensive research into each of our investments and how they reacted and responded to the recent market shocks. While most of the portfolio recovered well and the opportunistic investments made have performed well to date, we are not satisfied that one of our investments has a sufficiently robust investment strategy and as such will be adjusting the portfolio mix this quarter.

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 3.85% for the March quarter and a return of 10.23% for the year to 31 March 2018. The fund benefited from a fall of 1.7% and 4.0% in the AUD against the USD and the TWI respectively. We note that the G1 return for the quarter was achieved in an environment when the

Australian Stock Exchange (ASX) return was -3.9%. Similarly, for the past 12 months, G1's one-year return of 10.23% compares to a 2.5% return on the ASX for the same period.

While this is in no way an excuse for our early performance and we do not use the ASX as a benchmark, it does give me confidence that G1 is now performing as designed. As an example, one of our early and largest investments was in US multi-family real estate. While this investment had a slow start, we invested for the longer term and remain confident two years later that this investment should deliver as forecast, noting that it was up 7.5% for the March quarter.

In its latest World Economic Outlook report, the IMF forecasts global GDP growth to be 3.9% in both 2018 and 2019, up slightly from 3.8% in 2017. If achieved, that would be the fastest pace for global growth since 2010. The IMF noted that global growth surprised to the upside in the second half of 2017 amid strengthening industrial production and trade. They expect the US tax cuts to have a stimulative effect on growth this year, but warn of the growing dangers of trade protectionism.

The Conference Board's latest US Leading Economic Index, a composite of ten variables that lead the business cycle by 6 to 12 months, for March increased by 0.3% to 109.0 (2016 = 100), following a 0.7% increase in February and a 0.8% increase in January.

While the views global growth are positive for economic activity if inflation and debt can be contained, we have long held the view that most equity markets, specifically the US markets, are fully valued. In early April, to further protect against potential correction, we reduced our weighting to long only equity funds, directing these funds to long/short funds or alternative investments.

While we see equities as fully valued at a macro level and remain underweight domestic and global equities, we do see opportunities in certain sectors of the equities markets where rising profits will outweigh rising discount rates. We also continue to seek out beta alternative investments we view as having downside protection qualities. 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.

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 1.69% for the March quarter and a return of 4.58% for the nine months to 31 March 2018. This was achieved with an average loans-to-total funds ratio of 67% for the March quarter. While these results are in line with our targets, HYT is now 95% invested and as such we are of the view that yields should further improve this quarter.

HYT drew against existing commitments from investors for three investments in April and we anticipate that HYT will be able to invest all existing committed capital in the June quarter. We are confident that HYT should start to deliver a return that reflects the fact that it is now fully invested. We are in various stages of review on several investments in the pipeline for the June quarter and will continue to talk with our investors to selectively take up opportunities where they meet out investment parameters.

Market and Economic Commentary

Finally, one of the many market predictions for the past year has proven correct. Over the past 18 months, the consensus has been for low but uniform growth, flat stock markets, a lower AUD and a bond rout. And for all of 2017, none of these predictions occurred. Well this past quarter one came true (well possibly two, with the recent weakness in the AUD, which we discuss below). As predicted, volatility returned to the markets in 2018. The daily swings in equity markets have been extreme. So far this year, the S&P 500 Index has already tripled the number of plus or minus 1% daily swings seen over all last year. There have been eight plus or minus 2% daily swings so far this year, compared to none last year. Yet, despite some major corrections during the quarter, global markets only gave back a small part of their 2017 gains.

Trade tensions that flared in March and April to replace the geopolitical tensions of North Korea have also, for the moment, eased. Synchronised global growth has continued, yet while prospects remain positive for the US, momentum in other markets, China and Europe particularly, appears to be moderating somewhat, such that we are seeing a material slowdown from last year's surprisingly strong performance.

As a result, while the Fed's policy tightening cycle remains firmly on track, any tightening moves from other central banks, including Australia, still look to be a long way off.

Across financial markets, global equities recorded their first quarterly fall in many years. The potential for higher inflation driven by higher US wage growth, tit-for-tat tariff moves between the US and China, the ongoing revolving door policy at the White House, a tech tantrum centred on Facebook but spreading across the sector and signs of softer global growth all played a part. It was a volatile quarter for the equities and bond markets. US equities registered their first quarterly loss since 2015, finishing down 3.2%. While most of this information was focused on the US, other markets experienced similar or larger falls. The ASX 200 finished down 5% for the March quarter.

The Australian Economy

A slowing housing market, weak inflation and soft wages growth have left the Reserve Bank with little choice but to further delay its plans to normalise monetary policy. Most economists and financial markets don't expect a rate cut before 2019, with some forecasting that this will not occur until 2020.

While the RBA predicts that economic growth will exceed its potential, currently estimated at 2.75%, employment growth has moderated this year, lessening progress in reducing unemployment toward the estimated non-accelerating accelerating rate of 5 per cent. Business surveys have remained strong and the post-mining boom downturn in capital expenditure has run its course, but consumption has been restrained by near record-low growth in wages and record household debt-to-income ratios, as an unprecedented housing boom starts to cool.

Interest Rates

In the debt market, we crossed an important threshold with the US 10yr treasury yields rising to above 3% for the first time since 2014. While much has been written about the potential fallout from this, the markets seemed to absorb it well. We are still of the view that it is not the quantum of the increase in bond yields that is the primary concern, but the speed of the increases. To that point, we share the concerns that the combined effects of the lower tax rates and the increased fiscal spending in the US, combined with the low unemployment may accelerate the return of wage inflation and leave the Fed with no alternative but to accelerate rate rises, despite their comments this week that they are willing to accept an inflation overshoot.

With the RBA announcement on 1 May, Australian official borrowing rates have remained unchanged at 1.5% for 21 months since August 2016. While the RBA has confirmed that the next move in interest rates is more likely to be up than down, it has also said that it expects progress toward its goals on employment and prices to be gradual, implying that rate hikes could be some way off.

Currencies

The USD is rallying after floundering for most of the past year, which may be a sign that global growth momentum is shifting back to the U.S. away from other major economies. As economists grow more doubtful that Europe can keep up last year's pace, signs of stronger U.S. economic growth and inflation are becoming a focus of financial markets, helping lift the dollar to its highest level since January.

Despite the recovery, the USD lost 0.3% against its trade weighted index (DXY), for the period 1 January through to 30 April. The AUD on the other hand has fallen significantly for the same period falling 3.4% and 4.6% against the USD and the TWI respectively. And further, as at the date of this report, it had fallen a further 1.8% against the USD. It is not clear what is driving this sudden weakness in the AUD. Commodity prices and demand out of China are strong. The Australian Federal Government has just announced a responsible budget designed to achieve surplus in the medium term and there has been limited movement in the AUD/USD carry trade. We can only surmise that the factors that have been supposed to take effect for some time, which is primarily the reversal of the carry trade, may be starting to take hold. Our investors will be aware that G1 has a high level of its investments denominated in USD and any strength in the USD against the AUD works well for the G1 AUD price and return.

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