MEMO FROM:

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DATE: 6 March 2019

SUBJECT: Well that was quick

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 (CPI). CP1 is structured to provide an efficient and effective mechanism for investors to gain access to a 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 targets a return of 1.5% over the Australian CPI.

CP1 delivered a return to investors of 0.22% for the quarter to 31 December 2018. Since inception, the fund has returned 3.69% p.a. to investors.

2018 was a volatile year for all asset classes and credit was no exception. CP1 had four down months during the year as equity contagion and over supply affected the spreads in our investments. In spite of this volatility, CP1 delivered a return of 2.00% for the year, which while below our target was better than the RBA and bank bill rates against which we benchmark ourselves.

Growth Trust #1 (G1)

G1 is an absolute return, high conviction fund. We allocate capital to a small number of high quality domestic and international investment opportunities structured 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, opportunistic credit and private equity. 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 equity markets. G1 targets a return of 4.5% over the Australian CPI.

G1 realised a return to investors of -3.03% for the December quarter and a return of 7.4% for the year to 31 December 2018.

As mentioned, 2018 was a difficult year for all asset classes. To put this in perspective, the chart below shows that not one major asset class outperformed US inflation in 2018. This is the first time this has occurred in over 15 years. While this chart is US centric and only goes to November 21, it highlights how rare 2018 was with respect to multi-asset allocation.

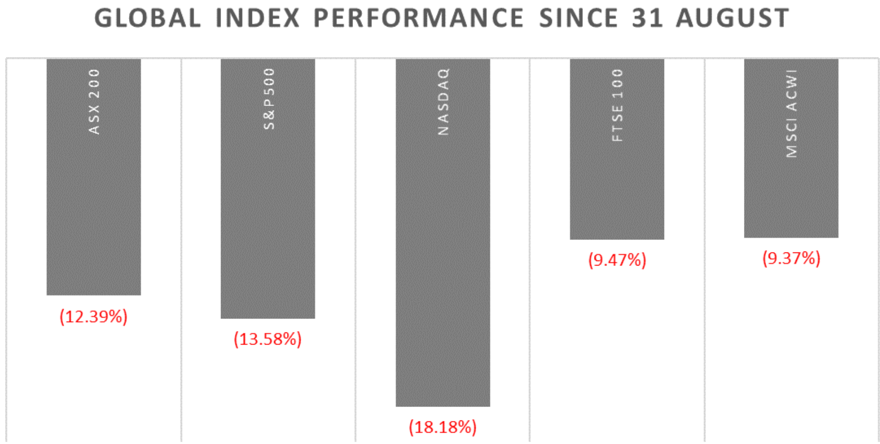
Asset class Excess returns over US inflation

Ranking	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
1	REITS	MSCI EM	MSCI China	MSCI China	US 10Yr	MSCI EM	REITS	US 10Yr	MSCI China	Russell 2000	REITS	MSCI Japan	Commodities	MSCI China	REITS
2	MSCI EM	Commodities	REITS	MSCI EM	US 2Yr	MSCI China	Russell 2000	Inflation Bonds	MSCI Europe	S&P 500	S&P 500	REITS	Russell 2000	MSCI EM	S&P 500
3	MSCI Europe	MSCI Japan	MSCI Europe	Commodities	US Agg. Bond	Global HY	Commodities	EM$Sov Credit	Global HY	MSCI Japan	US 10Yr	US 10Yr	US HY	MSCI Europe	US 2Yr
4	Russell 2000	MSCI China	MSCI EM	MSCI Europe	EM Local Debt	US HY	MSCI EM	US IG	REITS	MSCI Europe	MSCI China	EM$Sov Credit	Global HY	MSCI Japan	US HY
5	MSCI Japan	EM$Sov Credit	Russell 2000	Inflation Bonds	US IG	Commodities	MSCI Japan	US Agg. Bond	MSCI EM	US HY	US IG	S&P 500	S&P 500	S&P 500	US Agg. Bond
6	Inflation Bonds	REITS	S&P 500	US 10Yr	Inflation Bonds	MSCI Europe	US HY	REITS	EM$Sov Credit	Global HY	EM$Sov Credit	US 2Yr	MSCI EM	Russell 2000	Russell 2000
7	Global HY	MSCI Europe	Commodities	US 2Yr	EM$Sov Credit	EM$Sov Credit	S&P 500	US HY	Russell 2000	MSCI China	US Agg. Bond	US Agg. Bond	EM$Sov Credit	EM Local Debt	Commodities
8	Commodities	S&P 500	Global HY	US Agg. Bond	US HY	REITS	Global HY	Global HY	S&P 500	REITS	Russell 2000	US IG	REITS	Global HY	US 10Yr
9	EM$Sov Credit	Russell 2000	US HY	EM$Sov Credit	Global HY	Russell 2000	EM Local Debt	S&P 500	US HY	US 2Yr	Inflation Bonds	MSCI Europe	US IG	EM$Sov Credit	Global HY
10	US HY	Global HY	EM$Sov Credit	S&P 500	Commodities	S&P 500	EM$Sov Credit	US 2Yr	EM Local Debt	US IG	US HY	Global HY	EM Local Debt	REITS	US IG
11	S&P 500	EM Local Debt	Inflation Bonds	US IG	MSCI Japan	US IG	US 10Yr	EM Local Debt	US IG	US Agg. Bond	US 2Yr	Russell 2000	Inflation Bonds	Inflation Bonds	Inflation Bonds
12	US IG	US HY	MSCI Japan	EM Local Debt	Russell 2000	EM Local Debt	US IG	Russell 2000	Inflation Bonds	MSCI EM	Global HY	US HY	MSCI Japan	Commodities	EM Local Debt
13	US 10Yr	US Agg. Bond	US Agg. Bond	Global HY	S&P 500	Inflation Bonds	US Agg. Bond	Commodities	MSCI Japan	Inflation Bonds	MSCI EM	Inflation Bonds	US Agg. Bond	US HY	EM$Sov Credit
14	US Agg. Bond	US 10Yr	US IG	US HY	REITS	MSCI Japan	MSCI China	MSCI Europe	US Agg. Bond	EM Local Debt	EM Local Debt	MSCI China	MSCI China	US IG	MSCI Japan
15	EM Local Debt	US IG	US 2Yr	Russell 2000	MSCI Europe	US Agg. Bond	MSCI Europe	MSCI Japan	US 10Yr	EM$Sov Credit	MSCI Japan	EM Local Debt	US 10Yr	US Agg. Bond	MSCI Europe
16	MSCI China	US 2Yr	US 10Yr	MSCI Japan	MSCI China	US 2Yr	Inflation Bonds	MSCI EM	Commodities	US 10Yr	MSCI Europe	MSCI EM	US 2Yr	US 10Yr	MSCI EM
17	US 2Yr	Inflation Bonds	EM Local Debt	REITS	MSCI EM	US 10Yr	US 2Yr	MSCI China	US 2Yr	Commodities	Commodities	Commodities	MSCI Europe	US 2Yr	MSCI China

Source: Bloomberg, Morgan Stanley Research; Note: Note: We compute annual returns minus US headline inflation. Green means returns (in USD) beat inflation, and red means returns trailed inflation. 2018 data as of November 21, 2018.

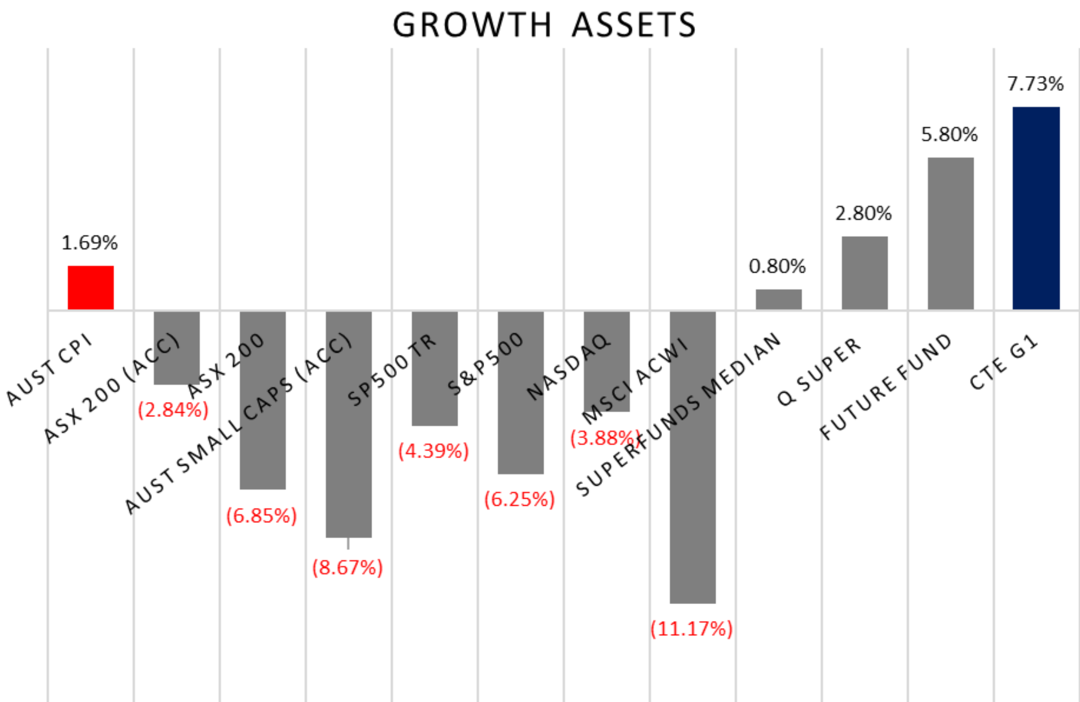
Note: Green indicates that the asset class outperformed US inflation: Red is an underperform. Asset classes are ranked according to performance.

Most of this pain was felt in the last third of the year. The next chart shows the performance of the world's major equities indices since 31 August 2018. All were in or about correction territory.



Source: Bloomberg, Investing.com, CTE analysis

While positive performance in the first half of the year meant that losses were not as pronounced as the previous chart, not one major equities market realised a positive return in 2018. The graph below highlights various single and multi-asset strategies in 2018 against G1[1].



Note: CPI number includes December estimate of 0.5%. Each Asset class is quoted in its home currency
Q Super was the highest performing large publicly available superfund in 2018
Source: RBA, ABS, Bloomberg, ChantWest, Future Fund, Investing.com, CTE analysis

I have written for some time in these updates about our concerns with overweight equity positions and structuring a portfolio in anticipation of global equities' volatility. While one can plan for these events,

[1] *As G1 is an absolute fund, we use Australian superannuation funds and the Future Fund as proxies for the market return of other multi-asset strategies*

one never knows the true resilience of a portfolio until it is tested. To date, the G1 portfolio has performed as designed: to protect against material loss from a global equities correction. While the December quarter was negative, the 2018 performance was above target which is our goal.

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 credit primarily secured by first registered mortgage over Australian 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 2.06% for the September quarter and a return of 7.45% for the year. During the quarter average funds deployed were 87% of total funds.

HYT continues to deliver a return materially superior to bank bills with low volatility. The investment team has managed to find investments that provide above target returns that we consider provide a return in excess of their attributable risk.

Market and Economic Commentary

The Global Equities Market

We have already shown charts summarising the performance of the global equities markets in 2018. There were three major corrections (greater than 10%) during the year.

Most of the equities market story in 2018 was a revision of Price to Earnings (PE) ratios triggered by a change in the market view on the discount rate. This was initially brought about in February by the incorrect wage data release in the US; again, in October as the US 10-year bond rate reached 3.24%; and in December as a response to the Federal Reserve not being dovish enough and dropping its previously proposed three hikes in 2019; a position it has since reversed.

In the background, issues such as the US/ China trade war, Brexit, along with Italy and Turkey and The Donald provided additional fear concerns, which are entirely normal for markets.

A potential concern is that profit growth in the US may be on the wane[2]. Through all of the noise of 2018 including the impact of increasing interest rates, the underlying health of the US economy was and still is robust. Low unemployment and high jobs creation. Further, corporate profits were growing at increasing rates. These factors would always have tempered the effect of rising interest rates on long-term equity values. If we are seeing the end of an economic cycle that grew from the depths of the GFC and corporate profits are on the wane, then we may be entering a protracted period of equity prices in the doldrums.

On the positive side the effect of the recent corrections is that the 2019 P/E ratio is below its long-term average, thus if profits remain robust and the effect of interest rates is already built into discount rates, equities may deliver acceptable returns in 2019. However, as January's rebound has shown us, it is likely to be volatile and far from homogeneous in its distribution as winners and losers emerge.

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[2] *It is worth noting that this may be attributable to the tax cuts introduced in early 2018. If this is the case, then we would expect a reduction in earnings growth as the effect of the tax cut will not be ongoing. The question remains as to whether there is more in the revisions that purely the runoff of this event.*

While stock markets outside of the US are more attractively prices, until we can see opportunity for earnings' growth, we remain cautious with respect to investing in these markets.

The Global Economy

The Global story is still primarily about how well the US is doing domestically and how poorly the rest of the world, both developed and otherwise, is doing. The IMF recently revised global growth targets for 2018 down, primarily in response to the ongoing potential impact of the trade war and disappointing growth numbers in Germany.

More broadly, industrial production across the 19-nation Euro Area is falling at the fastest pace since the financial crisis, and deteriorating demand is evident as the region finds itself squeezed between international and domestic pressures. That leaves expansion at risk of barely topping one percent this year, a sharp slowdown from 2018, with even continental powerhouse Germany in trouble.

In summary, our concerns on the global economy include:

- Potential impact of declining profit growth for US corporates;
- Potential slowdown in the Chinese economy;
- Continued low growth and possible recession in Europe;
- The longer-term impact of the trade and power battle between China and the USA; and
- Contagion from an Emerging Market debt crisis.

The Australian Economy

The Australian economy also continues to be a concern from an investment perspective. It lost momentum in the second half of 2018 led by housing and the consumer. GDP rose just 0.3% in Q3 and we are still to see the numbers for Q4. Housing price decline in Melbourne and Sydney is now at the 10% range with more than a few economists calling for a further 5-10% fall. House price declines will have an impact on headline GDP numbers and are likely to affect consumer confidence. Wage growth remains lower than average which affects consumers' ability to repay their record levels of debt and to drive retail sales growth. On the plus side, government infrastructure spending and exports are likely to contribute to growth.

In 2019 we continue to expect GPD growth to slow as was recently forecast by the RBA. A Federal election looms mid-year, which is causing a sense of uncertainty around such matters as negative gearing and dividend franking.

While employment, albeit favouring part-time over full-time recently, and the move to a Federal Government surplus are positives for the economy, we remain cautious about:

- an acceleration of the housing downturn;
- low wage growth combined with high household debt; and
- the outcome of the Federal election, which may bring changes to negative gearing and the value of franking credits;
- The potential for a recession in Australia after 27 years of growth.

Interest Rates

Interest Rates, primarily US rates, were the boogie man of 2018. Their direction both actual and perceived delivered most of the volatility for the year.

In 2019, while the US Fed has tempered its approach to rate rises and indicated that its balance sheet may be closer to temporary equilibrium than previously thought, two rate rises are still expected.

Here in Australia, while we started 2018 with the expectation of a rate rise in 2018, which did not transpire, markets recently priced in a 50% chance of an RBA interest rate decrease in 2019. This, along with the recent about face by the RBA, is unlikely to provide much support for the AUD, which may be the goal.

Currencies

The AUD had another year of material loss against many currencies, especially the USD, which has the most impact on our portfolios. The AUD/USD fell from 0.78 to 0.704 a fall of almost 10%. Against the TWI the AUD fell 6.5%. The AUD is now testing lows not seen since 2015 and prior to that 2009 at the time of the GFC. While cyclically these may be data points for a strengthening dollar there is little macro-economic data to support such a hypothesis. GDP growth is forecast to be in the 3% range and we are moving towards a Federal surplus. However, there are many factors that point to further pain for the AUD including:

- the risk of global recession;
- further decreases in Australian housing prices;
- the potential for a decrease in the RBA cash rate in the face of further rises in the US Fed rate;
- concerns around consumer debt levels and the ability for them to be reduced given low inflation and low wage growth;

So, while there may be less upside for the USD, there appears to be little upside risk in the AUD at this time and we remain unhedged in most of our international positions.

Effect on our Portfolio Strategies

Growth Trust #1
In the last six months of 2018, we made five investments in long-term unlisted assets. These assets take time to deliver returns, typically delivering most of their value in their later years. As at 31 December these assets represented 24% of the portfolio. We are in the process of completing a review of the US assets and we remain confident about their medium to long-term potential. We anticipate that they will start to contribute to returns in 2019. These assets together, with our other unlisted assets should provide a level of protection from whatever the equities markets deliver.

As to the markets, uncertainty and volatility appear to be the words of the day. There are plausible arguments to be made for a rebound and further correction. Our view is that our underweight exposure to the equities market along with our uncorrelated investments should temper any large movements either way. While we may be giving up the full impact of any major increases in global equities markets, we are prepared to make that concession to protect our investors from major drawdown.

There is no question that GDP growth (US and Australia) and corporate earnings (US) have been strong in 2018. While US tax cuts did inflate US earnings, underlying growth has also been strong.

In 2019, we anticipate that global growth will slow. This, combined with increased interest rates, is likely to create headwinds for equity prices globally and there is definitely the possibility of a US, and now an Australian, recession in late 2019 or 2020.

As such, G1 continues to have a lower exposure to listed equities than most multi-asset strategies and will continue to do so while these conditions remain in effect. Our first goal always will be “Don’t lose money”. To account for this underweight position in equities, we continue to seek out non-equity investments that we believe have superior risk/ return trade-offs over the medium term. One potential impact of this is that returns will be less volatile but lumpier, not necessarily occurring every quarter.

High Yield Trust
HYT is now performing above target and is now 99% invested. We continue to be very cautious about which loans we invest in, working to minimise any risk of capital loss.

Capital Protection Trust #1
The Capital Protection Trust is our most defensive fund, yet has provided many challenges throughout 2018. While it experienced volatility in the first half, we have recovered all short-term losses and continue to deliver medium to long-term returns that approximate our targets.

We continue to seek out defensive investments with returns that meet our targets and hopefully will reduce volatility in 2019. While we have outperformed our targets in the past, capital protection will always be our primary goal in this trust.

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