Managed Income Portfolio Service (MIPS) Quarterly Report

Period end December 2017 and the 2017 Calendar Year End Review

Welcome. This report contains a selection of summary information relevant to the fixed income market, informing readers of the major influences upon prices within the asset universe from which the MIPS team select exposure, and therefore derive performance, for all customised accounts and the three investment programs under management: Conservative Income, Core Income and Income Plus.

In this report we introduce the MIPS Bank Bond Investment Programs, which are available to investors with >$5m who seek an uplift in returns over cash and term deposits, whilst maintaining a significantly high level of liquidity.

MIPS Strategy - All programs are short duration awaiting higher (base) rates before extending.

All programs are (selectively) long credit exposure.

Key themes

- US and AUD Interest Rate positive correlation is unravelling slowly.
- Interest Rate directional view (duration strategy) is unchanged.
- Credit Margin directional view (Credit exposure strategy) is unchanged.
- Increased allocation to RMBS assets.

Economic Summary and Outlook

1. The 2017 year in review – Economics and Base Interest Rates

During 2017 global economies experienced improved economic growth alongside heightened geopolitical volatility, but conversely enjoyed low volatility for financial market asset prices. Global equity and property markets have experienced a slow grinding bull market trend, with minimal reversals in valuations, all funded by historically low interest rates that have been rising progressively from the extreme lows experienced in late 2016.

Global economic growth has been led by the United States, having posted growth back above 2%, seen unemployment fall to below 4%, and with a minimal uptick in inflation.

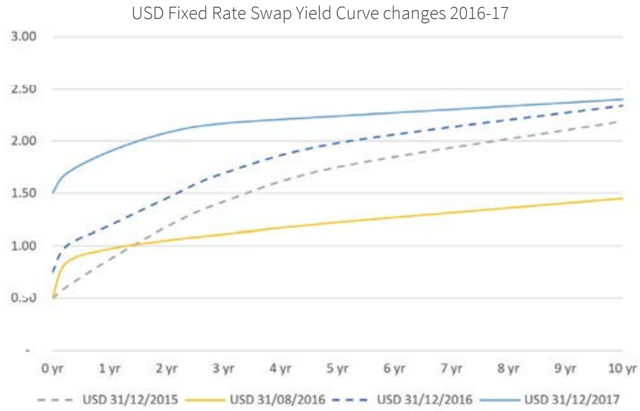
The US Federal Reserve has tightened monetary policy (four times) from lows, and commenced a reversal of their quantitative easing strategy, selling balance sheet assets into the open market.

MIPS Investment Returns

The MIPS investment returns net of fees, are contained in the table below. These returns are the averages across all individually managed accounts on an actual basis.

Total NET Returns December 2017	3 months	6 months	12 months
Income Plus	0.87%	1.55%	4.50%
Core Income	1.20%	2.00%	4.97%
Inflation Linked Income	1.93%	1.57%	3.98%
Conservative Income	1.26%	2.06%	3.66%
Bank Bond Program 3	0.69%	1.50%	3.34%

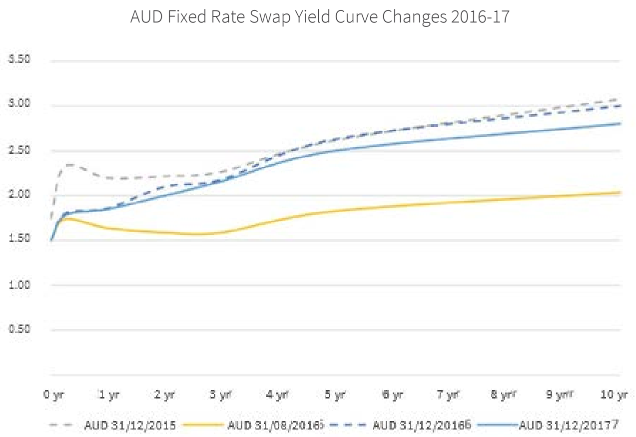
1. The 2017 year in review – Economics and Base Interest Rates (continued)



(Source: Bloomberg)

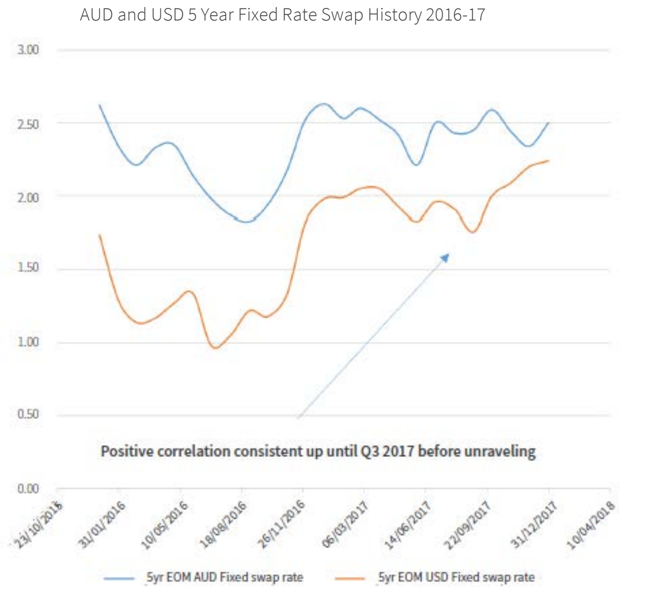
It bears repeating what we stated in our September Quarter report, "it could not have been heralded more loudly if Fed Chair Janet Yellen had struck a bell on Wall Street. The US Fed is on a path of tightening, only the pace of tightening along that path would appear debatable".

Other global economies are broadly improving, albeit at a slower pace. Australia posted economic growth of 2.6% in 2017, and unemployment was down to 5.4%. However, unlike in the US where a monetary policy tightening stance has been very well telegraphed, within Australia the RBA has delivered a consistent message of sustained monetary policy at current lows (1.50% Official RBA cash rate) citing a weak inflationary outlook, forecast excess labour capacity, weak wage growth and 'high' unemployment at 5.4%.



(Source: Bloomberg)

That would seem inconsistent given both Treasury and the RBA forecast somewhat buoyant economic growth of between 2.75% - 3.00% and 2.75% - 3.25% in FYE 2018 & 2019 respectively. The RBA appears to have set a high hurdle for growth before increasing the official interest rate. By extension it would also appear clear that until the RBA moves or indicates that they will be moving monetary policy higher, the breakdown in correlation between US and AUD interest rate changes that began in the 4th quarter of 2017 will likely continue.



(Source: Bloomberg)

This 'moderate' growth outlook and low monetary policy stance in Australia, as opposed to within the US, is attributed by the MIPS team amongst other factors, to two key component parts.

Firstly, the belief that the current strength in commodity prices is not sustainable, especially iron ore. The significant benefits of strong commodity prices, volume sustainability and State & Federal balance sheet improvement are clear, however Treasury forecasts are somewhat down beat.

Secondly, and most importantly, the current significant mortgage indebtedness of the household sector is clearly impacting consumer discretionary spending. This is evidenced by weak retail sales growth in 2017, and RBA concerns of the impact of further indebtedness upon economic growth.

The RBA is holding monetary policy at all-time lows in pursuit of economic growth improvements toward the 3.25% target, not fearful that lows might drive further increases in household indebtedness as the regulator is applies macro-prudential brakes. Those brakes are clearly working, slowing the property sector bulls down, as evidenced by flat and even negative property growth in the largest Australian capital cities since mid-2017.

Subsequently, given our view of the direction of US interest rates and of the positive correlation between US and Australian interest rates during 2017, we retained a short duration strategy for all our investment programs, avoiding potential poor performance associated with the devaluation of long term fixed rate bonds. This was a continuation of our successful 2016 strategy that worked well up until the fourth quarter 2017.

Unlike 2016, the Australian yield curve changed minimally over the calendar year and longer dated bonds delivered marginally higher returns by virtue of the positive yield curve shape. By the maintaining short duration we have foregone the opportunity to earn that slightly higher return, as evidenced by difference between the 2017 YE performance of the longer duration (4.60 years) 0-10 year maturity index which returned 3.15%, and the shorter duration (2.56 years) 0-5 year maturity index which returned 2.56%.

2. Interest rate outlook 2018 – 'Bearish' interest rate directional stance

The US economy continues to be the driving force behind global growth and we believe global interest rates will experience upward pressure if expectations of the pace of the Fed hikes increase. Australian longer term interest rates have and will continue to be impacted. The 4th quarter of 2017 saw the Australian yield curve hold against a climbing US yield curve, however it is likely the correlation will return as Australia is a significant global debtor and competitor for global capital.

We acknowledge that in the first half of 2018 the domestic economy is likely to be constrained by high household debt levels, both wage growth and inflation are unlikely surprise on the upside. We forecast that constraint will dissipate as indebtedness is paid down and real global and domestic growth surprises on the upside.

In summary, we forecast that the RBA may delay lifting the official cash rate, but the yield curve will nonetheless steepen and may well do so progressively from the 3 year point of the yield curve.

Subsequently, we position our portfolios in the short duration target range of 2 to 3 years, given the portfolio performance outcomes that would occur should base interest rates rise or fall given our probability adjusted forecasts.

Term to Maturity Start	Base Fixed Interest Rate Valuation Start	Credit Margin Average across portfolio	Total Yield at each maturity date	Return IF interest rates go UP by .50%	Return IF interest rates go down by .25%	Variance
10	2.80	3.50	6.30	3.03%	8.17%	5.13%
5	2.50	3.50	6.00	4.34%	7.01%	2.67%
3	2.17	3.50	5.67	4.81%	6.23%	1.42%
2	2.08	3.50	5.58	5.11%	5.84%	0.73%
1	1.90	3.50	5.40	5.44%	5.44%	0.00%

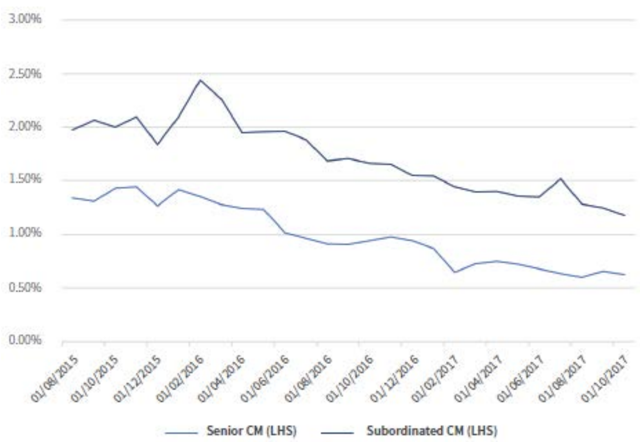
As a result of our 'Bearish' interest rate directional stance, we forecast an equal probability of the yield curve going up by 50 basis points or down by 25 basis points.

Due to total return outcomes under each scenario we favour staying shorter duration, given lower variance between higher and lower return outcomes and a tolerable minimal return outcome (blue figures). By moving longer in duration, we would risk lower than tolerable return to achieve a higher excess return (red figures) that we do not believe will occur given our forecasts.

3. The 2017 year in review – Corporate Debt Credit Margins

The Australian Corporate bond market exhibited clear correlation to the bullish trend exhibited in equity markets. Credit margins were lower across nearly the entire universe of Investment Grade (IG) and Non-Investment Grade (NIG) assets from which the MIPS Investment Programs choose.

The rally in credit margins is attributable to a number of factors, including but not limited to generally improved macroeconomic conditions (growth) and microeconomic conditions (corporate balance sheet strength). Specifically, the Australian Banking sector in isolation probably led the rally as their ability to raise cheaper senior and subordinate (Tier 2) capital was led by the Australian Prudential Regulatory Authority (APRA) enforcing higher capital adequacy positions and more prudent lending standards in the residential property sector. The trend that commenced in early 2016 gathered pace in 2017.



(Source: Bloomberg)

As the average credit margin of senior and subordinate debt issued by major banks rallied, professional investors progressively sought yield within the corporate debt universe and subsequently bid credit margins lower as supply could not match demand.

The MIPS Investment Programs of Conservative Income, Core Income, Income Plus and the various Customised Mandates that include the Bank Bond Programs, invested amongst a universe of approximately 70 assets (that were held within the programs for the entire calendar year), all of which, with the exception of one rallied over that period.

The top 20 performers from the MIPS universe were:

Security Details			Valuation Yield / Change			Credit Margin / Change 2017			Duration
Security	Rating Status	Capital Structure	Jan-01	Dec-31	YOY Change	Jan-01	Dec-31	YOY Change	YOY change due to duration
LaTrobe 2016-1 E-BBSW+7.50%-19Feb20	NIG	Senior Debt	9.50%	7.62%	1.88%	7.18%	5.55%	1.64%	0.24%
CapitolHealth-8.25%-10May20	NIG	Senior Debt	8.14%	6.40%	1.74%	5.84%	4.33%	1.51%	0.23%
McPhersonsLtd-BBSW+4.30%-31Mar19	NIG	Senior Debt	6.56%	5.00%	1.56%	4.50%	3.10%	1.39%	0.16%
AAI-BBSW+3.30%-18Nov20c	IG	Subordinate Debt	5.00%	3.64%	1.36%	2.53%	1.49%	1.04%	0.33%
Downer-4.5%-11Mar22	IG	Senior Debt	4.99%	3.66%	1.33%	2.34%	1.22%	1.12%	0.21%
Liberty 2016-2 D-BBSW+4.30%-16Dec19	IG	Senior Debt	6.68%	5.36%	1.32%	4.24%	3.23%	1.01%	0.32%
Asciano-5.25%-19May25	IG	Senior Debt	5.59%	4.37%	1.22%	2.69%	1.69%	1.00%	0.23%
SCT-BBSW+4.40%-24Jun19	NIG	Senior Debt	6.05%	4.83%	1.22%	3.96%	2.90%	1.05%	0.16%
Downer-5.75%-29Nov18	IG	Senior Debt	4.10%	2.89%	1.21%	2.09%	1.02%	1.07%	0.14%
StockCo-8.75%-6Oct21c	NIG	Subordinate Debt	8.05%	6.92%	1.13%	5.46%	4.57%	0.89%	0.23%
BendigoAdelaide-BBSW+2.80%-29Jan19c	IG	Subordinate Debt	4.27%	3.22%	1.05%	2.24%	1.35%	0.88%	0.16%
Lendlease-6%-13May20	IG	Senior Debt	4.20%	3.16%	1.04%	1.89%	1.09%	0.81%	0.23%
WBC-BBSW+3.10%-10Mar21c	IG	Subordinate Debt	4.54%	3.52%	1.01%	2.00%	1.31%	0.69%	0.32%
Qantas-6.5%-27Apr20	IG	Senior Debt	4.21%	3.20%	1.01%	1.92%	1.13%	0.79%	0.22%
Qantas-7.50%-11Jun21	IG	Senior Debt	4.45%	3.45%	1.01%	1.88%	1.17%	0.72%	0.29%
MEBANK-BBSW+2.70%-29Aug19c	IG	Subordinate Debt	4.74%	3.74%	1.00%	2.62%	1.78%	0.84%	0.16%
NAB-BBSW+1.85%-26Mar20c	IG	Subordinate Debt	4.18%	3.19%	0.98%	1.92%	1.14%	0.77%	0.21%
ANZ-BBSW+2.70%-17May21c	IG	Subordinate Debt	4.54%	3.56%	0.98%	1.99%	1.30%	0.68%	0.29%
Moneytech-BBSW+4.65%-17Apr20c	NIG	Subordinate Debt	6.85%	5.88%	0.97%	4.58%	3.83%	0.75%	0.22%
Qantas-7.75%-19May22	IG	Senior Debt	4.55%	3.58%	0.97%	1.88%	1.12%	0.76%	0.21%

Source: Independent market leading bond valuation service provider

The top performers were a mix of both Investment Grade and Non-Investment Grade assets and both senior and subordinate in the capital structure.

The average changes across the universe by Investment Grade and Capital Structure categorisation were:

Security	Valuation Yields and change			Credit Margins and change			Dec-31
	Jan-01	Dec-31	YOY Change	Jan-01	Dec-31	YOY Change	YOY change attributable to duration
IG Senior Debt	4.26%	3.58%	0.69%	1.76%	1.32%	0.44%	0.24%
IG Subordinate Debt	4.53%	3.65%	0.88%	2.18%	1.53%	0.65%	0.24%
NIG Senior Debt	6.85%	6.13%	0.71%	4.51%	4.04%	0.47%	0.24%
NIG Subordinate Debt	7.71%	7.89%	-0.17%	5.26%	5.69%	-0.44%	0.26%

Source: *Independent market leading bond valuation service provider*

Notable is that the average Senior IG and NIG debt credit margin changes were very similar, but that IG Subordinated Debt, led by the major (& minor banks) that outperformed the weaker (but higher yielding) NIG Subordinated Debt sector. So whilst base interest rates remained flat, and volatility was low, credit margins rallied.

Singular debt asset under performance

As communicated to investors in the second half of 2017, the debt asset issued by Mackay Sugar Limited devalued as profitability continued to decline in 2017, a legal challenge was mounted opposing management plans to raise revenue via an increased tariff, and refinancing options available were dwindling and their negotiations protracted.

MIPS IMA exposure to unrated debt assets is always well diversified, and the MSL holdings were, prior to the commencement of the price decline, set a maximum of 6% of individual account size. The average holding was below 3%. Despite a valuation price decline to 85c in the dollar the MIPS team further diluted exposure when a bid was found at this level setting a cap on exposure of a maximum of $10,000 Face Value or 2.50% per account value. The asset now is distressed and has traded as low as 30c in the dollar, and is currently valued at 50c in the dollar, with no current liquidity.

4. Credit Margin outlook 2018 - 'Bullish' credit margin direction likely to continue

We retain a positive outlook for (selective) corporate debt credit margins and envisage that the current bull market trend in credit margins has a solid foundation and will likely continue, however various sectors are likely to outperform given the risk differentials.

The solid foundation is two pillared. Credit margins have been rallying on the back of a fundamentally supported rally in bank debt margins. The changes enforced upon the banks by APRA have bolstered their balance sheets and justify the credit margin contraction. Indeed, within the specific large volume bank bond investment mandates under the management of MIPS, we remain 'long' on both the senior and subordinate debt yield curves, confident that the regulators work will drive further gains. Secondly, credit margins have and will continue to rally as economic growth ensues.

However, the equivalent balance sheet regulation enforced upon the banks is not forced upon corporates, and subsequently we expect that the correlation in credit margin directional changewill break down progressively as bank margins rally further.
The 'relative' attraction of lower rated and unrated corporate debt over highly rated bank debt will dissipate as the base margin (bank) credit margins rally further. Just as the equity market historically will devalue Real Estate Investment Trusts (REIT's) in line with interest rate rises, we expect those corporates with interest rate sensitivity, due to high leverage ratios, will underperform if balance sheet expansion in line with growth opportunities is not matched by productivity that delivers a sufficient return on equity.

In summary, we believe Investment Grade credit margins will outperform Non-Investment Grade Credit margins, and senior debt will outperform subordinate debt. Combining this with our interest rate view, we will be reluctant to take long duration low rated credit risk.

Residential Mortgage Backed Securities (RMBS) - increased allocation to RMBS assets.

We especially favour investment in the Residential Mortgage Backed Securities (RMBS) market, both relatively (versus other equivalently rated corporate debt) and absolutely (given total yield versus other opportunities). This is despite market commentary of stretched residential house valuations in Australian Major Capital cities especially.

We favour the issuance of the conforming (full documentation) over the non-conforming ("low doc') sector of this asset class. We see macro-prudential tightening of lending standards, continued forward residential property supply constraints and strong population growth as more overwhelming contributors to the likelihood of a 'soft' landing for property prices.

This combined with the significantly robust LVR (Loan to Valuation Ratio) requirements of banks and LMI (Lenders Mortgage Insurance) in support of equity below 20%, and the capability of leading originators to construct securitisation pools with significant geographical, dwelling type and demographic diversity are significant advantages of the sector.

We expect 2018 to see a significant increase in RMBS Securitisation volumes, with possibly significant 'jumbo' issuance. We will target investment, in primary issuance phase, in the lowest investment grade rated issuance tranches with possible interest in the first tranche below that level.

5. Inflation Outlook – Potential Gradual inflation pick up related to economic strengthening

Global economic conditions have improved with manufacturing data continuing to exceed expectations in China, the Eurozone and the US. The RBA has acknowledged in particular in their most recent meetings, that weak domestic and international wage growth will, in the near term, likely keep core inflation low.

Subsequently they expect the CPI (Consumer Price Index) outcome will likely be below or at the lower end of their target range of between 2% - 3%. In the long term they expect inflation will pick up gradually as and when the economy strengthens. We note, as we did above, that their 2019 growth forecast is 3.25%.

Source: ABS

Although it's too early to determine the overall impact of the "Amazon effect" on the Australian economy, speculation continues that increasing online retail efficiencies and resulting sales will be at the detriment of traditional distribution systems, resulting in a future lower trend inflation.

Murmurs in the market indicate that Amazon's impact alone could potentially reduce inflation by 0.25% over time. However, this was not reflected during the Christmas period with sales well and truly exceeding traditional retailers' expectations, largely attributed to the highly successful inaugural 'Black Friday' sales and a relatively 'soft launch' by Amazon.

The subdued impact of Amazon's soft launch, despite sluggish department store sales, suggests that the impact on traditional retail distribution systems to date, is not currently such that it will materially contribute to a low inflation environment in the short term.

Additionally, although there is the potential for price pressure to be applied to the consumer if on line distribution platforms crush traditional competition and become monopolistic or oligopolistic, this is considered a lower probability outcome.

6. Bond Market New Issuance

Credit markets have been quiet during the last quarter of 2017 with a handful of Investment Grade and Non-Investment Grade issuers coming to market.

Debt issues including the following:

- Elanor Investors Group, $40m, 5 year Fixed @ 7.10% (+450bps).
- United Energy Distribution Pty Ltd (BBB+), $170m, 7 year Fixed @ 3.85% (+125bps).
- Nissan Financial Services Australia Pty Ltd (A), $100m, 1 year FRN @ (+44bps).
- Ausgrid Finance Pty Ltd (Baa1/BBB+), $1.2bn, 7 year FRN @ (+122bps).
- Merredin Energy Pty Ltd, $44m, 5 year Fixed @ 7.50% (+515bps).
- Toyota Finance Australia Ltd (AA-), $175m 3 year FRN @ +60bps.
- Network Finance Company Pty Ltd (Baa1), $350m, 7 year FRN @ +123bps.
- Challenger Life Company Ltd (BBB), $400m, 25 year FRN @ +210bps.

Large volume debt issuance from low IG and NIG issuers were easily sold into the market in the last quarter of 2017 at the prevailing new lower credit margins.

Portfolio Management Team

Kieran Quaine

Head of Managed Income Portfolio Services

Kieran has in excess of 30 years' experience in senior roles in the fixed income market, primarily as a fund manager in charge of investing multiple billions of dollars across a wide range of investment mandates. His experience includes roles as a proprietary interest rate trader, debt originator, syndicator and institutional debt sales, with his expertise in the unrated market likely unsurpassed. He has been with FIIG securities for 7 years and is the Head of the Managed Income Portfolio Service.

Megan Romeo

Assistant Portfolio Manager

Megan Romeo has over 7 years' experience in financial market data segment with a focus on the Asia Pacific Fixed Income markets. Prior to joining FIIG, Megan was the Valuations Product Manager at S&P Capital IQ which required local Fixed Income market knowledge and a technical understanding of the asset class in order to tailor a Fixed Income market data solution to participants across Asia Pacific.

Previously Megan was the Senior Fixed Income Analyst at Interactive Data (IDC) where she developed an analytical skillset specialising in valuation of domestic and international securities across the entire asset class spectrum. At both S&P Capital IQ and IDC, Megan conducted extensive research into the global financial markets to identify trends and events affecting bond markets and valuations.

MIPS Investment Strategy

Alongside continuation of pillar strategies of maximum portfolio diversity, the MIPS team maintain a 'short duration, long credit' exposure strategy across all investment programs, with a higher weighting to senior debt that is Investment Grade weighted. Key exposure statistics and changes over the September quarter period end include:

Exposure Category by Program	Income Plus		Core Income		Conservative Income		Bank Bond Program 3	
Date Period	30 Sep	31 Dec	30 Sep	31 Dec	30 Sep	31 Dec	30 Sep	31 Dec
Duration (tenor exposure)	1.82	1.61	2.09	2.4	2.38	2.2	0.15	0.14
Investment Grade Senior	18%	28%	87%	92%	88%	81%	53%	53%
Investment Grade Subordinated	15%	12%	0%	0%	12%	19%	47%	47%
Non-Investment Grade & Unrated	67%	60%	13%	8%	0%	0%	0%	0%

MIPS Example Portfolios

Conservative Income Investment Program

Investment objective

This program provides a portfolio that only invests in investment grade securities while investing across the capital structure. Like the fundamentals of the fixed income asset class, this portfolio, or program option, aims to provide investors with strong levels of capital preservation and regular income flow.

Investment Program Limits (selection)	Min/Max
Investment Grade	0/100
Sub Investment Grade/Unrated	0/0
Senior Debt	80/100
Subordinated Debt	0/20
FIIG Arranged Bonds	0/35
Number of bonds	5/no max
Modified Duration	0/7

Core Income Investment Program

Investment objective

This program aims to provide a portfolio that is primarily focused on investment grade securities, investing in the most senior parts of the capital structure. Like the fundamentals of the fixed income asset class, this portfolio, or program option, aims to provide investors with strong levels of capital preservation and regular income flow.

Investment Program Limits (selection)	Min/Max
Investment Grade	0/100
Sub Investment Grade/Unrated	0/15
Senior Debt	100/100
Subordinated Debt	0/0
FIIG Arranged Bonds	0/35
Number of bonds	5/no max
Modified Duration	0/7

Income Plus Investment Program

Investment objective

This program aims to increase the investment return through a larger allocation to high yield securities while still retaining the benefits of a fixed income portfolio. This program allows the Portfolio Management team to invest, with more flexibility along the capital structure and credit ratings spectrum. This additional scope allows the team to identify strong risk-returning investments. This is achieved through extensive credit analysis on both the issuer/ guarantor(s) of the bond as well as the security itself

Investment Program Limits (selection)	Min/Max
Investment Grade	0/100
Sub Investment Grade/Unrated	0/75
Senior Debt	60/100
Subordinated Debt	0/40
FIIG Arranged Bonds	0/60
Number of bonds	5/no max
Modified Duration	0/7