Investor Update

31 December 2017

ALTIUS
ASSET MANAGEMENT

Altius Sustainable Bond Fund

ARSN 601 681 179

The Fund is an active and diversified fixed income investment.

It aims to optimise returns in all economic cycles—delivering investors solid income generation coupled with low capital volatility.

CHRIS DICKMAN
Senior Portfolio Manager

> In 2017 we witnessed the world's most synchronised economic growth in a decade.
>
> Looking ahead we have positioned the Fund's portfolio with settings we believe can reasonably be expected to generate higher returns than cash.

Performance as at 31 December 2017

Period	Total Return (%)	Benchmark (%)
1 year	2.61	2.58
2 years p.a.	2.84	2.46
3 years p.a.	2.66	2.43
Since inception p.a.	**3.07**	**2.83**

Total returns are calculated after fees and expenses and assumes the reinvestment of dividends. Past performance is not a reliable indicator of future performance. Inception date for the Portfolio is 21 November 2014. Effective 1 July 2016, Benchmark is 50% Reserve Bank of Australia Cash Rate and 50% Bloomberg∞ AusBond Composite 0+Yr Index and applied retrospectively for all periods.

How bond markets performed in 2017

Having been a drag over the last five years, European economic growth outstripped the US during 2017 and contributed, along with the growth emanating from Asia, to the most synchronised world growth in a decade. At the heart of much of this activity was the improvement in the middle class income levels of many developed economies.

Critical to bond markets in 2017 was the ongoing progress by central banks to unwind their asset purchase programs. In the US, the Federal Reserve (Fed) announced its path to balance sheet reduction; the European Central Bank (ECB) halved the pace of its monthly bond purchases, and the Bank of Japan (BoJ) announced its intention to keep the yield on 10-year Japanese government bonds at zero, and that it will adjust the pace of its bond buying as required to achieve this.

Moreover, the Fed has now lifted the cash rates in the US five times since late 2016, and it is widely expected there are three more hikes on the way in 2018.

Towards the end of the year, the US Government successfully passed new tax legislation, which incorporated significant corporate tax cuts. This is expected to add approximately 0.5% to US economic growth over the next year to an economy that is currently tracking at around 3% per annum.

In Europe, central bank fiscal austerity has been less damaging. Here, economies have been steadily transitioning from being overly reliant on increased activity in the US and China to a more virtuous growth cycle, where rising employment generates more income and flow-on business investment.

Long-dated bonds yields experienced little change over the course of the year. Global inflation lifted a little, but largely remains below central bank targets. Growth in Chinese foreign exchange reserves and the spill over effects of Japanese Government Bond purchases consistently added buying pressure to the sector. Later in the year, the US corporate tax cuts and approximately 20% returns from the US stock market created short-term buying pressure as profit taking on equities and tax-incentivised, short-term demand for long-dated US Treasuries by US pension funds. This effectively held long-term bond yields down in the closing stages of 2017.

Outlook

Looking to 2018, we do not expect central banks to raise official interest rates in Europe, Japan or Australia. Core measures of inflation in these economies are expected to remain largely contained. However, our view is that many of the forces that previously held down long-dated yields in the second half of 2017 are likely to give way in 2018.

The reduction in the US Fed's balance sheet will offset the Chinese foreign exchange reserve purchases of US Treasuries during the first quarter of 2018, and shrink more rapidly over the remainder of the year. A new financial year also likely reduces US pension fund liability matching Treasury demand. The reduced asset purchase program by the ECB will also likely allow longer-dated European bond yields to rise, reducing its magnetic effect on all yields, and placing downward pressure on the price of long-dated bonds in Australia and the US.

In Australia unemployment fell to 5.4% in 2017*, despite the extraordinary population growth over recent years. The flipside of this impressive labour force absorption was that wage growth has been non-existent. Middle class incomes, particularly in real terms, are yet to lift. Related to this, non-mining business investment growth – a key element in kicking the Australian economy into a higher gear – has been subdued.

* Source: Trading Economics www.tradingeconomics.com.au

Contact Details

Address
Australian Unity
114 Albert Road
South Melbourne VIC 3205

Website
australianunity.com.au/wealth

Email
investments@australianunity.com.au

Investor Services
T 13 29 39 F 03 8682 5057

Adviser Services
T 1800 649 033 F 03 8682 5057

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Mining exports to China have driven much of Australia's GDP growth, although this has also kept the Australian dollar sufficiently high to effectively dampen others in the business of exporting. But, when combined with weak wages growth, ongoing low inflation and relatively low business investment, we don't expect that the RBA will lift official interest rates until 2019.

With interest rates on hold during 2018, we expect short-dated bond yields will likely remain anchored, with corporate bonds the most likely destination for adding yield. Mid to long-dated yields will, we expect, progressively move higher with the global unwinding of central bank asset purchase programs.

How the Altius portfolio is positioned for 2018

Investors often look for the sanctuary of cash in a rising interest rate environment. Our corporate holdings are specifically targeted in generic bond funds and ETFs, given we are wary of the build-up of passive risk. In 2018 the continued unwinding of prior central bank policy could be the tonic for a lift in volatility across bond and equity markets.

We have positioned the portfolio such that, under our central case outlook for higher long-dated yields, the portfolio duration and yield curve settings can be expected to generate returns higher than cash. Indeed, even under our pessimistic outlook, which contemplates a rally in bonds, the duration and yield curve settings would be expected to generate similar absolute returns.

It is important to reiterate that Altius Asset Management is an active manager of fixed interest portfolios; seeking to generate positive yield by adjusting our portfolio across all of our invested interest rate environments.

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If you have any questions about the Fund, call a member of our Investor Services team on **13 29 39**.

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FMGT0039-201806