Fund Update

31 October 2018

ALTIUS ASSET MANAGEMENT

Altius Bond Fund

Altius Asset Management employs a diversified strategy to fixed interest funds management that aims to take advantage of the mispricing of bonds in all market conditions.

Performance as at 31 October 2018

	1 mth %	3 mths %	1 yr %	3 yrs %	5yrs %	Since inception* %pa
Total return[1]	**0.19**	**0.56**	**1.84**	**2.68**	**3.23**	**4.30**
Benchmark[2]	0.31	0.62	2.30	2.27	3.15	3.80
Active return[3]	(0.12)	(0.06)	(0.46)	0.41	0.08	0.50

1. Total returns are calculated after fees and expenses and assumes the reinvestment of distributions. Past performance is not a reliable indicator of future performance. Inception date for the Portfolio is 1 October 2011
2. 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.
3. Active return is calculated on Total return.

Portfolio Performance and Activity

Over the month the fund generated an absolute return of 0.19 percent underperforming its benchmark by 12 basis points. Over 12 months the fund generated a return of 1.84 percent, well exceeding cash of 1.50 percent.

There was a strong risk off tone in global equity markets over October. While interest rates did react to the increased volatility it was not as one would have expected. Of most surprise was that US yields actually rose over October largely attributed to a large sell-off in the first week of the month, with US 10 year yields increasing 7 basis points to 3.12 percent. Domestic yields on the other hand fell a modest 3 basis points with two and 10 years finishing at 2.09 percent and 2.63 percent respectively. Over the month we maintained our short duration position believing that rates will trend higher over the medium term. Duration finished the month at 0.18 years.

The cause of the equity correction wasn't entirely clear but as with previous months it appears to be a combination of things that have been building over time. Fear is growing the Federal Open Market Committee (FOMC) will over-tighten policy and trigger a slowdown in the US economy, US/China trade war continues to simmer in the background, US mid-term elections with a growing chance of a Democrat lead House, crossed fingers and numerous geopolitically issues from Italy, Germany and Brexit all weighing on market sentiment.

As with the rates market local credit performed extremely well. Over the month corporate spreads were unchanged to slightly tighter. This positive outcome wasn't experienced in other markets with US and European credit widening up to 14 basis points in October. While US reporting season was largely positive there is growing doubt in the market that these numbers are sustainable which is weighing on credit risk premium. With extremely quiet primary markets there was no new credit activity over October. We continued to hold a cautiously optimist view towards credit with the fund holding 1.14 years of spread risk.

Outlook

This is a peculiar part of the cycle. Central Bank bond purchase programs have dampened volatility and caused a strong correlation between bonds and equities. Quantitate easing (QE) provided persistent support for the economy, as well as stocks and property, until such time it could stand on its own two feet. Nearly a decade on from the global financial crisis (GFC) the US certainly can. And so with US QE in reverse what remains is this; stocks adjusting to increasing yields associated with higher cash rates and the US Federal Reserve (Fed) reducing its bond holdings.

What we saw in October is part of an adjustment process that will be with us for some time. In the current time frame the US QE is in reverse and at some point in the distant future, the European Central Bank (ECB) will do the same.

While this isn't an equity narrative the yield adjustment across asset class remains a central part of Altius's outlook. The impact is that the lift in yields (US included) will not be smooth and there will be rallies along the way. Our portfolio is positioned to take advantage of this shift to higher rates; more particularly the gradual rise of bond rates in Australia.

To illustrate the adjustment process, the yield on 10 year US Treasuries rose from 2.83 percent in late August to 3.22 percent in early October. It was at this point that stock yields began to adjust higher. The dividend yield on the Nasdaq lifted from 0.98 percent, the lowest in eight years, to 1.09 percent. It did this by adjusting prices down nearly 13 percent. Over time, quality companies in a position to grow their earnings will take the adjustment process in their stride and their share prices will recover. However for companies that don't have

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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earnings as a lever their yield adjustment will create share price declines.

The significant fall in share prices saw investors progressively sell equities, particularly exchange traded funds (ETFs), and switch into safer assets. What did they buy instead? Some bought US treasuries others bought Australian and other bonds. Once the “excessive” part of the sell-off had settled, bonds resumed their path to higher yields and equities recovered (somewhat).

The adjustment also impacts emerging market and high yield corporate bonds. In Australia we are not looking for an uplift in default rates - but we think corporate bonds will feel the pressure of longer dated yields rising more than shorter dated bonds. It is for this reason we are focused on shorter dated holdings, where we can take advantage of the opportunities presented by the steepening yield curve while selectively buying high grade corporate bonds.

The strength of the US economy is well established. Wages growth in the US is function of a tight labour market. The services sector is about 70 percent of the US economy. These are largely jobs that are driven by local factors, with scarcity of labour noted by most regions. US underemployment has fallen to 7.8 percent - a 20 year low. After adjusting for inflation US median household incomes are nearly 10 percent higher than they were in 2014. Core US inflation has shifted more consistently above the Fed’s 2 percent target. Cash rates are consequently being lifted as inflation pressures build. Moreover, the Fed is now at maximum velocity in unwinding its balance sheet at $150bn per quarter; inherently placing upward pressure on US bond yields.

That Australia’s jobless rate has fallen to 5 percent is a remarkably good outcome, when you consider Australia’s population has grown by about 16 percent over the last decade. Government sponsored infrastructure projects are contributing to economic growth. Tax receipts from businesses have been particularly strong. Underemployment, though, has lifted to 8.2 percent, with wages growing modestly as a result. After adjusting for inflation median household incomes show Australia largely at the same level it was in 2014 and core inflation is below the bottom end of the Reserve Bank of Australia’s (RBA) 2 percent target.

One area of concern unique to the Australian landscape is the possible consequences of the Hayne Financial Services Royal Commission. We are already seeing a tightening of credit standards. If bank customers are unable to demonstrate reliable sources of income, irrespective of the amount of assets, banks will not extend credit. The last thing they want to do – particularly in this environment – is foreclose.

Bank funding costs have already lifted, even though there has been no change to official cash rates.
This may incrementally slow the economy. Our view is that this supports the case for cash rates to remain unchanged into 2020.

There is a fear that US interest rates are set to explode higher, and take Australian interest rates with them. We believe US interest rates will move higher, but Australia has less pressure to follow in lock step. This is because European and Japanese investors search for higher yielding Australian bonds will remain while their Central Bank’s keep buying the local bonds at ultra-low yields. Given the ECB is very slowly reducing their purchases of European bonds, their yields will slowly drift higher, allowing Australian yields higher at similar velocity.

[1] Bloomberg Composite Bond Index
Altius Bond Fund uses a 50 percent Composite Bond Index, 50 percent RBA Cash

Sector Profile as 31 October 2018

Asset Class	Portfolio %	Benchmark %
Commonwealth Government	16.61	25.49
Semi Government	18.97	11.75
Supra Nationals	18.06	7.39
Financials	24.28	2.55
Industrials	10.92	2.80
Asset Backed	9.65	0.02
Money Market	0.00	0.00
11am	1.51	0.00
Cash at Bank	0.00	0.00
RBA Cash	0.00	50.00

Top 10 Holdings

Issuer	Portfolio %	Benchmark %
Commonwealth Government	16.61	25.49
Treasury Corp of Victoria	6.77	1.81
Queensland Treasury Corp	6.23	4.31
New South Wales Treasury Corp	5.97	2.29
Kreditanstalt fuer Wiederaufbau	3.00	1.20
Export Development Canada	2.79	0.17
European Investment Bank	2.71	0.80
National Australia Bank Ltd	2.71	0.26
Australia & New Zealand Banking Group Ltd	2.39	0.25
Asian Development Bank	2.23	0.52

Ratings Exposure

	Portfolio %	Benchmark %
AAA	56.85	36.41
AA+ to AA-	18.86	9.91
A+ to A-	12.34	2.45
BBB+ to BBB-	11.95	1.23
RBA Cash	0.00	50.00

Maturity Profile

Term	Portfolio %	Benchmark %
0 – 1 year	18.35	54.24
1 – 3 years	29.68	10.70
3 – 5 years	36.20	9.73
5 – 7 years	8.98	7.04
7+ years	6.79	18.29

Fund Asset Allocation

	Fund %
Australian fixed interest	98.49
Cash	21.51
Total	100.00

[1]Cash and cash equivalents may include cash at bank, 11am cash (i.e. overnight bank deposits) and discounted securities (e.g. bank bills)

Portfolio Summary Statistics

Asset Class	Portfolio %	Benchmark %
Running yield	2.68	2.02
Modified duration (years)	0.17	2.59

Fund Snapshot

APIR code	WFS0486AU
Inception date	14 Jun 2011
Fund size (net asset value)	$252.52m
Minimum initial investment	$5,000
Management fee*	0.46% p.a.
Buy/Sell spread	Nil
Distributions	Quarterly
Advice fee	Available

*Refer to the Fund's Product Disclosure Statement for more details on the Funds Management Costs which also include recoverable expenses and indirect costs. Total Management costs may vary.

Ratings

Recommended
Lonsec Research

Zenith Investment Partners
Highly Recommended
Recommended
Approved
Not Rated
Redeem