

# Managed Income Portfolio Service Quarterly Report

March 2017

Welcome to our Quarterly Report for the Managed Income Portfolio Service (MIPS). This report is to keep you up to date on Fixed Income market conditions and the performance and exposure of the four investment programs: Conservative Income, Core Income, Income Plus and Inflation Linked each designed to generate income while prioritising capital stability.

## Economic Summary and Outlook

Equities and corporate debt continues to rally with higher global growth and anticipated Trump administration stimulus. The uncertainty of Trump rhetoric turning into policy that delivers tax cuts and fiscal stimulus remains. Are expectations running ahead of reality?

Global political tensions increased with Trump ordering a missile strike on Syria further straining Russia-US relations. Increasing political uncertainty weighs on global growth. The potential for trade wars remains with Trump floating the idea of destination-based tax system favouring US exports and penalizing imports.

The US economy is increasingly robust with inflation ticking up leading the Federal Reserve to raise the official cash rate in March. The Fed forecasts two further rises in 2017. Global interest rates will experience upward pressure if expectations of the pace

Populist politics – markets continue to rally due to Trump presidency & Brexit

### Key themes

- Markets buoyant – equities, corporate credit and US\$ rallied
- The Fed Reserve raised the US cash rate to 1%
- RBA remains at 1.50% expecting moderate growth
- PMT retains short duration

of the Fed hikes increase. Australian longer term interest rates will be impacted with many viewing this as the bottom of the interest rate cycle.

The Portfolio Management Team (PMT) allowed duration to shorten across all programs with time. The PMT don't see value in medium and long term interest rates during an environment of US monetary policy tightening and historically low interest rates. The PMT kept the allocation to High Yield<sup>1</sup> bonds steady in the Core Income and Income Plus programs.

## MIPS Investment Returns

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

Total NET Returns to 31 March 2017	3 months	6 months	12 months
Income Plus	1.93%	2.43%	6.07%
Core Income	1.89%	0.84%	4.13%
Inflation Linked Income	1.71%	0.65%	1.88%
Conservative Income	1.45%	0.21%	N/A

### Note

<sup>1</sup> High Yield refers to sub investment grade (ie BB+/Ba1 and below) and unrated bonds

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The MIPS programs performed strongly in the quarter where interest rates were stable and credit continued to rally. The Income Plus program ranked in the top 5 and Core Income in the top 10 for the 12 months to 28 February 2017 when compared to the Australian Managed Funds in the Yield Report<sup>2</sup>.

### Key contributors to March returns:

- Interest rate curves were largely unchanged at quarter end with minimal impact on returns,
- Senior investment grade (IG) debt rallied along with credit spreads impacting positively on program returns in accordance with allocations (in brackets): Core Income (87%), Conservative Income (86%), Income Plus (30%) and Inflation Linked (64%),
- Investment grade (IG) subordinated bonds (T2) remained stable through the quarter with all programs holding floating rate notes. This provided accrual returns along with minor spread contraction in accordance with allocations (in brackets): Conservative Income (14%), Income Plus (9%) and Inflation Linked (10%), and
- High Yield bonds remained stable through the quarter. This provided strong accrual returns for programs in accordance with allocations (in brackets): Income Plus (61%), Core Income (13%) and Inflation Linked (26%).

Please refer to your individual MIPS Account Statement on your MyFIIG page for your portfolio returns.

## MIPS Investment Strategy

### Interest rate outlook

The RBA cash rate remained at the record low 1.50% and the market expects no change this quarter. The economy continues to grow moderately with sluggish domestic demand, low wages growth, slack in the labor market, and record high consumer debt levels. This economic forecast is somewhat at odds with the global expectations, particularly North America, and to a lesser extent Europe, where stronger growth is becoming evident. It is this global growth that is driving steeper yield curves including in Australia.

The PMT continues to see little value in holding medium and long tenor fixed rate bonds in this low interest rate environment. The US Federal Reserve has signaled it intends to increase the official cash rate twice the year which will likely result in a steeper Australian yield curve.

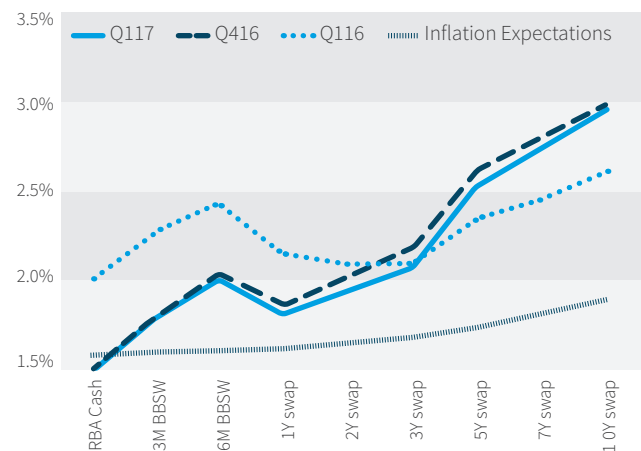
### Notes

- <sup>2</sup> Source: the "Yield Report" Performance of the Australian Fixed Interest Managed Funds Universe, <http://www.yieldreport.com.au/category/bonds-aust/monthly-performance/>  
<sup>3</sup> This is calculated by taking the difference between the Australian government nominal bond and inflation linked bond yields at the various maturity points.

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### Australian yield curve and inflation expectations<sup>3</sup>

Curve largely unchanged after significant steepening at the end of 2016.



### Source:

Interest Rates from Bloomberg as at 31 March 2017, 31 December 2016, 31 March 2016, Inflation expectations from Reuters as at 11 April 2017 (see note)

Again, the PMT allowed the duration to shorten naturally for all programs (by not rebalancing to a longer target and allowing bond maturities to roll closer with passing time). This positions the portfolios to take advantage of further increases in the medium/long end of the yield curve.

Invested portfolios are exposed to broader interest rate volatility in line with the modified duration targets (see MIPS Example Portfolio Metrics). The PMT intends to maintain this shorter duration exposure when rebalancing portfolios.

### Inflation Outlook – inflation remains low and unchanged over the quarter

Inflation expectations remain low with the market pricing inflation well below 2% for the next 10 years (as depicted in the chart above). The December Quarter inflation figure printed at 0.50% (following 0.70% in September, 0.40% in June and a negative 0.20% print in March). This indicates an annual CPI rate of 1.50%, stubbornly below the low end of the RBA's band of 2.00%.

The forecast by the PMT is for low short to medium term inflation. The strategy to generate yield for the Inflation Linked program is via an exposure to ILBs (65%), FRNs as a substitute for ILBs (30%) and the balance of exposure (5%) in higher yielding medium tenor fixed rate bonds.

## Credit outlook

Diversity of portfolios continues to drive asset allocation particularly in the High Yield sector. Credit, as measured by the ITraxx<sup>4</sup>, moved lower from 1.03% to 0.84% at quarter end. There was a short lived spike on the weaker than expected Australian employment in mid-March that reversed.

### Australian Credit

The Itraxx moved lower to 0.85% by quarter end



Source: Bloomberg April 2017

With credit rallying, allocations across senior and subordinated bonds remained unchanged as did the mix between rated and High Yield bonds. Example credit highlights include:

- o Purchase of the new StockCo primary issue at \$100 for Income Plus, adding to diversity and yield. StockCo is trading \$4 above purchase price,
- o IG subordinated bonds (T2) remained stable through the quarter with allocations static, and
- o Senior investment grade bonds' credit margins tightened, measured by the Itraxx, led again by property.

## Bond Market New Issuance

Corporate issuance had a strong start in 2017 led by property trusts. Strong investor demand for longer tenors led to several corporates upsizing. Key deals include:

- o Ausnet (A-/A3) raised \$425m of 10.5 year senior debt,
- o GPT (A-/A3) raised \$200m of 10 year senior debt,
- o Investa Office Fund (BBB+) issued Australian first corporate green bond raising \$150m,
- o StockCo tapped their existing unrated bond to raise \$17m via FIIG – Income Plus participated.

### Note:

<sup>4</sup> The graph shows the volatility of Australian investment grade credit as it examines the performance of the Aussie iTraxx. This represents the cost for corporates to borrow, or conversely the amount investors require to invest in investment grade companies.

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## 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 Example Portfolio Metrics

Investment metrics for example portfolios as at 3 April:

Example Portfolio Metrics	Conservative Income	Core Income	Income Plus	Inflation Linked
Gross Yield to Maturity	4.29%	4.53%	6.06%	4.94%
Running/Income Yield	4.22%	4.60%	6.15%	4.38%
Modified Duration	2.38 yr	2.57 yr	1.72 yr	4.94 yr
Weighted Average Credit Rating	BBB+	BBB	BB+	A-
Investment Grade Allocation	100%	87%	39%	74%
Unrated/Sub-Investment Grade Allocation	0%	13%	61%	26%
Cash Allocation	1%	1%	1%	0%

<sup>a</sup> assumes inflation derived from the Federal Government yield curve differential between nominal and inflation linked bonds.

High Yield = Unrated/Sub-Investment Grade

The Average Portfolio Credit Rating is the Standard and Poor's credit rating for each bond, adjusted for the bond's weighting in the portfolio, and displayed on the Standard and Poor's rating scale. Unrated bonds are treated as an equivalent to a BB rated bond. If a bond is not rated by the Standard and Poor's credit rating agency, then the credit rating will be the average of the ratings from Fitch and/or Moody's credit rating agencies and will be displayed on the Standard and Poor's rating scale

### 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

### Inflation Linked Investment Program

#### Investment objective

This option seeks to build a portfolio of inflation -linked bonds that provides the investor with an inflation hedge. The program's primary investment objective is to build and manage a fixed income portfolio that is focused on managing inflation risks.

Investment Program Limits (selection)	Min/Max
Investment Grade	0/80
Sub Investment Grade/Unrated	0/40
Senior Debt	80/100
Subordinated Debt	0/20
FIIG Arranged Bonds	0/35
Number of bonds	5/no max
Modified Duration	0/10

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