Fund Update

31 March 2019

Australian Unity Sustainable Enhanced Cash Fund

The Australian Unity Sustainable Enhanced Cash Fund invests in a combination of short-term money market instruments and medium-term floating securities that are investment-grade rated. The investment process is designed to maximise returns while balancing the risk and liquidity of the portfolio.

Performance as at 31 March 2019

	1 mth %	3 mths %	1 yr %	Since inception* %pa
Gross return[1]	**0.33**	**0.94**	**2.78**	**2.73**
Net return	0.30	0.87	2.54	2.50
Benchmark[2]	0.17	0.52	2.02	1.88
Alpha[3]	0.16	0.42	0.76	0.85

1. Gross returns are calculated before fees and expenses and assumes the reinvestment of distributions. Inception date for the portfolio is 14 June 2017
2. The Benchmark is the Bloomberg ∞ AusBond Bank Bill Index
3. Alpha is calculated on Gross Return

Portfolio Performance and Activity

Over the quarter the Fund delivered a return of 0.94 percent outperforming the benchmark by 0.42 percent, with the compression of credit spreads being the largest contributor. Over 12 months the fund has delivered a total return of 2.78 percent.

Following an extremely weak Q4 2018 credit market rebounded strongly over Q1 2019. The Fund added credit risk early in the year taking advantage of the late 2018 weakness. While credit spreads rallied strongly over the quarter with five year senior bank risk spreads moving from 1.13 percent to 0.90 percent the shorter duration of the credit markets meant the credit index only produced a total return of 3.02 percent. It is expected that spread product will continue to find support over the coming quarters, supported by the positive technical picture of globally low yields, supportive monetary policy and lower expected supply.

Expectation of cash rates changed significant over the quarter with the market going from pricing in a 50 percent chance of one cut in by April 2020 to having two full priced by Dec 2019. March was the turning point for the change of expectations. A speech delivered by Reserve Bank of Australia Governor on the year ahead described a view that the probabilities of cash rate changes were now more balanced compared to the quarter 4 2018 view that the next move would be higher. This change of view was further cemented by the March 8 Statement of Monetary Policy that detailed downgrades of growth and consumer price index expectations.

At the start of 2019 90 and 180 day bill rates sat at 2.07 percent and 2.23 percent by the end of the quarter they had fallen to 1.77 percent and 1.83 percent respectively.

While data released over the quarter was mixed the market appeared to place greater emphases on the weaker housing and household data. Over the quarter we saw the release of a weaker than expected Q4 2018 GDP number of 0.5 percent, which has limited by soft consumption and a series of weak housing related releases such as building approvals and CoreLogic house price series. The one shining light remains the clear strength of the employment numbers which remains key to future direction of the cash rate.

Socially Responsible Investments in Focus

March saw the inaugural issue by the National Housing Finance and Investment Corporation (NHFIC). NHFIC was established under the NHFIC act 2018. The aim of the organisation is to increase the supply of housing, particularly social and affordable housing. NHFIC raised funds through the capital markets and will use the proceeds to finance loans to registered community housing providers. The bond was issued for 10 years under the group's Social Bond Framework which was based on the International Capital Market Associations Social Bond Principles 2018. Coupled with this NHFIC has recognised the role it can play in Australia meeting its responsibilities of the United Nation's Sustainable Development Goals. The two key goals of the group will be no poverty and sustainable cities and communities.

The banking royal commission released their final report on 4 Feb after a year's inquiry into the banking and financial sector. The report highlighted the failings of organisational culture, governance arrangements and remuneration systems which resulted in misconducts in the financial sector. Commonwealth Bank and National Australia Bank were highlighted in case studies concerning governance and role of the board. NAB's leadership was singled out with the commissioner expressing concerns he is not confident that the lessons of the past have been learned. It led to an unprecedented resignation of both the CEO and Chairman at NAB. ASIC and APRA, the financial and banking regulatory bodies were also criticised for failing to enforce the law. The report contains a broad range of recommendations concerning the future of banking and financial

sector but there is some disappointment the commission did not go further and make more radical recommendations for structural reforms in the industry. The recommendations have in principle support of both the government and the opposition.

PG&E Corp, California's biggest power company filed for bankruptcy in January following crippling liabilities from Californian wildfires. The stock value dropped more than US$20 billion and most of its bonds were trading at around 70 to 80 cents on the dollar. It highlights the growing risk of climate change on a company's value potentially affecting bondholders.

Royal Dutch Shell, one of the world's biggest oil and gas groups, has just announced plans to become the largest electricity company by the 2030s in a shift which we have highlighted in our fossil fuel piece

Vale's second dam disaster in Brazil which resulted in 84 deaths and hundreds of people missing saw its share price plummet and Moody's has cut Vale's rating to junk status. Courts in Brazil have frozen almost US$3 billion of Vale's assets to pay for damages caused by the deadly spill. The disaster is testing for Vale as it comes just over three years after the collapse of another dam holding waste material in the same state. The disaster underscores the importance of environmental, social and governance risk assessment on corporates.

Outlook

Official cash rates in Australia will likely be 0.5 percent lower by year end. This view is predicated on our view that the "full employment" component of the RBA's three mandates will be threatened by retrenchment in the building industry as work in hand rolls off in the second half of the year. An exogenous tightening in credit conditions is occurring as regulations requiring more severe stress testing of loans combine with a loss of lending appetite at the banks post the Hayne Royal commission. The rapid cooling of house prices has removed the "fear of missing out" imperative that was stimulating residential property.

Globally, inflation data has been well contained for some time, with local inflation below the RBA target band for the past three years. Late last year oil prices fell 45 percent; setting off a global disinflationary pulse. Obviously, inflation is highly influential for bond yields and monetary settings and the disinflationary pulse has meant that central banks are now falling short on their mandate. In the absence of rising real yields this means the long wait for monetary policy normalisation is off the table and in some cases, easing has come back on the agenda.

Unhelpfully, global activity fell in a hole during the fourth quarter of 2018 and failed to meaningfully recover in January and February. Earlier tightening of financial conditions has tempered the strength in the US economy and was arguably overdone in China. Further, Chinese capital controls virtually halted Chinese household income finding its way into offshore housing markets. Previously well supported target markets such as Australia have seen property prices decline, further crimping household wealth and consumer activity. The slump in oil also coincided with idiosyncratic blows to activity in Europe, the US Government shutdown, Brexit intensification and trade battle impact on China. This "perfect storm", in our view, led to an overly gloomy pricing of growth and inflation being reflected in bonds yields (much more so than equities). German 10 year Bunds yields are negative again. UK Gilts are less than 1 percent, and Australian 10 year bonds are 1.80 percent.

The RBA stated at the April meeting that they would continue to "monitor developments and set monetary policy to support sustainable growth". The introduction of the "monitoring" phrase implied that the RBA is potentially more active. As a result, the Australian market has priced in a 35 percent chance of a rate cut as early as the May RBA meeting. We think this is premature. The key is unemployment and there simply hasn't been a sign of it rising (even though we think there will be a lift in the second half of this year). At the least a few months of poor data would be needed to indicate a shift in trend.

Oil prices have rallied 46 percent from late December lows price slump reflecting that supply - rather than demand factors - were paramount. Trump's sanctions against Iran and subsequent softening of those sanctions led to overproduction of oil which has since been reversed. The oil price recovery should modestly lift inflation and therefore bond yields.

European growth and political risk will continue to be problematic. Negative interest rates and European Central Bank's quantitative easing program continues to dampen all global bond rates. On a more positive note, Chinese authorities have responded to the trade battle headwinds with tax cuts and infrastructure projects and European manufacturing – a key source of weakness – should begin to benefit. Australia stands to benefit rather quickly from the infrastructure uplift via iron ore exports. In recent days, Chinese and US (post shutdown) data has begun to indicate a recovery in activity.

Our portfolio positioning reflects that global bonds have rallied excessively, due to leveraged fund and convexity related buying. Yields need not rise too far to become attractive though, given that global monetary normalisation has been put on the backburner for the time being. We have increased the portfolio holdings of higher yielding corporate bonds to take advantage of our view that corporate bond yields will compress to government bond yields, as the global hunt for yield re-emerges. In terms of interest rate management, we have implemented an overlay strategy that will take advantage the rise we expect in bond yields to incrementally add duration.

Sector Profile as at 31 March 2019

Asset Class	Portfolio %
Financials	61.79
Asset backed	16.56
Money Market	8.71
Cash at Bank	4.62
Supranationals	4.16
Industrials	4.16

Portfolio Summary Statistics

Asset Class	Portfolio %	Benchmark %
Running yield	2.76	1.77
Modified duration (days)	45	45
Credit duration (years)	1.88	N/A

Interest Rate Maturity Profile

Term	Portfolio %
0 – 30 days	41.27
30 – 90 days	51.28
90 days – 1 year	5.53
1 – 3 years	0.70
3 – 5 years	1.22

Top 10 Holdings

Issuer	Senior Rating	Portfolio %
ANZ Banking Corp	AA-	8.62
National Australia Bank	AA-	8.27
Westpac Banking Corp	AA-	6.98
Bank of Queensland	BBB+	3.73
Royal Bank Of Canada	A+	3.62
World Bank	AAA	3.46
Heritage Bank	BBB+	3.19
IMB Ltd	BBB+	3.11
Bank of Montreal	A+	2.95
Teachers Mutual Bank	BBB	2.81

Ratings Exposure

Rating	Portfolio %
AAA	20.72
AA+ to AA-	34.19
A+ to A-	18.42
BBB+ to BBB-	26.67
RBA Cash	0.00

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