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Managed Income Portfolio Service (MIPS)

Quarterly Report – September 2018

Welcome. This report contains a selection of summary information relevant to the fixed income market, informing readers of the major influences upon the prices of 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.

Key Observations

- The US Fed tightens monetary policy and is "a long way from neutral"
- Global interest rates are on the rise
- Australia's probability of a 2019 Federal Labor Government increases
- Australian banks tighten lending standards and residential property prices suffer
- The RBA holds monetary policy firm at 1.50% and the $A falls further

Generation of both income & total return during the quarter

The Managed Income portfolio Service seeks to generate both the highest possible income and total returns for investors, commensurate with the risk profile investors have chosen from a menu of three alternate investment programs.

Table 1: Key (NET) yield metrics of each MIPS Investment Program

Investment Program	Running Yield	Total Yield	Estimated Qtly Cash Flow*
Income Plus	5.53%	5.07%	$6,913
Core Income	3.75%	4.14%	$4,688
Conservative Income	3.47%	3.81%	$4,338

**per $500,000 invested*

The key theme that is developing in interest rate markets globally, as evidenced by economic data releases, policy implementation and bond yield changes, is that interest rates are rising, albeit slowly. They are rising in Australia, but at a slower pace than the rest of the globe. In such an environment, and one which is expected to continue developing, staying short on the yield curve will avert capital loss and maintain performance. However, it has a cost. The higher income yield that would be available from investing out further on the yield curve is foregone.

In this quarterly report the MIPS team convey key messaging regarding bond market investment choices, noting that as the momentum for the rise in rates dissipates we will have investors appropriately positioned so that we will take advantage of those higher rates at the right time.

Table 2: Top five coupon (income) yielding assets in each Investment Program

	Income Plus			Core Income			Conservative Income		
	Security	Running Yield	% Portfolio Exposure	Security	Running Yield	% Portfolio Exposure	Security	Running Yield	% Portfolio Exposure
1	Liberty RMBS 2017-3 Class F	9.35%	2.07%	La Trobe Financial RMBS 2017-2 Class E	8.24%	2.08%	MyState Bank	7.16%	4.12%
2	Lucas Total Contract Solutions	8.14%	6.11%	Lucas Total Contract Solutions	8.14%	2.55%	Liberty RMBS 2018-1 Class D	5.68%	3.01%
3	Resimac RMBS 2017-2 Class D	8.07%	4.04%	Next Generation Clubs	8.04%	2.55%	Asciano Finance	5.59%	8.53%
4	Next Generation Clubs	8.04%	6.12%	RSEA Finance	8.01%	2.59%	Reds Trust RMBS 2017-1 Class C	5.55%	2.10%
5	RSEA Finance	8.01%	6.22%	Merredin Energy	7.74%	2.47%	Sydney Airport Finance	5.55%	5.37%

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MIPS Investment Returns

The average gross returns for MIPS Investment Programs are contained in the Table below

Total Gross Returns to 30 September 2018	3 months	6 months	1 year	2 years (Annualised)
Income Plus	0.97%	1.86%	4.32%	4.81%
Core Income	0.91%	1.67%	4.01%	3.73%
Conservative Income	0.78%	1.57%	3.82%	2.93%

Economic Summary and Outlook

Within the United States

The US Federal Reserve (US Fed) increased the official cash rate mid-point to between 2.00% and 2.25% following their September meeting. This is the eighth increase since the tightening cycle began in December 2015, and the third since the end of quantitative easing. Meeting communications confirmed the Reserve members intentions to tighten one more time in 2018, three further times in 2019 and once more again in 2020. A further 1.25% in total.

Not mincing words, Jerome Hayden "Jay" Powell, the current Chairman of the US Fed, stated subsequently that regarding monetary policy, "we may go past neutral, but we're a long way from neutral at this point, probably". US 10 year treasury yields climbed from 3.15% to 3.23% immediately and the equity market indices began sliding significantly. If any bond trader or fund manager had any doubts about the clear intentions of US Monetary Policy moves to expect in the future, they were well and truly laid to rest.

Within the accompanying Federal Open Market Committee (FOMC) statements, reference was made to the labor market continuing "to strengthen", whilst business investment and household spending were growing "strongly", and inflation remained "near 2.00%." Whilst the language describing the monetary policy stance as "accommodative" was removed, Powell later stated that dropping (the word) "accommodative" does not change anything with regards to the path of policy.

Our quarterly report for the period ending June 2018 discussed at length the relevant US domestic economic data releases, federal reserve members rhetoric, White House policy and global economic influences, all major contributions to US Fed policy settings. But again, let's not deviate from the main attributable reason as to why yields are (currently) rising in the US: employment growth is extremely strong, is forecast to be stronger, and with labor unit prices rising the US Fed is responding aggressively.

Refer to Table 3. The US 10 Year Treasury note yield rose 0.20% over the quarter, and returned negative 0.90% to investors.

US Fed Chair Powell has stated that he expects and welcomes moderate wage price inflation, but does not expect consumer (goods) price inflation as a function. It would appear the US economy is experiencing near economic nirvana – full employment, improving per unit labor productivity and subsequently non-inflationary growth. Yet the economic bears are already pondering the timing of the reverse in the economic cycle, proposing that the aggressive monetary policy stance of the US Fed will eventually stall growth. Only time will tell.

Within Australia

Dominant news, but not that which impacted bond market price volatility, was the replacement of Australia's Prime Minister. Malcolm Turnbull, under pressure, resigned, and Scott Morrison won a contested party room ballot. Policy changes of significance are not evident but the ink is hardly dry on the appointment of his new cabinet, so we will monitor developments with interest.

What is most likely relevant for future bond price volatility is the improved probability of the Labor Party winning the next Federal election, and the subsequent implementation of their policy change initiatives. It is possibly too early to isolate this factor as a specific impact upon the Australian Yield curve. There is a lot of economic water to flow under the bridge between now and the likely election date period. We suggest it likely that the polls will eventually reflect a recovery in Liberal Party support after a period and that the current polling will be less relevant. We also suggest that current global economic volatility could be far more influential.

The Australian economy remains vastly different from that of the US. The Reserve Bank of Australia (RBA) is holding monetary policy stable at a record low 1.50% given minimal employment growth of significance that is posing no immediate threat to wages (growth). Household budgets are, on average, excessively geared and discretionary expenditure is not growing. Inflation is unlikely to break out. Recent retail sales and housing finance data reflect a sanguine state of economic growth, with the housing sector clearly impacted by banks demanding increased equity in support of new lending.

Yet the economy has exhibited recent signs of significant (enough) growth. The national accounts show an annualized 3.40% expansion in GDP and the federal fiscal position is improving markedly. Recent committed capital expenditure in the mining sector is significant, no doubt buoyed by the cheaper Australian dollar. China demand for Australian iron-ore is not waning and a boost in mining sector employment is in full swing.

Realistically however, if unemployment at 5.00% is the magic number needed to boost discretionary spending, and thereby potentially lift monetary policy, it would appear a long way off. Subsequently, the RBA is holding monetary policy at quite 'accommodative' levels of 1.50%, whilst other central banks are tightening, or moving toward a tightening cycle. The Australian Dollar subsequently, as expected, continues to slide lower, losing US1.16c to close the quarter at US72.24c, before hitting a low of US70.50c immediate post quarter end. The RBA will welcome the decline, noting that depreciation of this significance can be eventually expected to drive an increase in export led growth. Everything in Australia, in the hand of foreign denominated buyers, becomes cheaper and therefore more attractive, care of the decline.

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This economic and policy environment is, in our opinion, conducive to a steepening of the Australian yield curve. Short rates will remain low, pinned down by the monetary policy anchor, yet longer rates will rise, as investor capital is attracted to higher yielding bonds issued by other sovereigns, and Australian long dated bonds will therefore likely decline in value as yields rise to compete.

Globally

Refer to Table 3. Eurozone including the UK, and Japanese sovereign yields are all rising.

Table 3. Global interest rates are on the rise

	Yield change and return for benchmark 10 year bonds			
Sovereign Issue	30 Jun 18	30 Sep 18	QOQ Yield Change	Period return
USA	2.86%	3.06%	0.20%	-0.90%
Australia	2.63%	2.67%	0.04%	0.30%
Germany	0.30%	0.47%	0.17%	-0.90%
Italy	2.68%	3.15%	0.47%	-2.40%
UK	1.28%	1.57%	0.29%	-1.40%

The Brexit negotiations are producing little in the way of concrete outcomes and in fact contractual implications of Britain's divorce from the Euro block could be significant. Collateral damage could include Theresa May being replaced as Prime Minister by Boris Johnson. Some nickname him "BoJo". Is a nickname theme developing, with Australia's own Prime Minister being touted in brief as "ScoMo"?

Italian yields too are rising - less as a function of the rising tide of global interest rates and more because of an excessively leveraged sovereign budget. German 10 year yields rose 0.17% in the quarter. Whilst it might not sound significant in isolation, it is very significant when we note the yield of 0.30% that they commenced the quarter at.

Japanese 10 year rates rose by 0.14% in the same period. Yields rose from just 0.04% to 0.18%.

Whilst the impact of the monetary policy moves by the US Fed is reverberating globally, perhaps yields would be higher again if not for the rising cross border trade tension between the US and the rest of the world, but especially between the US and China. Collectively, the two sovereign super powers account for close to one third of global GDP, and subsequently Australia, significantly exposed to that GDP growth, would suffer in any downturn.

However, the policy conflict between the US and China is far more than simply a tariff or trade war. The conflict extends beyond simplistic trade protectionism into a wide range of issues that signal an aggressive foreign policy stance. Many international media headlines in the last quarter have compared this developing policy as equivalent to a cold war. Beyond the near quarter of a trillion in tariffs slapped on China's exports, the Trump administration has increased support for Taiwan's military aspirations, been overtly critical of China's human rights record and challenged the legitimacy of various activities within the South China Sea.

These significant geopolitical changes are likely to continue to influence the global cost of capital.

Key Contributors to September quarter end returns

Consistent with our medium term strategy, all investment programs retained a "short duration" and "long (short dated) credit exposure" position during the quarter. This is known as a 'short credit spread duration" strategy.

Table 4. Index returns for quarter end 30 September 2018

S&P/ASX Australian Bond Index	Quarter End Return
BBB Rating Band	0.95%
(All Maturities & Credit Grade) Fixed Interest	0.53%
Bank Bill	0.51%
Corporate Bond 0-5 Year	0.82%

Notes: The "all maturity" index has a duration of > 5.00 years, whilst the 0-5 year Corporate is < 2.50 years and the Bank bill index is 0.25 (or 3 months) in length.

Combining this information with that within Table 5, specifically that the Australian 10 year bond returned 0.30% for the quarter, it is fair to state that the longer an investors maturity exposure, and the lower the exposure to the corporate bond sector, the lower an investors total return would be. The longest 'all maturity index' only just managed to beat the lowest yielding (and highest liquidity) index – the bank bill index. The short dated Corporate Bond (0-5) year index performed well, only 0.13% shy of the BBB (corporate bond) index.

Table 5. Period returns, by investment category, for each investment program model portfolio

Investment performance attribution - quarter end September 2018					
			% exposure to investment category		
Investment Category	Average actual period percentage return	Average Credit Margin Change	Income Plus	Core Income	Conservative Income
Cash	0.35%	0.00%	1.33%	1.66%	1.35%
IG (ex RMBS)	0.97%	-0.05%	24.87%	90.01%	83.41%
NIG + UR (ex RMBS)	1.45%	-0.01%	59.56%	8.32%	0.00%
RMBS IG	1.68%	0.10%	8.12%	0.00%	15.25%
RMBS NIG	1.78%	-0.03%	6.13%	0.00%	0.00%
Expected Return NET			1.10%	0.79%	0.86%
Published Return NET			0.70%	0.70%	0.56%

Notes: (1) Index: IG = Investment Grade, NIG = Non-investment Grade, UR = unrated, RMBS = **Residential Mortgage Backed Securities***. (2) Individual IMA returns may differ from the returns published in this Table as a function of dispersion between the actual holdings and the model portfolio due to supply constraints. The PMT endeavor to replicate the model portfolio as closely as is possible at every juncture of opportunity.*

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Clearly the strategy set by the MIPS Portfolio Management Team (PMT), to invest short and in high accrual corporate assets, was correct. But returns delivered fell short of that in the model. The returns did however still rank very highly against peers. All MIPS Investment Programs performed in the top 10, and Income Plus in the top 5, against ~50 competitor bond funds as measured by the 'Yield Report'*. Whilst the strategy set proved correct, getting accounts exposed to the same assets that resided within our example portfolios proved difficult. We retain the same exposure preference and will continue to build client portfolios to match preferred exposure as and when supply is available at the right prices.

Getting set proved difficult due to lack of supply at an appropriate price, scaling in primary issuance subscription and the inability to get efficiently priced bids on assets posted for sale. Subsequently, client accounts retained a higher exposure to lower yielding substitute assets. However, we are extremely confident we can continue to improve exposures during the December quarter.

The most significant contribution to this asset availability shortfall lies with lack of new unrated senior issuance. Secondary market opportunity for these assets, especially and most importantly, a cornerstone for the Income Plus program, dried up. But new (primary) issuance is on the horizon.

Our portfolio rebalancing requirements per Investment Program consist of:

For Income Plus: An increase in NIG and UR exposure, including NIG and IG RMBS, of ~14.00%, funded from the sale of (Senior) IG assets.

For Core Income: An increase in (Senior) NIG and UR exposure, including IG RMBS, of ~4.00%, funded from the sale of (Senior) IG assets.

For Conservative Income: An increase in (Subordinated) IG exposure by ~7.00% and senior IG RMBS by as much as 13.00% funded from the sale of (Senior) IG assets.

Readers are directed to Table 8. Credit Margin and Yield change by investment category.

Whilst we experienced some difficulty in getting set, valuations of assets have changed minimally. Rather than chase these assets, and drive their current prices higher, or buy at expensive offer prices, thereby delivering poor returns for investors, we have elected to patiently acquire these assets over time.

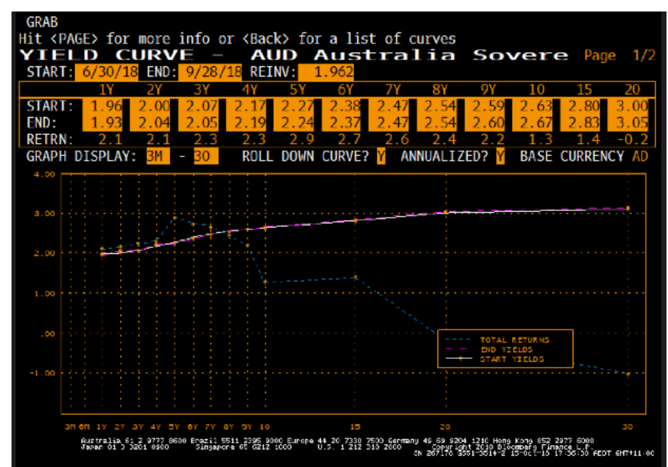
The RMBS sector valuations have been stable and have delivered higher returns than both the IG and NIG + Unrated sectors. RMBS averaged a 1.73% return, about 0.50% for the quarter above the alternate. Credit margins in RMBS land have not changed markedly, and we expect our strategy of slow accumulation is still best, especially given the pressure upon underlying (residential property) collateral. Whilst we have foregone one quarter of higher accrual advantage and performance, we still expect to be able to get set in this product sector at appropriate entry prices as time progresses and new issuance provides us the opportunity.

Getting "set' will continually require bidding to invest in primary (new) issuance. Currently, despite the underlying sector collateral being under downward price pressure, primary issuance is 'clearing' at lower credit margins as the sector has seen a surge in popularity with domestic institutional investors. As previously noted the RMBS sector has lagged the performance in credit margin contraction seen in the last few years in singular name corporate sector debt. Relatively, the RMBS sector still holds appeal.

Domestic (Australian) Interest rate outlook

The last quarterly period, as did the prior, exhibited extremely low base interest rate curve volatility. As evidenced by Chart 1, referencing the opening and closing shape of the yield curve, there has been an absolute minor change in base interest rates. The PMT believe the next quarter is likely to deliver the same for the short end of the yield curve up to the 4 year rate, but believes yields beyond 4 years will commence increasing, with progressively higher increases for longer maturities - the yield curve is expected to steepen.

Chart 1. Quarter on Quarter change in the Australian Sovereign Curve



Source: Bloomberg, September 2018; Key: X axis = Term to maturity, Y axis = Yield

Whilst it would appear there is little clear economic evidence of any imminent significant pressure to encourage the bond bears, the devaluation of the currency has been significant, and it will eventually deliver stronger economic growth. The short end is anchored by current monetary policy levels, perceived to be stable for the foreseeable future, whilst the appetite to invest longer will likely wane. We expect longer dated yields to drift higher commensurate with an expectation that a devaluing currency will eventually deliver the long awaited growth.

Everything in Australia is now markedly cheaper for offshore investors, and investing capital will be a more attractive proposition.

* Refer to yieldreport.com.au. Yield Report provides an independent analysis of the interest rate markets and interest rate securities. Access to the site free.

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Significantly, the New Zealand experience of imported price inflation post currency devaluation, is worth noting. The Reserve Bank of New Zealand (RBNZ) expected the September quarter CPI to be 0.4% but the actual outcome was a whopping 0.9%. Annualized, that is close to 4.0%! The RBNZ attributed the outcome to a weak NZ dollar and soaring fuel prices.

We repeat the statement of last quarter: “expect that given monetary policy is being tightened in the US and Europe, but likely to be stable in Australia for some extended period of time, that it will be the $A that falls as the compensating factor. This has already occurred but could easily extend. The Australian yield curve would, based upon historic evidence, be expected to steepen in such an environment.”

The PMT will look to extend duration longer, but will do so at points of any weakness (or rise) in yields before implementation.

Bank Bond (FRN) Investment Program (BBIP) outlook

In our last quarterly we stated that “we see the (slight) widening in credit margins (in bank fixed and floating credit margins) as an opportunity for investors. The PMT retains this bullish outlook for all major and minor bank credit margins.

Floating and fixed rate credit margins are tighter during the quarter. Refer to Tables 6 & 7 below. We attribute the change, and optimism for continued contraction of credit margins, to the same factors previously noted - the tighter lending standards adopted by banks in the wake of regulatory and royal commission pressure. Their balance sheets are now stronger, and are strengthening due to contracted credit lending metrics, and therefore the credit worthiness of their senior issuance is stronger. Bank share prices have fallen significantly.

Chart 2. Three month bank bill rates since the most recent change in monetary policy (August 2016).

Source: Bloomberg, September 2018; Key: X axis = Term to maturity, Y axis = Yield

Additionally, bank bill rates have stabilized at somewhat higher levels, but not quite at their peak rates above official cash (2.12%). Refer to Chart 3. With 3 month bank bills (and therefore BBSW) trading at ~0.45% above official cash, at 1.95%, investors in this sector are receiving higher quarterly rate-sets than in most periods during the last 3 years, bar the March and June 2018 quarters. Interest rates are on the rise, and in this environment, being exposed to short but revolving high rate-sets on a quarterly cycle can deliver significant benefits over the alternate strategy of locking in fixed rates.

We favor investing in this sector as a viable higher yielding and higher liquidity alternate to At Call cash and Term Deposits. Refer to the attached article, produced in ‘the WIRE’ on the 17th of October 2018. Investors are advised of the key advantages of FRN’s over cash and TD’s and the minor risks associated that are quickly dispelled by the breakeven advantage of higher yield.

Table 6: Bank Bond Investment Program analytics.

Bank Bond (FRN) Investment Program (BBIP) Outlook				
Bank Bond (FRN) Investment Program & Average Metrics for quarter period end	30 Jun		30 Sep	
	Average Credit Margin	Expected YTM	Average Credit Margin	Expected YTM
1. Major Bank Senior	0.82%	3.13%	0.76%	3.02%
2. Major & Minor Bank Senior	0.94%	3.30%	0.87%	3.18%
3. Major Bank Senior & Subordinated	1.11%	3.41%	1.05%	3.30%
4. Major & Minor Bank Senior & Subordinated	1.39%	3.69%	1.34%	3.59%

Credit margins are slightly tighter, but the interest rate swap curve has also rallied slightly. Total book value entry yields have fallen slightly. Note our bank bond (FRN) investment programs constantly change their constituents, so any quarter on quarter comparison is best undertaken alongside discussion with the MIPS team.

Selected asset examples showcase tighter credit margins. Note that credit margin tightening has effectively been linear, with lower rated, subordinate assets of longer maturities mostly outperforming higher rated, senior assets of shorter maturities.

Table 7: Specific FRN asset example changes for constituents of Bank Bond programs.

Bank Bond (FRN) Investment Program (BBIP) Outlook				
Specific Issuer and FRN maturity or call	30 Jun		30 Sep	
	Average Credit Margin	Expected YTM	Average Credit Margin	Expected YTM
ANZ (Major Bank Senior) 18 Jan 2023	0.91%	3.35%	0.82%	3.23%
BOQ (Minor Bank Senior) 3 Feb 2023	1.23%	3.68%	1.12%	3.53%
WBC (Major Bank Subordinated) 16 Feb 2023	1.78%	4.23%	1.72%	4.14%
BENDIGO (Minor Bank Subordinated) 9 Dec 2021	1.62%	3.88%	1.59%	3.77%

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Bank Bond (FRN) Investment Program strategy and credit outlook

Our strategy recommendation is the same as in the prior two quarters.

Recent macro prudential controls upon bank lending will support credit margins, capping the extent and period of time for which any short term weakness occurs. The strength in credit margins for term FRN product has not been significant and the PMT see no logical reason to alter our well communicated investment strategy. We continue to roll up the yield curve, positioning portfolios to maintain the current weighted average (~3.5 years) term exposure, or longer, taking advantage of 'riding' the steep shape of the credit curve.

Inflation outlook

Our inflation expectations in Australia are unchanged for this quarter, as they were for the prior quarter. Whilst the lesson learnt from the NZ September 2018 release is to be wary of the currency devaluation, we do not predict a meaningful impact upon long term inflation is imminent.

Chart 3. Year-end percentage change in Consumer Price Inflation

Source: ABS

Inflation remains below the lower boundary of the RBA's 2.00% - 3.00% tolerance and target band. Whilst global economic conditions have improved the RBA has acknowledged, that stubbornly high unemployment and consistent weak domestic wage growth, will, in the near term, likely keep core inflation low.

As discussed at length in prior quarterly reports, significant competitive forces in on-line retail product distribution will benefit consumers with lower prices, but will also be at the detriment of traditional distribution systems, resulting in a future lower trend inflation. Changes in product distribution are continually facilitating cost reduction and the consumer can be expected to continually benefit. Whilst the weaker AUD could historically result in higher import price inflation, this is now offset by price falls in products across many important categories that are now both more efficiently produced and distributed. Examples of note include consumer electronics, motor vehicles and clothing.

Credit (margin direction) Outlook

The PMT retains a bullish outlook for credit margins.

The widening of credit margins experienced in the June Quarter was short-lived, whether for major and minor bank FRN spreads, IG or NIG corporates, or IG or NIG RMBS. This is evident in the tables here within and on Chart 4: the movement in average issuer credit spreads as represented by the Itraxx Index.

The PMT stated in the last quarterly report that they were positive on the outlook for bank credit margins, believing the margin deterioration will be minimal, and that the accrual advantage will offset any potential (minimal) capital loss. That positive opinion is the first building block in support of credit margins for corporate debt.

Combining this with our interest rate direction strategy – to remain invested in the shorter end of the yield curve – leads the PMT to favor buying short maturity credit. Subsequently, we retain a short 'credit spread duration' as a cornerstone strategy – and one that we continue to pursue.

As evidenced within Table 8, credit margins for all investment categories have moved only marginally.

In summary, the predominant credit exposure strategy, especially in the NIG sector, is to hold short dated credit with a high accrual advantages.

(Credit) RMBS Strategy

We retain a positive outlook for the RMBS sector credit margins, believing that by lagging the contraction experienced by singular corporate names, they represent excellent relative value.

As evidenced by both Table 8 and Table 4, both IG and NIG RMBS have outperformed IG and NIG + UR Corporate debt. The credit margins offered by IG and NIG RMBS, at +2.94% and 5.75% are attractive compared to NIG & Unrated (UR) debt at 4.12%. And they exceed the margins offered by IG (at an average of 1.89%) markedly.

Table 8. Credit Margin and Yield change by Investment Category

	Average Credit Margin			Average Yield		
Investment Category	30 Jun	30 Sep	Credit Margin Change	30 Jun	30 Sep	Yield Change
IG (ex RMBS)	1.85%	1.89%	-0.04%	4.28%	4.17%	0.11%
NIG + UR (ex RMBS)	4.11%	4.12%	-0.01%	6.35%	6.31%	0.04%
RMBS IG	3.03%	2.94%	0.10%	5.47%	5.32%	0.15%
RMBS NIG	5.72%	5.75%	-0.03%	7.87%	7.85%	0.02%
Average	2.77%	2.79%	-0.02%	5.14%	5.05%	0.09%

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Getting set in the preferred volume of exposure, to the preferred list of diversified issuers, has been difficult. Building this exposure will take more time. The PMT will continue to rebalance portfolios to have increased exposure to this sector, matching target or example portfolios, as opportunities present.

Media reporting of a deterioration of residential property prices continues. The major capital cities of Sydney and Melbourne have experienced declines in prices for established dwellings in the order of 5%, but that said, the same dwellings grew in value in the order of 50% for the prior 5 years.

Price falls are a function of oversupply of housing, weak demand from new entrants at current price points and excessively heavy gearing embedded within budgets of existing owners. Lack luster employment and wage growth alongside more restrictive lending ratios implemented by the banks are impacting the market heavily.

Does this mean that the RMBS sector will underperform in the future?

Possibly. But likely selectively. Poorly structured RMBS issues are to be avoided. Those that are overly exposed to east coast unit developments that have insufficient equity or lenders mortgage insurance, are the ones to avoid.

For a significant collapse in property prices, and therefore collateral security, to occur, unemployment would need to climb significantly. At this stage, as evidenced by the recent (September quarter) healthy rebound in the NAB Employment Index that would appear very unlikely. NAB estimate a 'gradual reduction' in spare employment capacity in late 2018 and into early 2019, leading to a rise in wage growth, a small fall in unemployment and eventually a general lift in inflation.

We stand by our observations made in prior quarterly reports. The RMBS sector will outperform singular name corporate credit. RMBS margins have lagged the compression in credit that corporates lending in senior and subordinate structural form have benefited from. Additionally, residential mortgage lending standards have improved. Pool diversity and LVR's of course need review for credit approval to meet MIPS investment criteria but standardization of this process to deliver IG rated outcomes and subordination support are positives.

We suggest that the sector will constantly surprise on the volume upside, and be supported by large funds that will otherwise be earning less investing in corporate unsecured credit as a large increase in population through migration and births develops constant demand for more housing.

Chart 4: History of the Australian credit index – 'ITraxx' from January 2016.

Source: Bloomberg, September 2018; Key: X axis = Time, Y axis = Index Price

The 'Itrax' is exhibiting signs of trending higher. It has seen a low not revisited since December 2017, and has posted a high in the prior quarter that appears to be imminently revisited.

Bond Market New Issuance

Credit markets have been supportive of new issuance in fixed and floating rate form across the yield curve.

Key deals include:

- AMP Bank, (A) $400m 3.0 year FRN @ +108bps
- AT&T, (BBB) $475m 5.0 year Fixed @ 3.45%
- AXSESStoday, (UR) $55m 5.0 year FRN @ +490bps
- General Property Trust, (A) $200m 6.0 year Fixed @ 3.6725%
- Maurice Blackburn, (UR) $40m 4.0 year Fixed @ 7.45%
- Medallion Trust RMBS 2018-1 D, (BBB), $6.5m 9.2 year FRN @ +350bps
- Optus Finance, (A) $500m 5.0 year Fixed @ 3.25%
- Societe Generale, (BBB+) $450m, 5.0 year Fixed @ 3.925%
- Suncorp, (A) $600m 5.0 year FRN @ +215bps
- Zenith, (UR) $40m 7.0 year Fixed @ 7.55%

MIPS Investment Strategy – Summary statistics

The MIPS programs performed adequately during the quarter – a period that encompassed a near stable interest rate curve and slightly tighter credit margins. 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	
Date Period	**30 Jun**	**30 Sep**	**30 Jun**	**30 Sep**	**30 Jun**	**30 Sep**	**30 Jun**	**30 Sep**
Duration (tenor exposure)	1.82	1.88	2.59	2.73	2.35	2.64	0.13	0.12
Investment Grade Senior	35%	20%	92%	82%	86%	89%	50%	50%
Investment Grade Subordinated	16%	14%	0%	0%	14%	19%	50%	50%
Non-Investment Grade & Unrated	48%	66%	8%	18%	0%	0%	0%	0%

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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 9 years and is the Head of the Managed Income Portfolio Service.

Megan Romeo
Assistant Portfolio Manager

Megan Romeo has over 8 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. She has been with FIIG Securities for 3.5 years all of which within the Managed Income Portfolio Service.

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	0/25
Number of bonds	10/no max
Modified Duration	0/5

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	0/25
Senior Debt	100/100
Subordinated Debt	0/0
FIIG Arranged Bonds	0/35
Number of bonds	10/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 riskreturning 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	80/100
Subordinated Debt	0/20
FIIG Arranged Bonds	0/60
Number of bonds	10/no max
Modified Duration	0/5

Note: The Investment Programs may contain Asset backed securities including Residential Mortgage Bond Securities (RMBS). RMBS are senior secured assets issued in floating rate note form and are an approved investment within MIPS Investment Programs. Please refer to "Section 3" of the Information. Memorandum for more detail regarding the parameters of each Investment program.