AMCBF Series Quarterly Update

1 January 2014 - 31 March 2014

Summary

AUSTRALIAN MASTERS CORPORATE BOND FUND SERIES (AMCBF SERIES) HIGHLIGHTS

- The following dividends have been announced:
  - Australian Masters Corporate Bond Fund No 5 (AMCBF5) announced a fully franked dividend of $1.05 per share to be paid on 14 May 2014.
- All existing fixed income investments held in the AMCBF Series continued to perform as expected.

MARKET HIGHLIGHTS

- **Global markets:** : Janet Yellen takes over as the US Federal Reserve (Fed) Chair. With the US economy showing positive signs of recovery, the tapering of the bond purchase program continues, with an expected end date of Q4 2014. Speculation now surrounds when the Fed will begin hiking interest rates. Ongoing tensions between Russia and Ukraine and concerns over the stability of China's financial system have also dominated headlines.
- **Australian rates:** Recent positive economic data for the Australian economy has been offset against volatility in emerging markets and a cold winter in the US. The Reserve Bank of Australia (RBA) has moved its focus away from the Australian dollar (AUD) to the property market, which may be showing signs of overheating. In response, the market is currently pricing in no more rate cuts. However, the market is pricing in a delay in rate hikes, with the interest rate curve flattening over the period.
- **Domestic credit:** While overall debt issuance remains robust, corporate debt issuance remains low. BBB rated bond yields continue to fall off the back of the flattening interest rate curve. However, credit spreads continue to remain range-bound over the period.

AMCBF Activity

AMCBF Series announced the payment of the following quarterly dividends:

FUND	DIVIDEND	FRANKED	GROSSED UP	CAPITAL RETURN	(EXPECTED) PAYMENT DATE
AMCBF5	$1.05	$0.45	$1.50	$0.00	14 May 2014

All existing fixed income securities held within the portfolios of the AMCBF Series continued to perform as expected.

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Global Markets Update

The era of Federal Reserve (Fed) Chairman Ben Bernanke came to a close with the baton being passed on to Janet Yellen. A known 'dove', it came as a surprise to markets during her first Federal Open Market Committee (FOMC) meeting that she was quite hawkish around interest rates. However, Yellen has subsequently taken a softer tone providing market assurances that interest rates will remain low until the economy is much stronger. Yellen's first order of business was to take a more qualitative approach to data interpretation and intended guidance around Fed policy. Gone is the hardline, forward-looking guidance, which has been replaced by a multi-faceted and qualitative assessment of economic health.

Despite a cold winter season, it appears that the US economy remains on the road to recovery. However, risk assets, such as equities, remain volatile as it adjusts to life without central bank liquidity and a higher interest rate environment. The Q114 reporting season will be the first indicator as to how corporate America is faring through the initial stages of this transition, with results being mixed so far.

While Europe's recovery still remains wobbly, most of the focus during the quarter was on the emerging market space. There was an increase in volatility as a sell-off ensued during the months of January and February, with investors seeking to pull money out of the system in light of growing concerns over political tensions between Russia and the Ukraine and worries over China's property market and stability of its financial system. However, emerging markets have settled, clawing back some of those losses.

For the most part, global corporates have maintained robust performance. However, it's important to read between the lines. Most of the performance has been balance sheet led with the low interest environment continuing to support a low cost of debt and ongoing post-GFC cheap labour costs. However, in general, top line revenues continue to struggle as demand remains muted. In addition, corporates continue to shy away from investing capital into growth initiatives.

Headwinds remain through this recovery cycle, taking the form of ongoing US government dysfunction, increasing debt burdens and the eventual unwinding of quantitative easing programs. While the US recovery continues to gain traction, it is likely it will remain sluggish.

Australian Financial Markets Update

Australian financial markets have had a lacklustre quarter, with better than expected domestic economic data being offset by global issues outlined earlier.

The latest domestic economic data was robust with employment data showing strength, despite a marginal rise in unemployment. Strong data prints with respect to new jobs and full-time jobs were interpreted as a sign of economic resilience as the economy continues to transition and reinvent itself post-mining boom. The tick up in the unemployment rate was, to some extent, driven by a positive driver, which was the increase in participation rate from 64.5% to 64.8% between the months of February and March.

Other data, such as GDP, retail sales and building approvals, have also remained robust, based on most recent releases.

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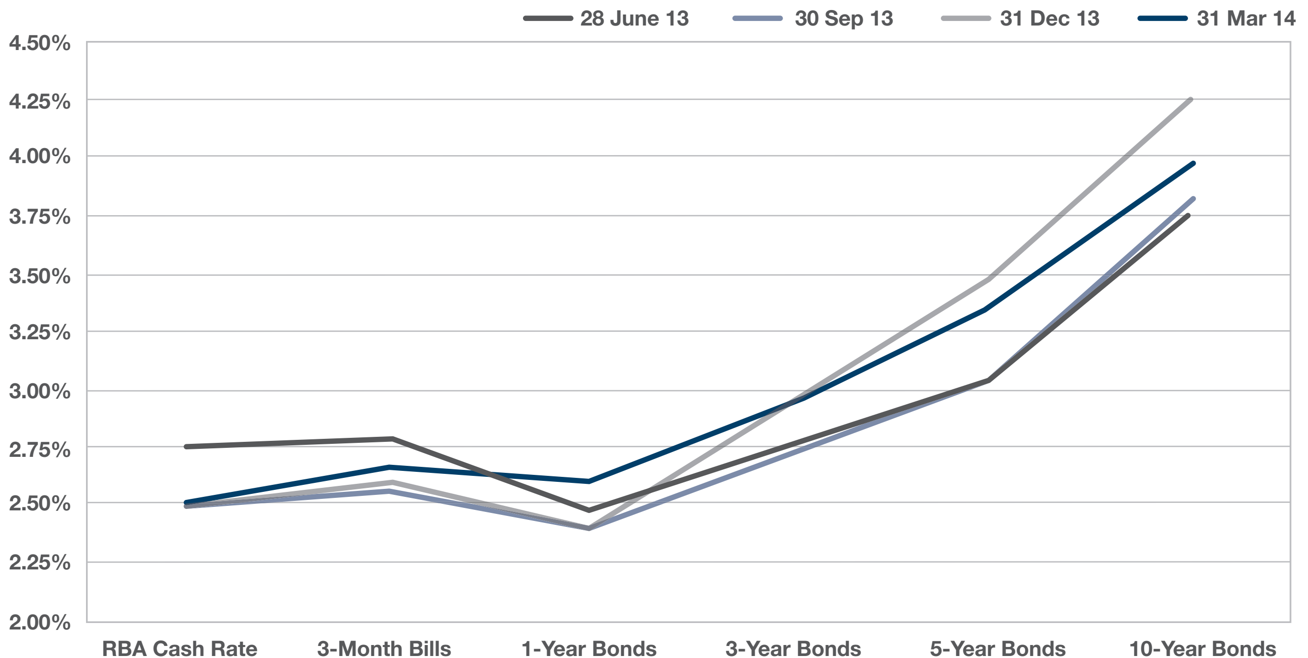
Domestic Rates

The Australian interest rate curve flattened over the course of the quarter, with the RBA keeping the cash rate at 2.50%. The central bank's approach is less to do with comfort regarding the country's economic stability and inflation and more to do with the high currency versus frothy property market conundrum. In recent months, the RBA moved from a hard line for the AUD of 85 US cents to an 85c-90c range and has subsequently shifted its attention to the Australian property market. This has resulted in the AUD trending up again, with most recent highs of circa. 94 US cents.

The market is not expecting any official cash rate moves in the short to medium term. A cut seems unlikely amid the RBA's concerns regarding the property market and inflation being at the upper end of the target 2% to 3% range, while a rate rise also appears improbable given ongoing volatility in the emerging markets, the slow burn recovery being experienced in the US and Europe continuing to struggle through its woes, together with a degree of uncertainty with domestic condition trends.

The RBA is likely to influence short-term market behaviour through the strength of its conviction around the economy, and will convey this through its rhetoric. Action appears to be focused more on the longer term at present.

AUSTRALIAN GOVERNMENT YIELD CURVE



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Domestic Credit

Despite 2014 year-to-date domestic debt issuance remaining marginally down from the same period in 2013, actual primary corporate debt issuance has been low. Primary issuance has been dominated by sovereign and supranational entities, as well as financial institutions. In March, two corporates came to market, totalling $750 million in issuance volume. This is compared to $8.5 billion of total debt issuance during the month.

Despite expectations by the market that 2014 would once again be a robust year for new issuance volumes, corporate debt issuance via the capital markets has remained tempered.

In part, financial institutions are responsible. Australian banks have become very well capitalised post-global financial crisis (GFC) and, as a result, they are scrambling to deploy idle balance sheets, with lending executed at tight spreads for relationship-driven reasons. While a lot of the reinforcement of Tier 1 and overall capital bases by banks is in anticipation of a stricter regulatory framework, the unusual anomaly where high funding costs, especially high retail deposit rates, and the post-GFC corporate deleveraging experience, has resulted in banks needing to support net interest margins through a more aggressive lending strategy.

Thus, new corporate bond issuance continues to remain low and well bid as demand continues to outstrip supply. Corporate BBB rated yields have continued to trend lower.

AUSTRALIAN BBB 5YR CORPORATE BOND YIELDS

As displayed in the graph below, Australian investment grade credit spreads, as per the iTraxx Australian CDS index, continued to trade in a tight range. While we did experience some volatility off the back of the recent sell off in emerging market equities and US markets, volatility settle during the month of March, with the iTraxx Australian CDS index continuing to trade in and around the 1% level.

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ITRAXX AUSTRALIAN CREDIT SPREADS

In the context of the current tight yields resulting from a low interest rate environment, credit spreads, while tight, are trading around fair value. At current levels, they remain around 0.25% from pre-GFC tights, with the corporate default rates close to historical lows. Overall corporate leverage remains at the lower end of the historical range (around 26%), debt interest coverage is at more than acceptable levels (about 8 times) and profit margins, while they have shifted down from the highs experienced in 2011/12, remain strong (around 15%). Therefore, all the major components of credit – low default environment, balance sheet strength, liquidity and profitability – remain healthy for corporates in Australia, justifying the current credit spread levels.

HYBRID MARKET

The hybrid market had a relatively quiet start to the year. Financial institutions were the primary contributors to the robust issuance levels of hybrid issuance during 2013. However, it is expected that in 2014, most of the Tier 1 capital issuance undertaken by financial institutions will be more to replace/refinance maturing issues.

Most of the new issuance by banks and insurance companies this year has taken the form of Tier 2 capital and senior debt as these institutions seek to bolster and diversify overall capital bases.

The only Tier 1 issue during the quarter was the ANZPE capital notes. This was issued as a perpetual instrument that had a six-year non-call period and an eight-year mandatory conversion date. The issue size was $1.61 billion with a margin of 3.25%.

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	DECEMBER QUARTER DIVIDENDS & CAPITAL RETURNS			
FUND	CASH	FULLY FRANKED	CAPITAL RETURNS	FUND MATURITY*
AMCBF#5	$1.05	$0.45	$0.00	31-Dec-15

*Anticipated end date

AMCBF#5

ISSUER	MATURITY	FACE VALUE	CONSIDERATION	GICS INDUSTRY	COUPONS RECEIVED JANUARY	FEBRUARY	MARCH
Downer EDI*	29-Oct-13	$11,400,000	$11,624,536	Commercial & Professional Services	-	-	-
Volkswagen Australia*	26-Nov-12	$3,000,000	$2,983,500	Automotive	-	-	-
Stockland*	15-May-13	$500,000	$467,255	Real Estate	-	-	-
GPT Property*	22-Aug-13	$1,000,000	$933,490	Real Estate	-	-	-
Envestra	14-Oct-15	$2,500,000	$2,062,750	Utilities	-	-	-
Santos Finance	23-Sep-15	$6,000,000	$5,511,440	Energy	-	-	$187,500
Leightons	28-Jul-14	$6,900,000	$7,229,182	Capital Goods	$327,750	-	-
Melbourne Airport (Fixed)	14-Dec-15	$1,000,000	$863,320	Transportation	-	-	-
CFS Retail Property	22-Dec-14	$2,400,000	$2,282,473	Real Estate	-	-	-
AMP Limited	5-Oct-14	$3,500,000	$3,508,330	Insurance	-	-	-
Stockland	18-Feb-15	$18,190,000	$18,362,081	Real Estate	-	$773,075	-
Mirvac	15-Mar-15	$2,300,000	$2,349,798	Commercial & Professional Services	-	-	$94,875
Sydney Airport Finance	20-Nov-14	$3,030,000	$2,696,706	Transportation	-	$23,383	-
Brisbane Airport*	11-Dec-13	$5,000,000	$4,629,810	Transportation	-	-	-
Melbourne Airport (FRN)	14-Dec-15	$3,510,000	$3,056,324	Transportation	-	-	$24,019
Goldman Sachs	24-Jun-14	$2,500,000	$2,310,918	Diversified Financials	-	-	-
Dexus Finance	28-Jul-14	$2,500,000	$2,701,975	Real Estate	$44,834	-	-
		$75,230,000	$73,573,888		$372,584	$796,458	$306,394

*Investment has been redeemed or has matured.

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