BT Investment Management

Fund update

Income & Fixed Interest Strategies
December 2017

→ BT Sustainable Australian Fixed Interest Fund

ARSN: 612 664 730

About the Fund

The BT Sustainable Australian Fixed Interest Fund (**Fund**) is an actively managed portfolio of Australian fixed interest securities. Investments are selected based on a range of sustainable, ethical and financial criteria.

Investment Return Objective

The Fund aims to provide a return (before fees, costs and taxes) that exceeds the Bloomberg AusBond Composite 0+ Yr Index by 0.75% p.a. over rolling 3 year periods.

Description of Fund

The Fund offers investors access to a diversified portfolio of fixed interest securities and seeks exposure to issuers that demonstrate leading environmental, social and corporate governance (ESG) and ethical practices while avoiding exposure to issuers with activities that we consider to negatively impact the environment or society.

The Fund will not invest in issuers with material business involvement in the following activities:

- production of tobacco or alcohol,
- manufacture or provision of gaming facilities,
- manufacture of weapons or armaments,
- manufacture or distribution of pornography,
- directly mine uranium for the purpose of weapons manufacturing,
- extraction of thermal coal and oil sands production.

We consider that an issuer has a material business involvement in an activity if 10% or more of its total revenue is derived from that activity.

The Fund uses a security selection process that combines sustainable and ethical criteria with BTIM's credit analysis. BTIM's investment process for fixed interest aims to add value through multiple strategies and investment research. BTIM seeks to generate excess returns through strategies including active security (including Green, Social and Sustainable Bonds) and sector selection, duration, yield curve and credit management.

We believe our strategy is unique in the Australian marketplace due to our top down process which combines a large number of quantitative models, our qualitative overlay and technical analysis giving us a greater understanding of global forces that affect the domestic market and the opportunities it presents. This is a more robust process than focussing primarily on domestic economic factors when evaluating the opportunity set.

Our investment approach for credit management seeks to identify opportunities on a sector, issuer and security basis by incorporating top-down and bottom-up research. Top-down research includes analysis of economic and market data, along with macro credit fundamentals such as company earnings, balance sheet health, default rates and equity volatility. The bottom up research includes analysis of earnings and cashflow volatility, balance sheet, business diversity, industry and valuation.

Investment Team

BTIM's Income and Fixed Interest team includes thirteen dedicated investment professionals. The team also draws on a wide range of knowledge resources including BTIM's other specialist investment teams: Equity Strategies and Diversified Strategies. The portfolio manager of the Fund is Tim Hext, assisted by George Bishay, who have a combined 48 years of industry experience.

CERTIFIED BY RIAA

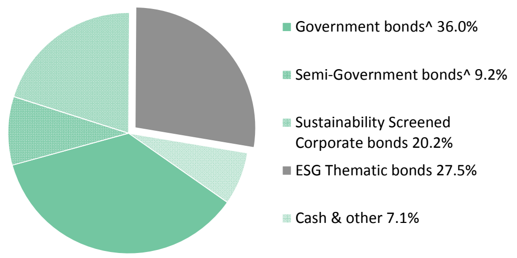
The BT Sustainable Australian Fixed Interest Fund has been certified by RIAA according to the strict operational and disclosure practices required under the Responsible Investment Certification Program. See www.responsibleinvestment.org for details.

The Responsible Investment Certification Program does not constitute financial product advice. Neither the Certification Symbol nor RIAA recommends to any person that any financial product is a suitable investment or that returns are guaranteed. Appropriate professional advice should be sought prior to making an investment decision. RIAA does not hold an Australian Financial Services Licence.

Performance

(%)	Total Returns (post-fee)	Total Returns (pre-fee)	Benchmark Return
1 month	-0.55	-0.52	-0.52
3 months	1.38	1.49	1.44
6 months	1.39	1.60	1.37
1 year (pa)	3.95	4.36	3.66
Since Inception (pa)	0.44	0.84	0.40

Sector Allocation (as at 31 December 2017)



^ Ex Green, Social & Sustainable Bonds

Green, Sustainable & Social Bonds Holdings

QTC Semi-Gov. Green Bond
KFW Green Bond
TCV Semi-Gov. Green Bond
NAB Climate Bond
ANZ Climate Bond
WBC Climate Bond
CBA Climate Bond
EIB Climate Awareness Bond
Aust. Catholic Uni. Sustainability Bond

Other Information

Fund size (as at 31 Dec 2017)	$156 million
Date of inception	August 2016
Minimum investment	$500,000
Buy-sell spread[1]	0.09% (0.05%/0.04%)
Distribution frequency	Quarterly
APIR Code	BTA0507AU

[1] The buy-sell spread represents a contribution to the transaction costs incurred by the Fund, when the Fund is purchasing and selling assets. The buy-sell spread is generally incurred whenever you invest in the Fund, and may vary from time to time without notice.

Management Costs[2]

Issuer fee[3]	0.40% pa

[2] You should refer to the latest Information Memorandum for full details of fees and other costs you may be charged.

[3] This is the fee we charge for overseeing the operations of the Fund and managing the assets of the Fund. The Issuer fee is paid from the assets of the Fund and is reflected in the unit price of your investment.

Risks

An investment in the Fund involves risk, including:

- **Market risk**: The risk associated with factors that can influence the direction and volatility of an overall market, as opposed to security-specific risks. These factors can affect one country or a number of countries.
- **Security specific risk**: The risk associated with an individual security.
- **Interest rate risk**: The risk associated with adverse changes in asset prices as a result of interest rate movements.
- **Credit risk**: The risk of an issuing entity defaulting on its obligation to pay interest/principal when due.
- **Liquidity risk**: The risk that an asset may not be converted to cash in a timely manner.

Please read the Fund's Information Memorandum (**IM**) for a detailed explanation of each of these risks.

Market review

Australian bonds experienced a negative return during the month as yields rose in sympathy with global peers and supportive local economic data. Market pricing for an RBA hike was also brought forward to December 2018 from early 2019. Near-term expectations for the cash rate however held steadfast, alongside little indication from the Board that a change in policy is needed for the time being. Governor Lowe's statement was in keeping with prior months and noted strength in leading indicators like business activity, as well as employment growth. However, this has stood in contrast to soft retail activity and persistently subdued inflation, including wage increases.

One of the top-tier economic releases during the month was third quarter GDP data, which was lower than expected with a 0.6% quarter-on-quarter increase resulting in annual growth of 2.8%. The monthly Labour Force report was more encouraging and beat expectations with a healthy 61.6K jobs added during November. Most of the growth was also skewed to full-time positions. The unemployment rate remain unchanged at 5.4% due to a rise in the participation rate. In contrast the NAB Business Conditions survey retreated from its record high achieved in the prior month. In other local economic developments, the Treasury released its Mid-Year Economic and Fiscal Outlook, which revealed a $5.8bn improvement in this year's Federal deficit forecast versus the prior estimate. Forecasts for individual states also improved, but by a smaller margin.

Looking abroad, the Federal Reserve raised rates by 25bp as widely-anticipated. Committee members also raised their forecast for 2018 GDP growth from 2.1% to 2.5% and their inflation estimate from 1.6% to 1.7%. Most major US data during the period was relatively robust including GDP growth of 3.2%, a 0.8% jump in retail sales and a sound 228K NFP print. A long-awaited tax reform proposal also passed both chambers of Congress, which helped support global investor sentiment. This was in addition to stopgap measures being passed to keep the government funded into the New Year.

In Europe, the ECB maintained its policy settings and President Draghi emphasised a need to keep interest rates at present levels for an extended period, given persistent subdued inflation. Meanwhile on the political front, some uncertainties were felt as the Catalan independence bid regained its footing and the Italian election date came into sight. In contrast, progress on Brexit negotiations were perceived positively by markets.

In terms of market movements, the Australian yield curve rose and flattened as 3 year yields increased by 25bp to 2.14% and 10 year yields added 14bp to 2.65%. At the front-end, 90 day BBSW rose a more modest 5bp to 1.80%. In the US, 2 year yields climbed 10bp to 1.89% while the 10 year finished unchanged at 2.41%. In the FX space, the Australian Dollar recovered 3.2% versus its US counterpart, helped in part by firmer iron ore prices. More broadly, metals were generally stronger over the period with copper rising to a 4 year high, bolstered by strong Chinese import data.

Credit spreads contracted further during the month, which reflected ongoing healthy risk appetite. This was spurred by the passage of a long-awaited US tax reform proposal and the ECB emphasising a need to maintain its current low policy rates.

In turn, the Australian iTraxx index (Series 28 contract) traded in a tight 7bp range finishing the month 7bps tighter to +58bps. Physical credit spreads were generally a touch stronger with the best performing sectors being resources, infrastructure and real estate narrowing 5, 3 and 2bps respectively, whilst domestic banks underperformed widening 1bp. Semi-government bond spreads performed well tightening 4bps to government bonds over the month.

Fund performance and activity

The Fund performed broadly in line with the benchmark over the month of December.

In the alpha component, the Yield Curve strategy added value from Australian front-end positions. These gains were partly offset by losses in the Duration strategy from Australian 3 and 10 year maturity positions.

The physical portfolio slightly underperformed the benchmark in December. The government sector positioning slightly detracted from performance whilst the non-government sustainably screened portion of the portfolio slightly added to performance. Infrastructure and industrial sector positioning were positive contributors whilst supranationals and financials detracted.

In terms of portfolio activity, we increased our exposure to industrials which was funded out of cash.

Outlook

The key economic release in January will be the 4th quarter inflation data. Inflation data has continued to disappoint recently and has provided little near term impetus for the Reserve Bank to tighten monetary policy. There are positive signs for the Australian economy however. The labour market over the past year has seen 380k jobs created, the bulk of which are in full time employment. The unemployment rate would be lower than its current 5.4% but for the pick up in the participation rate. That wage inflation remains subdued indicates that some slack does remain in the labour market and is also weighing on household consumption expenditure. Higher household debt levels are also weighing on consumption. Business conditions, despite the fall in the NAB business survey last month, are well above average levels and global economic conditions are supportive for the Australian economy. We expect no change from the Reserve Bank until at least mid 2018 - the inflation data will however be the key determinant for monetary policy expectations going forward.

We remain constructive on the outlook for investment grade credit. From a macroeconomic standpoint, the backdrop remains supportive with central banks maintaining dovish communication. This was evident during the ECB's communication during the month, that indicated a need to retain low policy rates in response to persistently subdued inflation. Meanwhile in the US, the Federal Reserve continues to emphasise that additional rate increases will be gradual. In turn, monetary policy normalisation should be slow and not disruptive for risk appetite. Further, the global growth picture continues to improve, as reflected in the economic surprise indices in the US and Europe. Credit fundamentals are also encouraging with healthy balance sheets and earnings growth. Defaults for high yield issuers globally also remain low and demand for credit is strong given the low yield environment.

Risks to the outlook include if central bank communication turns overtly hawkish and yields increase sharply, which could cause increased market volatility and credit spreads to widen. We are also cognisant of more country-specific risks like a high degree of corporate leverage in China and slowing credit growth in the region.

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