Fixed Interest

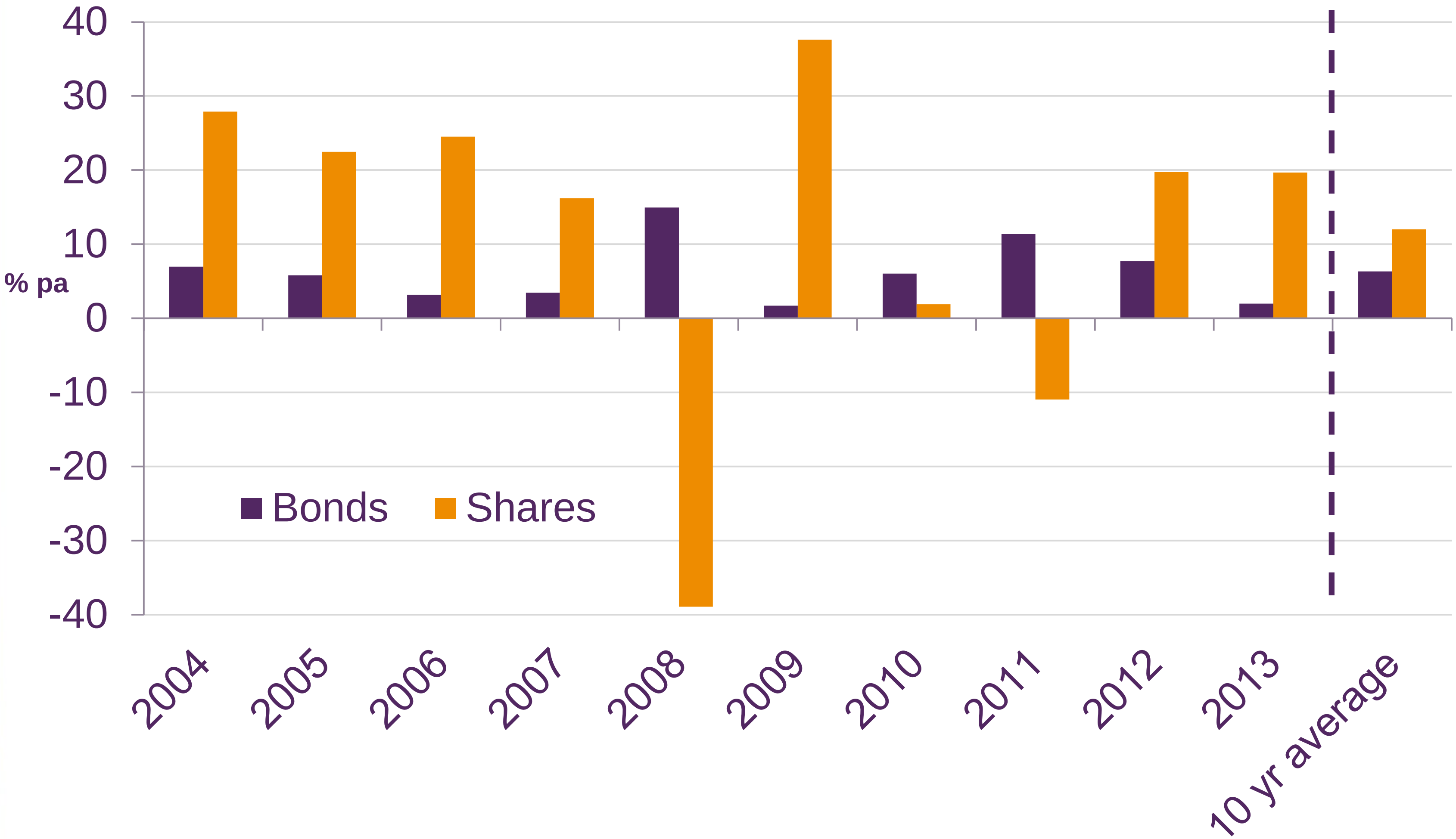
‘Less risky than you think’

Glenn Feben
Head of Perennial Fixed Interest

Agenda

- Diversification - the role of fixed interest
- Bond market update
- How risky are bonds in the current environment?
- Where are fixed interest returns headed?
- Product /strategy update – Tactical Income Trust
- Summary

Diversification – Bonds playing their role

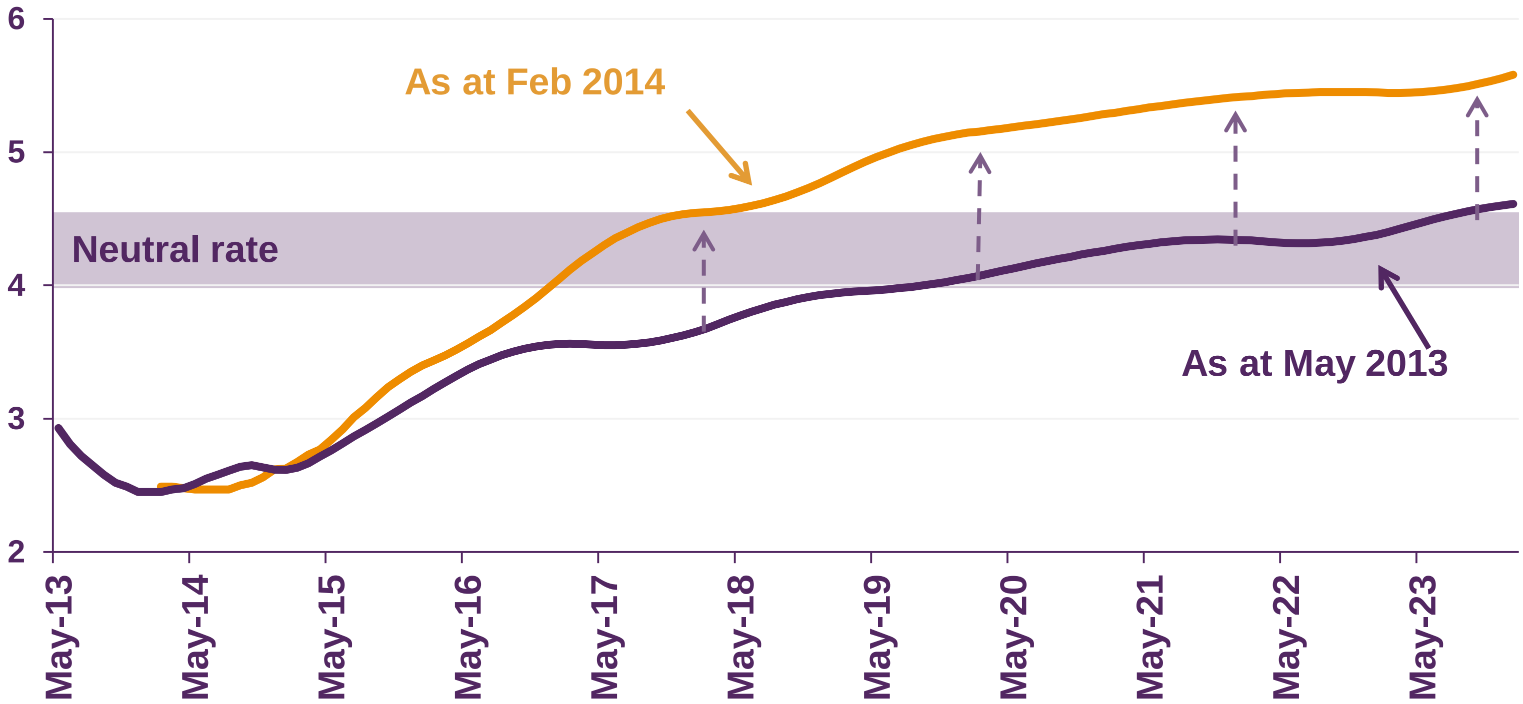


Source: Bloomberg, Perennial

Bond Market update

- Cash rate expectations
- Bond yields
- Credit margins
- Returns

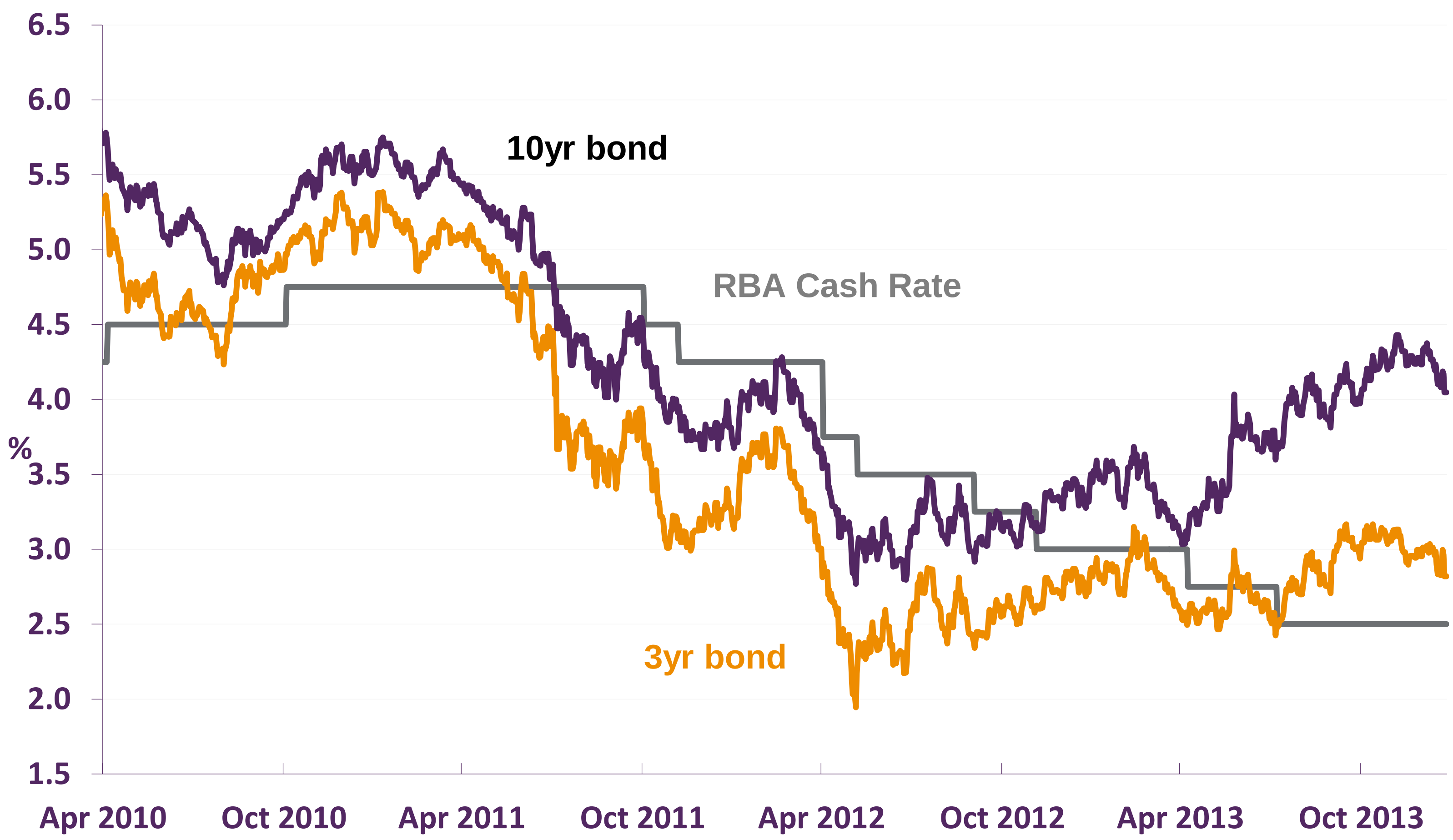
Cash rate expectations



- Since May 2013 the market has materially re-priced higher its expectations of future cash rates
- Current pricing has the cash rate reaching 5% in 2019 and rising steadily thereafter
- In contrast in May 2013 this was priced at a little below 4%
- Cash expectations drive changes in longer term bond yields

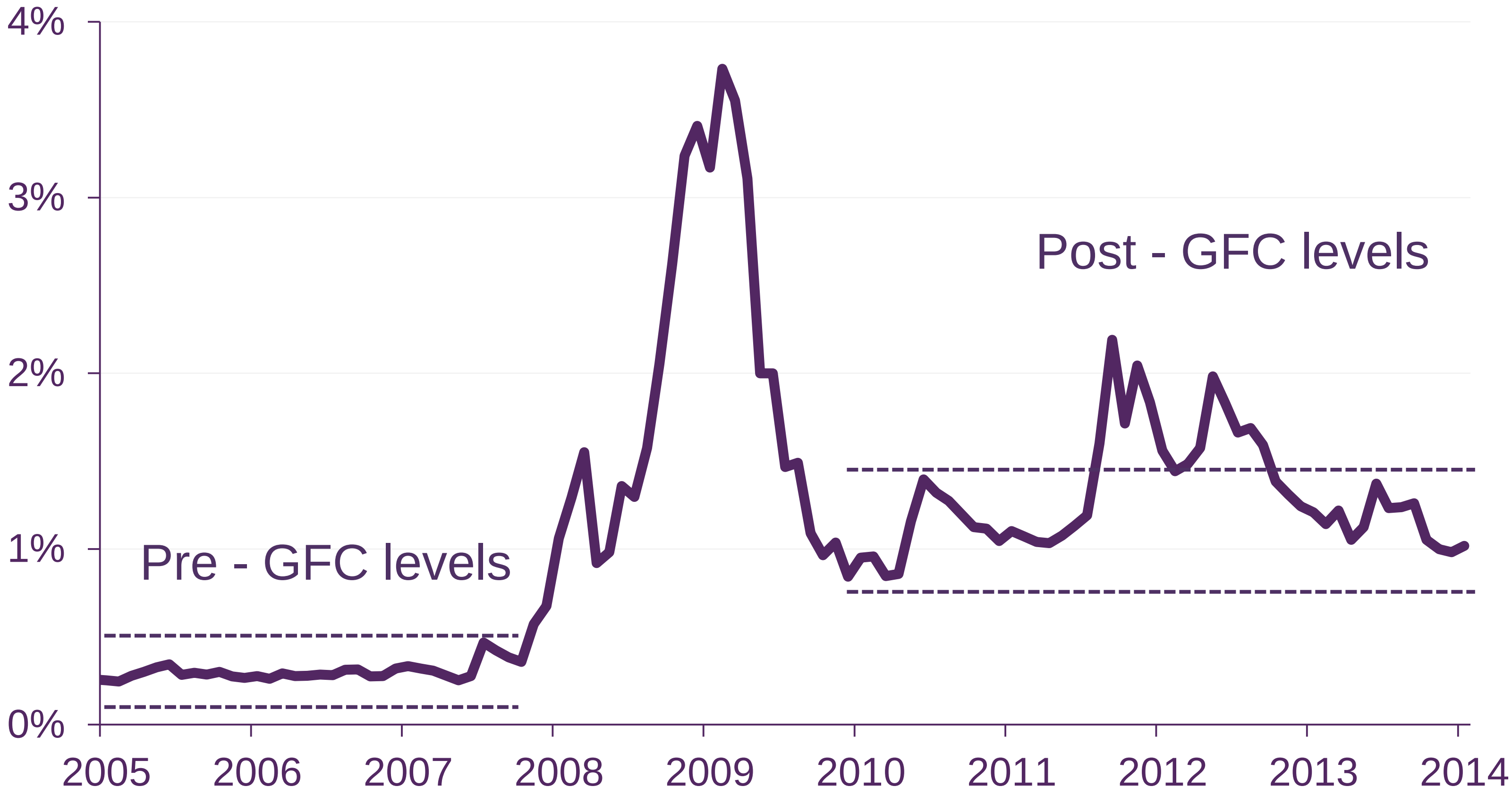
Source: Bloomberg

Australian Government bond yields



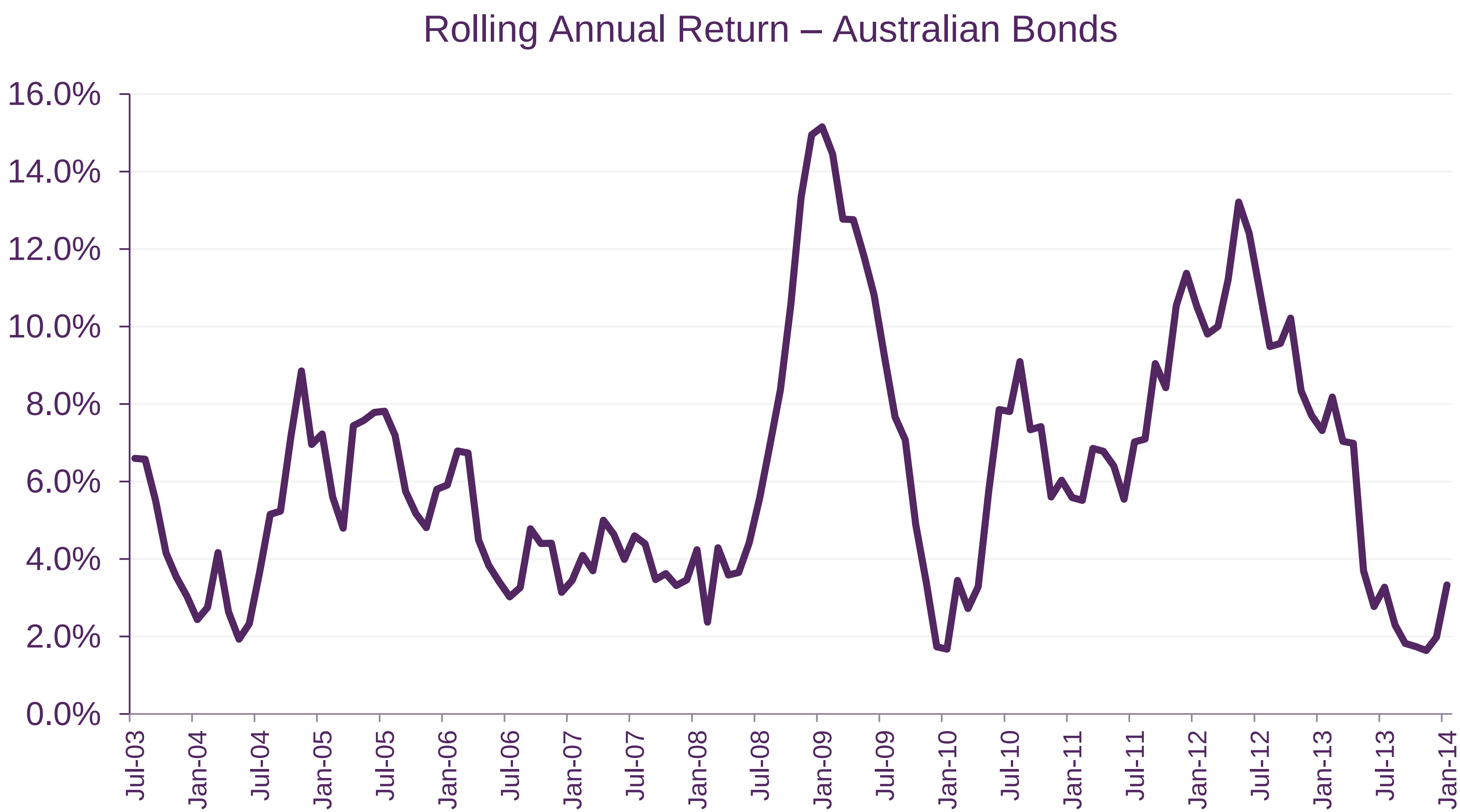
Source: Bloomberg

Australian Investment Grade Credit Spreads



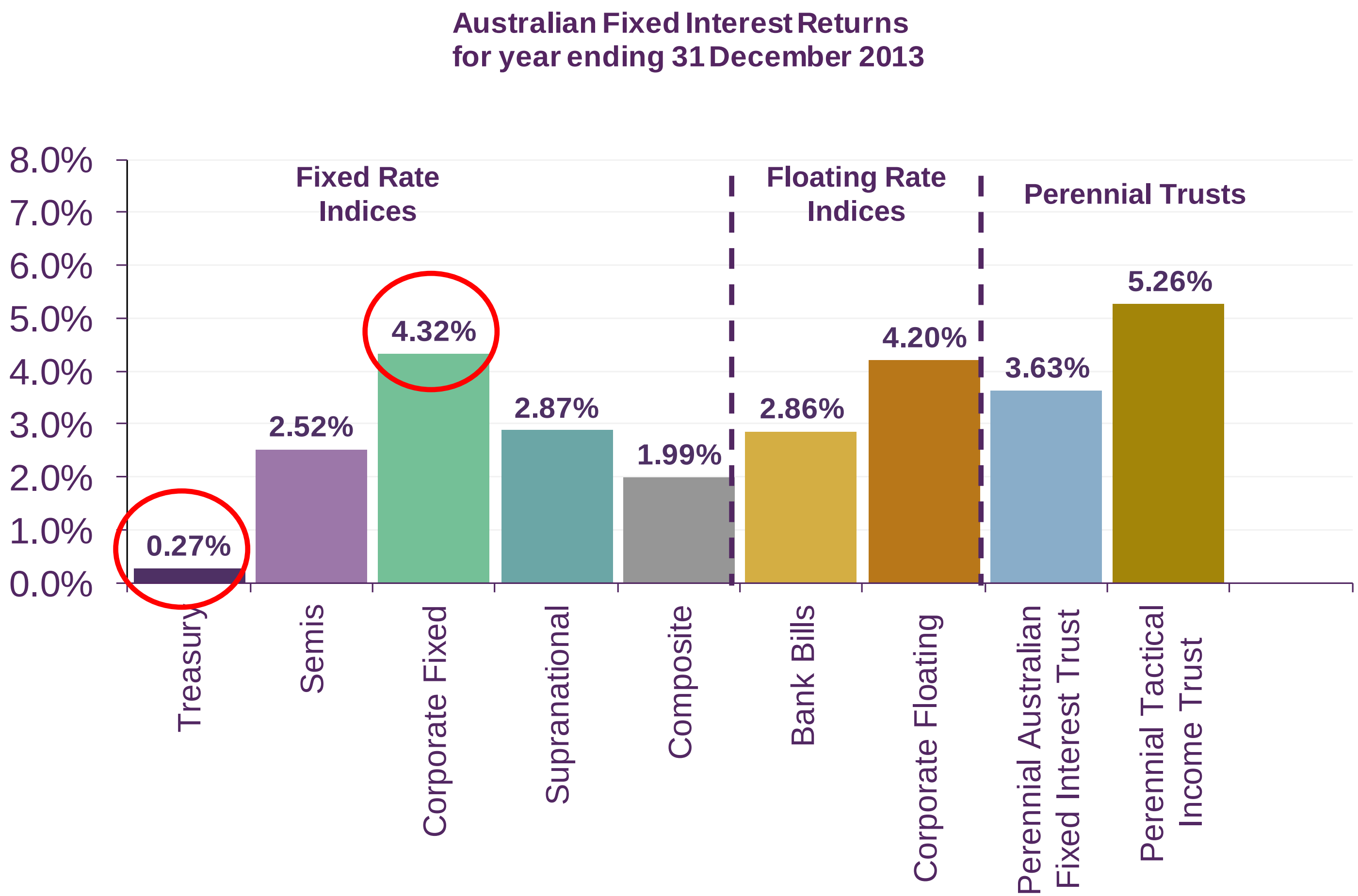
Source: Bloomberg. Data to 31 January 2014.

Fixed Interest Returns



Source: Perennial. UBS Composite Bond Index (0+ years) returns shown.

Fixed Interest Returns



Source: UBS, Perennial

How risky are bonds in the current environment?

- The macroeconomic environment in 2014
- The relationship between the RBA cash rate and bond yields
- Yield curve – how much does it protect against rising yields?

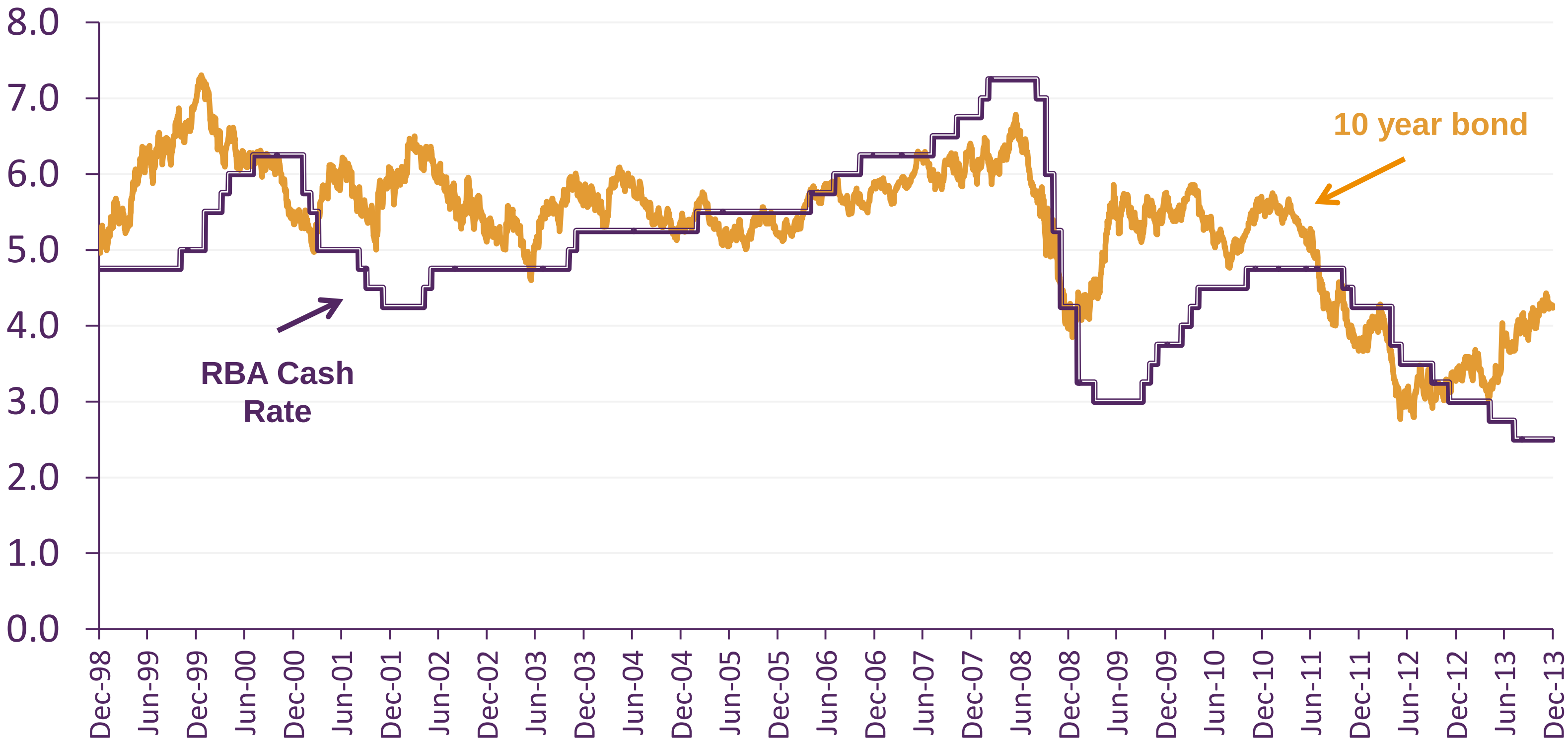
The current environment

- Subdued growth outlook as the mining investment cycle rolls over
- Structurally lower credit growth
- Unemployment likely to be edging higher
- Inflation contained in the RBA's target range of 2-3%
- Housing and consumer spending responding to easy monetary policy

Implications for interest rates:

- The cash rate will remain at around its current level for an extended period
- The neutral cash rate is well below the level that prevailed over the pre GFC period
- Yield curves therefore do not need to be as steep as in the past
- In our view, a significant part of the rise in bond yields has already occurred

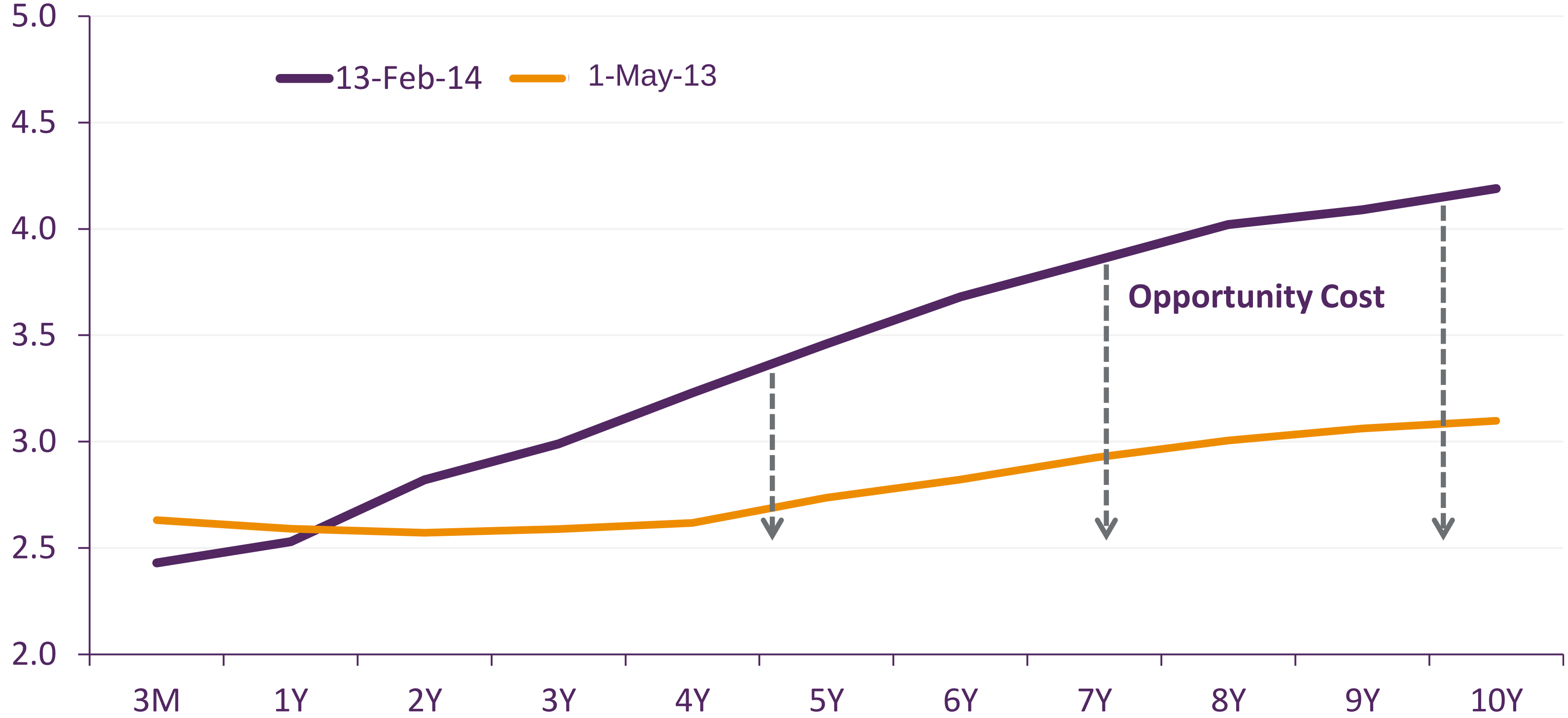
The relationship between the RBA cash rate and bonds



- Bond yields rise / fall well in advance of changes in the stance of monetary policy
- Typically much of the change is fully priced before changes to the RBA cash rate occur

Source: Bloomberg

Yield curve slope



- The yield curve has steepened materially since mid 2013
- The slope of the yield curve represents the opportunity cost of preferring cash over bonds
- A steeper curve helps to protect investors should bonds rise further

Source: Bloomberg

A steep yield curve protects against rising yields

	Bond type	Government	Semi-Govt.	AA Rated Major Bank	A Rated Industrial	A Rated Property Trust
Option 1	1 year rate	2.52%	2.75%	3.05%	3.20%	3.70%
Option 2	5 year rate	3.46%	3.82%	4.55%	4.60%	5.00%
	4 year rate 1 year forward	3.72%	4.11%	4.95%	4.98%	5.35%
	Holding Period Return	2.52%	2.75%	3.05%	3.20%	3.70%
1 year holding period	Change in Yield	26bps	29bps	40bps	38bps	35bps
Option 3	**10 year rate**	4.05%	4.60%	5.60%	5.70%	6.00%
	9 year rate 1 year forward	4.34%	5.00%	5.99%	6.05%	6.33%
	Holding Period Return	2.52%	2.75%	3.05%	3.20%	3.70%
	Change in Yield	29bps	35bps	39bps	36bps	33bps

For illustrative purposes only. Yields estimates shown for representative bonds as at February 2014.

WHERE ARE FIXED INTEREST RETURNS HEADING?

Key investment views

Interest Rates

- Cash rates to remain at current levels during 2014, with monetary tightening to commence during 2015
- After rising sharply during H2 2013 we expect bond yields to remain reasonably stable over 2014
- The longer term trend is for yields to rise modestly further but this is reflected in forward pricing
- Returns from bonds will steadily rise, driven by higher income returns and a reduced impact from adverse yield movements

Credit

- The rally in credit margins is largely over
- Credit and state government securities can still perform relatively well by virtue of the higher yields they offer
- The listed high yield / hybrid sector offers the prospect of attractive income and capital stability

Return Matrix

Bond Yields \ Credit Spreads	-0.50%	-0.25%	0.00%	0.25%	0.50%
0.50%	2.42%	2.29%	2.16%	2.04%	1.92%
0.25%	3.43%	3.31%	3.17%	3.05%	2.93%
0.00%	4.43%	4.27%	4.18%	4.06%	3.94%
-0.25%	5.45%	5.32%	5.19%	5.07%	4.94%
-0.50%	6.45%	6.33%	6.20%	6.01%	5.95%

Best guess **Predicted Range** **Possible**

Returns reflect estimates for the Perennial Fixed Interest Trust based on portfolio as at 31 December 2013

PERENNIAL FIXED INTEREST

Reasons for a core allocation to Fixed Interest

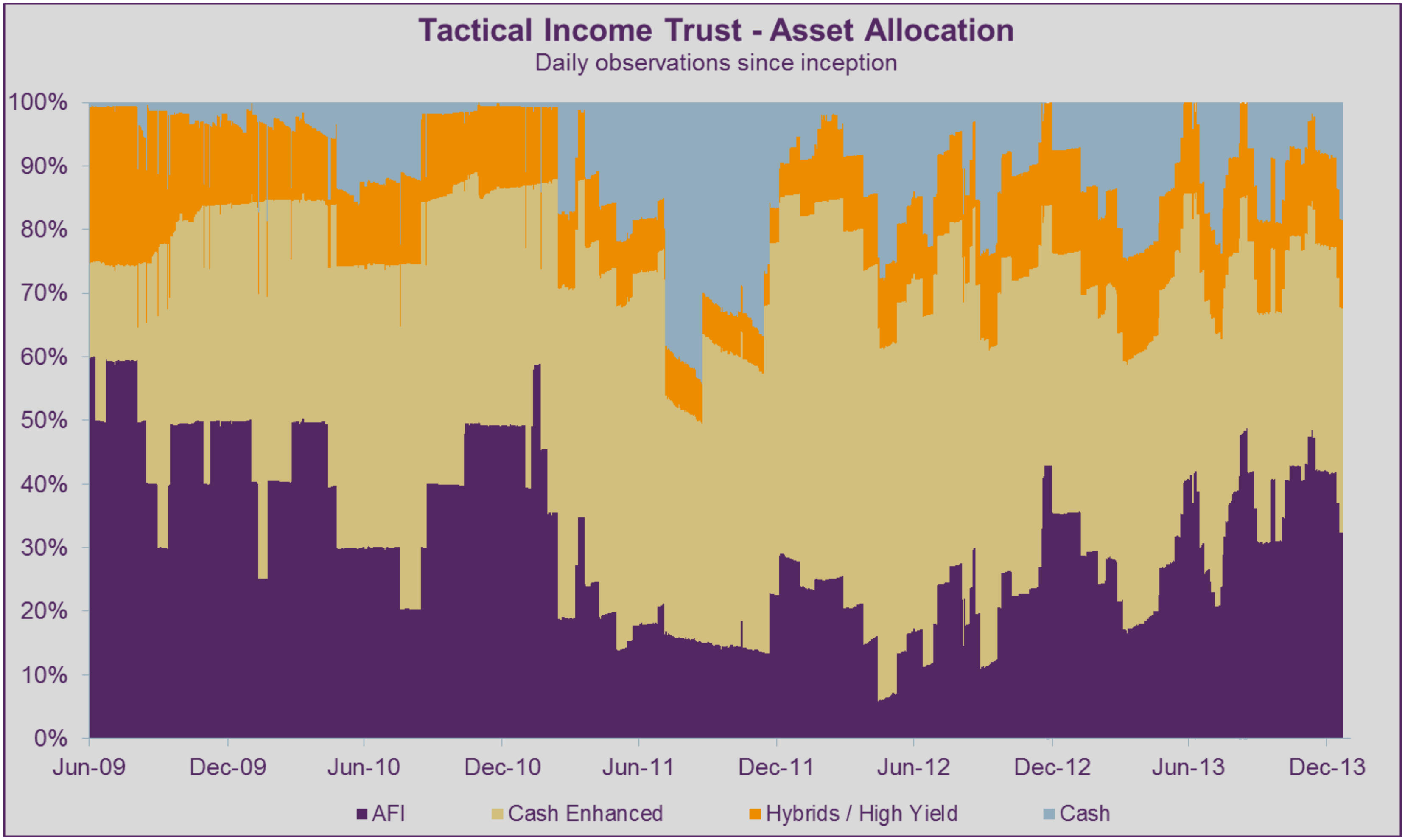
- The only truly “defensive” asset class – diversify equity risk
- The rise in bond yields that occurred over 2013 has enhanced the defensive attributes of bonds
- Higher income than cash investments – steep yield curve
- Growth assets have performed strongly over recent years
- Sensible risk management becomes even more relevant following a period of strong returns

STRATEGY UPDATE – PERENNIAL TACTICAL INCOME TRUST

Perennial Tactical Income Trust - Investment Strategy

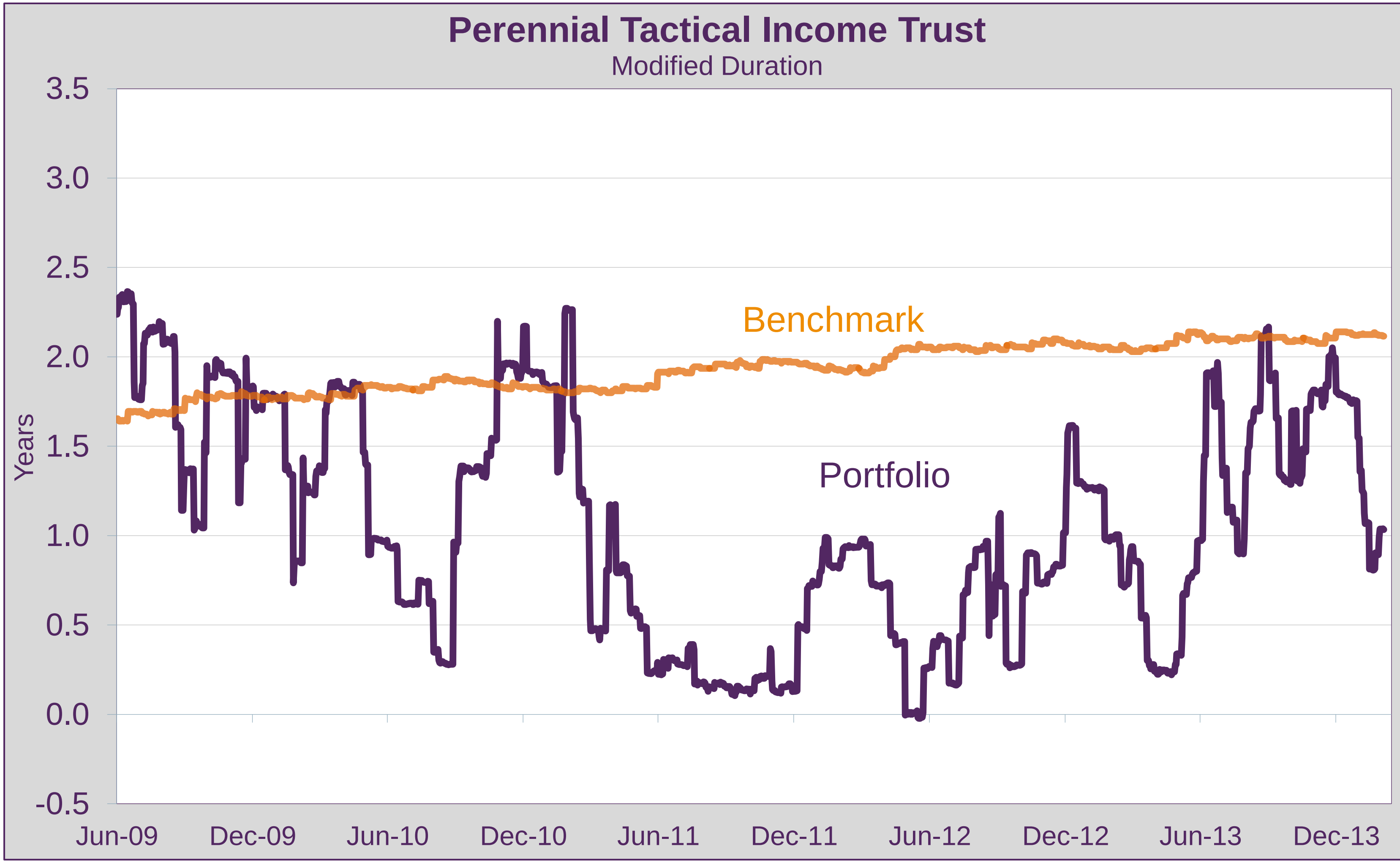
- Maintain a higher allocation to fixed interest going forward reflecting the current ‘fair value’ status of bonds
- But it is too early to consider moving aggressively overweight fixed interest
- Adopt a more cautious approach to credit investments with a bias to lower exposure to this sector upon any further spread tightening
- Maintain current exposure to the high yield sector

Perennial Tactical Income Trust - Asset allocation



Source: Perennial

Interest rate risk - modified duration

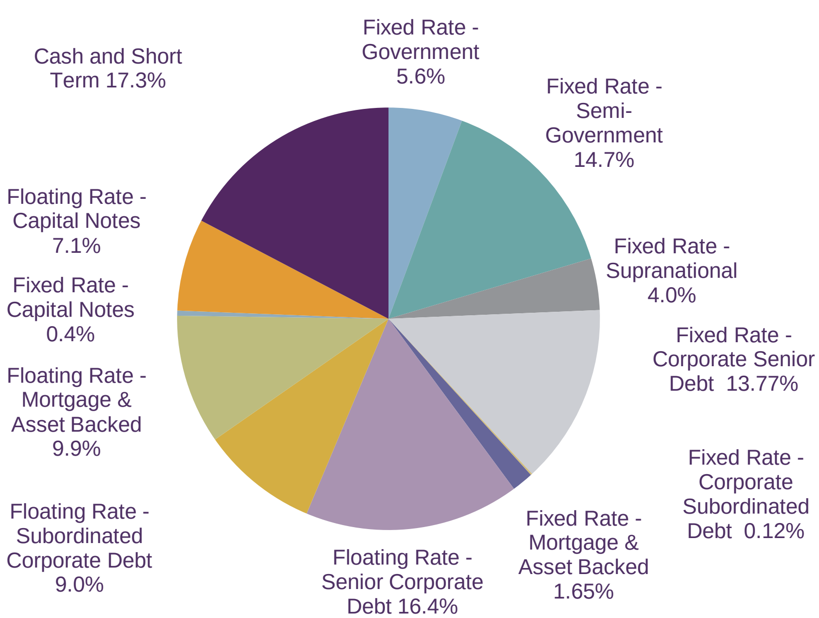


Source: Perennial

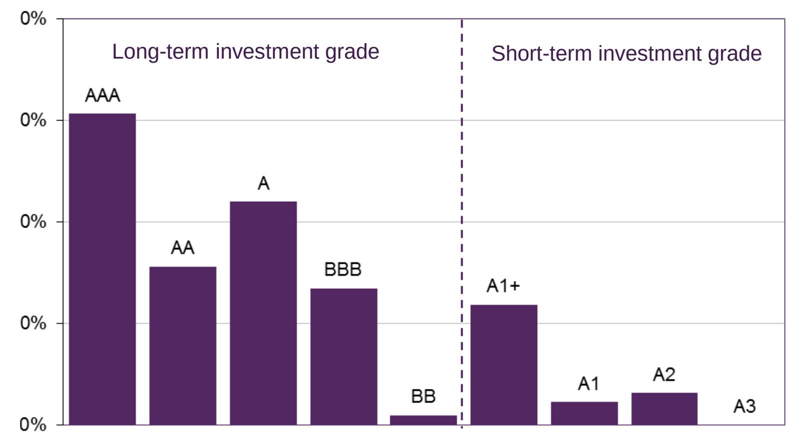
Perennial Tactical Income Trust

Date:	31 January 2014		
Credit Quality:	A-	Estimated Portfolio yield:	4.04%
Portfolio Modified Duration	0.82 years	Index yield:	3.06%
Index Modified Duration:	2.12 years	Number of Securities:	278

Asset Allocation



Credit rating distribution



Source: Perennial. Information is for the Perennial Tactical Income Trust.

Perennial Tactical Income Trust Performance

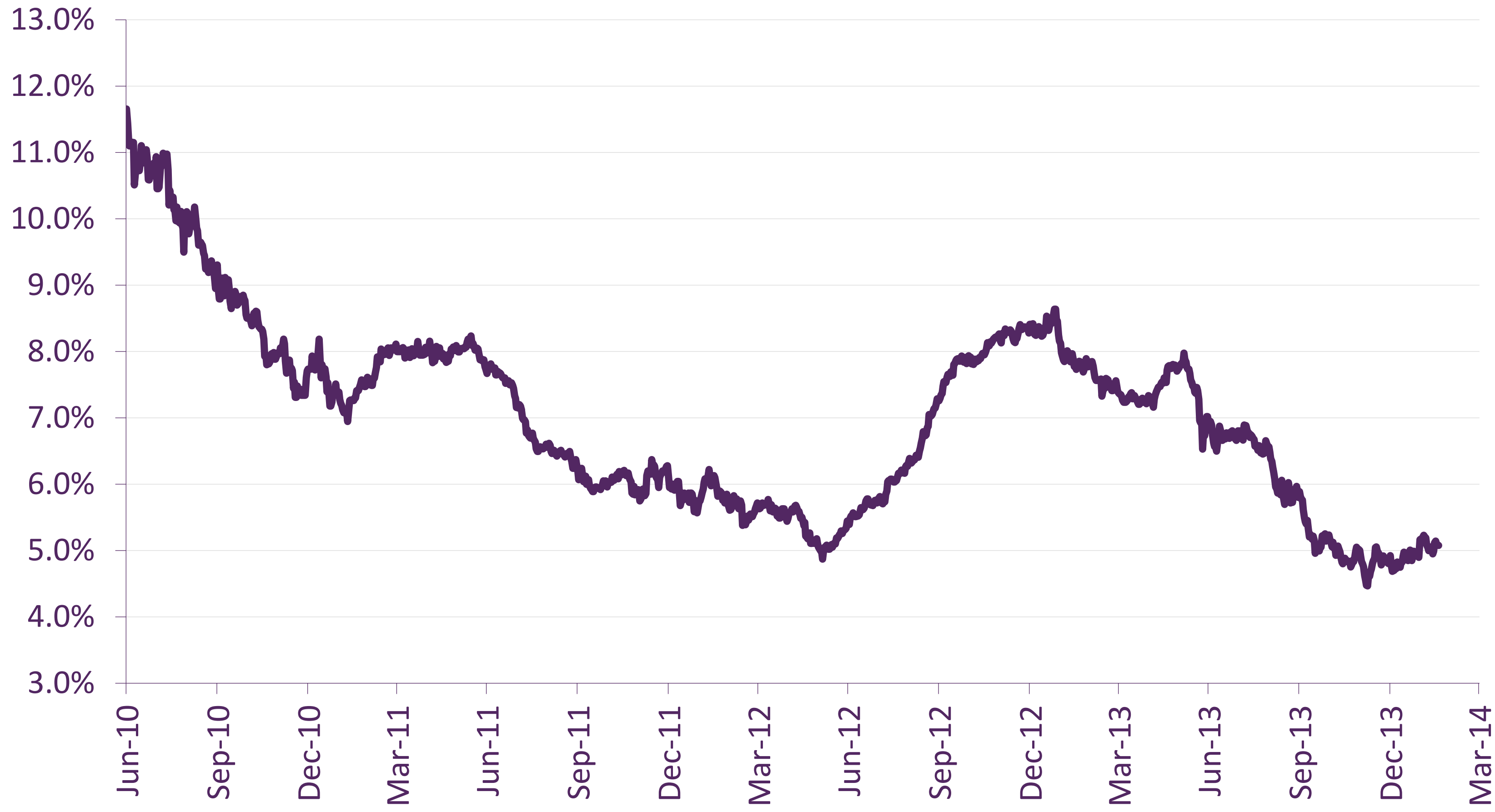
Performance Target: Benchmark + 1.0% p.a. over rolling 3 years (gross)

For period ending: 31 December 2013

	Three Months (%)	One Year (%)	Two Years (% p.a.)	Three Years (% p.a.)	Since inception (% p.a.)
Perennial Tactical Income Trust	1.24	5.26	7.06	6.85	8.11
50% UBS Composite Bond Index / 50% UBS Bank Bill Index	0.51	2.43	4.12	5.45	5.32
Excess	0.73	2.83	2.94	1.40	2.79

Source: Perennial Investment Partners. Performance shown is for the Perennial Tactical Income Trust. Inception date is 30 June 2009. Past performance is not a reliable indicator of future performance. Gross performance (shown) does not include any applicable management fees.

Perennial Tactical Income Trust rolling annual returns



Source: Perennial. Data to 31 January 2014.

In summary

- Consider fixed interest investments from the perspective of the role they play in a diversified portfolio, rather than short term return expectations
- Bond yields typically rise well in advance of the RBA cash rate
- Steep yield curves help to protect investors should yields rise further
- It is far from certain that bond yields will keep rising
- Bond returns are expected to improve modestly over 2014
- Bonds can still outperform cash investments in a rising yield environment

Disclaimer

- Investment Manager: Perennial Investment Partners Limited ABN 59 087 901 620, AFSL No. 238763 (“Perennial”). Perennial Value Management Limited ABN 22 090 879 904, AFSL No. 247293. Perennial Fixed Interest Partners Pty Limited ABN 35 099 336 357, Perennial Growth Management Pty Limited ABN 41 099 336 384 and Perennial Real Estate Investments Pty Limited ABN 35 117 913 685 are Subsidiaries and Authorised Representatives of Perennial. Responsible Entity: IOOF Investment Management Limited ABN 53 006 695 021, AFSL No. 230524.

- Whilst every effort has been made to ensure that the information in this presentation is accurate; its accuracy, reliability or completeness is not guaranteed. Perennial expressly advises that it shall not be liable in any way whatsoever for any loss or damage which may be suffered by any person relying upon such information or any opinion, analysis, recommendation or conclusion contained in this presentation or otherwise arising in connection with the content of, or any omission from, this presentation.

- The fact that particular securities may have been mentioned should not be interpreted as a recommendation to either buy, sell or hold those securities.

- The contents of this presentation were prepared for information purposes only. Accordingly, reliance should not be placed on this presentation as the basis for making an investment, financial or other decision. This information does not take into account your investment objectives, particular needs or financial situation.

- Investment in the Trusts must be accompanied by an application form. The current product disclosure statements, reference guides and application forms can be found on Perennial’s website www.perennial.net.au.