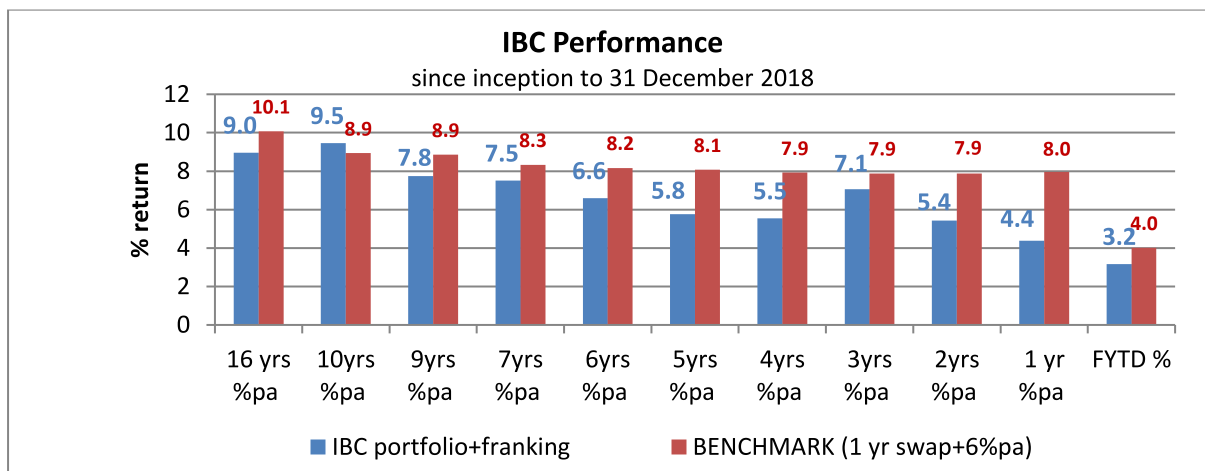
Investment Manager Report –half year to 31 December 2018

The manager's focus is to deliver consistent returns over market cycles with relatively low volatility and a high fully franked dividend yield from the portfolio. The portfolio successfully demonstrated its resilience to adverse market conditions over the six-month period by returning 3.2% or 10% above the sharemarket ASX Accumulation Index. The investment return objective is the 1 year swap rate plus 6%.

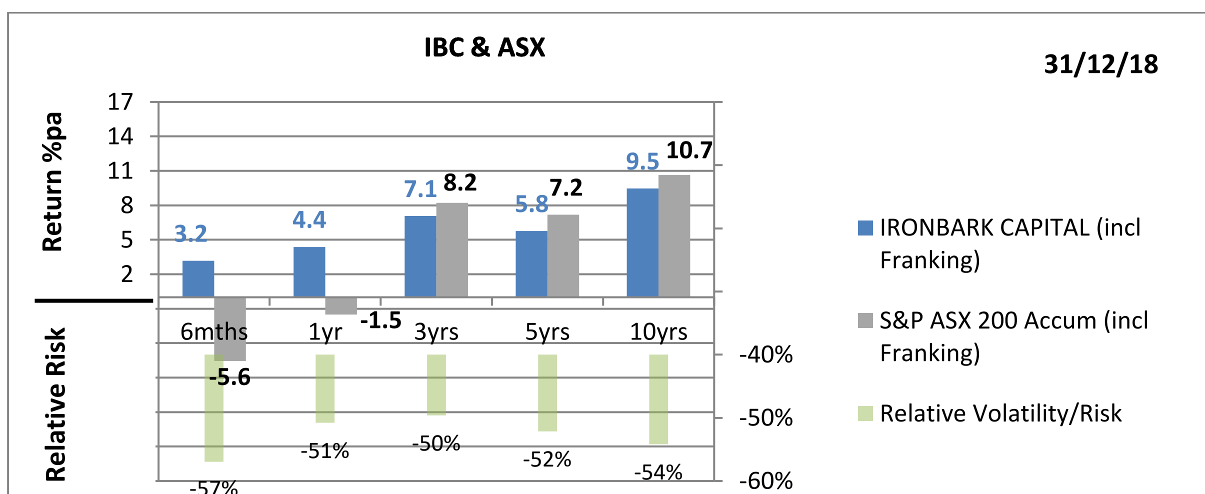
Performance measurement includes franking credits and option premium income. Franking credits are a significant source of return from IBC's hybrid investments and for shareholders. Option premium income is generated from buy & write activity and varies with market conditions. Over the half year period, realised option premium income was approximately $440,000. The calculation of the portfolio's current running yield of 7.4% excludes option income because realised option premiums are highly variable from year to year.

IBC recorded a portfolio return of 3.17% over the December half year period, underperforming its benchmark return of 4.01%, but delivered a sound result compared to the -6.8% decline in the ASX Accumulation Index. Since inception (16 years) including two years of the disastrous GFC, the portfolio achieved a return of 9.0%pa with risk measuring approximately 52% of equity market risk.



IBC's focus on income generation and capital preservation from a balanced portfolio structure coupled with active asset allocation has delivered superior risk adjusted returns compared to the equity market.

Over the 10-year period the portfolio's return was 9.5%pa with 54% less risk than the ASX200 Accumulation Index return of 10.7%pa (inclusive of franking credits). Over the past 1-year, a return of 4.4% was delivered with 51% less risk than the equities market that fell-1.5% (inclusive of franking credits) in the same period.



Portfolio

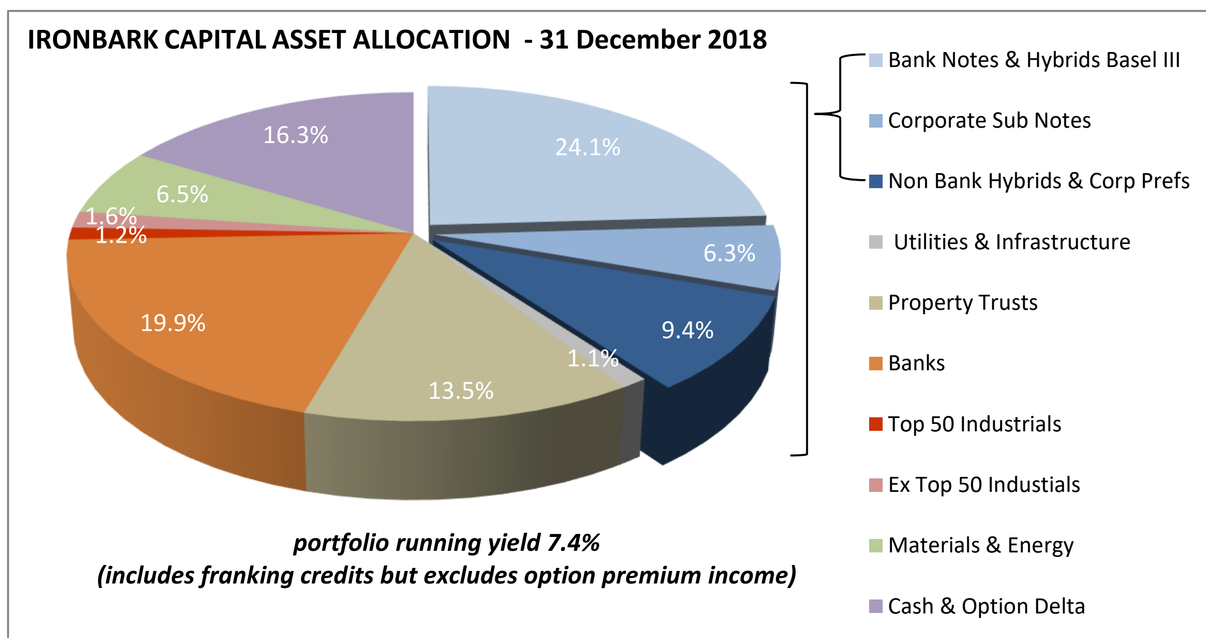
The portfolio is structured with an emphasis on income through yield orientated securities (hybrids and corporate bonds, utilities, property trusts) and buy & write positions in Banks, BHP, Telstra and other leading companies. The portfolio's running yield was 7.4% inclusive of franking credits but excluding option premium income.

The buy & write strategy involves buying selective shares and selling, subject to appropriate timing, call options over those shares. This strategy gives away some of the upside potential from a shareholding but generates option premium income consistent with the income emphasis of the portfolio.

The portfolio is diversified across 26 different entities. Higher risk exposures in banks, industrials and resources are largely held through buy & write option positions for income enhancement or added protection. The portfolio's hybrid and corporate bond holdings are mostly floating rate securities with little duration risk.

Approximately 40% of the portfolio was held in hybrids and corporate bonds and 28% in buy & writes in Banks, Telstra and BHP. The balance is represented by: property trusts 13.5%, mid-cap and small companies 1.6%, utilities 1.1% and cash & option delta 16.3%.

Asset allocation reflects a cautious stance.



Portfolio Performance-half year to 31 December 2018

The portfolio delivered a return of 3.17% for the 6 months to December from good security selection and defensive asset allocation.

Corporate credit and hybrid securities representing 40% of the portfolio outperformed the sector's 3.2% return. Hybrid securities performed well following the digestion of new issues by CBA and WBC. The market demand supply balance remains orderly with new issues largely replacement securities. CBAPC Perls VI and CWNHA notes were redeemed from the portfolio, and SVWPA (up 30%) was exited through a favourable conversion offer. The portfolio participated in the issue of unlisted Suncorp subordinate notes that replaced maturing listed SUNPD notes. The floating rate structures of corporate debt and hybrid securities continued to benefit from the bank bill reference rate trading over 50bps higher than the official cash rate.

The manager introduced unlisted investment grade corporate debt early in the year to improve diversity and better access to higher ranking capital in subordinate and senior notes. The unlisted market is very liquid, and the listed market is increasingly becoming concentrated with financial tier 1 hybrid securities.

New loss absorbing capital requirements were announced by APRA to increase bank capital by 4%-5% of risk weighted assets. This will largely be funded by new supply of Tier 2 subordinated notes. The proposed implementation date is 2023. The increase in capital is considered credit positive for the banks and for senior bonds supported by more lower ranking capital.

The equities market fell heavily during the period, down -6.83%, alongside substantial declines in major overseas markets. The portfolio's buy & write positions in BHP (up +3.6%), Telstra (up +11.6%) and the banks (down -7.8%) experienced mixed results and outperformed the ASX Index. The high physical weighting to BHP was maintained. BHP's performance was assisted by capital management returning US$10bn to shareholders via a buy back and special dividend.

The portfolio's holdings in property trusts outperformed the sector's steady return with corporate activity a feature. The portfolio exited Investa Office Fund and Folkestone under takeover bids.

Cash exposure (including option delta) was 16% at the end of the period reflecting the manager's cautious outlook.