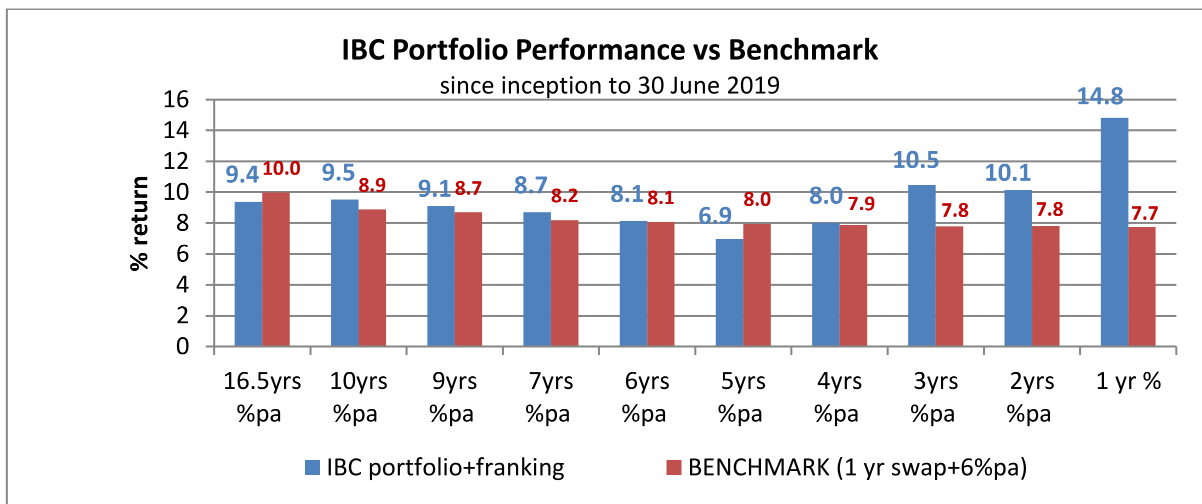
Investment Manager Report –financial year to 30 June 2019

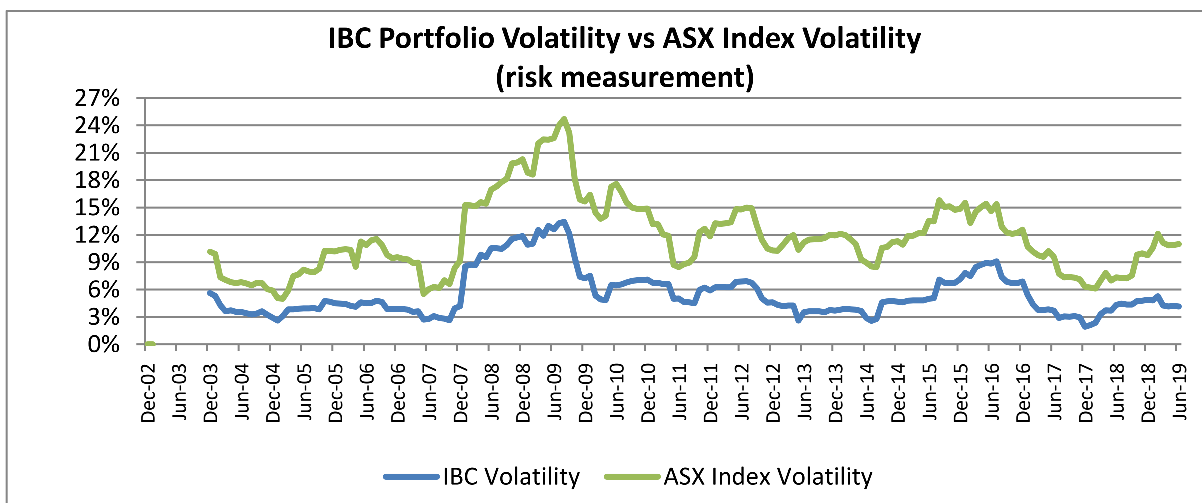
The manager's focus is to deliver consistent returns and a high fully franked dividend yield from the portfolio. IBC's performance benchmark is the 1-year swap rate plus 6% per annum.

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 financial year, realised option premium income was approximately $395,000. The calculation of the portfolio's current running yield of 6.6% excludes option income because realised option premiums are highly variable from year to year.

IBC recorded a portfolio return of 14.8% over the financial year outperforming its benchmark return of 7.7%. Since inception, over 16.5 years including two years of the GFC, the portfolio achieved a return of 9.4%pa with risk measured in terms of volatility approximately 52% of equity market risk.



IBC's focus on income generation and capital preservation from a balanced portfolio structure has delivered superior risk adjusted returns compared to the equities market. Over the 10 year period the portfolio's return was 9.5%pa with 55% less risk than the ASX200 Accumulation Index return of 11.7%pa (inclusive of franking credits). In the most recent year, a return of 14.8% was delivered with 62% less risk than the equities market return of 13.1% (inclusive of franking credits).



Portfolio

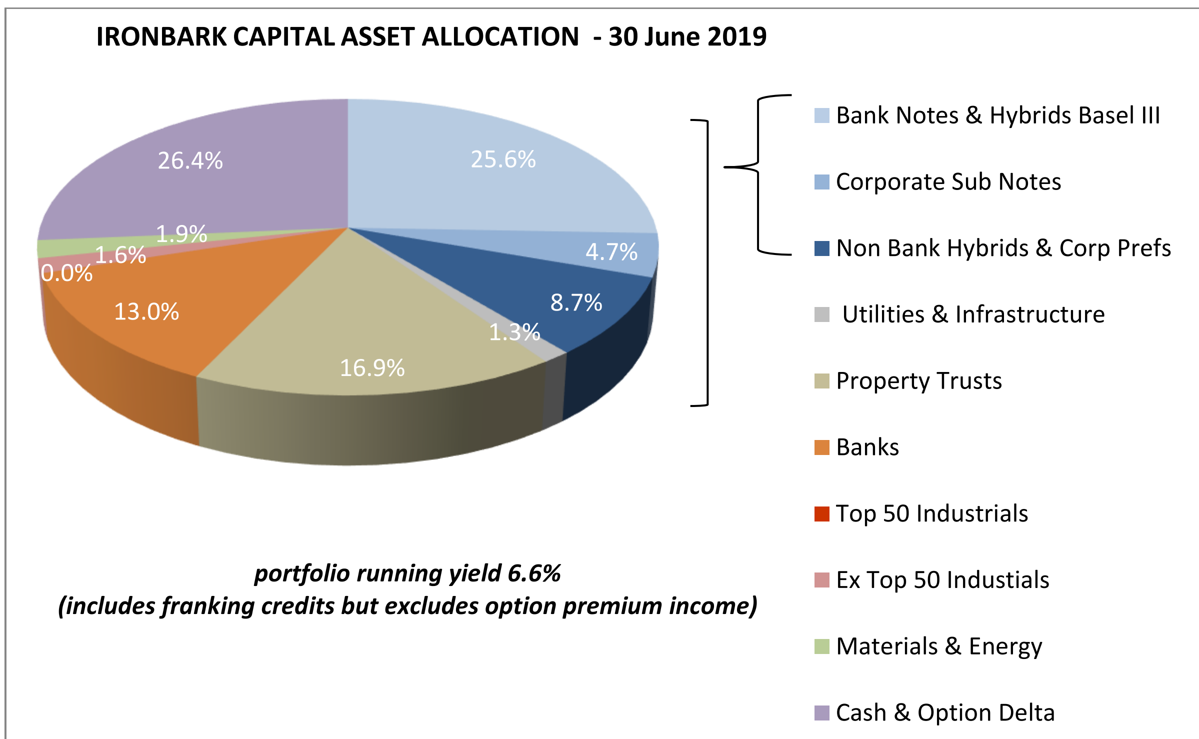
The portfolio is structured with an emphasis on income through yield orientated securities (hybrids and corporate bonds, utilities, property trusts) and buy & write positions in Banks, BHP, Telstra and other leading companies. The portfolio's running yield was 6.6% inclusive of franking credits but excluding 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 22 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 39% of the portfolio was held in hybrids and corporate bonds and 14.9% in buy & writes in Banks, Telstra and BHP. The balance was represented by: 16.9% in property trusts, 1.6% in mid-cap and small companies, 1.3% in utilities and 26.4% held in cash & option delta.

Asset allocation reflects a cautious stance.



Portfolio Performance-financial year to 30 June 2019

The portfolio produced a return of 14.83% for the financial year.

The strong portfolio and market gains were driven by declining bond yields, RBA interest rate cuts, strong iron ore prices, LNP election victory, and removal of the threat to abolish franking credit rebates.

Australian government 10-year bond yields fell to 1.33% from 2.64% recording the largest one-year decline in bond yields globally, effectively half the rate a year before. Bond markets have priced in further rate cuts by the RBA to a low of 0.5%-0.7% by mid-2020 and the 3-year bond yield declined to 0.96%.

The portfolio experienced solid returns from hybrids and corporate bonds (+8.7%) and strong performance from property trusts (+24.6%), buy & writes (+17.9% including franking credits) and utilities (+13.1%).

Hybrid performance lifted markedly following the election. The surprise LNP victory reinstated the value of franking credits to super funds in pension mode. The outlook for new hybrid supply looks tight and the high margins are attracting yield investors despite the fall in the bank bill reference rate. The average 5-year major bank Basel III hybrid margin fell from 3.55% to 2.85% over the year.

Bank subordinated debt issuance, on the other hand, is expected to rise dramatically from APRA increasing the major banks loss absorbing capital requirements by 3% by 2024. Banks are expected to satisfy the increase through issuance of around $50bn of tier 2 subordinated debt, compared to the existing market size of $40bn. There will be a corresponding reduction in senior notes, which rallied on the announcement. The cost to banks will reflect the wider spread differential of about 100bps between sub debt and senior debt. S&P raised the credit outlook from negative to stable for the major banks following the APRA announcement and election result.

The portfolio participated in several property trust placements lifting the property weighting to 17% from 13%. Other major changes were a reduction in bank exposure to 13% from 21% and an increase in cash exposure (includes options delta) to 26% from 13%.