DAINTREE CORE INCOME TRUST

QUARTERLY COMMENTARY

31 March 2018

Fund Description

The Daintree Core Income Trust (the Fund) is an absolute return, cash plus, investment grade bond strategy. The Fund is not constrained by any traditional fixed income index, which provides us the flexibility to seek out the best risk adjusted returns available across regions, sectors and securities.

Fund Objective

The aim of the Fund is to provide a steady stream of income and capital stability over the medium term by investing in a diversified portfolio of fixed income securities and cash. The Fund seeks to produce a return (net of fees) that exceeds the RBA Cash Rate by 1.50-2.00% p.a. over a rolling three year period.

Quarterly Highlights

- The highlight this quarter was the return of volatility to credit markets. Whilst credit spreads ended the quarter wider, the income earned from our assets more than offset this.
- By contrast, interest rate volatility remains low in Australia, and has only risen a little off a low base in the US. Yield curves have flattened sharply, with the Australian curve now at its flattest level since 2016.
- Other performance attributes were essentially flat for the quarter.

Key Statistics

Modified Duration (Yrs)	0.02
Spread Duration (Yrs)	3.79
Portfolio Yield (%)	3.43
Average Credit Quality	A+

Note: Portfolio yield is the expected return of the portfolio over the next year, assuming no changes to either portfolio composition or market yields

Fund facts

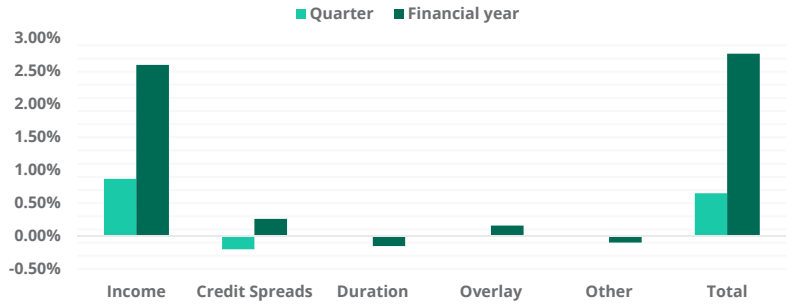
Trust name	Daintree Core Income Trust
Responsible Entity	Perennial Investment Management Ltd
Portfolio managers	Mark Mitchell & Justin Tyler
Inception date	5 June 2017
APIR code	WPC1963AU
Management costs	0.60% pa
Buy/sell spread	+0.05% / -0.05%
Entry and exit fees	None
Pricing frequency	Daily
Initial investment	$25,000
Distribution frequency	Monthly
Currency	Australian Dollar

Performance	Quarter (%)	Financial Year (%)
Performance After Fees (%)	0.50	2.31
RBA Cash Rate (%)	0.37	1.13
Relative Performance to RBA Cash Rate (%)	+0.13	+1.18
Performance Before Fees (%)	0.65	2.77
Distribution Return	0.45	1.26
Growth Return	0.20	1.51

Note: Fund inception is 5 June 2017

Returns for periods longer than one year are annualised. Distribution return is the monthly cents per unit distribution divided by the ex-distribution unit price at the start of the month. Past performance is not a reliable indicator of future performance.

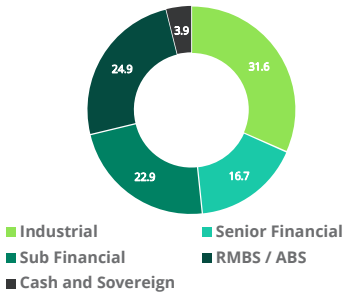
Performance Contribution (Pre Fees)



Note: Overlay strategies use derivatives to ensure that the fund exposure to interest rates, credit and other relevant factors is controlled separately to the physical assets in the portfolio

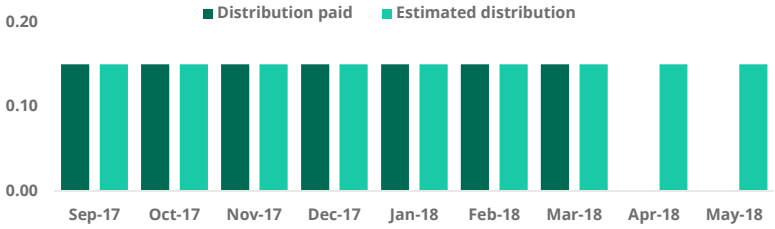
Rating Exposure (%)

Sector Exposure (%)



Income

The Fund distributed 0.15 cents per unit in March, in line with our estimate.



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Daintree CAPITAL

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Fund Review

The Daintree Core Income Trust (the Fund) posted a net return of 50 basis points for the quarter. Performance was assisted by the income from assets in the Fund, although wider credit spreads offset.

Fixed income markets were primarily driven by the US where the likelihood of fiscal stimulus and monetary policy tightening continue to put upward pressure on bond yields. Positive sentiment towards risk assets was also a feature early in the quarter, although this has faded in light of protectionism, the failure of volatility-based structured products in the US in February, and difficulties in the tech sector in March. Longer tenor government bond rates rallied through March as a result, although across the curve they remain solidly higher than they were at the December lows. Economic data disappointed expectations as well (particularly in the Eurozone, for example weak PMI data and French weak consumer spending) and this added to the impetus for lower yields.

Credit markets remained resilient early in the quarter, rallying in January and remaining flat in February, before correcting meaningfully in March (and finishing the quarter slightly wider) amid worries about increasing funding spreads in the US. Market participants have been expecting, arguably even waiting for, a correction in credit spreads for some time now. The market has certainly been stretched after rallying steadily over the last couple of years. As most people would know, bonds are much less homogenous than equities. Certain types of securities can perform quite well while others struggle. The March correction in spreads was a good example of that dynamic. One of the better performing sectors was Australian residential mortgages, where secondary spreads hardly moved at all. Spreads on BBB-rated corporate securities with maturities less than five years performed well too, while by contrast longer maturities saw a reasonable move wider. Major bank senior bonds, which have higher credit ratings and are generally consider much safer investments, materially underperformed shorted-dated BBB corporates. Tier two bank capital securities also witnessed volatility before finishing the quarter marginally wider.

The backdrop for credit was undeniably a more difficult one than we have seen for some months. Despite this, protection of investor capital is paramount for us and in keeping with this, the Fund return for the month and the quarter was positive.

Outlook

The March quarter may well be remembered as the one where volatility returned to markets. Wider funding spreads have worried a broad range of market participants (in equity and bonds), but the monetary policy trajectory has not been meaningfully altered. Thus the flattening of the yield curve we talked about last quarter has continued with gradual expectations for tighter monetary policy coinciding with a flight to quality rally at the longer end of the curve. This is interesting, because increased volatility in financial markets most often leads to a bull steepening of government bond curves, as a flight to quality rally in bonds coincides with a reassessment of the monetary policy trajectory. Whilst we do expect that changes to the conventional monetary policy trajectory will be the main source of interest rate volatility in the coming months, the data flow will need to justify any such change and at least in the US, the outlook remains quite robust.

Whilst interest rate volatility has remained well-behaved, credit markets by contrast have been spooked by developments in funding markets. Whilst we think the reaction to funding spreads is a little overdone, this correction is nonetheless a healthy thing. It reminds participants that markets don't always rally, and that you can't just "set and forget" in fixed income. We are now neutral to mildly bearish on Australian credit spreads because whilst we are not quite back to the levels seen in 2005-2006, we are not terribly far off. Spreads may shake off this correction and continue to march tighter, but we believe there is limited room for significant further spread compression. The average A and BBB rated corporate paper is only trading about 20% above the 2005-2006 period average, which some would argue was far too low and not appropriately pricing risk.

Funding pressures in the US are also affecting local funding markets in Australia and New Zealand. In his comments post the April interest rate decision, however, Governor Lowe indicated little concern despite the fact that funding costs are likely to rise in at least a portion of the Australian economy. We remain alert to the risk that higher funding costs feed through to broader financial conditions, but our view at present is that they will not. As such we continue to focus on the gradual uplift in the Australian economy with a view to a hiking cycle beginning sometime in early 2019. Despite risk asset weakness commodity prices have remained resilient. Business and consumer confidence continue to improve, and a strong labour market continues to draw fresh participation that increases the size of the labour force. We still believe wage growth will be slow to accelerate though, because it will be associated with some weakness in employment. As a result, household income growth will be slow. Thus the consumer remains the key risk to the Australian economy, in contrast to New Zealand where household spending has increased by 4.3% YoY and was robust across all subsectors. In Australia, the sectoral composition of employment growth will be important in monitoring the extent to which increased wages growth comes at the expense of the current robust levels of employment growth the economy is experiencing. This interaction will in turn determine the extent to which the Australian consumer can regain the desire to spend that has now been missing for some time.

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