DAINTREE CORE INCOME TRUST

QUARTERLY COMMENTARY

30 June 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)	0.24
Spread Duration (Yrs)	3.64
Portfolio Yield (%)	3.51
Average Credit Quality	A+
Portfolio ESG score (MSCI)	A

Note: Portfolio yield is the expected return over the next year, assuming no changes to either portfolio composition or market yields. The Portfolio ESG score is the weighted average portfolio ESG rating based on Daintree Capital's application of MSCI data

Fund facts

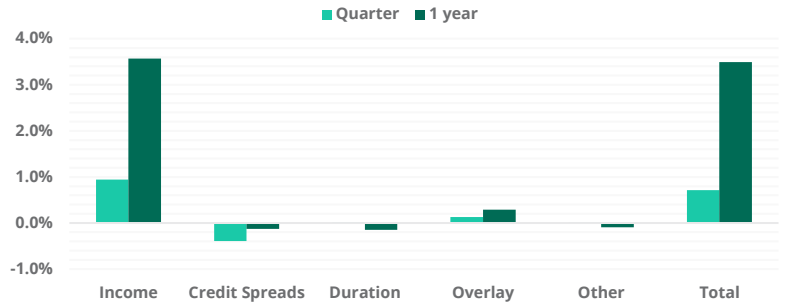
Trust name	Daintree Core Income Trust
Responsible Entity	Perennial Investment Management Ltd
Portfolio managers	Mark Mitchell & Justin Tyler
Inception date	5 June 2017
APIR code	WPC1963AU
Management costs	0.60% pa
Buy/sell spread	+0.05% / -0.05%
Entry and exit fees	None
Pricing frequency	Daily
Initial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

Performance	Quarter (%)	1 Year (%)
Performance After Fees (%)	0.56	2.88
RBA Cash Rate (%)	0.38	1.50
Relative Performance to RBA Cash Rate (%)	+0.18	+1.38
Performance Before Fees (%)	0.71	3.48
Distribution Return	1.57	2.84
Growth Return	-1.01	0.04

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.

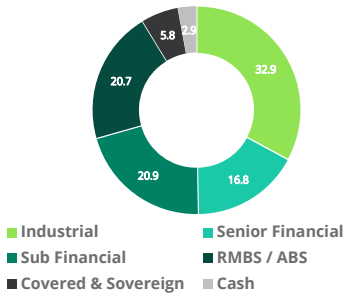
Performance Contribution (Pre Fees)



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

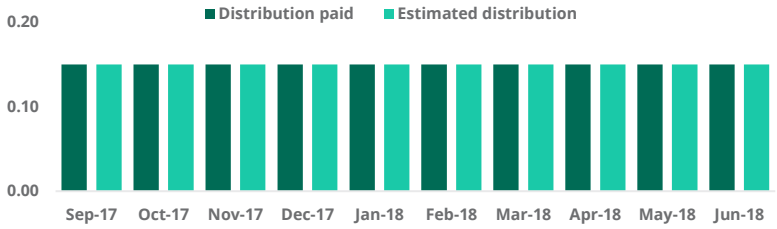
Rating Exposure (%)

Sector Exposure (%)



Cash income

The Fund distributed 0.15 cents per unit in June, 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 56 basis points for the quarter. Performance was assisted by the income from assets in the Fund, wider credit spreads detracted but a positive contribution from various overlay trades partially offset this.

Headline risks around trade and Italy severely limited the extent to which US yields moved higher over the quarter, even as the US Federal Reserve became a little more hawkish. Australian fixed income markets followed global developments for the most part, but the Australian 10 year bond ultimately ended the quarter slightly lower in yield despite the upward impetus to bond yields emanating from the US. Three local data points had an outsize influence on this performance differential: CPI data released in April, GDP data released in early June, and the May labour market data that was also released in June. The CPI data belied expectations of a long awaited pickup, and saw Australian bond outperformance that remained priced into markets for several weeks. Better than expected GDP data in early June saw this outperformance reversed for a short period, before the June labour market data saw some capitulation of views that the local labour market is gradually improving. The reality is that the unemployment rate has been stuck at around 5.5% for the entire quarter, wages are not yet showing signs of acceleration and the details of the June labour market data were weak. We expect no notable progress in the local labour market over the coming months and consequentially with wage increases still some time away, the Australian rates market has quite rightly outperformed. We see the RBA out of play until late in 2019.

Credit spreads continued their slow march wider during the June quarter, on the back of headline risks and in sympathy with offshore spread widening. It is worth noting that credit spread widening has been relatively controlled. Spreads are not falling off a cliff, but rather rolling slowly down a gentle sloping hill. Corporate and Financials both widened about or 8-9 basis points during the quarter, but have widened 4 and 15 basis points respectively year to date. Low levels of corporate paper issuance led to limited interest in selling stock, which saw Australian credits outperform global peers. Financial issuance on the other hand is running around the long term averages midway through the year.

Outlook

It is interesting to note the performance of the Australian corporate bond market in the context of both equity and sovereign bond market performance. Global equity markets have performed well (the ASX200 Accumulation Index rose almost 8.5% over the quarter) so it is clear that equity and credit markets have decoupled for now. But duration exposure has not been an effective hedge as credit markets have weakened. We believe that a withdrawal of liquidity from financial markets is a main driver of this dynamic. This takes several forms, including quantitative tightening in the US, higher US cash rates in the US, the ECB finishing QE later in the year (all of which limit the extent that sovereign bonds can outperform), and also reduced bank market-making capacity (which is a headwind for credit). While the ECB has noted that the deposit rate will remain low for some time in an effort to massage the market reaction to the end of the European QE programme, the unavoidable conclusion is that bond yields globally are headed higher and that the flow on effects of this are yet to be fully seen across global markets.

In the midst of this, Australia is somewhat of a fixed income safe haven. Renewed concerns about the labour market following the most recent figures have pushed local rate hike expectations further into the future. Thus Australian sovereign bond yields have outperformed global peers while Australian credit spreads have done likewise. We remain only mildly bearish on Australian credit spreads. We do acknowledge that downside risks are starting to build that would be realised if equity markets fall on the basis of geopolitical and trade risks, higher rates, or some other exogenous catalyst. For now though, we don't expect to see a further material widening in local credit spreads and our understanding from dealers is that the recent widening has not been driven by aggressive selling by long term holders. Despite clear risk factors, it remains difficult to define near term catalyst for significant credit spread contraction in the face of the ongoing imbalance between excess demand and a lack of supply of corporate paper.

These recent trends in market performance underline our core belief that in the current environment, the local market continues to offer some of the best relative value globally. A heavy reliance on interest rate exposure (a feature most of fixed income products that are benchmarked to an index) is, however, not a sensible portfolio construction decision because the Australian market will ultimately follow the global lead. A fund that chases income from local or global credit, without giving serious thought to protecting capital when credit underperforms, is not going to serve investors well either. The Daintree Capital Core Income Trust addresses these deficiencies, continuing to deliver positive monthly returns and protecting investor capital in increasingly volatile markets.

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