MILFORD

Milford Investment Funds Monthly Review
January 2020

# Market and Economic Review

December saw share markets extend the strong run they have been on since the start of 2019. The uncertainty of trade wars and Brexit has subsided, and investors expect global economic growth and company profits to pick up. Most Milford funds posted gains in the month, capping a strong 12-month performance across funds of all types.

Interest rates have been the major driver of asset prices in 2019 with global central banks cutting interest rates at the fastest pace since 2009. This has directly benefited bond investments and indirectly benefited shares as investors seek higher yielding assets – in many cases dividend yields remain well above interest rates.

This has been most evident in the performance of the NZ share market (NZX 50 Gross Index up 30.4% in 2019) although Australian and global share markets have also posted strong gains. The question facing investors in 2020 is what next?

Although economic growth is expected to improve, the rate of growth is likely to remain moderate. The cyclical areas of the economy such as manufacturing can improve meaningfully but the global consumer is largely spending at close to full potential. Government spending has room to increase but this faces either political hurdles, such as in Europe, or fiscal hurdles from the high levels of global government debt. Company profits are also unlikely to rise significantly as corporations face higher costs in the form of rising wages.

Interest rates around the world are unlikely to fall much further, and should growth be better than expected they could even rise - this would be a headwind to broad gains in share markets.

Finally, investors begin 2020 in a relatively optimistic state, meaning positives will be expected whilst negatives could come as a surprise. 2020 brings its fair share of catalysts, most notably the US election in November. Recent aggression by the US in Iran also reminds us that geopolitical tensions remain high.

Whilst we remain optimistic over the outlook, broad market gains like we saw in 2019 are unlikely to be repeated. Instead, opportunities will lie in active management - selecting the right sectors and companies to invest in.

## Conservative Fund

**Portfolio Manager: Paul Morris**

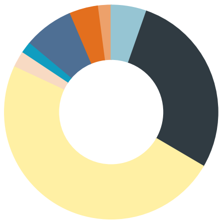
The Fund returned just 0.03% in December but has delivered a strong 1-year return of 9.5%.

During December the Fund's exposure to global corporate bonds and shares contributed positively to returns. Global shares performed well into year-end as a result of positive developments in US-China trade negotiations and the UK election result. Global corporate bonds outperformed some moderate weakness in government bond prices.

Australasian market returns were more mixed. NZ shares generated a positive return, with the Fund benefiting from gains in the retirement sector as a result of a takeover bid for Metlifecare. These positive returns were offset by a weak month for Australian shares and lower bond prices in both NZ and Australia as a result of higher market interest rates.

The Fund maintains slightly less defensive positioning relative to earlier in the year, but still with less shares than the long run neutral. The risk of a rise in market interest rates means we retain below long run neutral interest rate exposure. We remain cautiously optimistic on the outlook for returns, underpinned by accommodative central bank monetary policy and an improving economic outlook. We do, however, reiterate that the price gains already posted by bonds and shares mean the recent moderation in Fund returns may continue in the near term.

**Actual investment mix [1]**



- Cash and Cash Equivalents 5.39%
- New Zealand Fixed Interest 28.05%
- International Fixed Interest 48.48%
- New Zealand Equities 2.41%
- Australian Equities 1.73%
- International Equities 7.52%
- Listed Property 4.34%
- Other* 2.08%

## Diversified Income Fund

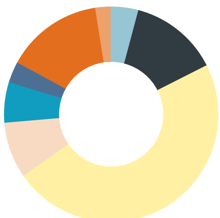
**Portfolio Manager: David Lewis**

The Fund generated a modest 0.3% return in December, capping off a strong year (+14.1%). Returns were mixed this month across key asset classes with gains in NZ shares and global high yield bonds offset by declines in Australasian bonds and Australian shares.

Performance highlights in the share portfolio this month included NZ retirement companies Arvida (+19.7%) and Summerset (+15.6%), which rose following a foreign takeover bid for listed peer Metlifecare. Meridian Energy (+6.2%) and Charter Hall Group (+4.2%) were also higher with both benefiting from strong earnings momentum. On the negative side, Goodman Group (-8.8%) and Charter Hall Social Infrastructure REIT (-5.2%) were lower amidst a weak month for the Australian listed property sector.

In fixed income, our holdings of European and particularly UK bank capital securities performed well this month as the conclusive UK election result brought greater certainty on Brexit and broader economic policy. Finally, the Fund also benefited modestly from a tactically higher exposure to the strong NZ dollar.

In portfolio activity, the Fund made five new investments in the US utility (water) and railroad sectors, supported by research by new team member Dan Simmonds who has deep experience in these areas (see his bio here). These positions are modest in size at present with combined exposure at 1.6% of the Fund. Over time, we expect the Fund's exposure to international real estate, utility and infrastructure shares to grow to 5-10% of the Fund. As always, we will be actively managing these positions, and focussed on finding opportunities where the returns appear attractive relative to the risks, and relative to opportunities in other sectors where the Fund invests.



- Cash and Cash Equivalents 4.17%
- New Zealand Fixed Interest 13.40%
- International Fixed Interest 47.61%
- New Zealand Equities 8.46%
- Australian Equities 6.08%
- International Equities 3.16%
- Listed Property 14.63%
- Other* 2.49%

*Other includes currency derivatives used to manage foreign exchange risk.

[1]The actual investment mix incorporates the notional exposure value of equity derivatives and credit default swaps, where applicable.

# Balanced Fund

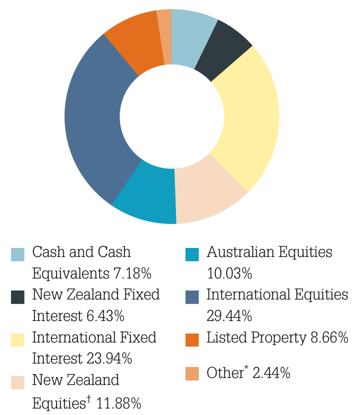
**Portfolio Manager: Mark Riggall**

The Fund returned 0.7% in December, with a strong 1-year return of 17.5%. Fund returns in 2019 were driven by a favourable starting point (after the share market falls of late 2018), economic weakness that was not as bad as feared and most significantly - meaningful falls in interest rates around the world. For the Balanced Fund this benefited share and bond portfolios with both contributing positively to the returns last year.

Active positioning around currency exposure contributed meaningfully to performance in December and the strong performance of global shares was the main contributor to the Fund's return in the month. The size of the return last year is unlikely to be repeated over the next 12 months. Broad and uniform market gains will be unlikely, with volatility in both directions becoming the norm. We are also likely to see greater rotation under the surface as the outlook for different types of companies changes.

Consequently, the Fund will be relying on active management and particularly stock selection within the underlying Milford funds to drive returns going forward. Even though returns from markets are expected to be lower, the backdrop for investing remains favourable with improving growth and low interest rates, therefore the Fund remains fully invested.

**Actual investment mix [1]**




# Active Growth Fund

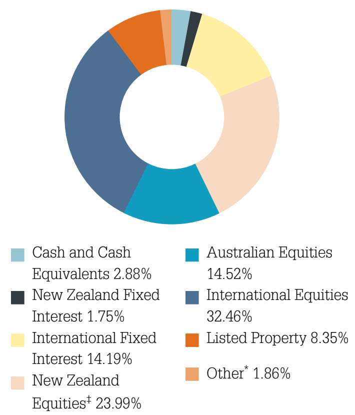
**Portfolio Manager: Jonathan Windust**

The Fund rose 1.0% in December and 20.6% for 2019. During the month global shares rose 2.3% benefiting from reduced uncertainty after a strong election win by the Conservative Party in the UK and progress on trade between China and the US.

Key performers included NZ retirement village companies: Arvida (+19.7%), Metlifecare (+17.0%) and Summerset (+15.6%). Retirement villages rose following a takeover for Metlifecare for $7.00 a share, a 38% premium to the price before the initial approach was announced. Given reduced risks the Fund increased its holdings in shares during the month. In particular we added to UK bank Virgin Money which we think is attractively valued and should benefit from greater certainty in the UK economy.

Looking into 2020 we believe shares remain attractive relative to low yields on cash and high rated fixed income investments. We believe economic growth, whilst not strong, should be broadly stable. After strong rises in 2019 the key headwind for shares is the starting point of relatively high valuations (particularly in NZ). Shares are also unlikely to receive further support from rate cuts in 2020 with most central banks on hold. The key risk for share markets is the resurfacing of political uncertainty and that growth and company earnings disappoint. Against this backdrop the investment team remains active to identify those companies which are attractively valued and which of them will exceed investor expectations.

*Please note this Fund is closed to new investors.*




†Includes unlisted equity holdings of 0.32% ‡Includes unlisted equity holdings of 2.14% *Other includes currency derivatives used to manage foreign exchange risk.
[1]The actual investment mix incorporates the notional exposure value of equity derivatives and credit default swaps, where applicable.

# Australian Absolute Growth Fund

**Portfolio Manager: William Curtayne & Wayne Gentle**

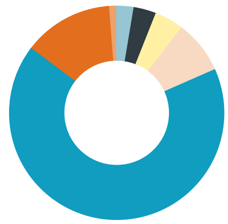
The Fund lost 0.9% ending a strong run of consecutive monthly gains.

The devastating Australian fires have been the most significant domestic event over the last month. There has been an enormous humanitarian and environmental impact on large parts of rural Australia which will have long lasting effects on many of those areas. From a wider Australian economic point of view, we may see a small impact on consumption as people appear to have travelled less over the break and many have donated to supporting charities. Prime Minister Scott Morrison's handling of the crisis has been poor, and his popularity has taken a hit which may see some political instability emerge this year.

However, none of this is substantial enough for us to change our strategy or positive view on Australian equities. On an individual stock basis, Sealink Travel Group may be impacted as it operates the ferry service to Kangaroo Island which has been severely impacted by the fires. The shares have sold off in January and we purchased more into this weakness.

The Fund is currently more fully positioned as we see the current environment as reasonably favourable for equities. We have a larger allocation to commodity and oil stocks which we expect to do well with a recovery in global growth prospects in 2020.

## Actual investment mix [1]



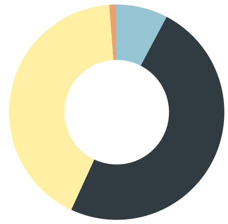

# Trans-Tasman Bond Fund

**Portfolio Manager: Paul Morris**

Improving growth expectations continue to push market interest rates higher, translating to lower bond prices and a disappointing Fund return of -0.7% in the month. The Fund is however up 5.9% over the past year as it benefited from the fall in market interest rates earlier in the year and outperformance of corporate bonds (its primary exposure) over governments.

During the month the Reserve Bank of New Zealand released its Bank Capital Review results which we deem constructive for NZ bank senior bonds. We have a similar view on Australian bank senior bonds. Therefore, we increased NZ and Australian senior bank exposure, primarily at the expense of NZ government bonds where fiscal stimulus may weigh on relative performance versus corporate bonds. Also of note was our participation in the new Synlait Milk subordinated notes issue.

December saw Australasian bonds, especially corporates, lag offshore peer performance. This increases their relative attractiveness and may provide some near-term support. That said, risks remain for a further adjustment higher in global and Australasian market interest rates. Therefore, Fund interest rate exposure remains slightly below neutral. Looking forward, the outlook is for moderate returns which, as evidenced by recent months, may be lower than last year given lower prevailing bond yields and less likelihood of another move lower in market interest rates.



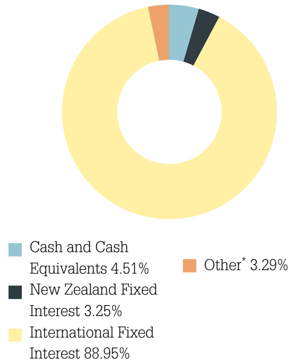

*Other includes currency derivatives used to manage foreign exchange risk.

[1] The actual investment mix incorporates the notional exposure value of equity derivatives and credit default swaps, where applicable.

# Global Corporate Bond Fund

**Portfolio Manager: Paul Morris**

**Actual investment mix [1]**




The Fund returned 0.3% in December and 8.8% over the past year.

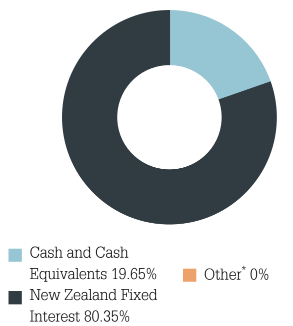
Developments in US-China trade negotiations and the UK election result underpinned outperformance in corporate bonds relative to moderate weakness in government bonds. It also led high yield bonds to outperform investment grade bonds.

The Fund has posted strong outperformance relative to its benchmark during 2019 but in December it lagged due to a combination of its larger Australian dollar bond exposure (which underperformed global peers) and a lower exposure to lower rated high yield bonds (which partially recovered recent underperformance). The exposure to Australian dollar bonds is primarily to global issuers. These bonds were already cheap versus those issuers' bonds in offshore currencies which should provide valuation support for retaining the exposure.

We are increasingly wary that elevated valuations in global corporate bonds versus government bonds does not adequately reflect their risk, however, we acknowledge accommodative monetary policy and an improving economic environment may underpin near term performance. Therefore, while we will take profit on the most expensive holdings, switching to more attractively priced alternatives, overall Fund settings will remain similar, i.e. slightly defensive positioning and an interest rate exposure slightly below neutral, given the risk remains for a further rise in market interest rates.

# Cash Fund

**Portfolio Manager: Paul Morris**




In December the Fund generated a return of 0.13%, in line with its objective to deliver a return in excess of the Reserve Bank of New Zealand (RBNZ) Official Cash Rate (OCR) after fees.

With the next OCR announcement not until February 2020, the OCR remained unchanged at 1.00%. The RBNZ has previously indicated that it expects the OCR will need to remain at low levels for "a prolonged time" but is ready to add further stimulus if needed.

Although the market remains moderately biased towards a further OCR cut, recent improvements in some NZ economic indicators have reduced expectations for further OCR cuts in 2020.

The portfolio management of the Fund remains focussed on maintaining its low risk strategy which is built on a diversified portfolio of cash, short dated debt securities and term deposits, so as to protect capital. We believe this should be an attractive, tax efficient (as a PIE vehicle), liquid (meaning investors have access to fund on request unlike term deposits) and low risk alternative to bank term deposits.

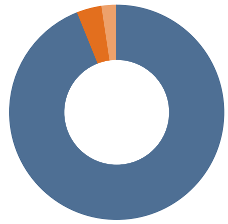
*Other includes currency derivatives used to manage foreign exchange risk.

[1] The actual investment mix incorporates the notional exposure value of equity derivatives and credit default swaps, where applicable.

# Global Equity Fund

**Portfolio Manager: Felix Fok**

### Actual investment mix [1]




The Fund climbed 0.7% in December, outperforming the market by 0.6%. The Fund is 50% exposed to major overseas currencies and during the month a strong NZ dollar offset gains from international shares.

Positive contributors included Freee (+61.3%), a Japanese cloud-based accounting/payroll software developer that listed in Tokyo last month. Freee has a similar business model to local champion Xero but is 100% focused on serving small and medium sized businesses in Japan. Growth prospects are attractive given low penetration rates of cloud-based accounting and payroll software in Japan.

EOG Resources (+18.1%) climbed as US crude oil inventories declined and investors bought into the sector which lagged in 2019. EOG is a best-in-class operator employing technology to make drilling and extraction more efficient in a still essential segment of the economy.

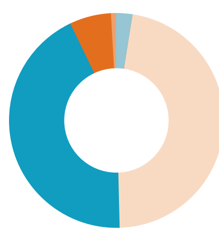
Detractors from performance included Constellation Software (-11.1%), a Toronto listed group that specialises in acquiring and managing a portfolio of software companies. Its low-key founder Mark Leonard has a long and successful track record executing a strategy of finding mission critical, industry specific software applications.

Pigeon (-20.4%) lowered guidance for its financial results. Despite strong demand for its nursing bottles and baby accessories in China, Pigeon's sales and distribution of products are being impacted by disruptions in Hong Kong. The Fund exited this position during the month.

Overall, the economic backdrop remains one of slow economic growth, but global central banks have responded with lower interest rates. The portfolio remains focused on our key investment themes and dominant companies.

# Trans-Tasman Equity Fund

**Portfolio Manager: Sam Trethewey & Wayne Gentle**




The Fund delivered a stellar 29.4% return in 2019. This return was driven by the tailwind of falling interest rates and good stock selection. December was mixed for local markets, the ASX 200 Accumulation Index fell 2.2% while the NZX 50 Gross Index rallied 1.5%, the Fund fell 0.2%.

Key winners in December included retirement village developer and operator Summerset (+15.6%) and Australian gold miner Northern Star Resources (+17.9%). Summerset rallied after the local retirement sector was buoyed by takeover activity in peer Metlifecare (+17.0%). The initial offer price of $6.50 was revealed in December, 28% above the share price prior to the announcement of the initial expression of interest in November. With a final offer of $7.00 now received and recommended by the Board, it is likely the NZ share market will lose another listed company in 2020. The Fund's minimal holding in Z Energy (-14.2%) was also beneficial relative to the index performance in December. The company downgraded earnings once again due to heightened industry competition. Over the month the Fund increased its holding in building materials exposure James Hardie Industries and oil exposure Woodside Petroleum while we took profits on Sydney Airport and Meridian Energy.

We are delighted with the Fund's return in 2019. However, while we are positive on the outlook for local share markets, we would caution that the 2019 return is unlikely to be repeated. We continue to focus on ensuring the Fund remains positioned in stocks offering attractive returns relative to their risk and away from stocks where we see downside risk to earnings or stretched valuations.

*Other includes currency derivatives used to manage foreign exchange risk.

[1]The actual investment mix incorporates the notional exposure value of equity derivatives and credit default swaps, where applicable.

# Dynamic Fund

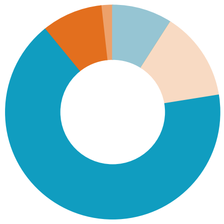
**Portfolio Manager: William Curtayne & Michael Higgins**

After what was a consistently volatile 12 months, 2019 was a strong year for the Fund having delivered a 27.3% return against the Small Ordinaries benchmark return of 21.5%. December provided a lacklustre conclusion down 0.6% for the month.

December performance was led by gold miner Northern Star Resources (+17.9%) which rallied post the highly accretive part-acquisition of the Western Australian Super Pit mine; payments company SmartPay (+24.4%) continued its strong run following the proposed sale of its highly valued and strategic NZ operations; and mortgage aggregator Australian Financial Group (+9.6%) rounded out our top performers for the month. Laggards included panel beating consolidator AMA Group (-27.8%) following a weak trading update citing lower volumes due to dry conditions and declining new car sales. We are confident these issues won't be ongoing. Credit Corp and Collins Food were weak on no specific news.

While our recent performance has been strong, the market remains volatile. We remain cognisant that we are in a period of elevated uncertainty with a broad range of potential market moving scenarios in play. While it is too early to position strongly for an upswing in global growth, with the trade truce and of course Brexit, we are cautiously optimistic into 2020.

**Actual investment mix [1]**




| Upcoming Distributions | Target | Payment Date |
|---|---|---|
| Conservative Fund | 0.5 cents (Quarterly) | 16/01/2020 |
| Diversified Income Fund | 1.1 cents (Quarterly) | 20/02/2020 |
| Trans-Tasman Bond Fund | 0.45 cents (Quarterly) | 19/03/2020 |
| Global Corporate Bond Fund | 0.45 cents (Quarterly) | 19/03/2020 |
| Trans-Tasman Equity Fund | 1.5 cents (Biannually) | 19/03/2020 |

*Other includes currency derivatives used to manage foreign exchange risk.

[1]The actual investment mix incorporates the notional exposure value of equity derivatives and credit default swaps, where applicable.

# Milford Investment Funds Monthly Review as at 31 December 2019

## Fund Performance

| | Past month | 1 year | 3 years (p.a.) | 5 years (p.a.) | Since Fund inception (p.a.) | Unit price $ | Fund size $ |
|---|---|---|---|---|---|---|---|
| **Multi-Asset Funds** | | | | | | | |
| Conservative Fund* | 0.03% | 9.52% | 6.86% | — | 6.72% | 1.1843 | 371.8 M |
| Diversified Income Fund* | 0.25% | 14.11% | 9.43% | 9.76% | 11.48% | 1.8238 | 2,456.5 M |
| Balanced Fund | 0.72% | 17.51% | 10.06% | 9.37% | 10.12% | 2.4660 | 791.9 M |
| Active Growth Fund# | 0.96% | 20.56% | 12.13% | 11.15% | 12.72% | 4.0486 | 1,182.6 M |
| Australian Absolute Growth Fund | -0.90% | 16.06% | — | — | 8.15% | 1.1514 | 185.4 M |
| **Cash and Fixed Income Funds** | | | | | | | |
| Trans-Tasman Bond Fund*^ | -0.67% | 5.92% | 5.19% | 4.87% | 5.52% | 1.1629 | 698.4 M |
| Global Corporate Bond Fund*^ | 0.31% | 8.78% | — | — | 5.24% | 1.0697 | 642.4 M |
| Cash Fund | 0.13% | — | — | — | — | 1.0154 | 48.0 M |
| **Equity Funds** | | | | | | | |
| Global Equity Fund† | 0.75% | 25.24% | 11.45% | 8.20% | 8.65% | 1.7306 | 651.3 M |
| Trans-Tasman Equity Fund* | -0.17% | 29.41% | 17.70% | 14.72% | 11.85% | 3.2194 | 461.2 M |
| Dynamic Fund | -0.63% | 27.31% | 13.44% | 12.88% | 13.31% | 2.1606 | 295.8 M |

For details of how investment performance is calculated, and returns at each PIR please see www.milfordasset.com/funds-performance/view-performance#tab-performance.
Performance figures are after total Fund charges have been deducted and at 0% PIR.
Please note past performance is not a guarantee of future returns.
Inception dates for the Funds: Active Growth Fund: 1 October 2007, Trans-Tasman Equity Fund: 1 October 2007, Balanced Fund: 1 April 2010, Diversified Income Fund: 1 April 2010, Global Equity Fund: 12 April 2013, Dynamic Fund: 1 October 2013, Trans-Tasman Bond Fund: 2 December 2013, Conservative Fund: 1 September 2015, Global Corporate Bond Fund: 1 February 2017, Australian Absolute Growth Fund: 1 March 2018, Cash Fund: 1 March 2019.
*Performance figures include the reinvestment of the Funds' distribution.
^Returns prior to 1 March 2018 are from when the Fund was previously offered to wholesale investors only and have been adjusted for current Fund charges.
†Returns prior to 1 October 2018 are from when the Fund was structured to achieve an absolute return.
#The Active Growth Fund is closed to new investors.

## Key Market Indices

| | Past month | 1 year | 3 years (p.a.) | 5 years (p.a.) | 7 years (p.a.) |
|---|---|---|---|---|---|
| S&P/NZX 50 Gross Index (with imputation credits) | 1.60% | 31.64% | 19.94% | 16.93% | 17.38% |
| S&P/ASX 200 Accumulation Index (AUD) | -2.17% | 23.40% | 10.26% | 8.97% | 10.02% |
| S&P/ASX 200 Accumulation Index (NZD) | -3.27% | 22.41% | 10.37% | 8.86% | 7.09% |
| MSCI World Index (local currency)* | 2.28% | 27.34% | 11.80% | 9.23% | 11.92% |
| MSCI World Index (NZD)* | -2.00% | 26.89% | 13.82% | 11.99% | 13.80% |
| S&P/NZX 90-Day Bank Bill Rate | 0.11% | 1.68% | 1.89% | 2.31% | 2.51% |
| Bloomberg Barclays Global Aggregate Bond (USD-Hedged) | -0.21% | 8.22% | 4.30% | 3.57% | 3.59% |
| S&P/NZX NZ Government Bond Index | -1.89% | 4.89% | 5.01% | 4.78% | 4.21% |

*With net dividends reinvested

# Top Security Holdings (as a percentage of the Fund's Net Asset Value)

## Multi-Asset Funds

| Conservative Fund | Diversified Income Fund | Balanced Fund | Active Growth Fund | Australian Absolute Growth Fund |
|---|---|---|---|---|
| Westpac 2.22% 2024 1.66% | Spark New Zealand 2.29% | Spark New Zealand 1.75% | Spark New Zealand 3.33% | BHP Group 6.08% |
| ANZ Bank Float 2024 1.53% | Contact Energy 1.63% | a2 Milk Company 1.57% | a2 Milk Company 3.29% | Woodside Petroleum 4.79% |
| ASB Bank 1.83% 2024 1.46% | Transurban Group 1.56% | Contact Energy 1.49% | Contact Energy 3.14% | National Australia Bank 3.40% |
| NZLGFA 1.5% 2029 1.43% | QBE 6.75% 2044 1.48% | Microsoft Corp 1.20% | iShares MSCI EAFE Min Vol ETF 2.61% | CSL 3.34% |
| Westpac 2.6% 2020 1.38% | Mirvac Group 1.37% | Alphabet 1.12% | EBOS Group 2.10% | Charter Hall Group 3.17% |
| Bank Of China 3% 2020 1.37% | Charter Hall Education Trust 1.13% | Visa 1.10% | Visa 1.90% | a2 Milk Company 2.67% |
| NAB Float 2024 1.37% | Bank of America 3.458% 2025 1.04% | Transurban Group 0.92% | Microsoft Corp 1.82% | Australian Finance Group 2.36% |
| Vector 3.45% 2025 1.21% | JPMorgan 1.09% 2027 1.03% | HDFC Bank 0.90% | Summerset Group Holdings 1.70% | Macquarie Group 2.36% |
| John Deere 1.75% 2024 1.21% | Aventus Retail Property 1.02% | Mastercard 0.90% | HCA Holdings 1.53% | Aristocrat Leisure 2.23% |
| ANZ Bank 3.03% 2024 1.06% | Kiwi Property Group 1.02% | Amazon 0.88% | Alphabet 1.51% | Santos 2.22% |

Note: Fixed interest securities are reported in the following format: Issuer name, interest (coupon) rate, maturity year, size of fund holding (as % of total portfolio).

## Cash and Fixed Income Funds

| Trans-Tasman Bond Fund | Global Corporate Bond Fund | Cash Fund |
|---|---|---|
| Westpac 2.22% 2024 3.23% | AT&T 3.45% 2023 2.11% | Auckland Airport CD 2020 6.75% |
| ANZ Bank Float 2024 3.15% | John Deere 1.75% 2024 2.02% | Kiwibank 2.1% 2020 6.47% |
| NZLGFA 1.5% 2029 3.14% | Kerry Group 0.625% 2029 1.88% | TSB Bank CD 2020 6.45% |
| ASB Bank 1.83% 2024 2.98% | Dell Float 2023 1.88% | Westpac CMD 2019 6.35% |
| NAB Float 2024 2.88% | Seagate 4.75% 2025 1.83% | Port of Tauranga CD 2020 6.24% |
| ANZ Bank 3.03% 2024 2.39% | McDonald's 3% 2024 1.78% | Fonterra CD 2020 6.23% |
| Housing NZ 3.36% 2025 1.86% | Downer Group 4.50% 2022 1.69% | Mercury CD 2020 6.23% |
| John Deere 1.75% 2024 1.86% | Sumitomo Mitsui Float 2022 1.69% | SBS Bank CD 2020 6.23% |
| ING Group 1.45% 2024 1.85% | QBE 6.75% 2044 1.54% | ANZ 2.14% 2020 5.63% |
| Synlait Milk 3.83% 2024 1.67% | Aroundtown 4.5% 2025 1.49% | Transpower CD 2020 4.99% |

Note: Fixed interest securities are reported in the following format: Issuer name, interest (coupon) rate, maturity year, size of fund holding (as % of total portfolio).

# Top Security Holdings (as a percentage of the Fund's Net Asset Value)

### Equity Funds

| Global Equity Fund | Trans-Tasman Equity Fund | Dynamic Fund |
|---|---|---|
| Microsoft Corp 3.78% | a2 Milk Company 7.85% | Credit Corp Group 3.58% |
| Alphabet 3.64% | Fisher & Paykel Healthcare 6.37% | Northern Star Resources 3.36% |
| Visa 3.33% | CSL 4.08% | Australian Finance Group 3.20% |
| Mastercard 3.32% | Spark New Zealand 3.61% | Seven Group Holdings 2.97% |
| Amazon 3.23% | Ryman Healthcare 3.60% | EML Payments 2.89% |
| HDFC Bank 2.98% | BHP Group 3.51% | Bapcor 2.85% |
| Apple 2.83% | Contact Energy 3.15% | IDP Education 2.77% |
| Taiwan Semiconductor 2.55% | Mainfreight 3.11% | EQT Holdings 2.61% |
| CME Group 2.50% | Auckland Airport 2.89% | Collins Foods 2.50% |
| Starbucks 2.33% | National Australia Bank 2.73% | EBOS Group 2.48% |

Note: Fixed interest securities are reported in the following format: Issuer name, interest (coupon) rate, maturity year, size of fund holding (as % of total portfolio).

**Milford and Milford staff have approximately $29.9 million invested across our Unit Trust PIE Funds as at the end of December 2019.**

**Michael Higgins**
Portfolio Manager

# Investment Highlight - Australian Financial Group

AFG is one of Australia's largest mortgage broking groups. It has been a core holding since early 2017 when the share price was around $1.20. While it's been a bumpy ride, AFG has now returned about 160% inclusive of 45 cents in dividends over two years and has been one of our best performing companies in 2019.

Our initial investment went against the grain at the time given lending commitments in Australia were losing momentum in what was the beginning of a sharp and expected correction. What interested us was the depressed valuation given the weak economic climate, 30% of the market cap was held in cash, the increasing penetration of mortgage brokers in Australia (50% at the time) and the earnings potential of the AFG Securities business.

It was smooth sailing over 2017/18 as the business generated strong cash and retained a healthy fully franked 8% dividend despite a weakening property market. However, in early February 2019 the Royal Commission announced a shock recommendation which proposed that the borrower, not the lender should pay the mortgage broker a fee for originating a home loan. The implications of this change were wide reaching. Not surprisingly, all major banks traded 5% higher on the day given the expected reduction in competition while mortgage brokers like AFG cratered 30% from $1.27 to $0.90.

Both political parties were blindsided by the rogue recommendation (along with us!). The Liberal party came out strongly in favour of brokers, rejecting the consumer pays model given the obvious implication of a reduction in competition. A week later, the Labor party also rejected the recommendation instead proposing a larger upfront fee for the broker instead of an upfront fee and trail commission.

After the public backing of brokers by both political parties, we took the opportunity to increase our stake. We identified that the Royal Commission would likely be a significant positive for brokers like AFG given tighter regulation. When the UK went through a similar review in April 2014, broker originated loans ballooned to about 80%, as applicants faced longer interrogations about income and expenditure to ensure they could repay their loans.

In the latest home loan channel survey in Australia, 6 out of 10 residential mortgages are now originated using a broker. During a recent refinance of my own 3-year-old family home loan, my bank didn't even respond when I inquired over email about refinancing to a better interest rate. When I engaged a broker, I had three rate offers from major banks within a week that were all sharper. The bank I ended up choosing was a major bank that also offered a $3,500 cash incentive payment to move!

Mortgage brokers increase choice and competition between lenders which in many cases lead to better service levels and competitive pricing. Like the UK experience, we think the shift towards mortgage brokers is likely to continue in Australia.

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