INVESTMENT UPDATE

RESPONSE TO MARKET VOLATILITY

Dear client,

As you are no doubt aware, investment market volatility has been steadily increasing over the past few months on the back of a range of concerns which we have previously discussed and provide an outline of below. The purpose of this note is to outline some of the reasons for this volatility and to reassure you that we are closely monitoring events and remain ready to act should we see a major deterioration in fundamentals.

How have major markets performed recently?

The table below provides an outline of the performance of major markets since the start of the year, as well as over longer periods. 2016 has seen a definite flight to quality, as riskier assets such as share markets struggle under the weight of uncertainty. This is an environment where bonds tend to be a safe haven for investors.

Total Returns	YTD	3m	1yr	3yr	5yr
S&P 500 Index	-4.96%	-6.19%	-0.67%	11.29%	10.90%
FTSE 100 Index	-2.49%	-3.83%	-6.52%	2.57%	4.47%
Shanghai Stock Exchange Composite Index	-22.65%	-19.05%	-13.38%	7.48%	2.09%
Brazil Stock Exchange Index	-6.79%	-15.86%	-17.72%	-13.56%	-10.33%
Nikkei 225	-7.95%	-6.86%	2.18%	18.81%	13.75%
S&P/ASX Accumulation 200 Index	-5.48%	-3.57%	-6.13%	5.45%	5.73%
S&P/ASX Small Ordinaries Index	-5.11%	-1.38%	3.59%	-1.43%	-3.10%
Brent Crude Futures Commodity	-6.81%	-30.91%	-35.38%	-33.33%	-19.46%
Iron Ore Spot Price Index	-4.61%	-18.18%	-35.51%	-34.98%	
BofA Merrill Lynch Global Government Index	2.26%	2.43%	3.49%	6.47%	7.71%
BBG Global HY Corp	-1.61%	-5.94%	-5.32%	-0.43%	3.58%

Source: Atrium, Bloomberg
Past performance is not a reliable indicator of future performance. Data as at 31 January 2016.

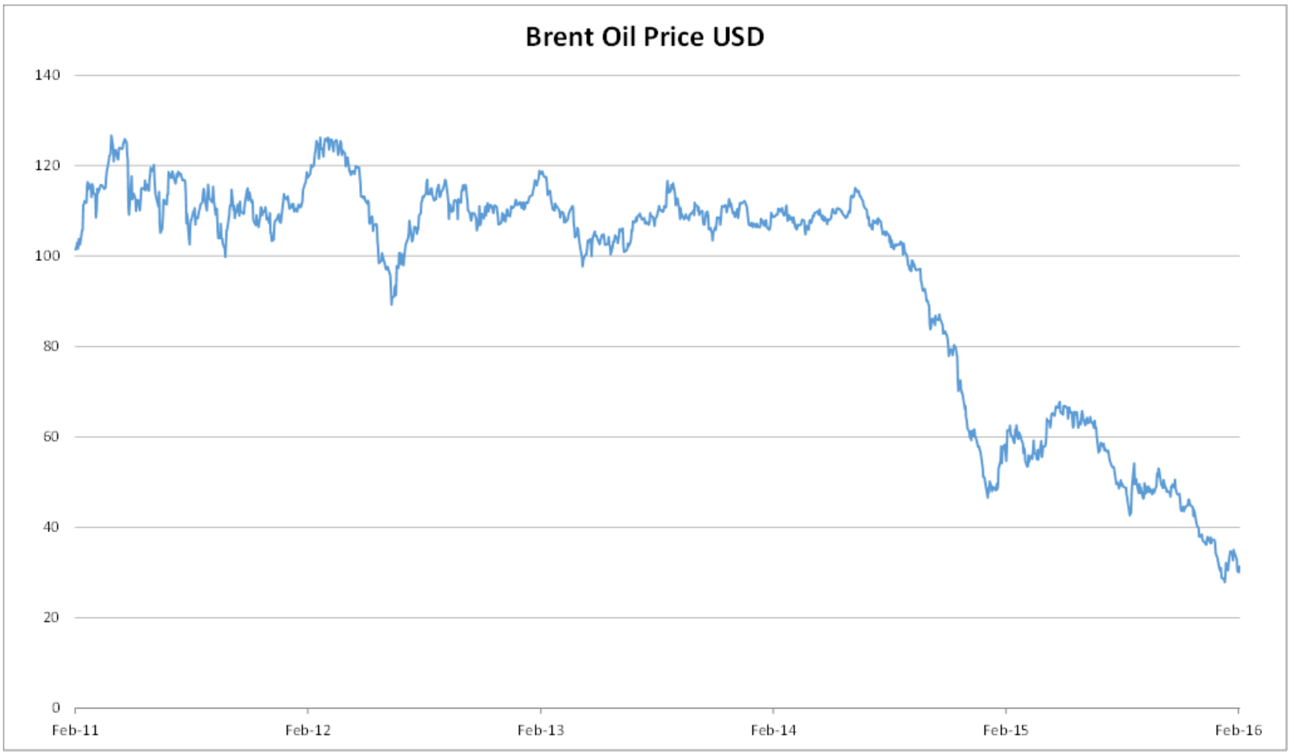
What is driving this daily volatility of large sell-offs, then major reversals?

As we highlighted in our 2016 Investment Outlook *(link below)*, there are a range of factors which are contributing to market uncertainty. This includes the slowdown in the Chinese economy, the likely speed of the lifting of US interest rates, a rising US dollar and the pressure on commodity markets such as Iron Ore & Coal and the sharp fall in the Oil price more recently.

http://www.fitz.com.au/wp-content/uploads/2016/02/160129_2016-Investment-Outlook_FTZ.pdf

What is specifically impacting the oil price and do we see the situation changing in the short term?

There are a range of factors impacting the oil price, but essentially this comes down to supply & demand economics. The steady increase in supply due to US/Canadian Shale Oil production has increased overall supply of oil, with a backlog of additional projects coming to production stage. OPEC and the Saudi's are not willing to cut supply as they have the lowest cost of production and don't want to lose market share. This is coupled with the trade barriers placed on Iran recently being released, which will add capacity/supply to the market. Slowing global growth and a slowing Chinese economy is also leading to overall lower demand for petroleum in the face of this increase in supply. We anticipate the current environment is likely to continue for the foreseeable future resulting in lower oil prices for an extended period of time. Ultimately this means continuing pressure on producers leading to lower company profits, reduced expansion plans, the closure of wells & ultimately lower supply. This could take some time to play out and we expect to see continued volatility in this space.



Source: Atrium, Bloomberg

What other factors are at play which are contributing to volatility and how concerning are these?

There is certainly a long list of things that are contributing to investor uncertainty. Here's a quick snapshot:

- Falling commodity prices: This is a function again of oversupply at a time of slowing demand, particularly out of China as well as a rising US Dollar story (commodities tend to be priced in USD).

- Devaluation of currencies: As central banks try to keep their economies competitive, devaluation of the currency can help export industries. However, market participants can also see this as sign of overall economic weakness – with general uncertainty around the potential for asset price deflation.

- US Economy and rate rises: The signs are still positive for the US economy, with employment numbers still relatively strong. However, the rate of growth is showing some signs of tapering which is concerning investors.

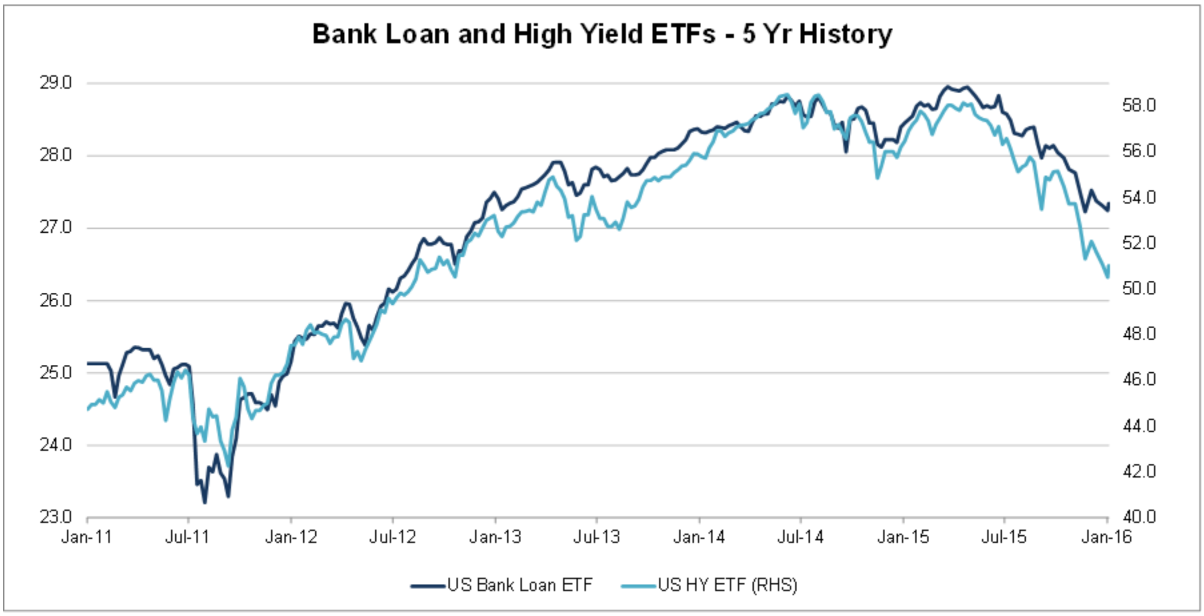
Given the market sell-off, do we believe shares are cheap or expensive in the current environment?

Given the recent sharp pullback in share prices being in excess of earnings revisions, equity markets do not look stretched on our current forecasts over the medium term. However we expect markets will remain volatile in the near term as earnings risks in our view remain skewed to the downside. We do not expect a 'profit recession' but are more of the view that expectations will be gradually tempered over the coming year reflecting lower revenue growth arising from weaker global economic growth. This means investors must be very selective in allocating capital to investments. That is, we are selecting assets based on their ability to maintain positive cashflow growth, underpinned by strong balance sheets. Given our outlook for weaker economic growth we continue to favour well run companies operating in sectors that have structural as opposed to cyclical drivers of growth.

As we continue to remind investors, we remain very negative on the outlook for cyclical businesses attached to commodity prices.

Why have the global credit markets sold off (especially the high yield market) and do we see this being a concern for investors?

The aforementioned pressures on commodity prices is placing particular pressure on the balance sheets of energy producers and resource companies in general. The US High Yield Index which includes a significant number of these types of businesses has had a sharp pull-back, with concerns as to whether this will lead to contagion into the banking sector (those who lend the money to these businesses). Investment grade corporate bond spreads have also widened, but certainly less than the levels seen in high yield markets. This for now suggests that investors are less concerned about the mainstream corporate/credit markets. The overall cost of borrowing remains much lower than the lead-up to the GFC. In addition, we are not seeing this spreading to the interbank lending market (LIBOR) with liquidity levels still reasonable.



Source: Atrium, Bloomberg

Do we believe this is the precursor to another 2008-style event?

In a word, no. The situation that led to the GFC was the bursting of a credit bubble that caused a liquidity crisis across the globe. This situation is very different. We don't believe that the current volatility in the oil price and the uncertainty of other factors is necessarily a precursor to a sustained major fall in markets (notwithstanding that markets are already down). We continue to expect that the overall story of a stronger US economy, a recovering European region and the stabilisation of growth in China will provide the backdrop for continued economic growth and company profits, albeit at a more modest rate than we had previously anticipated. The lower price of energy can act as a significant boost to company profits (for those who are heavy users of oil as a cost of production) as well as lower fuel costs at the bowser meaning more money in consumer's pockets. The main game continues to be the pace of rate rises in the US which we anticipate will be steady and over an extended period of time.

What portfolio changes are we undertaking to ensure our portfolios remain defensive in this environment?

We are comfortable with the diversification of assets (and risk factors) across our diversified portfolios. Our allocation to assets such as Alternatives that are not (or are very lowly) correlated with equity markets, remains at an elevated level within the portfolios and at a much higher level than the standard industry allocation. In recent times, the Alternatives allocation in our portfolios have provided strong defensive attributes and a positive contribution to portfolio returns over the past six-months when equity markets have experienced material declines. This outcome has assisted the Diversified portfolios to deliver healthy positive returns and significantly outperform the competitor universe over the past 12 months. The allocation to Alternative assets we expect will continue to be a key contributor to portfolio outcomes in the current economic environment and we are looking to bolster the asset base with new investments over forthcoming weeks. We have modestly increased our cash holdings and have been adding to other diversifiers such as Real Assets where allowed within the mandate.

Our focus on portfolio diversification, effective risk management and preservation of capital remains at the forefront of our investment approach. Our portfolios are positioned to manage through periods of elevated market volatility such as the current market environment.

Please feel free to contact us with any queries.

Regards,

Fitzpatricks

Important Information