ATRIUM INVESTMENT MANAGEMENT

Half Yearly Review
January 2017

One of the ongoing issues faced by anyone in the world of investment is how to deal with uncertainty. If we were to look back over the year of 2016, increased levels of uncertainty have become a feature across a number of different arenas on a global basis with a potential wide range of outcomes. The key questions we face as investors as we move into 2017 are both what the likely impact of any changes to the status quo will be on the global economy and investment markets, and how to manage portfolio risk in the resulting times of elevated uncertainty.

The first arena of uncertainty has been political (not typically a favoured topic for investment professionals). The western world saw two seismic and unexpected outcomes during the year. The UK took the initiative in late June, deciding through a referendum that an exit from the European Union would place the country in better stead. Across the pond, their American compatriots made a similarly surprising decision, by electing Donald Trump as the 45th President of the United States.

In both circumstances, the decision was a firm rejection of the status quo. Both decisions have the potential of very material impacts on the global trade of goods and services, immigration movements (which equates to work force potential) and capital flows. Whilst populist agendas rally against these variables seeking protection, the reality is that each can contribute meaningfully to greater economic prosperity. Unfortunately, short-termism impacts decision making in more than just investment markets!

This thematic may yet have further to play out in 2017, with both France and Germany returning to the federal electoral booths. The impact of this will take some time to understand, given Trump is only in the early days of his presidency and the UK is yet to formally commence negotiations with the EU relating to the nature of their post-divorce relationship and the terms of their access to the European single market (their largest trading partner!).

However, all of this will continue to unfold in the context of another major change. The US is leading the way in the early stages of normalising global monetary policy, shifting from its hugely expansive post crisis policy stance that resulted in interest rates at levels the world has never seen. With global central banks having spent nearing US$20 trillion in monetary stimulus in recent years (in an attempt to re-invigorate their economies), a question remains as to the impact low interest rates have had on distorting asset prices. Therefore, as interest rates head towards more normal levels (which they have already started to do in certain markets), the question remains as to the impact this will have on asset prices. A simple example is helpful to illustrate this. To what extent would Australian residential house prices be impacted if mortgage rates rose back toward more normalised levels, resulting in a 40% increase in interest payments? You would be brave to assume no impact!

These, amongst other key risks, are the issues we face moving into 2017. While uncertainty is always a reality of investing, there are elements of the current market environment that we believe are not being priced appropriately. Markets have generated strong returns for many years now and valuations are above historical averages in most asset classes.

What do we do when asset prices are already high and risks don’t seem to be fully appreciated? Being patient is key. The one thing that I never lose any confidence over is that opportunities always present themselves and we will be handsomely rewarded for exercising our patience. Over the past year as equity markets have moved higher, we have progressively increased our cash levels and our portfolios continue to hold low risk / highly liquid investments that will serve us well as opportunities present themselves.

Finally, it is important to touch on our recent investment returns. I was asked briefly if we were content with our achievements in 2016. Our answer is simple. When we don't exceed our investment objectives we are never content. However, being cognisant of market movements and our relative performance is important. Firstly, there is no client capital we manage with anything less than a 3 year time horizon and while we are aware of shorter-term performance metrics we remain firmly focussed on achieving our investment objectives over the appropriate timeframe. Further, we remain unconvinced in the short term exuberance being displayed by the markets at the moment and are comfortable holding cash as well other defensive assets in anticipation of opportunity. It is also important to point out that 2016 was the lowest return we have ever experienced out of our Alternatives portfolio – investments that seek to generate positive returns irrespective of equity market movements. Again we manage this component of the portfolio over a 3 year time frame and seek to have this component contributing strongly in 2017 as it has over the long term.

Kind Regards

Alex Hone

MARKETS AND MACRO

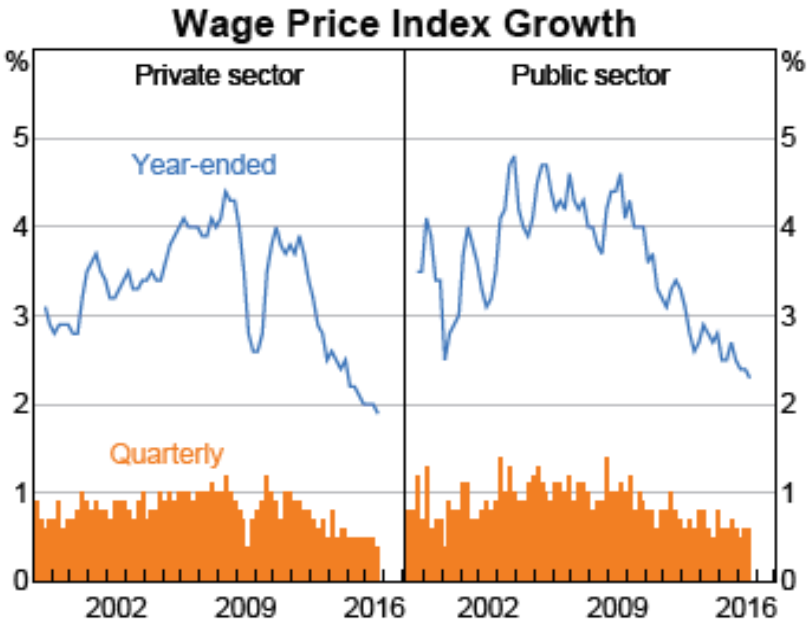
Equities (accumulation indices)	6 Months %	1 Year %
Australia (ASX200)	10.6%	11.8%
ASX Small Companies	5.8%	13.2%
ASX Listed Property	-2.6%	13.2%
ASX Resources	23.2%	42.4%
US (S&P500)	7.8%	12.0%
Germany (DAX)	18.6%	6.9%
China (Shanghai Composite)	7.2%	-10.5%
MSCI World Ex Australia (AUD)	9.8%	7.9%
MSCI World Ex Australia (Local currency)	9.7%	8.9%
Bonds		
US 10 year Treasury (change in yield)	1.0%	0.2%
Australia 10 yr Government Bond (change in yield)	0.8%	-0.1%
Currencies		
Australian Dollar	-2.8%	-0.5%

Source: Atrium Investment Management, Bloomberg, Iress. As at 31 December.

AUSTRALIA

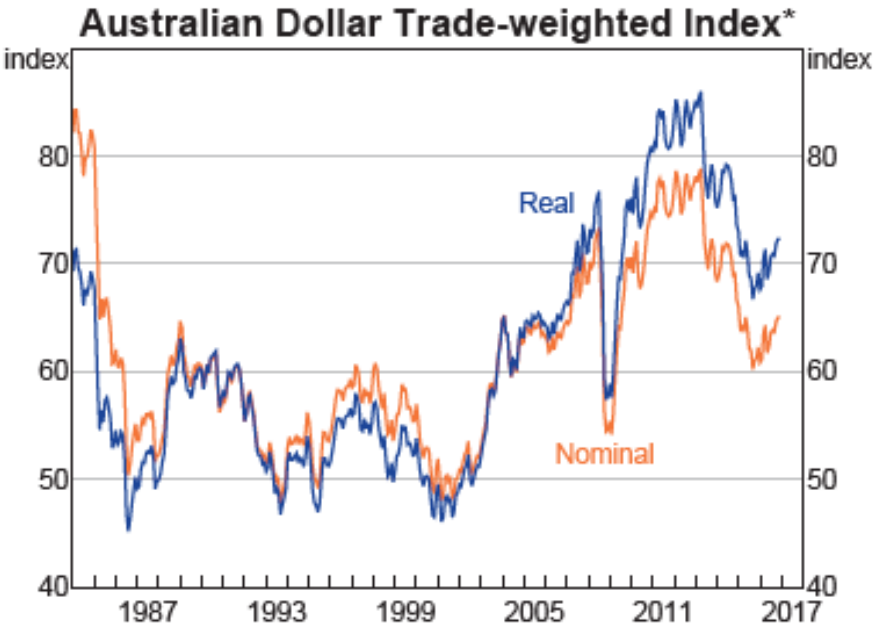
Australia saw a similar surprise to much of the globe during the year in the form of very weak inflation readings, which fed directly through to two cuts of 0.25% by the Reserve Bank of Australia. 2016 started on a concerning note with the weak data in China, and the continued implosion of key commodity prices. However, the commodity complex turned around very rapidly in mid-February providing support on the export side and a positive impact through the terms of trade

effect. The most notable trend has been the continued decline in inflation (which the RBA believes will remain below its target band for the next ~2 years), with a significant contribution from very weak wage growth. The unemployment rate turned mid-year, topping out at 6.2%, and closing the year below 6%, however, much of this is seen as arising from the weak participation rate, and there is also a further underlying weakness in the mix of part time jobs vs full time jobs. There is a view that the post commodity super-cycle has created a labour market which is more fragile than what the headline unemployment rate indicates, and this is certainly backed up by the inability or unwillingness of labour to seek faster wage growth.



Source: Reserve Bank of Australia

Late 2016 saw an end to the term of former Governor Glenn Stevens, and a pass over to Phil Lowe, seen broadly as a continuation of the previous regime. Overall, particularly given the incredible strength in the East Coast property market, the RBA seems to prefer to sit on its hands rather than cut further (to new record lows), although with the Australian dollar finding a temporary floor in the low 70's, any rise in the AUD may be the trigger for a further move.



Source: Reserve Bank of Australia

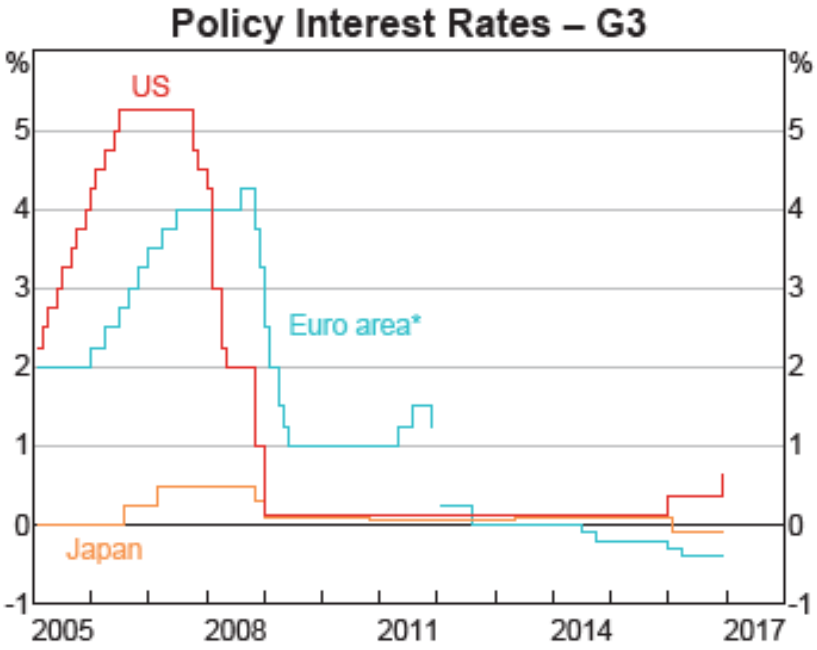
Given the commodity market turnaround in February, the Australian equity market closed with a return of 11.8% including dividends for the full year, coincidentally the same as its 5-year annualised return. The resource sector outperformed the market materially, and there was a notable recovery in value segments of the market, with a significant move higher in heavily shorted stocks in particular, making it a difficult environment for some equity managers. The rise in bond yields saw negative returns on the composite bond index (which is followed by many investors) for 4 consecutive months, its longest streak in over 20 years.

US

The highlights for 2016 in the US were the election of Donald Trump as next President of the US in early November, and the US Federal Reserve's monetary policy. Leading into the presidential election, Donald Trump was given little chance of being the next president, and fears were for a sharp decline in risk markets (and the US dollar) if he were to be elected. Trump was elected - despite losing the popular vote - and Republicans won a clean sweep of the Presidency and both Houses of Congress. Despite a savage move lower for equity markets (and bond yields) upon the news, this lasted only 12 hours and equities, treasury yields and the US dollar all rose sharply into the end of the year as markets were hopeful of a reflation in the US led by fiscal policy. Trump had indicated that he desired to cut corporate taxes, personal taxes, allow repatriation of trapped cash, and would push for a significant infrastructure spending program.

The second highlight mentioned above was the US Federal Reserve. In December 2015, the Fed hiked for the first time in almost 9 years, raising the cash rate from 0 - 0.25% to a 0.25 - 0.50% range. More importantly, it indicated to the market that it expected the cash rate to be hiked a further 4 times during 2016. Whilst it appeared to be on the verge of hiking in the middle of 2016, it wasn't until December 2016 when the Fed delivered its next 0.25% hike, a full 12 months after the initial hike. The Fed indicated in December 2016 that it expects to hike 3 times in 2017; markets will be watching closely for anything that could derail this. The first possibility might be macro data turning less positive, the second source may be political / geopolitical. The Fed will also need to

watch the impact on the US dollar; perceived strength in the dollar has already become a political issue, and has been alluded to in speeches and papers by the Fed. The US dollar rallied 10.4% from lows in late June to the December highs, most of this rise occurred after the election outcome in November, as the markets focussed on a possibility for higher growth and inflation, and therefore interest rates.



Source: Reserve Bank of Australia

Despite a strong third quarter of growth at 3.5% (seasonally adjusted annual rate), real GDP in the US continued to grow at a sub-par level, with the year on year measure at 1.7%, and if anything, most forecasters continued to downgrade their near term expectations for growth. Inflation remained under 2% on the Fed's preferred measure, the core PCE deflator. The deflator has spent almost the entire period since 2012 in a 1.3 – 1.8% range, perhaps surprising the Fed and other market observers in their inability to create an inflationary mindset given the massive amount of stimulus put into the economy since the GFC. The latest reading in the year, November, saw a rise of 1.65% year on year. Better signs were clearly seen in the labour market, the unemployment rate falling to a level where many believe wage inflation should start to appear. Indeed, late in the year positive signs were seen with wage pressure trending higher, approaching 3%, a level not seen since 2009.

Overall, the US economy continues to heal from the GFC scars and we expect that barring a shock, the Fed will hike 3 times in 2017. The rise in US Treasury yields of only around 0.20% over the year masks the incredible moves seen during the year. The period immediately following the UK Brexit vote saw US Treasury yields fall to their all-time lows at around 1.30%, with the yield drifting slightly higher into early November, then surging from 1.80% to close the year at 2.44% on higher real yields and higher inflation expectations. Given the US dollar is the reserve currency of the global financial system, the importance of US interest rates is that they provide the basis for pricing all other risk assets. Therefore, their level and movement is incredibly important for global markets.

EUROZONE

Following a series of crisis years post the GFC, much of the data started to improve at the margin, with Italy the main downside story in 2016. The European Central Bank's Deposit Facility Rate started the year in negative territory, and was cut further in March to -0.40%. However, late in the year the European Central Bank (ECB) gave indications of a move to taper its quantitative easing purchases of sovereign debt (reducing monthly buying, but extending the period over which purchases will be made), as the ECB become more comfortable that core inflation was bottoming out and as data in Germany remained quite firm. As oil prices rose, German headline inflation accelerated quite sharply into the end of the year finishing at 1.7% year on year which followed on from negative outcomes earlier in the year. It is unlikely that the Bundesbank will be comfortable with negative rates as German inflation approaches the ECB's target (close to but below 2%), so it is understandable that the ECB is now starting to think about an unwind of liquidity provision.

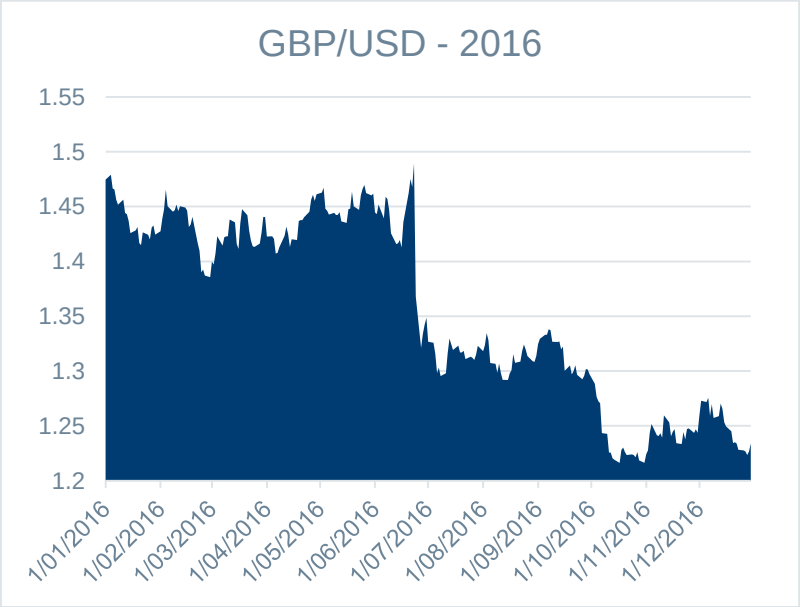
As noted above, the key downside risk remains Italy. The failure of the constitutional reform referendum was not unexpected, although it leaves Italy (yet again) in a position with no apparent political leadership. PM Renzi resigned immediately, and Italy swore in its ninth PM since 2000. Its banking sector is seen as very weak, and unable to raise capital, and the economy itself is seen with no growth prospects over the coming 10 years. The IMF raised concerns around Italy noting its lack of competitiveness and weak bank sector. Undoubtedly this will be a factor for the ECB going forward, although there seems to be a hope that a strong Germany and weak Euro can provide support and time to muddle through.

Whilst equities in Europe traded in a relatively tight range, most of the action was seen in the banking sector, where Deutsche Bank remained in the front of mind for global investors, hitting lows not seen since the early 1990's as US regulators sought a settlement broadly equal to Deutsche Bank's total market capitalisation for GFC-related issues. The final settlement was around half of the initial claim, and the Deutsche Bank recovered into year end. However, as always the banking sector is a source of risk for European markets, and it was Italian banks which remained pressured by heavy selling on concerns around their capital and loan portfolios. Yields in the German bund market were calm early in the year, trading down to almost zero at 10 years, although rose in sympathy with global bond yields over the second half, and closed the year at around 0.2%. Spreads of peripheral bond markets over the German bund market remained in tighter ranges than in recent years, supported by the ECB's quantitative easing program. For example, Portugal was in a range of 2.5% - 3.8% over the bund yield for 10-year debt.

GREAT BRITAIN

The standout development of 2016 for the UK was the Brexit vote of late June. The vote had been promised by then-Prime Minister David Cameron at the last election, as a means to resolve the question of whether the British voter wished to remain within the European Union. The result was seen as one with a binary outcome, and a skew to downside risks; that is, a Remain vote would have seen minimal upside to markets and was the most expected result, whilst an Exit vote was not expected and would have led to significant downside for markets (to such an extent that it was seen as a reason the Fed was unable to hike during the year). Predictions were made of severe losses in output in the following years if the Exit vote prevailed. The Exit was not the expected result, Prime Minister Cameron resigned shortly afterwards, and the Bank of England cut rates further to new 300+ year lows (0.25%). Similarly, the market results were not as expected and it was the sharp decline in the value of the British Pound that acted as something of a cushion to the economy, so data readings (and market outcomes) were not as dire as expected.

Towards year end, Brexit remained a focus as new Prime Minister, Theresa May, moved to commence the negotiations to leave the EU (a 2-year process from the point at which Article 50 is triggered, which she has stated will be done by March 2017). Concerns remain around a hard exit from the EU, what model the UK is able to negotiate in terms of trade access, and what it means for London's role as a key financial centre, and it is likely to be a regular source of volatility going forward.

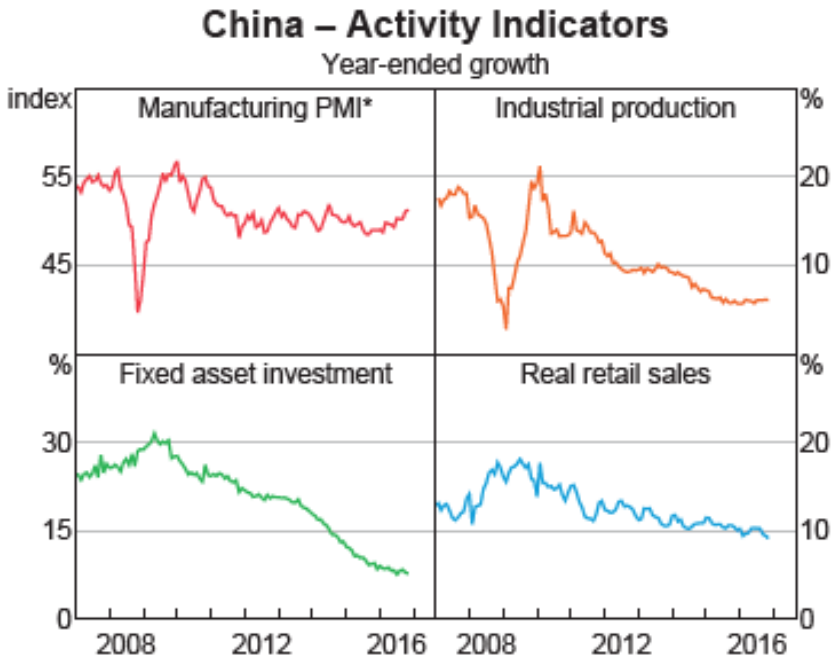


Source: Bloomberg

On the macro side, inflation started to creep up late in the year as there were some early signs of imported inflation, notably in imported foods.

CHINA

China was the initial focus of major markets in early 2016, following the release at the start of January of a very weak PMI. Fears began to grow of a sharper devaluation of the Renminbi, and capital outflows became a key focus. The Chinese currency weakened against the US dollar from 6.5 at the start of the year to a low of around 6.95 at the end of the year. Capital outflows accelerated and over the 2 ½ years to 31 December 2016, China's FX reserves fell from approximately $4 trillion to almost $3 trillion. Rising yields in the US are seen as potentially providing further impetus for this, so liquidity inside China remained tight. Tighter liquidity is seen as a major risk for the Chinese economy given the very substantial build-up of debt since late 2008. Economic data inside China remained stable, with GDP growing in line with Government targets at 6.7% year on year in the 3rd quarter. CPI closed the year at 2.1%, although the PPI finally turned positive after 4 years of deflation, and accelerated into year end.



Source: Reserve Bank of Australia

China's impact on global commodity markets remained apparent for the year; measures taken early in the year to reduce the maximum number of days the local coal mines could operate (mainly for environmental reasons) had a significant impact on the coal market.

There are a number of apparent fragilities in the Chinese system, although 2016 was not a year in which any of these became in any way systemic.

JAPAN

Downside risks came into view during the year a number of times when events within and outside of Japan caused sharp risk-off events leading to a strengthening Yen. The first such event was on 29th January when the Bank of Japan introduced its new policy regime, "Quantitative and Qualitative Monetary Easing with a Negative Interest Rate". Yields across the JGB market fell, in most cases to new record lows and in many instances less than zero, but the somewhat perplexing move was the Japanese Yen which rallied sharply. Subsequent significant underperformance of the banking sector in Japan was a theme repeated a month or so later when the ECB cuts rates further negative. The focus shifted to the impact negative rates has on NIM's in the bank sector, and the BOJ subsequently adopted a new regime later in the year, aimed at steepening the curve by having 10-year JGB yields pinned at around zero.

Dollar Yen dropped sharply after the Brexit vote in June, and again briefly upon the election of Donald Trump. The strong correlation between USDJPY and Topix continued through the year, even post-election as both the equity market and USDJPY rose. In the real economy, growth was surprisingly firm (3rd quarter was up 1.1% year on year), although prices are again starting to decelerate, and the BOJ seems less confident of hitting its inflation objectives. Bank lending growth finally seems to have turned positive on a sustainable basis which is a positive sign given it had been an indicator of the deflationary pressures within Japan for many years.

INVESTMENT IN FOCUS

As publically listed markets became increasingly fully valued in recent years, we have stretched our investment to include private markets. Put simply, a private market investment is any investment that is not listed on a stock exchange or traded in a liquid market. Investments in these markets include but are not limited to commercial property, infrastructure or energy assets. Similarly, an investment can include equity or debt (lending against an asset).

Our view in this space is that these investments do not need to be any riskier than investments we make in liquid or listed markets. The key difference is that investments are not able to be realised on any given day. For being illiquid, investors require additional return to compensate them for locking up capital.

A good example is a residential home. Individuals don't think of their house being a higher risk investment simply because they can't sell it on any single day, but rather understand the underlying fundamental characteristics of the asset (the cost of construction, land values, supply and demand for the asset, rental yields etc).

We frequently come across investments in Private Markets that are mispriced (the same as buying your family home for a discount to others on the street). This is something that excites us! These investments in our portfolio have returned in excess of 10% in recent years with almost no deviation. While it is only a small part of our portfolios, we continue to actively allocate given the consistent stream of new investment opportunities that present themselves. An example pre-Christmas was an A-grade regional office building that we acquired a material stake at a 15% discount to its valuation and on a yield of 10%, all because the existing institutional investor was required to sell in a short term period.

IMPORTANT INFORMATION