Policy

Investment Strategy

Responsible Manager (Title)	Manager Finance & Supply		
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Community Plan Linkage	**5 Leadership**		
	5.2 We will have an effective and efficient organisation		
	5.2.1 Operates in a financially responsible and sustainable manner		

1 Purpose

Having outlined the framework for investment in the **Investment Policy**, this document sets out:

1. current market conditions;
2. how Council is responding to structure its investment portfolio;
3. realistic objectives for the investment portfolio;
4. risk management.

2 Investment Strategy

2.1 Strategy

Council's Investment Strategy is set in relation to the following parameters:

Diversification

Council's investments are diversified only within the fixed interest sector: cash, term deposits and FRNs. It has not been Council's practice to diversify further across other asset classes into risky assets.

The Policy and Minister's Order permits investment in the TCorpIM Funds; TCorpIM as a business decision excluded sector funds from Councils from 2019, and this is not expected to change for all but the largest investors. Currently the only viable path to higher risk-return is the Long-Term Growth Fund – approximately 65-70% shares. (The Medium-Term Growth Fund is effectively a 0.5x delivered.)

TCorpIM Growth has fallen somewhat, but macro risks remain high with valuations no bargain in most markets.

Long-term growth assets are risky, and would only be used to back long-term liabilities specifically designated of appropriate funding horizon. Risky assets would only be used with specific Council approval.

COVID-19: Impact

This strategy is written at a time when there is no clear resolution for COVID-19. The world had limited success with lockdowns, the cost of which are becoming unbearable. With almost 6 million cases (6% of which have been fatal), there is currently no vaccine, anti-viral, or clearly effective treatment.

The market impact of COVID-19 has already passed through three distinct stages:

1. A recurrence of SARS in China, potentially affecting China-related trade (education, tourism, manufacturing supply chain).
2. A multi-national outbreak, raising the prospect of more widespread trade and travel interruptions.
3. Global lockdown and mass unemployment, lasting 2 months.

Markets now look forward to the imminent Stage 4: *Reopening and Economic Recovery*. Given the extraordinary support from governments and the short-expected shutdown, the net impact on markets has been modest. After severe financial losses and extreme panic, a very strong recovery followed.

The market reaction is completely disconnected from economic data. China (the earliest to lock down) reported a 10% contraction in Q1. This is likely to be replicated or exceeded elsewhere in Q2, with unemployment rates not seen since the Great Depression. Much of the financial system impact is disguised by measures such as rental waivers, foreclosure forbearance and government subsidies (e.g. in Australia, the $70bn JobKeeper programme).

Efforts to minimise financial system distress have been very effective. Bank senior credit trades at similar levels to the start of FY20! Banks cut their dividends to minimal levels, or suspended them – this is good for credit, and was also well accepted by the stock market. **Banks are following the** 2009 playbook, launching a market-share grab from a position of capital strength and accepting some near-term dilutive capital-raising to be in this position.

Central banks not already at zero interest rates before COVID-19 are generally there now. The US Federal Reserve and Reserve Bank of Australia both cut their benchmark rate to 0.25%, and provided extended forward guidance at this level as well as targeting of the 3-year rate in Australia. This reflects expectations that it will take many years for employment and other economic data to recover, expecting extended support will be required. High yield and non-bank credit has also recovered, although less completely.

In April's recovery:

1. The iTraxx Australia index of investment-grade credit traded in to 118bp (-61bp tighter) in one of its best ever months.
2. Major bank 5-year credit firmed 40bp from ~+130bp to inside +90bp, back to June 30th levels.

3. The MSCI World gained over 10% in local currency, dominated by US stocks with over 13%.
4. The modern ASX200 index had its best ever month, also soaring double digits. (This was the strongest month for the older All Ordinaries since 1988.)
5. Bonds lost value in the month, with yields rising +13bp despite stronger conditions in the US.

Stockmarkets appear to be assuming the pandemic remains manageable at the same time as normalisation of economic conditions. With new daily counts still making new highs globally, this is by no means guaranteed. The major downside risk is from a second round of rising infection rates.

Market Conditions

3-year bonds trade around the RBA's 0.25% target. This, and bank bill futures, reflect market confidence in the RBA's guidance. Neither rapid rate rises, nor a plunge into negative rates, are expected.

Bond yields traded to meet monetary policy expectations at the short term, with 3-year bonds anchored at the record low 0.25% target. 10-year bonds were already expensive leading into CY20, and while new records were set they did not hold – the 10-year bond yield was around 0.9% at time of writing, compared to 0.7% in the US.

Bonds are trading with relatively low volatility, as there is greater certainty around their fundamentals in the next 2-3 years than for other asset classes.

Markets treat "lower bound" interest rates as locked in for several years.

Deposit markets are very wide at the short end, and rates are expected to decline further over time despite record low rates already.

The gap from unrated to A rated has widened to **typically 40bp across the curve** – whether for tradeable securities, or deposits. At 1 year, highly rated deposits pay no more than 1%; this compares to 1.45% for BBB range (an unusually wide +130bp over swap) or 1.6% for unrated.

Major bank rated "AA-" have tightened dramatically to the ~+90bp area although other new issues suggest a material premium would be required.

Major bank paper is priced relatively expensively. Better yields can be achieved in AAA covered FRNs, which have typically traded 20-25bp tighter than major banks on account of the superior credit but are currently issuing 20bp wide of the major bank curve. This could reflect a specific dislocation, or a very large new-issue premium in a relatively illiquid market where credit funds face some redemption pressures.

FRNs are preferred for tradability, potential capital gains (leading to greater total return potential) and the much wider spread for equivalent ratings.

In stockmarkets, 2020 has been perhaps the most extraordinary year in history already. While markets are always forward-looking, recent market cycles have been extraordinarily fast even by post-GFC's accelerated timeframe. The fastest 20%, and 30% falls from a record. The briefest bear market in history, and it was ended by the quickest 20% recovery in history. And that turned into the quickest +30% from the lows in US history. Based on projected earnings for FY20 and even FY21, multiples are relatively expensive.

While Australian shares have not quite kept pace with the US, the ASX200 is only at the levels of early 2019, giving back a year of gains – at the lows, it had been over 4 years'.

High yield credit traded at spreads of around 700bp, compared to a cyclical low +350 before the COVID-19 crisis and a peak around +1100. This improvement partly reflected stockmarket sentiment, but also the measures taken by the US Federal Reserve. These included including credit (even high yield) in their bond purchase programme – the latest and largest round of quantitative easing yet.

Economic and Policy Background

US GDP shrank by -1.2% (-4.8% annualised) in Q1's first estimate. The US is therefore in recession, as the second quarter is assured to also see a large contraction – probably double digit. This is true of most developed economies.

Any economic data from prior to Q2 (with the possible exception of China) is now obsolete. Job losses and employment contraction have been without precedent in its speed, and without modern precedent in their end point. Much of the global economy is closed by government order; many workers are laid off. Unemployment in the US is around 15%, disguised by lower participation rates with the job losses even more severe.

There is no possibility of "stimulus" in the conventional sense – economic activity cannot be created under lockdown conditions. Instead, governments have looked for "deep freeze" measures. The aim is to minimise permanent harm, and preserve the ability of economic activity to resume. Measures include:

1. Concessional funding for the banking system, enabling them to continue lending and reducing earnings pressure.
2. Lower-bound interest rates, to minimise the cost of carrying questionable debts to the recovery.
3. Foreclosure holidays and rent waivers, so that the owners and occupiers of property are kept largely intact to resume normal activity (and to prevent a flood of real estate owned by banks).
4. Suspension of new capital rules, and allowance for counter-cyclical measures such as consuming capital buffers intended for recessions.
5. Bond purchases to improve credit market conditions.
6. Employment cost subsidies, encouraging employers to maintain their payrolls.

The Fed expanded their renewed quantitative easing program to include high-yield debt after downgrades. They also reiterated their commitment to near zero rates for at least a year. QE has bought $1.1tr in its first month – equal to 5 months' worth of 2008's original QE1.

Central banks have not entirely closed the door to even more extreme policy responses.

There has also been a large fiscal programme everywhere. Tax receipts are well down. Employment subsidies, unemployment benefits (often expanded), additional income support and medical costs are large unbudgeted imposts.

The combined fiscal-monetary injection is estimated at 16.4% of GDP in Australia, one of the larger programmes globally (although this could reduce modestly due to smaller JobKeeper subsidy claims than first thought).

The recovery is unlikely to be a complete "V-shape". The IMF expects developed economies to be 6-7% smaller over 2020, despite the initial rebound in 2H20 as economies reopen. It may not be until at least 2022 that production returns to 2019 levels. Employment may take longer still to recover, having taken a decade to recover from the (smaller) GFC in the US.

Also relevant is the impact of first repairing budgets, and then ultimately paying down this debt.

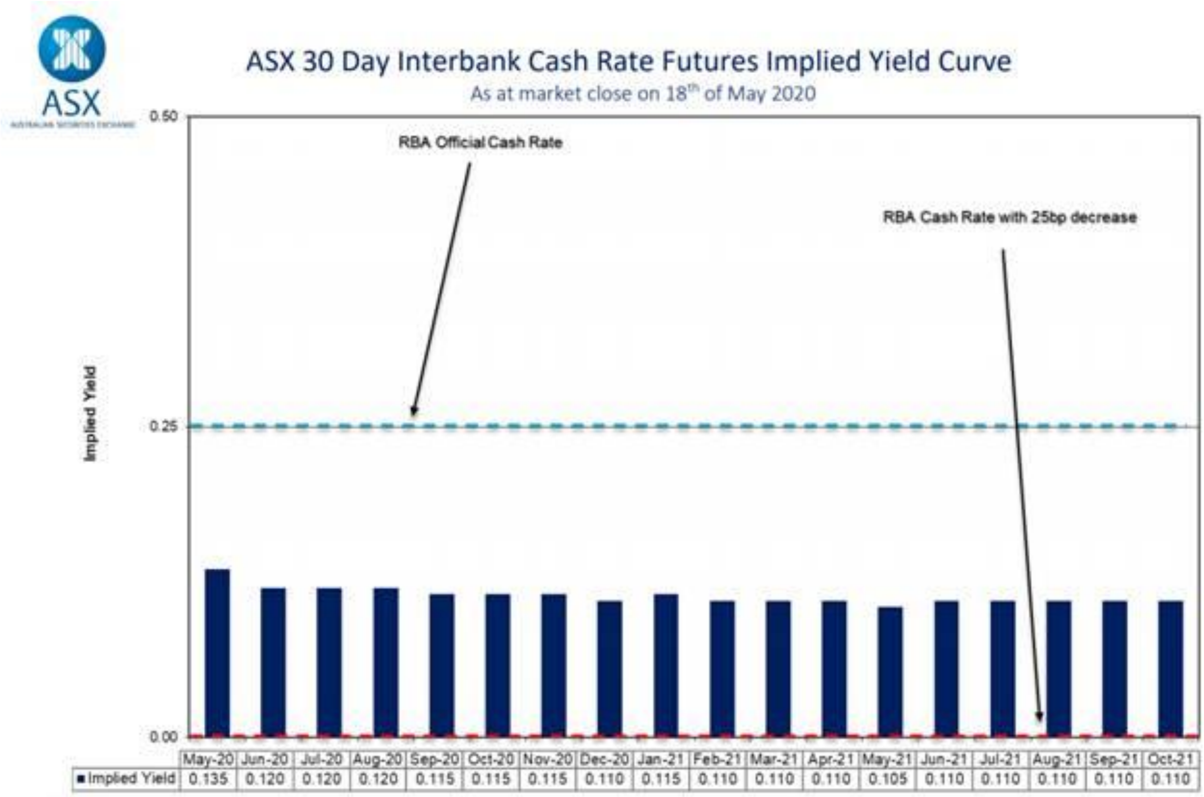
Interest Rate Outlook

USA and Australia cut rates to the perceived 0.25% "lower bound", declining to follow Europe and Japan into negative rate territory.

The RBA affirmed its March policy settings at subsequent meetings, with no new initiatives as markets recovered. Rate increases would require inflation to be sustainably in the 2-3% target band and progress towards full employment – the latter, at least, is some years off.

The market outlook on rates is consistent with the targets announced by the RBA, and the "yield curve targeting" appears to be effective and treated as credible by the market. The bond yield curve has been gradually steepening, with 10-year bonds closing in on the top of the 0.8-1% trading range in place since early April.

Figure 1 – ASX Future Cash Rate



Governor Lowe expects the biggest contraction since the 1930s, with expectations of GDP to fall by 10% in the first half of 2020 and unemployment to rise to 10% by June. (This may be disguised by low participation and subsidies.)

Europe already had negative rates, and therefore little flexibility to respond. Indeed, studies suggested that negative rates pressure the banking system to the extent that they reduce lending, and therefore suppress GDP recovery. This was reflected in Scandinavian countries ending their negative rates experiments.

Therefore, the interest rate responses were quite conventional.

Where central banks are evolving their thinking, is a more “through-the-cycle” approach to inflation targeting. Having undershot inflation targets since the GFC (and presumably during COVID-19), they now consider this a “credit balance.” While inflation targets were once considered a hard barrier for policy intervention, this became tolerance of brief excursions. Current language suggests targets have become “on average.”

This implies cash rates lower for longer, but is also negative for long bonds if central banks are perceived as weaker on inflation. For investors, it suggests central banks will keep near-zero rates through even rising inflation.

This could make the next inflation cycle more severe than it would be in a prompt response. Inflation uncertainty is seen as a risk only in future years.

Term Deposits

T/D rates have adjusted down to reflect the record low cash rate of 0.25% at time of writing, and for the extended outlook for ultra-low rates acknowledged by the RBA. There may be further room for adjustment with downward pressure on shorter deposits given unreasonably high margins.

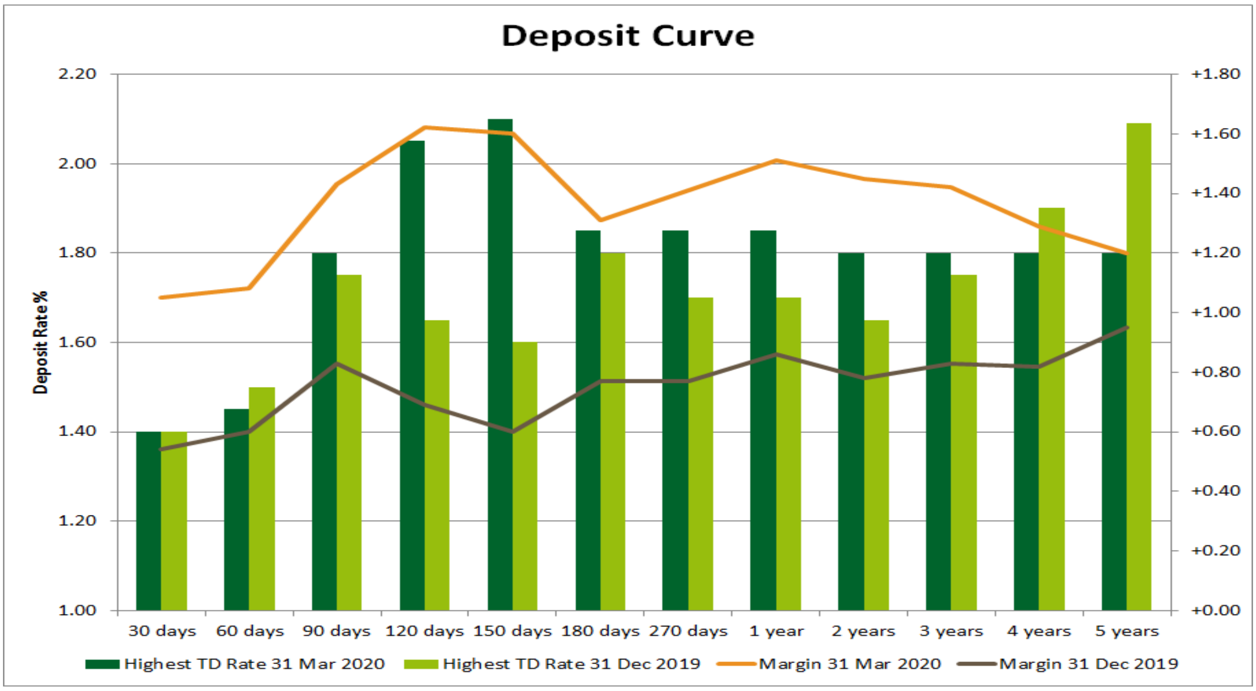
Highly rated banks have moved rated to reflect the market faster than BBB and unrated ADIs, and have less adjustment to come.

Bank capital ratios are strong, but will not increase further during the current cycle as APRA suspends additional capital requirements. Larger banks have significantly improved on pre-GFC ratios.

L/T Rating ADI	Common Equity Tier 1	Tier 1 Capital Ratio	Total Capital Ratio
AA (major banks)	11.00%	13.10%	15.85%
A	33.98%	13.67%	15.53%
BBB	14.52%	15.01%	15.86%
NR (CU's & BS)	16.49%	16.49%	17.05%

As bond yields fell, spreads are unusually wide (shown excluding unrated Judo):

Figure 2 – Deposit Curve



Floating Rate Notes (FRNs)

Credit spreads widened dramatically through March 2020, but reversing with a remarkable comeback – effectively back to June 2019 levels. Now in the high-80s region for major bank 5-year marks, demand is untested but the major banks appear to be priced as a relative safe-haven. They appear expensive relative to all other credit categories, which are nowhere near the levels of FY19.

FRN market implications are as follows.

1. **BBB ADIs are sticking to 1-2 year issues, as pricing would otherwise be prohibitive**. These are good relative value. There has been price discovery in BBB names. The fact that they are using limited capacity to fund through covered bonds (the AAA rating coming from pledging secured assets) suggests they are unable to access the market at a viable price for long-dated funding.
2. **New issue premiums appear to be extremely wide**. Covered bonds that would normally trade well inside major banks are issuing 20bp wider. It is unlikely that this is unique to covered bonds, suggesting new issues will be particularly attractive in 1H20.
3. **Major bank FRNs are showing strong gains their March lows, and are relatively expensive**. Almost all credit investments lagged in the first quarter after, but have regained all of this and more to post gains in Q2. Each FRN investment is currently marked above par.
4. **Selling FRNs is likely to be more lucrative than usual**, given a combination of high issue margins and a significant new issue premium. A recent study suggested that **an active investor rolling every two years would have outperformed a passive buy-and-hold**

strategy by 40bp, although this is unlikely to be replicated in major banks in current conditions.

5. **There is no indication Australia is particularly safe (economically) – unlike 2008**. GDP contraction and unemployment is likely to be similar in developed markets and so investors can consider foreign major banks. Of course, under the Minister's Order they need to be issued in $A, through ADI branches.
6. **We look in 2020 to switch major bank 2023s**.
7. **Covered bonds** are the most attractively priced complying securities relative to risk and ratings.
8. **Buying a major bank FRN today on a two-year holding period has a +120bp target on the current curve** (including new issue premium), which is comparable to lower rated deposits. They are useful for maintaining overall ratings, but not likely to show the same returns as other FRNs.

2.2 Existing Portfolio Status

As at March 2020, the deposit portfolio was averaging a yield of 2.30% p.a., which is far in excess of anything available today. It compares to a benchmark bank bill rate that has traded as low as 0.1%.

Council has not invested in TCorpIM's Growth strategies, which are sharply lower in 1Q20.

The Strategy throughout the past few years has been to prioritise long-dated deposits - ahead of significant cuts to interest rates. This has been extremely successful over a long period, and continues to dominate portfolio returns today.

The portfolio is dominated by deposits today.

Future reinvestments will now be at far lower rates. Reinvestment rates are now generally under 1½% even at lower ratings, with highly rated deposit no longer offering a yield competitive with other asset classes.

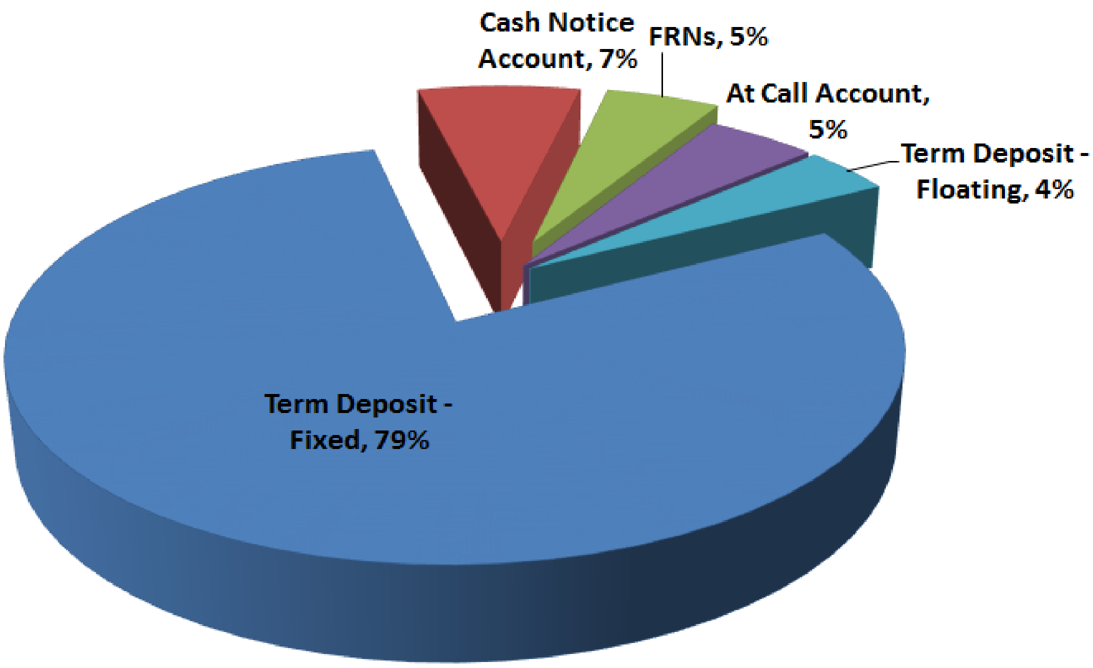
Given the dominance of higher rated issuers, FRNs would invariably improve credit metrics. The risk of FRNs underperforming deposits on a yield basis could only really occur given potential negative rates (which the RBA has ruled out). Conversely, FRNs would participate in any recovery in interest rates should inflation return in future years. T/Ds would tend to underperform in a more inflationary period, at least until interest rates reset.

FRNs are now completely back to "normal" levels, at least for the major banks held. This has been the most resilient credit sector, and so the portfolio has been dominated by the two most defensive factors available (fixed rate duration, and major bank credit).

These are now the most mature of investment themes, with broader credit more early cycle.

This suggests a more diversified portfolio in future.

Figure 3: Council's Investment Portfolio 31/03/2020



The credit allocation is relatively small, having been largely traded out around peak valuations. Over the past year, being tilted to fixed term deposits has been the more advantageous positioning. Current spreads are not generous enough from major banks to drive an aggressive tilt at this time – but Council can opportunistically access other names.

2.3 Proposed Actions

Council will need to assume returns declining below 1.5% through FY21, with deposits ultimately headed to below 1%. This is likely to be below previous long-term forecasts, as most of the rate cuts only occurred in Q1.

Only the higher-risk Growth Funds at TCorpIM have the potential to offer higher returns. This is a topic for consultation, but no investment in risk assets is intended at this time.

To maximise performance, the intention is to pursue the following actions during this strategy period (subject to conditions broadly outlined in this document):

New Investments

1. Ratings capacity is near-fully utilised; new investments can be in either short FRNs or deposits – both achieve historically wide yield uplift over majors.
2. Currently investments below BBB are not used, which excludes the highest payers such as start-up Judo Bank and this will continue for the period of this Strategy.
3. The AMP 31-day Notice Account paying 1.40% (including CPG Rebate), is very competitive against short-term or even longer term deposits.
4. Short-term investments (3-12 months) will most likely continue to be invested into fixed term deposits in the absence of a realistic alternative – TCorpIM's new Short Term Income Fund has a satisfactory 1-year performance and offers some prospects of excess return over highly rated deposits.
5. A or AA infrequently pay competitive rates - specials carrying retail pricing are the most promising avenue.
6. The top payer for longer terms tend to be almost exclusively low rated or unrated.
7. As such, for additional funds excess to liquidity requirements medium-term (3-5 years) liquid FRNs going forward are increasingly the preferred option. Higher rated names ("AA" or "A" rated) dominate this space, but Council does not need large volume and can also participate in other names.
8. Where "BBB" capacity emerges, any FRNs are likely to be at very attractive relative yields.
9. Private placement FRNs are not currently a priority, with benchmark names already paying prohibitive prices to access wholesale markets.
10. Council will generally work towards maintaining a portion of investments in the medium-term allocation, primarily FRNs in the near term.

The ability to transact quickly is critical for new FRN issues. To support this, Council can utilise existing at-call reserves (to be replenished from subsequent deposit maturities). In principle approvals at an early stage are also advantageous.

Council will conduct stakeholder consultation on the applicability of the higher risk TCorpIM investments.

Risk Management Guidelines

The strategy addresses risk management as outlined below:

Preservation of Capital

Council has already enacted major strategies to manage capital risk given the portfolio is now 100% compliant with the Minister's Order (no more grandfathered assets are held).

Over the short term, growth assets would be inconsistent with this objective.

Credit Risk

Fitch downgraded Australian majors to A+ with a Negative Outlook on various pressures on profits – COVID-19 has also seen the sovereign rating placed in Negative Outlook from AAA. This has no impact under the current Policy.

Credit rating profile is currently acceptable, well within Policy limits, as all assets in the portfolio are investment grade (rated "BBB-" or higher).

Given recent downgrades, it is expected that Council will prioritise careful management of credit quality during the term of this Strategy, but no sectors or counterparties are currently outside Policy limits. Attractive covered bond pricing is a bonus in offering access to highly rated assets without sacrificing yield.

Diversification

Investments are currently diversified within the fixed interest sector – fixed deposits, senior FRNs, at-call and cash notice accounts. Diversification outside the fixed interest sector would require broad-based buy-in and there is no current intention to diversify into other asset classes.

Liquidity Risk

Council's portfolio is highly liquid from at-call accounts and near-term maturities. Approximately 70% matures within 12 months; unusually high. 2018 saw a significant ramp-up of long-term assets, ahead of rate cuts.

Additional assets such as traded securities can be realised at very short notice.

Market Risk

Along with credit risk, market risk has now been substantially minimised given all investments are directed to conservative, senior fixed interest assets. While the FRNs have some mark-to-market effect, the allocation is minimal. More exposure to this factor is desirable at current levels.

Council does not hold any bond exposure, which experienced severe mark to market losses late in the year.

Market risk would significantly increase from any growth assets.

Maturity Risk

Council's longer-term investments are entirely directed to term deposits and senior FRNs, minimising the effect of maturity risk as there is a regular maturity pattern and spread of maturity dates. The FRNs are also liquid – saleable so that funds can be accessed within 2-3 business days.

Rollover Risk

Council has reduced risk to minimal levels through an average deposit portfolio duration of 1.0 year, considerably longer than the 45-day benchmark and one of the longer durations in the Local Government sector. This is considered a strong level of protection, deferring rollover risk for a full reporting cycle. Council is very well positioned after 2019’s interest rate cycle although this is only a deferral – the full impact will ultimately manifest in FY21.

Protection is against economic shocks causing a radical change in monetary policy, but also against lower spreads. There has been a long-term trend for deposit margins to fall post-GFC; this has been especially pronounced in shorter deposits.

Medium and longer term holdings are lightly utilised, and there is capacity for liquid investments.

2.4 Performance Benchmarks

Council’s portfolio returned an annualised yield of 2.10% for the latest quarter. This is supported by high yields on deposits placed in earlier years, averaging 2.30%.

This yield is considered very strong given the high credit ratings targeted, but is no longer possible to maintain. Yield is facing further pressure over time, as official interest rates are expected to remain lower for much longer based on official RBA benchmark.

Council benefits from longer-than-benchmark positioning, with relative performance boosted by the cut in interest rates to the RBA’s declared “lower bound.”

2.5 Delegations/Responsibilities

Within the constraints of the Policy, strategic or execution decisions are delegated to the General Manager, Director Corporate & Governance and the Manager Finance & Supply. While Council is notified of significant strategy updates and the reasons for them, implementation of investments optimised within the approved Policy is part of management’s operational responsibilities.

2.6 Effective Date and Review of Strategy

The effective date of this Investment Strategy is the date it is adopted by Council and will be reviewed at regular twelve monthly intervals, or as required in the event of legislative change or as a result of significantly changed economic/market conditions.

Council is in regular contact with its advisors and is able to adjust strategy as market conditions dictate.

3 Related Documents

This Strategy relates to implementation of the portfolio within the constraints set out in the **Investment Policy**.