Dear Investor,

We are pleased to provide you with the June quarterly letter for the Milford Australian Absolute Growth Fund. Thank you for investing alongside us and trusting us with your capital.

Over the last quarter, the Fund returned a very pleasing 5.5% with an average equity exposure of 70%. It was a particularly strong period for the Australian equity market, so we do not expect this level of quarterly return to be sustained.

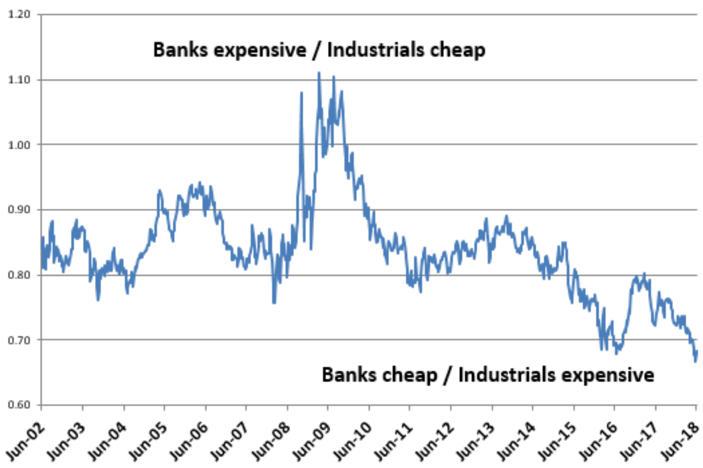
In this letter, we take a brief look at the likely impact of the royal commission on the Australian economy and share market.

## The Australian Economy and Royal Commission

One of the key events in Australia this year is the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. It is having a significant impact on the Australian share market, with widespread media coverage and repercussions for the banking sector and Australian economy.

We have seen the share prices of the major banks fall between 8% and 15% from the beginning of the year to their June lows. As investors sold bank shares, they have sought safer or better investments elsewhere. This has driven up share prices of companies like CSL, Cochlear, Macquarie Bank, Woolworths and Wesfarmers which have rallied between 14% and 37% this year. Consequently, the valuation gap between the banks and other large cap industrial stocks has reached historic levels.

*Figure 1: Relative Price to Earnings multiple - Banks vs ASX 100 Industrials*



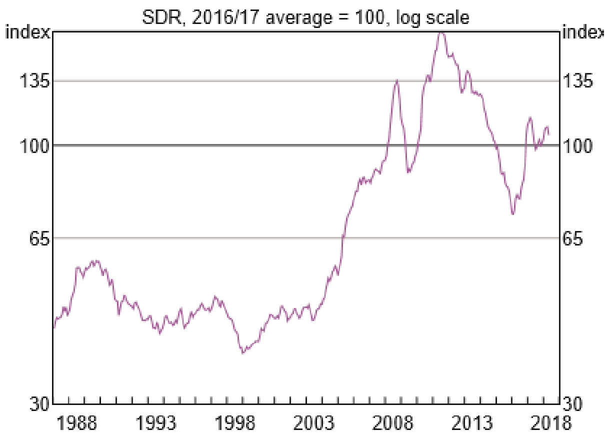

*Source: Factset*

There are also risks to the wider economy. Some commentators are concerned about a "credit crunch" and subsequent crash in house prices brought on by tighter lending following the royal commission. We'll start our analysis of these concerns with a quick look at the economic backdrop.

## The current state of the Australian economy

The Australian economy is in a better position than it has been since the last commodities boom ended abruptly in 2012. The mining sector has recovered, with the price of commodities up significantly since bottoming in late 2015 and early 2016. Mining companies are generating higher profits and consequently paying more tax which supports government budgets. The recovery is also stimulating new mine development and increased maintenance expenditure on old mines.

*Figure 2: RBA Index of Commodity Prices*



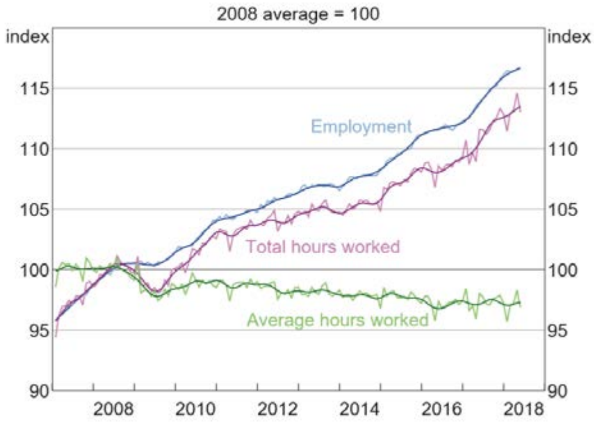

*Source: RBA*

The eastern states are benefiting from a large infrastructure investment program, particularly NSW. This is driving activity and employment growth in non-mining states and producing a positive wealth effect.

The mining recovery and infrastructure boom has driven a significant improvement in the labour market. Growth in employment and hours worked is the strongest it has been since before the global financial crisis in 2008. However, subdued wage growth persists, reflecting spare capacity in the labour market. This may be contributing to the relatively benign consumer environment in which retail sales remain subdued. It is also dampening inflation and reducing the likelihood of interest rate hikes.

Another potential concern for the economy is a cooling housing market. However, generally the Australian economy is improving and has a positive outlook.

*Figure 3: Employment and Hours Worked*




*Source: ABS, RBA*

## Royal Commission 101

A royal commission is an independent public inquiry typically instigated by a state or federal government. It has the power to summon witnesses to give evidence under oath and ask parties to produce documents. With its powers underpinned by the criminal code, failing to comply with a royal commission request can result in a jail term. However, the royal commission has no powers to pass regulations or create law. This responsibility lies with the Government and industry regulators who may act on recommendations from the royal commission.

The current royal commission was called by the Federal Government to examine misconduct into the banking, superannuation and financial services industry. It has four rounds of public hearings spanning March to July, with an interim report due by the end of September 2018.

## What has happened so far?

It was widely anticipated the royal commission would have relatively little impact on the banks. But the royal commission revelations – and public outcry – have been more severe than anticipated. These allegations include giving bad financial advice, poor lending practices, rewarding staff for channelling customers' money into their own products, denying legitimate insurance claims, forging documents and bribery.

As some of the conduct we've heard about is negligent, we will certainly see an improvement in industry standards and compliance.

The biggest issue that may impact the economy is the allegation of irresponsible lending practices. The banks have been accused of not properly verifying borrowers' living expenses and consequently approving loans that are too large. In response to the royal commission spotlight, the banks are improving due diligence processes. It is feared that this will reduce the supply of credit to the housing market and cause property prices to fall.

Before exploring this subject further, we will review previous regulatory changes in this industry.

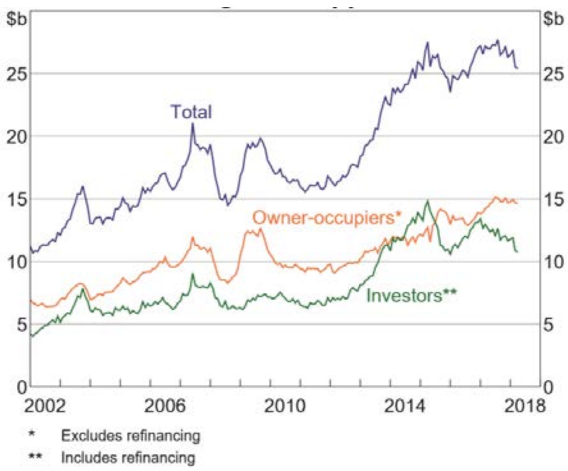
## Regulation of banks prior to the royal commission

Regulation of the banking sector is under the jurisdiction of the Australian Prudential Regulatory Authority (APRA). APRA began tightening and improving housing credit standards in 2014 – well before the launch of the royal commission in March this year. Over the period from 2014 to 2017, APRA introduced:

- A cap on banks' investor loan book growth of 10% per annum
- A minimum interest rate stress test for borrowers of 7-7.25% and a buffer over the prevailing loan rate of 2-2.25%
- Limiting the use of negative gearing for investor loan assessments
- Assessing serviceability on interest-only loans over the residual principal and interest term, not the full loan term
- Reducing the maximum interest-only term on a loan
- Reducing maximum loan-to-value-ratios (LVRs) for a range of loans, including high LVR interest only loans
- Capping interest only loans at 30% of a lender's book

These standards have constrained housing credit growth. The value of new loan approvals has fallen, and total housing credit growth has slowed to 5.8%, from 7.5% in September 2015[1]. More importantly, riskier lending on interest-only, high LVR and investment purpose loans has fallen significantly.

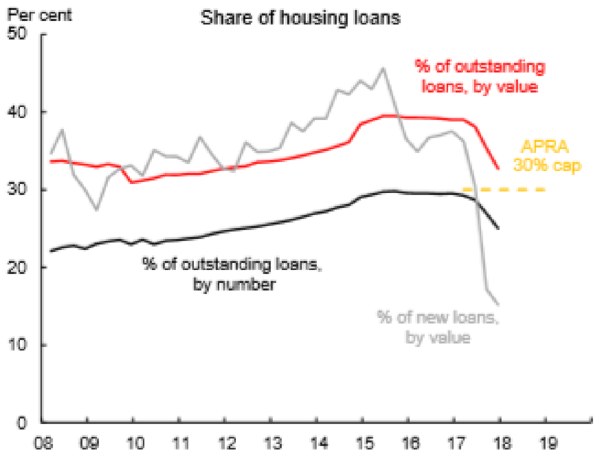
*Figure 4: Housing Loan Approvals Figure*




*Source: ABS, RBA*

[1] RBA

*Figure 5: Interest-only loans following APRA 30% cap*




*Source: APRA, Macquarie Macro Strategy*

This tightening eventually filtered through to the housing market. National prices have been largely flat over the last year and Sydney prices are down about 4% from their peak in June 2017[2]. APRA has also conducted targeted reviews to scrutinise lending standards and released prudential guidelines to improve industry standards. While revelations from the royal commission have been enlightening for the public, many of the issues identified were in the process of being rectified by APRA.

## Is the housing market overvalued and poised for a major correction?

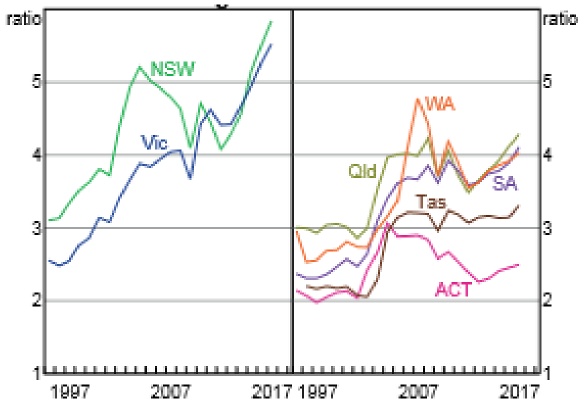
While the housing market is weakening, this needs to be taken in the context of the recent rally. Sydney prices are still 69% above their September 2012 level and national prices are 45% above[2].

Following this rally, dwelling prices look expensive relative to household income. NSW and Victorian house prices now transact at 5.5 times household income, up from around 3 times in 1997. However, this measure ignores the fact that mortgage rates are far lower today, which makes debt easier to service and housing more affordable.

The official cash rate has fallen from 6% in 1997 to 1.5% today, resulting in recent mortgages advertised at rates as low as 3.6%. Affordability is less concerning when looking at mortgage repayments as a percent of household disposable income. The repayment burden is slightly higher than in 1997, but remains well below peaks in 2007-2008.

[2] ABS, CoreLogic

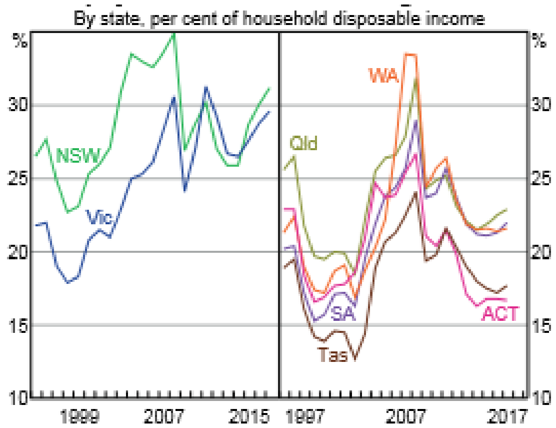
*Figure 6: State Housing Price-to-income Ratios**




* Ratio of dwelling price to average household disposable income; income includes unincorporated enterprises and is before deduction of interest payments; mean dwelling prices

*Source: ABS, CoreLogic, RBA*

*Figure 7: Repayments on New Housing Loans**




* Housing loan repayments calculated as the required repayment on a new 80 per cent LVR loan with full documentation for each state or territory's mean-priced home; income includes unincorporated enterprises and is before deduction of interest payments

Source: ABS, CoreLogic, RBA

Higher house prices do however make it more difficult for buyers to save the required deposit and stamp duty, particularly first home buyers, who have not built equity in the rising property market. Despite this, we expect demand to remain strong for Australian property due to strong population growth and low interest rates assisting debt affordability.

The elevated debt to income levels does make the housing market more susceptible to increases in interest rates. This makes interest rate policy very important for Australian housing and economy stability.

The royal commission's possible impacts on the economy

As discussed above, the availability of credit was tightened before the royal commission. The important question is whether the royal commission fallout could result in a more severe tightening of credit that could accelerate this housing downturn.

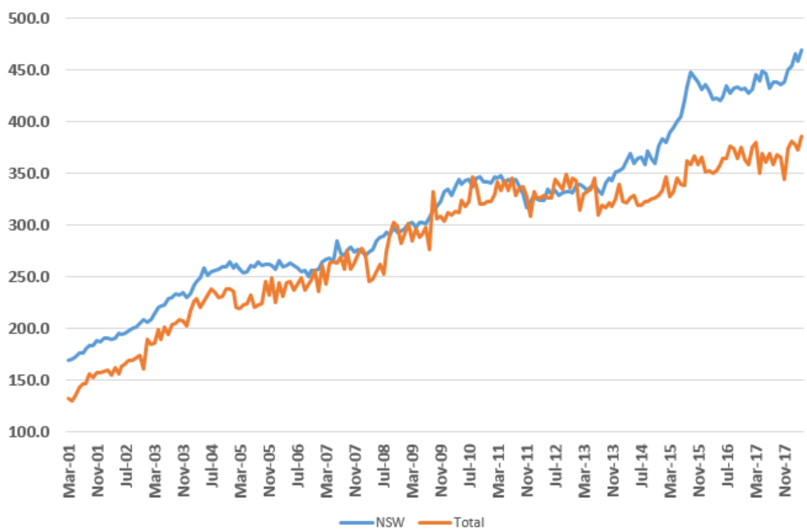
Key issues highlighted by the royal commission include the failure of banks to verify borrowers' living expenses and other debt obligations. Responding to this in April, APRA called upon lenders to:

1. Increase the collection of information on borrowers' actual living expenses and reduce reliance on industry benchmarks for living expenses.
2. Strengthen controls to verify borrowers' exiting debt commitments.
3. Develop internal risk appetite limits on the proportion of new lending where debt is greater than six times a borrowers' income.

Anecdotal feedback from our channel checks with bankers, mortgage brokers and real estate agents suggests that these measures appear to be slowing the mortgage approval process and, in some cases, causing a reduction in the maximum loan size.

Data from the Australian Bureau of Statistics confirms a slowdown in the number of loan approvals, but does not show a reduction in the average loan size. This indicates the reduction in loan size at this stage is probably isolated to some larger and riskier borrowers rather than a broader reduction for most borrowers.

*Figure 8: Average Loan Size to Owner Occupiers*




*Source: ABS*

We do however think overall housing credit growth will slow from the current 5.8% growth rate. In our view, population growth of ~1.7% per annum and nominal wage growth of ~2.3% per annum should support housing credit growth of 4% or more over the medium term.

## What can be done to prevent a crisis?

At this point, we do not believe that the property market is poised for a significant decline. Strong population growth and low interest rates should continue to drive strong demand for housing. While we believe the measures by APRA and recommendations from the royal commission will tighten the availability of credit, we think it will be marginal and unlikely to cause a severe housing downturn.

However, if the housing market decline accelerates, there are tools that APRA and the RBA can use to soften the housing market downturn.

APRA can begin by unwinding some of the tightening measures introduced over the past few years. For example, APRA has already removed its 10% annual growth cap on investor loans. This has seen banks reintroduce rate discounts on investor loans. If necessary, APRA can also relax LVR limits and interest-only loan restrictions.

A weaker housing market will likely see inflation pressures abate, allowing the RBA to cut interest rates to stimulate demand. This may then allow APRA to reduce its 7% interest rate stress test threshold.

## Conclusion

Housing downturns in Sydney and Australia over the last 30 years have been reasonably shallow. The tables below show downturns since 1989. The largest downturn was in Sydney dwelling prices from 2003 to 2006 where prices fell 8.4%[3]. Of course, just because recent housing downturns have been small, doesn't mean the next one will be.

| Peak (1) | Trough (2) | Years to trough (1) to (2) | Fall Peak to Trough (1) to (2) | New High (3) | Years to new high (1) to (3) |
|---|---|---|---|---|---|
| Jun-1989 | Dec-1990 | 1.5 | -2.4% | Jun-1991 | 2.0 |
| Dec-2003 | Mar-2006 | 2.2 | -8.4% | Dec-2007 | 4.0 |
| Dec-2007 | Mar-2009 | 1.2 | -5.9% | Sep-2009 | 1.8 |
| Jun-2010 | Dec-2011 | 1.5 | -3.0% | Dec-2012 | 2.5 |
| Jun-2017 | Jun-2018 | 1.0 | -3.6% | N/A | N/A |

*Source: ABS, CoreLogic. Note: June-2018 is a Milford estimate for the ABS quarter release using CoreLogic monthly data*

*Figure 10: Australia Housing Downturns - Dwelling Price*

| Peak (1) | Trough (2) | Years to trough (1) to (2) | Fall Peak to Trough (1) to (2) | New High (3) (3) | Years to new high (1) to (3) |
|---|---|---|---|---|---|
| Dec-2003 | Jun-2004 | 0.5 | -1.4% | Mar-2005 | 1.2 |
| Mar-2008 | Mar-2009 | 1.0 | -4.6% | Sep-2009 | 1.5 |
| Jun-2010 | Dec-2011 | 1.5 | -4.7% | Jun-2013 | 3.0 |
| Dec-2017 | Jun-2018 | 0.5 | -1.4% | N/A | N/A |

*Source: ABS, CoreLogic. Note: June-2018 is a Milford estimate for the ABS quarter release using CoreLogic monthly data*

[3] ABS

Our base case is that strong demand, lower interest rates, and policy responses from APRA will provide a degree of stability. While prices will likely fall further from here, we do not think it will cause a broader economic downturn.

We will however see a removal of the positive wealth effect that rising house prices generate. Home owners don't feel as wealthy when the prices of their homes are not rising, so are reluctant to spend. This could see an already sluggish retail environment weaken and would likely impact the earnings and share prices of Australian retailers. We have no significant exposure to domestic retailers within the Fund.

It will be very important to monitor interest rates. Multiple rate hikes could be enough to increase the severity of a housing downturn. This would certainly have wider economic consequences, requiring a more defensive strategy within the Fund. Our base case is that interest rate rises will remain unchanged in the near term. However, we will be closely monitoring inflation for warning signs of a change in interest rate policy.

Outside of the housing market, the Australian economy should continue to perform with tailwinds from the mining recovery and infrastructure boom.

## Investment Review

### *National Australia Bank (NAB)*

With structural and cyclical headwinds, the major banks' share prices have fallen over the last few years. From their highs in 2015 to their lows in June 2018, CBA has fallen 30%, NAB 36%, ANZ 40% and Westpac 31%.

The structural headwinds the major banks are facing include:

- Lower credit growth from macroprudential tightening.
- More onerous regulation on banks and market share loss to non-bank lenders.
- Increased competition as mortgage brokers increase share of loan originations.
- Competition lowering net interest margins. Net interest margin is the difference between what a bank earns on its loan book and what its pays on its deposits and other funding sources.
- Stricter capital requirements.
- A review and restructure of financial advice and wealth management businesses following the fallout from the royal commission.
- Further regulation resulting from the royal commission.

Cyclical headwinds include:

- Slowing lending growth with the cooling housing market.
- A potential rise in loan losses from cyclical lows.
- A rise in wholesale funding costs, reducing net interest margins.

*Figure 11: Growth in Housing Credit*

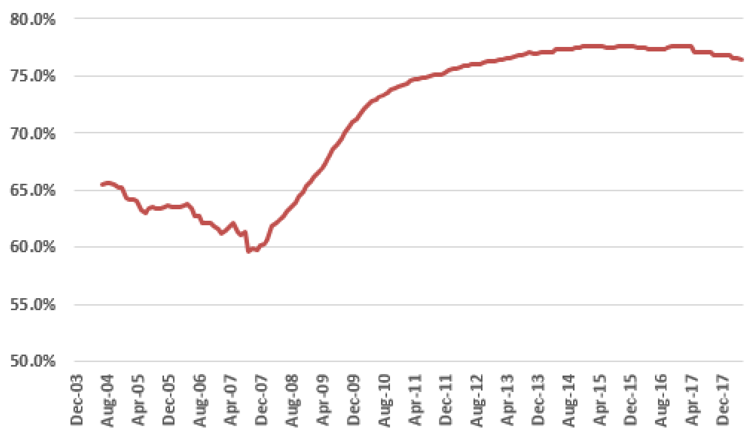

*Source: APRA, RBA*

## How significant are these headwinds?

While housing credit growth is likely to slow further, population and wage growth should underpin around 4% credit growth. The banks still have very strong core lending businesses and offer attractive imputed dividends for investors.

The banks have recently lost share to other lenders, but still have 76.0% of the total housing credit – down from a high of 77.6% in mid-2014[4]. While market share loss will likely continue in the near term, the major banks should still grow their housing books at around 3% per annum. In the next economic downturn, they may win share back as they did in 2008 and 2009.

*Figure 12: Share of total housing credit - ANZ, CBA, NAB and Westpac*




*Source: APRA, RBA*

The rise of mortgage brokers and the increased competition from other lenders should see structurally lower net interest margins. NAB's net interest margin has declined from 2.34% in 2006 to 1.87% for the March 2018 half year result. We see this tightening further with the recent increase in wholesale funding costs. The current public spotlight on the banks, and increased

[4] RBA, APRA

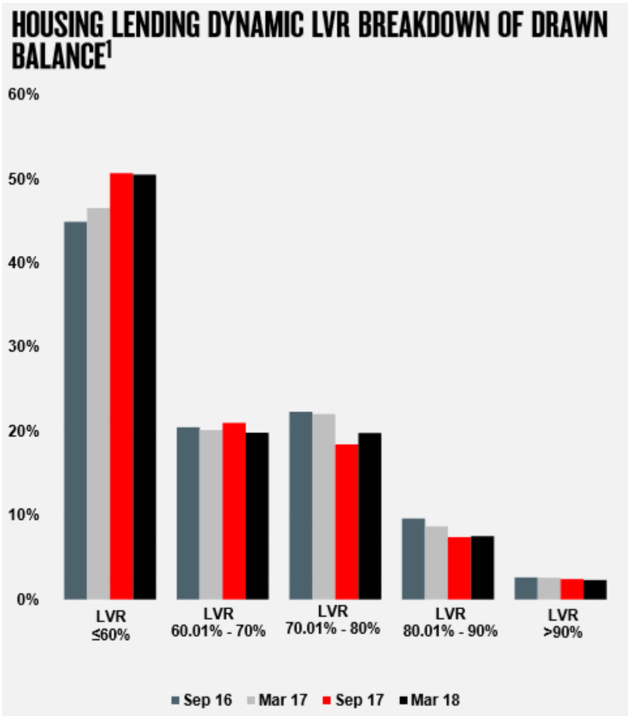
competition, will make it difficult to pass on these funding cost pressures through increases in mortgage rates – in the near term at least. At its first half result, NAB stated that its net interest margin would fall by 2-3bps if current wholesale fund costs are sustained.

We will likely see NAB and other banks increase operating costs as they resolve failings highlighted by the royal commission. But any increase in costs will likely be modest and offset by ongoing headcount reductions as banks invest more in technology and systems.

Further regulation from the royal commission is still a risk. However, we note APRA have increased regulation on the banks over the last few years. The banks are already preparing for any likely recommendations from the royal commission. While we may see more regulation, we don't believe it will have too large an impact on the banks' profitability.

Loan losses will likely increase from here, which will be a drag on earnings. We think it is very unlikely that loan losses become large enough to be a major threat to their capital levels. NAB's average drawn housing loan to underlying property value is only 42.7% – a significant improvement from 53.5% in March 2009. Only around 10% of NAB's housing lending is at an LVR in excess of 80%. This means even a 20% property correction will place only a small portion of borrowers in a negative equity position. As discussed earlier in this letter, we don't think a property correction of this magnitude is likely.

*Figure 13: NAB Housing Lending Dynamic LVR Breakdown of Drawn Balance*




*Source: NAB 1H18 Investor Presentation*

## Estimating normalised earnings and approximating value

In this section, we'll run through our valuation of NAB. This method involves calculating NAB's sustainable earnings and dividends and then applying an appropriate dividend yield to approximate fair value. While we use NAB in this example, results would be comparable across the other major banks.

Firstly, we need to normalise earnings for NAB's cyclically low credit impairment charge on their loan book. We think this would wipe about 12% off NAB's earnings. Pressure on net interest margins from competition and wholesale funding costs will likely take another 4%. This gives us *normalised* earnings 16% below current market expectations for 2019. We don't expect earnings to fall this much in FY19, but it is a good way to conservatively account for some of the headwinds NAB will face over the next five or so years.

| | cents per share | Change |
|---|---|---|
| **Current FY19 cash EPS expectaion** | **240.9** | |
| Normaled loan losses | -28.8 | -12% |
| 5bp NIM compression | -9.6 | -4% |
| **Normalised EPS** | **202.5** | **-16%** |

Secondly, we need to estimate NAB's sustainable earnings growth. As discussed in the previous section, we think the major banks can grow their housing credit at around 3% per annum. Growth in its business and other lending segments is likely to be similar, so we estimate sustainable book growth for NAB of 3% per annum. With some net margin decline over time from increased competition, NAB's net interest earned can grow at 2% per annum. Recent focus on technology should control operating cost rises to around 2% over the medium term, so we estimate sustainable earnings growth to be around 2%. If we assume no dividend reinvestment plan, then earnings per share will also grow at the same rate.

Finally, we calculate the dividend and target valuation using a fair dividend yield for NAB at this rate of growth. At around 3% book growth, we estimate NAB should be able to pay out 73% of their cash earnings as dividends, again assuming no dividend reinvestment plan. This gives a net dividend of 148 cents per share on our adjusted earnings base calculated above. We think investors need to get a pre-tax total return of about a 9.5% per annum on the banks through the cycle. With 2% earnings growth, this requires a 7.5% fully imputed dividend yield. This would give a target price of $28.15 for a domestically based investor. This compares to a share price of $27.92 at the time of writing.

| | |
|---|---|
| **Normalised EPS** | **202.5** |
| Dividend Payout | 73% |
| **Net Dividend per share (cents)** | **147.8** |
| Imputation credits (cents) | 63.3 |
| **Imputed divdend per share (cents)** | **211.2** |
| | |
| Target investor return | 9.5% |
| Less EPS growth | 2.0% |
| Target Gross Yield | 7.5% |
| **Target Share Price ($)** | **28.15** |
| | |
| Current Share Price ($) | 27.92 |

## Risks and conclusion

This analysis is overly simplistic but indicates that value is starting to appear in the banks. Our starting point, using earnings 16% below current market expectations for 2019 is conservative, but competitive forces may also drive net interest margins lower than we have assumed. There will also eventually be a recession where losses on their loans will likely be temporarily higher than we assume above.

Late in June, we purchased a 2.5% position in each of NAB and CBA, after selling completely out of bank shares a few months ago in April. We felt that the market concerns around the royal commission and slowing housing market had driven their share prices low enough to create a reasonable risk/reward investment opportunity when most other Australian equities were getting more expensive. But the longer-term growth prospects of the banks are poor and the discount to our valuations are only modest, so we will continue to review these investments to see if we can obtain better returning investments elsewhere in the market.

## Final Comments

The strong performance of non-bank Australian equities has seen the valuation of ASX industrial shares become elevated. In particular, growth companies have performed very well and many are trading at excessive valuations. The Fund has been reducing exposure to our investments that have reached overvalued levels, which has caused our equity exposure to fall to 65% at quarter-end. At some point over the next few months we will probably see a market risk-off event that will allow us to buy back some of our favoured growth companies at reasonable valuations. We will also likely uncover new equity investments that offer attractive returns. However, if neither occurs, we will be patient and hold more cash and fixed income investments.

Once again, thank you for investing with us.

Kind Regards

William Curtayne and Wayne Gentle

Portfolio Managers
Milford Asset Management