DUBBO REGIONAL COUNCIL

Investment Strategy

December

2017

Contents

General

Purpose of Document

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

- current market conditions;
- how Council is responding to structure its investment portfolio;
- realistic objectives for the investment portfolio;
- risk management

Related Documents

This Strategy relates to implementation of the portfolio within the constraints set out in the Investment Policy. It has been prepared to recognise the legislative requirements and obligations for the investment of Council's funds. The legislative requirements are listed in the Investment Policy.

Council will comply with investment regulations and directions of the Office of Local Government, which will prevail in the event of any inconsistencies with published Policy and Strategy.

Effective Date

This document replaces any previous Strategy document approved by Council.

The effective date of this Strategy is 18 December 2017 and will be reviewed in July and December each year or when a change in either regulation or market conditions necessitates a review.

Investment Strategy

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

Cash flow expectations

Council anticipates the following major capital expenditure in 2017-18:

- Recreation $6M
- Airport $21M
- Waste Services $8M
- Stormwater $3M
- Water Augmentation $9M
- Sewage Augmentation $7M
- Rural Roads $8M
- Urban Roads $7M

These projects are being funded from either loan funds, grants or restricted assets, and impact on the overall cash available for investment.

Sufficient liquid cash or near-cash is available to meet short term cash flow requirements in addition to these projects should this be required.

Diversification

Council's investments are diversified only within the fixed interest sector: Cash, term deposits and senior securities (bonds and FRNs). It is still dominated by term deposits, although there has been greater diversification into securities in recent quarters.

It is not Council's current intention to diversify further across other asset classes through TCorpIM Growth facilities, but should this change it will be ratified by Council resolution.

Ratings

Council now has a small allocation to BBB banks, on S&P's scale. Aggregate BBB+ range exposure and individual limits on BoQ are exceeded. These are not <u>outside</u> Policy, at the time of planning these investments they did comply with the existing Policy.

This pressure may well continue, with a negative outlook on the Australian government – a downgrade would flow through to major banks. Longer term, downgrades are probable from other agencies.

Economic Background

US 10-year bond yields closed October at 2.38%, with bond yields drifting slightly higher over 2017 as the Federal Reserve raised rates. Risk assets have been extremely strong and markets complacent, with record highs on stocks, post-GFC tights on credit spreads, and record low volatility measures. But the Trump Administration has struggled to enact reforms and stimulus measures, and feared no inflationary pressures from debt or trade barriers have eventuated thus far.

US GDP has been satisfactory, with consecutive 3% p.a. quarters quite unusual and coming as a surprise given Q3 was quite disrupted by the hurricane season. Local GDP has been variable but muted, with a strong Q3 driven largely by the public sector but below 2% trend.

Conversely, employment has been extremely strong in most countries, with the US, UK and Germany at decade or multi-decade low unemployment and Australia experiencing one of the strongest years of job growth on record.

Booming employment without inflation provides a puzzle for central bankers keen to normalise rates after a decade but without any firm trigger to justify a move. The RBA has talked for a year of tightening, but CPI remains below its target range.

The US Federal Reserve has said it would use higher interest rates before other monetary actions such as reducing its holdings of financial assets.

The Eurozone banking system is largely stabilised at the top end, with no panic or systemic issues as they bail in the junior debt of failing regional banks (but continue to protect senior debt and depositors).

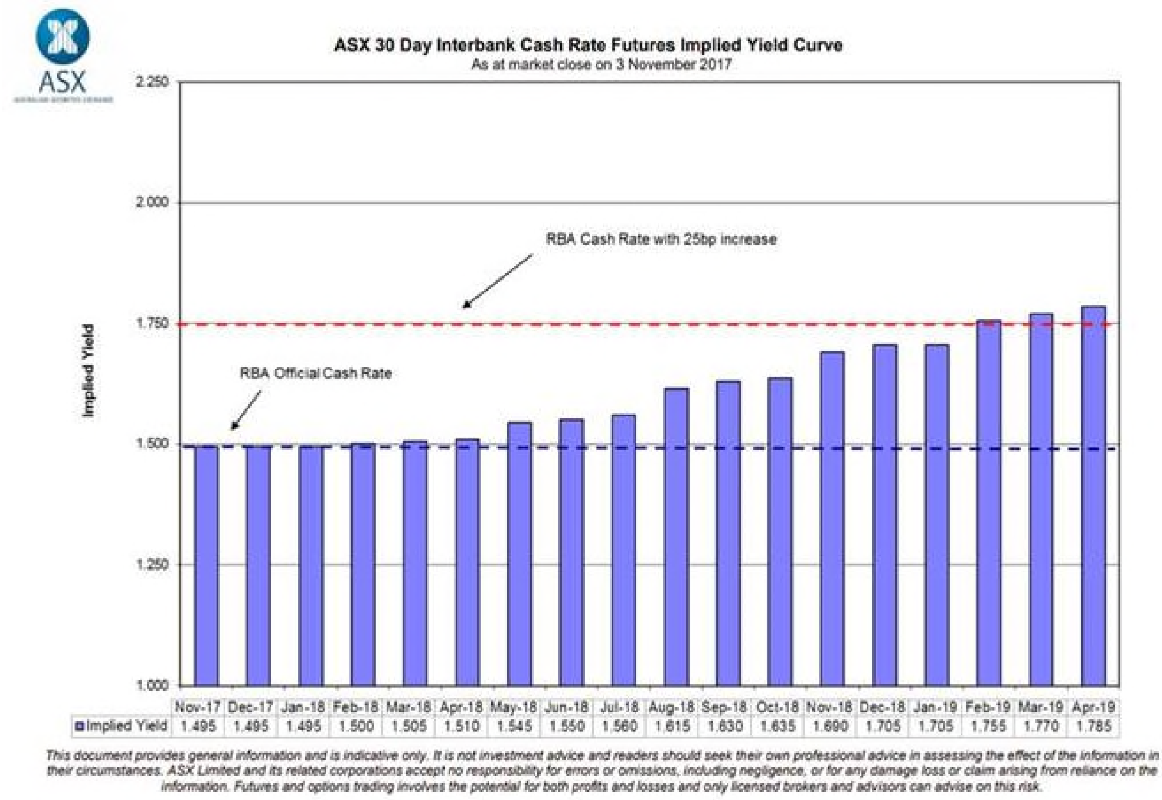
Australian long bonds are trading mid-range around 2 ½%, with no significant interest rate cycle factored in for a decade. Leading indicators like building approvals have recovered from recent lows, as have commodity prices. The most likely path for the economy is somewhere between continued sub-trend growth under 2%, and the much-predicted acceleration now expected by the RBA in 2018.

Return Outlook

So far, markets expect another US interest rate increase in December and then a gentle cycle under a new Chair in 2018 to a new, lower equilibrium. It is unclear when Australia will follow, but current expectations are for a year away to give inflation time to normalise.

The RBA left the cash rate unchanged at 1.5% in November. Their minutes increasingly fret about the property market – acknowledging weakness in mining states may be joined by Sydney. They are broadly optimistic on other sectors, including mining, but wary of any commodity spike driving up the $A to levels that would hurt the broader economy.

The market is positioned for rates to be flat in 2018, an outlook which appears reasonable given the lack of inflation in either prices or wages:



Source: ASX

Council’s return outlook is considerably better. As at October, deposits still had an average term of approximately 1.7 years (having further lengthened in the period of rising yields in late 2016), and returning, on average, 3.11% p.a. This is more than double the official cash rate. The strategy over recent years has made a dramatic difference to Council’s income – inevitably as the current deposits mature, this will tend to adjust lower.

Term Deposit Market

Deposit margins briefly traded at quite elevated levels, and Council took the opportunity to lengthen assets.

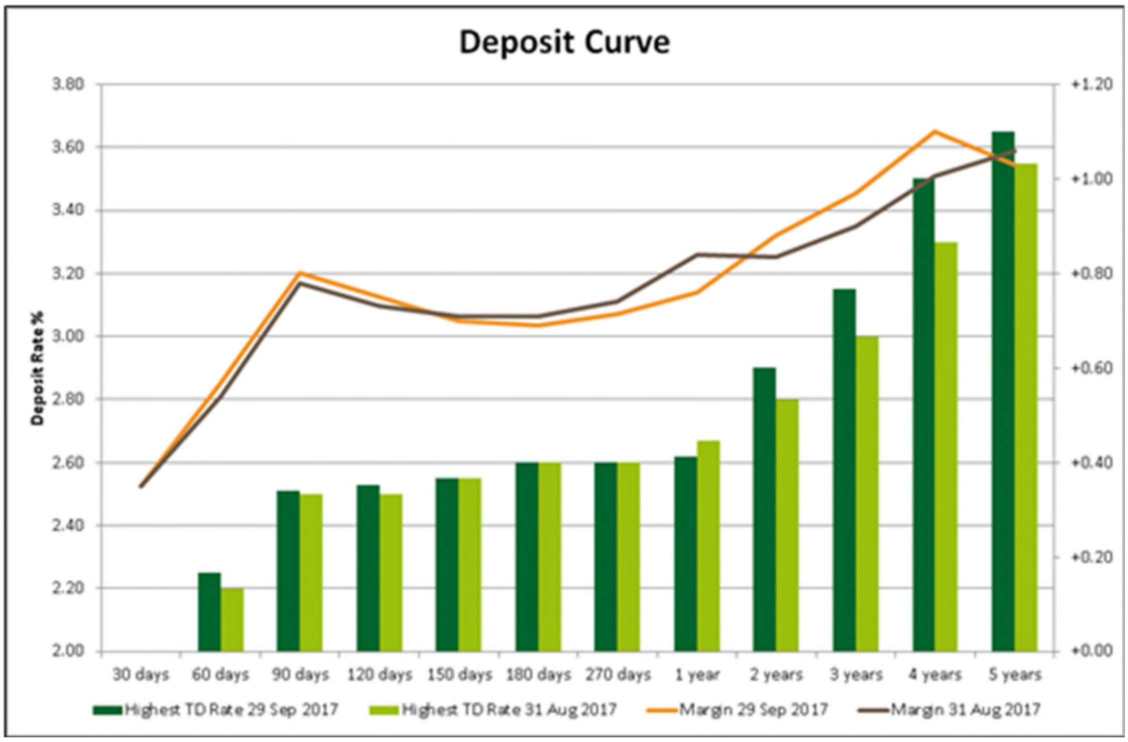
These have now pared back. Coupled with bond yields easing, no fixed rate deposit now offers above 3% over 3 years.

Floating rate deposits can sometimes exceed fixed rates for current income.

With BoQ consistently the highest rates by some distance, Standard & Poors’ downgrade has taken them from high investment grade (A or above) to low investment grade (BBB+) which is still within Council’s Policy. This further constrains investment – at A range, the highest rate at time of writing is 3.2% (Rabobank – restricted to $2M).

At the short end, 2½% or less is the norm up to a year.

Figure 2



The deposit curve is very flat; more so for the higher ratings.

Senior FRNs & Bonds

With spreads tightening consistently since early 2016, target returns on a 2-3 year horizon are only modestly higher than the best deposits.

Where secondary FRN's can be sourced at a discount, they will be evaluated as a "Held to Maturity" investment. Council reserves the right to sell existing FRNs prior to maturity.

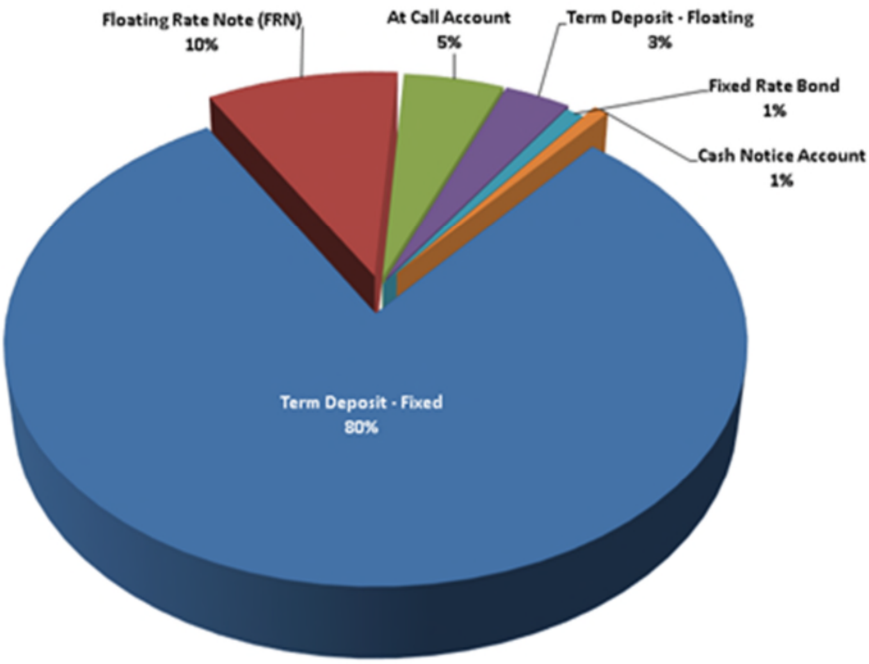
EXISTING PORTFOLIO STATUS

The Strategy throughout the past few years has been to prioritise long-dated deposits ahead of significant cuts to interest rates. Returns in the future will be significantly lower, given the current record low rates and the flat interest rate outlook over coming years.

Historically, the significant portfolio lengthening has reduced income risk, with the higher yields available from long-dated deposits an added benefit.

As at October, Council's deposits were still yielding 3.11% p.a., an excellent result – this is consistent with much longer maturity profiles, and lower credit quality in today's market.

Returns have also been enhanced by other Medium Term investments – the recent purchases of FRNs were secured at wider levels compared to recent years.



All assets comply with the current *Minister's Order*.

Proposed Actions

Returns of 3½% are not currently achievable in complying products at a guaranteed yield or volume. Only the higher-risk Growth Facilities at TCorpIM have the potential to offer high returns, and risks remain elevated with valuations stretched and earnings potentially falling.

Council's total investment income will continue to fall into FY18, barring an interest rate shock. Maturing assets are being reinvested well below current returns. This reduction in interest income will be incorporated into the forward budgets for FY2018 and onwards, with the potential of a cyclical low close to 2% if rates remain flat for a couple of years.

To maximise performance, the intention is to pursue the following actions during this strategy period.

New Investments

- *Cash*: Sourcing high yielding at-call accounts or cash notice accounts, checked against existing accounts or fixed rates.
- *Deposits*: With Bank of Queensland (BBB+ / A3) limited by its lower rating – banks such as ING (at the short end) and Rabobank (at the longer) can still offer rates that appear attractive relative to interest

rate outlook. Floating rate T/Ds are also considered, which would participate in future rate increases.

- *FRNs*: Surplus funds excess to liquidity requirements can be allocated towards 5 year liquid FRNs going forward where returns exceed term deposit rates, in the higher rated names. "A" rated ADIs are favoured as margins have contracted less than the domestic majors.
- Newly issued securities will be evaluated for pricing opportunities relative to deposit margins.

The ability to transact quickly is critical for new issues. To support this, Council has the ability to utilise existing at-call reserves (to be replenished from subsequent deposit maturities), or sell shorter-dated securities.

There is no intention at this time to invest in the long term (greater than 5 years) investments, being TCorpIM Growth Funds.

Risk Management Guidelines

The strategy addresses risk management as outlined below:

Preservation of Capital

Council has already enacted major strategies to manage capital risk, by redeeming from the various credit managed funds and the balanced growth fund through NSW Treasury Corporation in previous years. There are no more "grandfathered" managed funds in the portfolio and no credits of lesser quality than Australian banks. With the current composition of the portfolio consistent with the Minister's Order, there will be very minimal capital risk going forward.

Credit Risk

Credit rating profile is currently strong. The majority of investments are rated "A-" or higher.

It will be more difficult to comply with current rating constraints given the downgrades of existing assets, with fewer high rated banks to choose from.

Diversification

Investments are currently diversified within the fixed interest sector – fixed and floating, at-call and senior bonds and FRNs.

There is no current intention to diversify outside the fixed interest sector.

Liquidity Risk

Council's portfolio is highly liquid, from at-call accounts, near-term maturities and tradeable FRNs. Approximately 32% matures within 12 months.

Council has been in a position to extend the duration of some investments during recent years – sacrificing some liquidity in the portfolio in exchange for income protection and budgeting certainty.

Market Risk

Along with credit risk, market risk has now been substantially reduced by the exit from managed credit. The tradeable instruments (being short-dated major bank FRNs) have extremely low price volatility.

Maturity Risk

Council's long-term investments are primarily in a mix of term deposits and floating rate investments, minimising the effect of maturity risk as there is a regular maturity pattern and spread of maturity dates.

Rollover Risk

Council has reduced this risk through a deposit portfolio duration of 1.8 years. It includes assets maturing as late as 2022.

This is considered a very strong level of protection against rollover risk, and will continue to help anchor the FY18 income and contribute in FY19.

Economic weakness can see official cash rates remain low for a period significantly longer than the term of the investments. However, the current duration provides Council with time to plan for lower income.

Council is well within its required limits for working capital and short-term funds, which together account for around 32% of the portfolio.

Longer term holdings are conservative relative to portfolio limits, and there is capacity for further investments as opportunities and available cash permits.

PERFORMANCE BENCHMARKS

Council's overall portfolio (including cash) is currently yielding approximately 1.37% above the benchmark return. Deposits are higher still, at close to 1.45%% above benchmark - supported by extremely high yields on deposits from prior years ahead of the current interest rate cycle.

This yield is very strong given the high credit ratings targeted. It is almost certain to continue to fall over time, as official interest rates are expected to remain low over the long term which will mean lower rates on reinvestments.

DELEGATIONS/RESPONSIBILITIES

Within the constraints of the Policy, strategic or execution decisions are delegated to the Director Corporate Services and the Manager Financial Operations.

Review of Strategy

The Strategy will be reviewed in July and December each year, 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.