Macquarie Investment Management

Macquarie Income Opportunities Fund

Monthly report – 31 January 2021

Investment objective

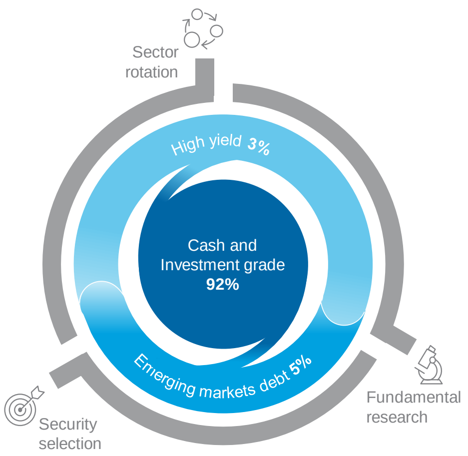
Aims to outperform the Bloomberg AusBond Bank Bill Index over the medium term (before fees). It aims to provide higher income returns than traditional cash investments at all stages of interest rate and economic cycles.

Key information

Fund details	
APIR code	MAQ0277AU
Inception date	18 September 2003
Fund size	$3,350.8m
Distribution frequency	Monthly
Management fee*	0.492% pa
Minimum investment (Direct)	$20,000
Unit prices and spreads	**macquarie.com.au/unit_prices**

*Read the Product Disclosure Statement for more details on fees and costs.

Current sector breakdown



Sector limits	(min/max)
Investment grade	0/100
High yield	0/20
Emerging markets debt	0/15
Cash	0/100

Fund performance to 31 January 2021

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	0.08	0.04	0.00	0.04
3 months (%)	1.38	1.25	0.01	1.24
1 year (%)	1.94	1.44	0.29	1.15
3 years (% pa)	2.89	2.39	1.21	1.18
5 years (% pa)	3.84	3.33	1.48	1.85
10 years (% pa)	4.37	3.86	2.39	1.47
Since inception (% pa)	5.23	4.72	3.76	0.96

Past performance is not a reliable indicator of future performance.
Total returns are calculated based on changes in net asset values and assumes the reinvestment of distributions.
Total net Fund returns are quoted after the deduction of fees and expenses. Due to individual circumstances, your net returns may differ from the net returns quoted above.

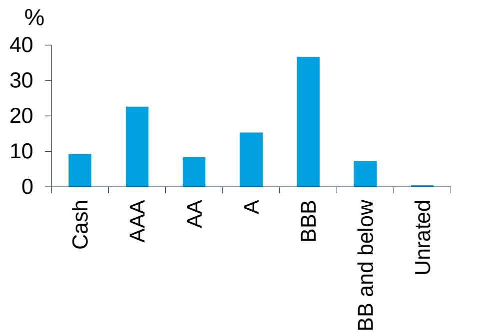
Asset allocation

	Fund (%)
Investment grade corporate^	51.4
Investment grade government	12.5
Asset-backed securities	19.2
High yield corporates^	3.0
Emerging markets corporate	1.6
Emerging markets government^	3.0
Cash	9.3

Asset-backed securities include but are not limited to residential mortgage backed securities, bank loans and other credit related securities.

^Fund holds 1.3% in investment grade, 3.7% in high yield and 0.2% in emerging markets credit hedges as synthetic cash (reduction in percentage of physical cash exposure).

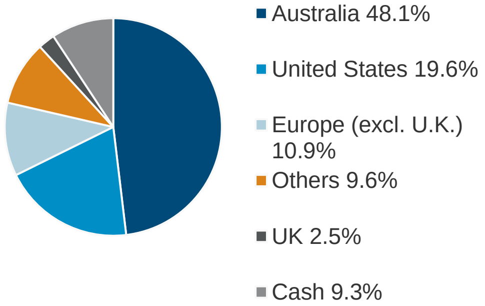
Credit profile breakdown



Average credit rating: A

BB and below include direct holdings and residual exposure to issuers held through our investment grade and emerging markets allocation.

Region breakdown



Fund statistics

Credit spread duration	3.1 years
Interest rate duration	0.9 years
Standard deviation[1]	1.8% pa
Yield to maturity[2]	1.3% pa
Cash	9.3%
Cash exposure through credit hedges[3]	5.2%

[1] Statistical measure of variance of Fund's post-fee monthly returns from average post-fee return since inception, used as gauge of volatility.

[2] Pre-fee returns Fund would earn over next year based on current market conditions if there were no changes to interest rates or holdings. It is not an actual or estimated return.

[3] Credit hedges swap the return for underlying credit index for cash.

Fund highlights

The new year did not start off quietly. Surging virus cases, new variants and pressure on hospitals have caused governments to re-tighten restrictions. In parallel, the vaccination process has begun but there is significant divergence taking place between countries in terms of supply and administration. The very long US election process came to a head with the Georgia Senate run-off early in the month. The Democratic party obtained both seats and, with the casting vote of the Vice-President, have won control of Congress. That said, the margin is wafer-thin, and is not the blue-wave sweep that pollsters had suggested. This reality was overlooked by the markets as expectations are for further near-term fiscal stimulus.

All of these events did not stop equity markets from surging to new highs in the US and credit spreads from tightening back towards pre-pandemic levels. Bond yields rose and yield curves steepened as the longer-maturity bonds underperformed, but rate markets are nowhere near their pre-pandemic levels. This has put bond markets in the cross-hairs of debate in terms of the outlook for 2021, where optimists are forecasting an inflation surge and higher interest rates. Others, like ourselves, are sceptical particularly as bond markets have a long history of accurately reflecting the reality.

The Fund outperformed the benchmark in January, while credit markets were mixed and bond yields grinded higher over the month. The Fund's credit exposures contributed positively to performance. Running yields and security selection in investment grade (IG) corporate credit were a key contributor as laggard BBB-rated issuers continued to perform well, even as the broader IG market was slightly weaker. Examples include holdings of Brisbane Airport, which had been added in the second half of 2020 and has benefited from the gradual re-openings; and Australian corporate hybrids, which continue to be well supported in the current environment. Tactical hedging positions against high yield (HY) exposures that were put in place early in the month also added to credit performance in during the sell-off in the latter half of the month. Emerging markets debt and HY exposures in the Fund were overall small positive contributors. The duration positioning detracted from performance as yields rose higher, though the higher yields are beginning to offer opportunities to extend duration again – after we significantly reduced duration exposure in September last year with yields trading at historic lows.

The Fund mostly maintained its overall risk exposure levels, trimming further some of the IG credit where there is limited upside. There were also reductions in some recovery trades that have performed very well, such as holdings of Southwest Airlines and Sydney Airport – both of which have traded back near or through their pre-pandemic levels. The higher beta sectors continue to offer better relative value, though given their increased volatility, exposures to those sectors are offset by owning less volatile shorter-dated securities with some yield (European bank subordinated debt, for example), as opposed to owning longer-dated IG credit with only modest spreads.

Market review

Global and Australian credit markets

The US credit market finished January with a mixed tone, with generic IG credit spreads 1bp wider to 97bps. The CCC-and-below segment outperformed, while the rest of the credit rating segments traded in a tight range. It was also a benign month overall for the European IG market, as a slower-than-expected rollout of the European vaccination programme, combined with the equity market volatility, dampened sentiment. Australian credit, on the other hand, outperformed global credit markets, with both low- and higher-beta as well as A- and BBB-rated sectors tightening 5 to 15bps over the month.

Outlook

The significant scars that will be left in the wake of the pandemic – the significant job losses, small business failures, and behavioural changes that we all have had to make – all suggest that the fundamental landscape is expected to remain challenging for some time and be dependent on the continued support from policy makers. We believe that the path of fiscal policy will play an important part in how the outlook is shaped. Continued 'support' by policy makers has prevented a worst case scenario, but the key looking forward is how can demand be kick-started? Monetary policy has little effectiveness in this regard with rates near the lower bound. With fiscal policy comes politics and we can already hear the siren voices of concern about the rise in budget deficit and debt levels. Politics is again on show in the US after President Biden outlined his first fiscal package, where debate is not just between the two parties but also within the Democratic party itself. Thus, in contrast to monetary policy, applying sufficient fiscal 'stimulus' is likely to prove more difficult than fiscal 'support' that the economies have been receiving.

What about valuations? What about positioning? Neither make a compelling case for investors, but technicals are strong, underpinned by a strong belief that central banks can continue to contain all risks. This disconnect between fundamentals and financial markets performance leaves us with an uncomfortable reality and the need to find yield. Thus, our challenge is to stay in front of consensus and not get caught up with uncomfortable positions.

What are the risks? On the upside we hope for successful vaccine rollouts, which will enable economies to re-open and supply chains to unlock. Governments can surprise by increasing spending, particularly on infrastructure, to create jobs and income and kick consumer spending sustainably higher. On the downside however, there are many risks around the virus and vaccines, while the scars left in the services sector and job markets will take years to repair. These all point to 2021 providing a challenging environment for investors, where our intention is to maintain discipline and recognise that opportunities will present themselves.

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For more information speak to your financial adviser, call us on 1800 814 523, email mim.clientservice@macquarie.com or visit macquarie.com