



AUSTRALIAN GOVERNANCE MASTERS INDEX FUND LIMITED (AQF) **QUARTERLY INVESTMENT UPDATE (MARCH 2016)**

MARKET REVIEW

It was a particularly volatile period, with the **S&P/ASX 100 Accumulation Index (Index)** falling approximately 10% by mid-February before rallying strongly, to finish down just 3.0% over the quarter. It was notably volatile for other developed equity markets, exemplified by the S&P 500 (+0.8%), which was also down by approximately 10% at one stage, before making a remarkable comeback, moving into positive territory by the end of March. Elsewhere, the Nikkei (-12.0%), Euro Stoxx 50 (-8.0%), NASDAQ (-2.8%) and FTSE100 (-1.1%) all recouped some of their early losses, however, ended lower.

Equity investors' anxiety was fanned by issues including the US high yield bond markets selling-off, weak US manufacturing sector surveys, increasing talk about the probability of a US recession and falling oil prices. There were also heightened worries around China's economy. However, as has been the pattern since the global financial crisis, markets were broadly reassured by the major Central Banks' commitment to loose monetary policy. Interestingly, an exception was in Japan, where after over a decade of quantitative easing, there are signs the limits of effective monetary stimulus may have been reached. A drop in the Nikkei followed the BoJ's announcement of a negative deposit rate for financial institutions.

From a domestic market perspective, perhaps the most remarkable sector developments were the de-rating of the banks and the marked turnaround in resource stocks' trajectory.

The worst performing sectors were Information Technology (-9.5%) and Financials (-7.3%) while Healthcare (-1.9%) – owing to the strengthening Australian dollar (AUD) and the sector's significant offshore revenue exposure – Energy (-1.0%), Telecommunications (-1.0%) and Consumer Staples (-1.0%) all posted negative returns but managed to outperform the Index. The strongest performing sectors over the quarter were Industrials (+5.6%), Materials (+4.4%), Utilities (+2.9%) and Consumer Discretionary (+1.7%).

In the broader **Financials sector (-7.3%)**, share prices of the banks and insurers retreated, with one exception being Medibank Private (+39.8%), which announced a profit upgrade. The domestic banks experienced a very difficult start to the quarter with macro concerns weighing on stocks. Potential overheating in segments of the Australian residential property market also attracted media and equity investors' (specifically hedge funds') attention. The subsequent relief rally while impressive, was tempered by ANZ and Westpac signalling bad and doubtful debt charges will rise. This resulted in downgraded earning forecasts and a sell-off into the end of March. The worst performers were Bendigo and Adelaide Bank (-21.3%), Macquarie Group (-20.2%) and ANZ (-16.0%). The "Big 4" experienced share price falls of -9.0% to -16.0%.

The **Materials sector (+4.4%)**, was again captive to commodities prices. A terrible beginning to the period was reversed by sharp commodity price rallies, which in turn led to both short covering and initiation/extension of long positions. The best performers were Bluescope Steel (+40.8%), Fortescue Metals (+39.0%), South32 (+37.6%) and Newcrest Mining (+30.8%), while BHP Billiton (-4.0%) and Rio Tinto (+0.4%) posted negative returns. A write-down of BHP's US onshore assets, a \$5.7bn loss in 1H16 and a dividend cut, all contributed to the decline in its share price.

The **Reserve Bank of Australia (RBA) held the cash rate steady at 2.0%** despite the soaring AUD.

The AUD appreciated 5.1% against the US Dollar (USD), consistent with broad USD weakness against the major currency crosses and commodity price momentum.

In the **US**, expectations of interest rate rises were diminished following the FOMC's announcement at the March policy meeting and Janet Yellen's speech at the Economic Club of New York. Currently, only two interest rate hikes are expected during the remainder of 2016. More recent economic data also helped, at least partially, to alleviate worries of a pending US recession. Jobs growth was solid over the quarter with non-farm payrolls increasing 628k.

In **China**, the central bank announced a 50 bps cut to the Reserve Requirement Ratio for all financial institutions in another effort to spur economic growth. While sentiment has broadly improved, many market participants remain wary of China's economic position with one primary lingering concern being the banking sector, specifically bad debts. China's Prime Minister Li Keqiang's comments on economic reforms during the National People's Congress session in Beijing raised hopes of further stimulus measures. China's declining FX reserves have also attracted greater market focus this quarter – suggesting the central bank has sold dollars to hold up the weakening Yuan amidst capital outflows.

Euro area GDP grew 1.1% q/q in 4Q15. The ECB continued to grow its balance sheet via QE, increasing asset purchases by EUR20bn to EUR80bn per month. The ECB also reduced the refinancing rate to 0.00% from 0.05% and the deposit rate to -0.4% (from -0.3%).

In **Japan**, the Bank of Japan surprised the market by announcing a negative interest rate of -0.1% on excess reserves that financial institutions place at the central bank.

COMPANY NEWS

AUSTRALIA AND NEW ZEALAND BANKING GROUP LTD (ANZ) – AQF WEIGHT: 6.23%; RETURN: -16.0%

The bank's retail and small business segments continued to perform well, however CEO, Shayne Elliot, expressed concern over slowing economic growth and increased market volatility in the region, a leading indicator of more difficult credit conditions. As a result, the company's bad debt charges are expected to rise above \$800m. This marked the worst quarter since December 2008 for ANZ, as concerns over rising bad and doubtful debt charges and its Asian exposure came to the fore.

BANK OF QUEENSLAND LTD (BOQ) – AQF WEIGHT: 0.42%; RETURN: -13.1%

At the results announcement, BOQ's CEO, John Sutton, announced the company is contending with strong competition for new business which is pressuring margins. He also detailed their restructuring, which is targeting a reduced cost base and improved cost-to-income ratio.

BENDIGO AND ADELAIDE BANK LTD (BEN) – AQF WEIGHT: 0.36%; RETURN: -21.3%

BEN experienced a mixed half-yearly result with their shares hitting a three-year low for the quarter. The fall in its share price is partly due to sector specific issues, with extreme price competition for mortgages.

BLUESCOPE STEEL (BSL) – AQF WEIGHT: 0.32%; RETURN: +40.8%

BSL reported strong underlying net profit growth compared with the prior corresponding period. The results are reflective of BSL's focus on lifting the performance of the steelmaking operations in Australia and New Zealand and reducing costs.

COMMONWEALTH BANK OF AUSTRALIA (CBA) – AQF WEIGHT: +11.67%; RETURN: -9.0%

CBA maintained its first-half dividend at \$1.98 per share, unchanged for the first time in seven years. Market volatility and a potential rise in bad debts contributed to this decision. ASIC is undertaking an investigation of CBA's insurance arm, CommInsure, on allegations it has engaged in unethical conduct to avoid and delay payouts to customers.

FORTESCUE METALS (FMG) – AQF WEIGHT: 0.00%; RETURN: +39.0%

FMG announced it had struck a non-binding agreement (MoU) with Vale that could see the Brazilian iron ore giant buy up to 15% of FMG's shares as well as invest in FMG's current or future mining assets. The deal is expected to be finalised in three to six months, subject to regulatory approval.

MACQUARIE GROUP LTD (MQG) – AQF WEIGHT: 2.05%; RETURN: -20.2%

At its investor day MQG reaffirmed their prior FY16 guidance for the March year-end. The fourth quarter, to-date, was described only as satisfactory and trading conditions across capital market facing businesses were said to reflect uncertainty.

MEDIBANK PRIVATE LTD (MPL) – AQF WEIGHT: 0.74%; RETURN: +39.8%

MPL soared to a new all-time high of \$2.97 per share during the quarter. Investors' optimism grew on the back of management guiding to a full-year operating profit above \$470m (a 27% increase from prior guidance of \$370m), driven by lower claims expenses. Recent premium increases and the appointment of new CEO Craig Drummond, formerly of National Australia Bank, were also well received.

NATIONAL AUSTRALIA BANK (NAB) – AQF WEIGHT: 6.31%; RETURN: -10.1%

Strong performance in the wealth division, a high net interest margin and higher lending volumes contributed to underlying revenue increasing 4%. An expected loss of \$4.2bn for the six months ending 31 March 2016 is largely attributable to the demerger of Clydesdale Bank in the UK.

NEWCREST MINING (NCM) – AQF WEIGHT: 1.18%; RETURN: +30.8%

NCM reported a half-year statutory profit of US\$81m and an underlying profit of US\$63m, underpinned by production of 1.2m ounces of gold. Free cash flow was up 19.0% and net debt reduced by 8.0% from June 2015.

PRIMARY HEALTH CARE (PRY) – AQF WEIGHT: 0.00%; RETURN: +63.2%

PRY's share price jumped 62.7% for the quarter after posting better-than-expected sales revenue and reaffirming its full year profit guidance of \$110m to \$115m. In the past year the company downgraded earnings twice amid revenue pressure on all three core businesses, regulatory uncertainty and government funding cuts in pathology and imaging services.

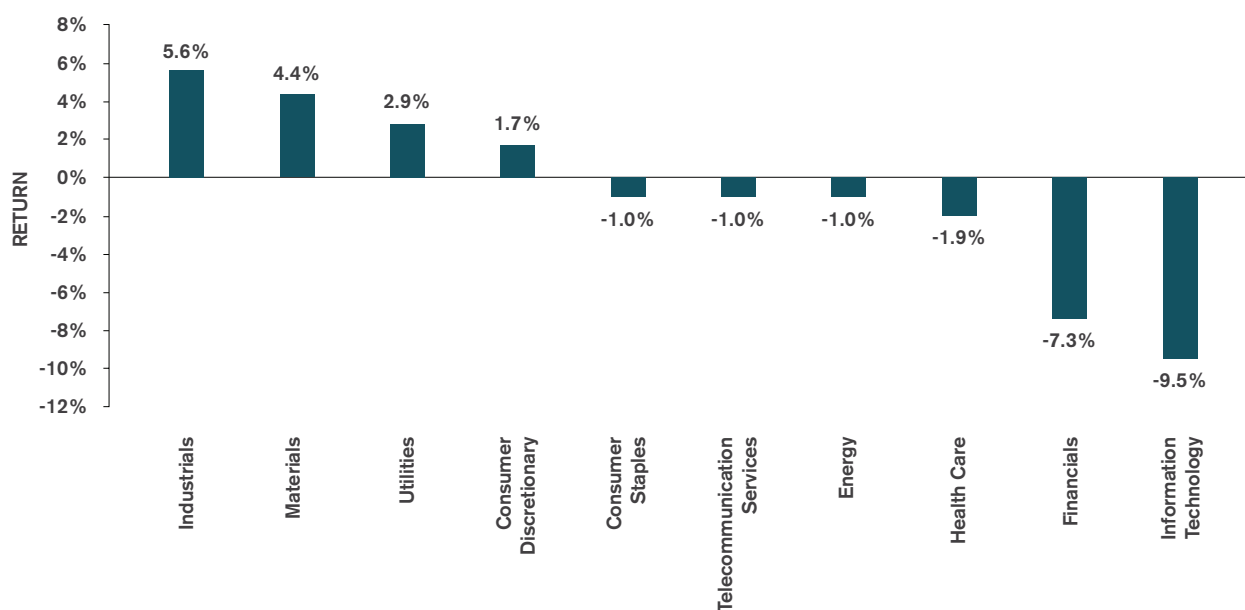
WESTPAC BANKING CORP (WBC) – AQF WEIGHT: 9.23%; RETURN: -9.6%

WBC flagged a rise in non-performing personal loans in mining-heavy regions and guided for a 10% increase in impaired loans provisions (~\$25 million) within its unsecured lending portfolio over 1H FY16. While the increase is immaterial relative to the size of the bank, WBC also highlighted its exposures to five troubled institutional customers that may further impact provisions. This potentially signals the end of the trend in declining bad and doubtful debts.

WOOLWORTHS LTD (WOW) – AQF WEIGHT: 2.56%; RETURN: -7.3%

WOW announced that Lowe's has exercised its put option in the Home Improvement JV and WOW in turn indicated it intends to pursue a sale or wind up of the business while hoping the new CEO, Brad Banducci, can help revitalise the company.

PERFORMANCE OF THE SECTORS WITHIN THE S&P/ASX 100 INDEX OVER THE MARCH QUARTER*



Source: Bloomberg, Walsh & Company Asset Management

* The S&P/ASX 100 sector returns are estimates and are based on average weightings during the quarter.

AUSTRALIAN GOVERNANCE MASTERS INDEX FUND (ASX: AQF) OVERVIEW¹

AQF listing date	February 2010
Total investments²	\$51,890,730
NTA per share²	\$1.73
Number of securities held	76

1. Figures are pre-tax estimates

2. As at 31 March 2016

AQF PERFORMANCE

For the 2016 March quarter (31 December 2015 to 31 March 2016), the accumulated unaudited pre-tax NTA of the Australian Governance Masters Index Fund (**Fund**), decreased by 3.8%. This compares to the Index, which decreased by 2.5% for the quarter (assuming gross dividends were reinvested and including franking credits for both Fund and Index).

During the quarter both the Index and the Fund rebalanced. The Fund added Dexus Property Group, Fairfax Media Ltd, Newcrest Mining Ltd, Clydesdale Banking Group PLC (a spin-off from the existing NAB holding) and Vocus Communications Ltd (a new entrant into the S&P/ASX 100), and sold Santos Ltd, Ansell Ltd and DUET Group as well as Sims Metal Management Ltd and Worleyparsons Ltd (both exited the S&P/ASX 100).

The most significant contributors to relative performance over the quarter were the overweight positions in OZ Minerals Ltd (+27.6%), Transurban Group (+8.4%), Medibank Private Ltd (+39.8%) and South32 Ltd (+37.6%), as well as the exclusion of Aurizon Holdings Ltd (-6.2%).

The largest detractors over the period came from the underweight position in Newcrest Mining Ltd (+30.8%)¹ and Commonwealth Bank of Australia (-9.0%), as well as the exclusions of Scentre Group (+8.5%), Westfield Corp (+7.0%), and Vicinity Centres (+13.9%).

PERFORMANCE

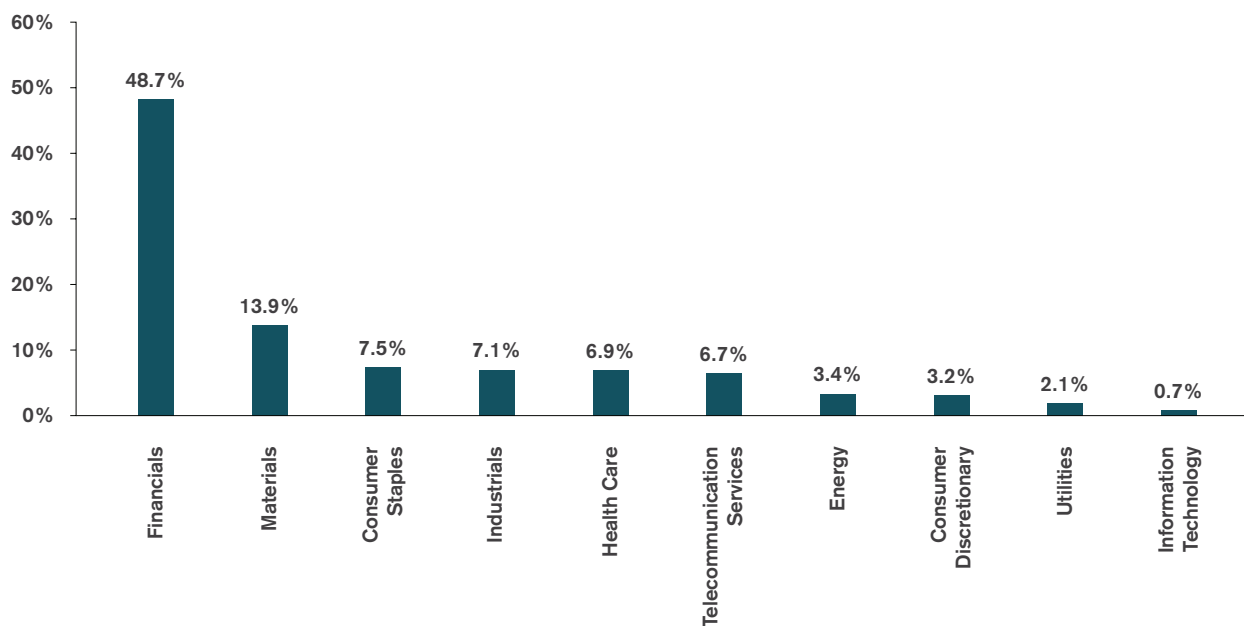
	AQF ¹	Index ²	Relative
March Quarter	-3.8%	-2.5%	-1.2%
2015	2.1%	3.8%	-1.7%
2014	7.4%	7.7%	-0.3%
2013	22.9%	23.4%	-0.5%
2012	22.3%	23.0%	-0.7%
2011	-10.0%	-8.4%	-1.6%
Since Inception p.a.	7.3%	8.6%	-1.4%

1. Assumes reinvestment of gross dividends (including franking credits).

2. The S&P/ASX 100 Accumulation Index returns assume reinvestment of dividends (including franking credits).

1. The Fund established a new position in Newcrest Mining towards the end of the period (mid-March), as part of the quarterly portfolio rebalancing. Its exclusion for most of the period detracted from AQF's relative performance.

AQF SECTOR ALLOCATION AT 31 MARCH 2016



Source: Bloomberg, Walsh & Company Asset Management

PORTFOLIO HOLDINGS AT 31 MARCH 2016

Company	Market Value (\$)	Weight (%)
COMMONWEALTH BANK OF AUSTRALIA	6,053,686	11.67%
WESTPAC BANKING CORPORATION	4,791,081	9.23%
NATIONAL AUSTRALIA BANK LTD	3,274,411	6.31%
AUST AND NZ BANKING GROUP	3,232,014	6.23%
TELSTRA CORPORATION LTD	3,084,263	5.94%
BHP BILLITON LTD	2,560,967	4.94%
CSL LTD	2,231,781	4.30%
WESFARMERS LTD	2,205,099	4.25%
WOOLWORTHS LTD	1,329,448	2.56%
TRANSURBAN GROUP	1,085,616	2.09%
MACQUARIE GROUP LTD	1,064,446	2.05%
BRAMBLES LTD	905,740	1.75%
WOODSIDE PETROLEUM LTD	870,646	1.68%
RIO TINTO LTD	857,130	1.65%
AMP LTD	810,571	1.56%
AMCOR LIMITED	786,624	1.52%
SUNCORP GROUP LTD	725,283	1.40%
QBE INSURANCE GROUP LTD	704,841	1.36%
SYDNEY AIRPORT	701,761	1.35%
INSURANCE AUSTRALIA GROUP LTD	642,158	1.24%
NEWCREST MINING LTD	612,765	1.18%
AGL ENERGY LTD	586,316	1.13%
STOCKLAND	480,512	0.93%
APA GROUP	464,666	0.90%
CALTEX AUSTRALIA LTD	434,776	0.84%
GPT GROUP	424,760	0.82%
ORIGIN ENERGY LTD	420,083	0.81%
ASCIANO LTD	413,647	0.80%
MEDIBANK PRIVATE LTD	381,931	0.74%
ASX LTD	379,582	0.73%

Company	Market Value (\$)	Weight (%)
JAMES HARDIE INDUSTRIES	374,810	0.72%
RAMSAY HEALTH CARE LTD	374,419	0.72%
SOUTH32 LTD	368,981	0.71%
SONIC HEALTHCARE LTD	365,252	0.70%
DEXUS PROPERTY GROUP	360,841	0.70%
LEND LEASE GROUP	348,165	0.67%
MIRVAC GROUP	334,474	0.64%
ARISTOCRAT LEISURE LTD	292,242	0.56%
COCHLEAR LTD	273,755	0.53%
ORICA LTD	267,868	0.52%
SEEK LTD	263,507	0.51%
TATTS GROUP LTD	261,357	0.50%
INCITEC PIVOT LTD	252,999	0.49%
COMPUTERSHARE LTD	235,708	0.45%
COCA-COLA AMATIL LTD	221,018	0.43%
BANK OF QUEENSLAND LTD	218,184	0.42%
HEALTHSCOPE LTD	218,075	0.42%
BORAL LTD	217,511	0.42%
THE STAR ENTERTAINMENT GROUP LTD	209,916	0.40%
VOCUS COMMUNICATIONS LTD	194,339	0.37%
BENDIGO AND ADELAIDE BANK	188,044	0.36%
DOMINO'S PIZZA ENTERPRISES LTD	171,693	0.33%
HENDERSON GROUP	168,338	0.32%
TPG TELECOM LTD	167,571	0.32%
TABCORP HOLDINGS LTD	167,438	0.32%
BLUESCOPE STEEL LTD	165,601	0.32%
ORORA LTD	142,785	0.28%
MAGELLAN FINANCIAL GROUP LTD	138,892	0.27%
ILUKA RESOURCES LTD	129,934	0.25%
REA GROUP LTD	125,728	0.24%
CLYDESDALE BANK PLC	125,422	0.24%

Company	Market Value (\$)	Weight (%)
CARSALES.COM LTD	121,587	0.23%
DULUXGROUP LTD	116,023	0.22%
FLIGHT CENTRE TRAVEL GROUP LTD	115,424	0.22%
RECALL HOLDINGS LTD	110,228	0.21%
JB HI-FI LTD	108,492	0.21%
ADELAIDE BRIGHTON LTD	106,688	0.21%
PERPETUAL LTD	97,313	0.19%
FAIRFAX MEDIA LTD	97,202	0.19%
OZ MINERALS LTD	93,694	0.18%
CSR LTD	80,612	0.16%
DOWNER EDI LTD	79,016	0.15%
SIRTEX MEDICAL LTD	77,187	0.15%
NAVITAS LTD	73,508	0.14%
SPOTLESS GROUP HOLDINGS LTD	67,817	0.13%
GRAINCORP LTD	65,168	0.13%
SUBTOTAL	\$51,271,426	98.81%
CASH	\$619,304	1.19%
TOTAL	\$51,890,730	100.00%

Source: Walsh & Company Asset Management Pty Limited. Note some figures may not reconcile due to rounding. The historical performance of the Manager is not a guarantee of the future performance of the Portfolio or the Company.

AQF BOARD OF DIRECTORS



JEFFREY ROBERT WHALAN
AO, BA

Non-Executive Chairman



MAXIMILIAN SEAN WALSH
AM, BEC

Non-Executive Director



JOSEPHINE TAN
BCOM, BSC

Non-Executive Director

The Company invests only in, what it considers to be, the best governed Australian companies within the S&P/ASX 100 Index, as ranked by the Company's corporate governance analysis and third party research. The Company pursues an index style of investing with an active corporate governance bias and expects to hold securities of approximately 75 to 85 Australian entities within the S&P/ASX 100 at any time.

The Company believes that boards and management that show relatively high levels of corporate governance tend to outperform companies with relatively lower levels of corporate governance over the long term. The Company also seeks to promote adherence to corporate governance best practice recommendations in its investments by voting in shareholder meetings.

The Company aims to achieve long-term capital appreciation, while reducing risk, preserving the capital of the Company and investing in a diversified portfolio of investments.

DISCLAIMER

This Quarterly Update (**Update**) has been prepared by Walsh & Company Asset Management as Investment Manager of Australian Governance Masters Index Fund (**Company**).

An investment in the Company is subject to various risks, many of which are beyond the control of the Investment Manager and the Company. The past performance of the Company is not a guarantee of the future performance of the Company.

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