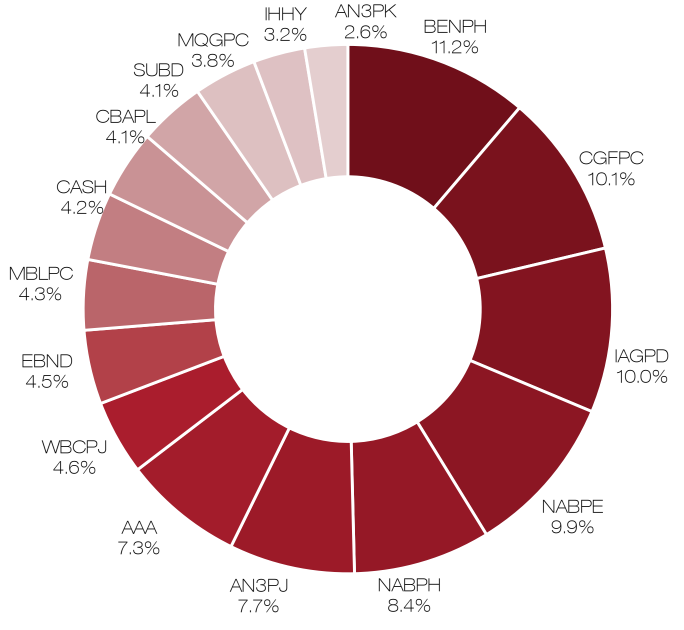
Enhanced Yield

March 2023



Portfolio Strategy

This income Strategy is designed for clients who want a better return than term deposits and cash while also have at-call access to their funds. It suits a conservative risk profile. The strategy invests in hybrids issued by investment-grade Australian financial institutions. There is also an allocation to bonds, both Australian and international including sub-investment grade. The strategy targets a return of the RBA cash rate +2.5 - 3.5%.

Portfolio Characteristics

Inception Date	2/09/2019
Benchmark	RBA Cash Rate
Weighted Avg. Maturity	2.74
Return Since Inception	3.2% p.a.
Benchmark Return Since Incp.	0.8% p.a.
Portfolio Manager	Will Allen

Weighted Average Maturity is the length of time until the average security in the fund will mature or be redeemed by its issuer. It indicates a fixed income fund's sensitivity to interest rate changes. Longer average weighted maturity implies greater volatility in response to interest rate changes. This metric considers the likelihood that bonds will be called or prepaid

The portfolio returned a small negative of 0.32% this month. This compared favourably with market contemporaries – small consolation. It's always disappointing to report a negative but for all in the bond and hybrid markets it was our turn to be the busy market as opposed to the usually more exciting equities.

Why so? They happen, not often, but there was a bank crisis in the US. This put pressure on the US bond markets which had a trickle down effect on our market. The trickle though became a flood when the crisis "jumped the pond" and effectively took down the poorly performing 1856 born venerable Credit Suisse Bank. There's much more detail I could go into here – as you can imagine. I will be brief. It all began with the collapse of a regional US bank called Silicon Valley Bank (SVB). The genesis of this started way back with the philosophical difference between Republicans and Democrats. Republicans preferred less oversight, less capital controls etc so with their election in 2016 that came to be. They switched oversight of the bank from the onerous, which comes with being monitored by federal regulators, to light regulation managed only at the state level. Poor governance, a poor understanding of asset and liability management and hubris (of course) at SVB then led to the crisis that caused a run on their deposits which quickly shut them down.

Over the pond, the markets quickly looked at themselves and asked "who could or would be next"? Credit Suisse (CS) had been performing poorly for years. It was as good as unprofitable and it had found itself with a poor franchise business. The run started on it and before you could blink its Swiss regulator stepped in and hastily arranged its sale to the only meaningfully sized bank left in Switzerland - UBS. What made this bank collapse hugely topical and important for us in Australia was that the current outstanding hybrid bonds CS had issued were written down to a zero value.

*Note: Performance of the strategy group is representative of individual client portfolios, although performance can differ due to inherent differences between clients' portfolios such as initial entry timing, legacy holdings or requested stock exclusions. Performance measured is after fees, taxes and franking credits.

Portfolio Commentary

What does that mean? Our portfolio can hold up to 80% of hybrid securities. In times of extreme bank stress these could be converted into equity. Our regulator, APRA, is the arbitrator of that possibility. Unlike the CS case, our securities could not be written down to a zero value, unless the bank's equity value itself was zero. Were that to happen you'd imagine that all bank issued bonds, and deposits above the government guarantee of $250,000 would also be worth zero. That's extreme to say the least. No hybrid in Australia has ever been converted to equity – even through the GFC, Covid etc.

APRA is known as one the best and toughest regulators in the world. Our banks continue to pass the "unquestionably" strong test. We are the highest capitalised banking system in the world – meaning we hold more equity versus deposits than any other. Our banks are very profitable meaning they can support themselves in times of stress. Our banking system is really a cosy oligopoly where the regulator (and by default the government) are happy for the Australian populace to essentially pay a tax (ie allow the banks to make very good money) so that we will always have a strong banking system underpinning our economy.

Hybrids trade at a "premium" credit spread of somewhere between 2% and 4% over other bank bond issuance (and TDs), depending on their maturity. For an investment grade rated instrument this is an exception return. Many would argue that there's almost zero chance of default in our banking system. Note also that we hold hybrids in Challenger Financial Group and Insurance Australia Group. These companies are also regulated by APRA as well as ASIC.

Please call us with any questions, we'd love to talk more about it.

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