COOLABAH CAPITAL INVESTMENTS

EVERY BASIS POINT COUNTS ...

Fund: **Active Composite Bond Fund**

Strategy: **Composite Bond (Institutional Only)**

Return (since Mar. 2017): **7.07% pa gross/6.01% pa net**

Net return volatility (since Mar. 2017): **3.36% pa**

August 2020

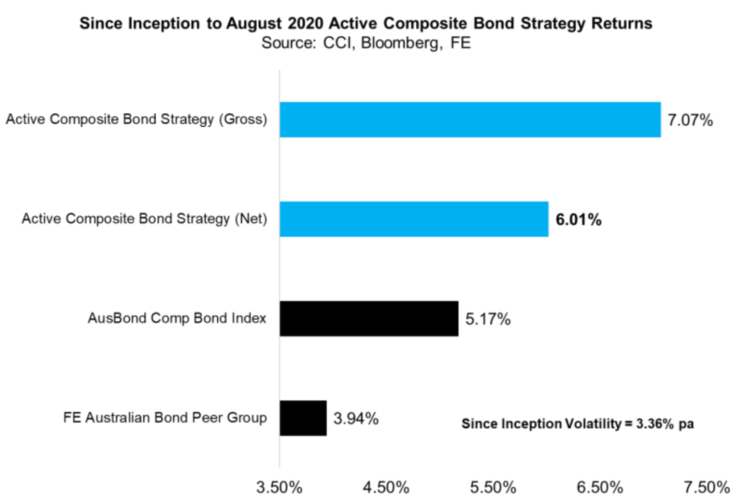
Objective: A relative return fixed-income strategy focused on mispricings in government and corporate bond markets. The performance objective for Coolabah Capital Investments' (CCI) Active Composite Bond Strategy is to outperform by the AusBond Composite Bond Index (0+yrs) return over rolling 12 month periods by 1% - 2%.

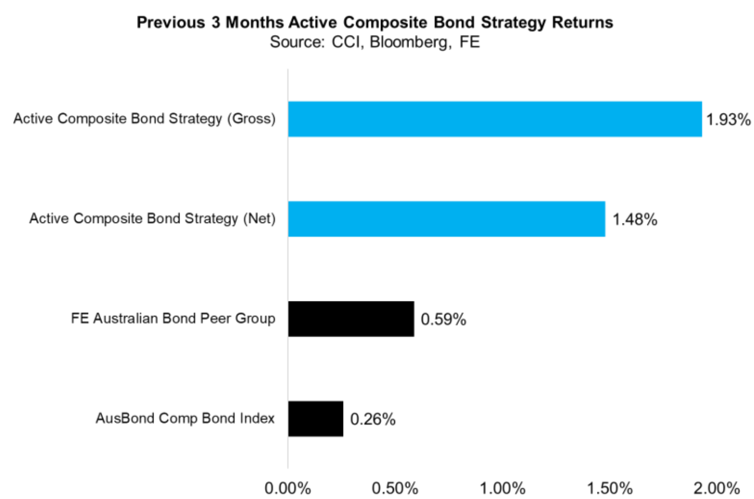
Strategy: CCI adds value via active asset-selection using a range of valuation models with the aim of delivering superior risk-adjusted returns over the Bloomberg Composite Bond Index. CCI actively manages a highly liquid and rated portfolio that consists of cash, cash equivalents, government bonds, and investment-grade floating-rate notes. The Manager will add value through its active asset-selection style that harnesses a suite of proprietary top-down and bottom-up quantitative valuation models. CCII's goal is to generate true valuation alpha by exploiting mispricings.

Period Ending 31/08/2020	Gross Return	Net Return*	AusBond Composite Bond Index	RBA Overnight Cash Rate	Gross Excess Return‡	Net Excess Return‡*
1 month	-0.13%	-0.23%	-0.42%	0.01%	0.29%	0.19%
3 months	1.93%	1.48%	0.26%	0.03%	1.67%	1.22%
6 months	2.43%	1.28%	0.26%	0.10%	2.17%	1.02%
1 year	4.48%	2.93%	1.61%	0.49%	2.86%	1.32%
2 years pa	9.27%	7.84%	6.30%	0.94%	2.97%	1.54%
3 years pa	7.52%	6.39%	5.47%	1.13%	2.05%	0.92%
Inception pa Feb. 2012	**7.07%**	**6.01%**	**5.17%**	**1.18%**	**1.89%**	**0.84%**

‡ The Excess Return columns represent the gross and net return above the AusBond Composite Bond Index

**Fees are available upon request*





Disclaimer: Past performance does not assure future returns. Returns are shown net of all Management and Performance fees unless otherwise stated. All investments carry risks, including that the value of investments may vary, future returns may differ from past returns, and that your capital is not guaranteed. To understand Fund's risks better, please refer to the Product Disclosure Statement available at Coolabah Capital Investments' website.

% Monthly Net Returns > Composite Bond (0+) Index	66.67%	Since Inception Av. Portfolio Weight to Cash	8.52%
Portfolio Weight to Cash Securities	18.19%	Portfolio Weight to AT1 Hybrids	0.00%
Portfolio Weight to Floating-Rate Securities	81.77%	Portfolio Weight to Sub-BBB- Securities	0.00%
Av. Portfolio Credit Rating	A+	Cash-Flow Duration Across Portfolio	3.95 years
No. Cash Securities	5	Credit Spread Duration	3.45 years
No. Floating-Rate Notes/Bonds	34	Annual Volatility (since incep.)	3.36%
Av. Interest Rate (Gross Running Yield)	1.77%	Gross/Net Sharpe Ratio (since incep.)	1.71x / 0.93x
Modified Interest Rate Duration	5.04 years	Awards: FE Alpha Manager 2019: Christopher Joye	

Past performance does not assure future returns. Please read the PDS to understand risks and disclaimers on final page

ALPHA MANAGER 2019
Christopher Joye

Portfolio commentary: **Coolabah's Active Composite Bond Strategy returned -0.13% gross in August (-0.23% net), continuing to substantially outperform the benchmark AusBond Composite Bond Index (-0.42%), representing 29bps of alpha. The strategy ended August with a weighted-average credit rating of A+. Over previous 3 months, the fund has returned 1.93% gross (1.48% net), compared to the Composite Bond Index's 0.26%, representing circa 167bps of alpha.** This alpha was fuelled by ongoing mean-reversion in credit spreads on assets that Coolabah had acquired during the COVID-19 shock, which have started normalising back towards their pre-crisis levels.

Over the previous 12 months, the strategy has returned 4.48% gross (2.93% net) compared to the Composite Bond Index's 1.61% (ie, alpha of 286bps). Since the strategy's inception in March 2017 it has returned 7.07% pa gross (6.01% net), outperforming the Composite Bond Index (5.17% pa) by 1.89% pa gross (0.84% net). While the return volatility of the mandate since inception has been low at around 3.36% pa (measured using daily returns), and comparable to the index's 3.12% pa, as a daily liquidity product with assets that are marked-to-market using executable prices, volatility does exist. This contrasts with illiquid credit (eg, loans and high yield bonds) wherein assets that have very high risk can appear to have remarkably low volatility, which is, in fact, just a mirage explained by the inability to properly value these assets using executable prices.

Strategy commentary: August was another strong month for Coolabah's high liquidity and zero interest rate duration alpha generation with all strategies reporting robust returns and outperforming their benchmarks. This was pleasing in the context of a material jump in long-term interest rates on the back of the US Federal Reserve announcing that it would revise its monetary policy framework to allow for sustained periods of inflation running above its official 2% target to make-up for past misses. Coolabah's CIO wrote about this at length, which you can read here for free via Livewire.

As central banks ramp-up money printing to fund ballooning fiscal deficits that could not be serviced without this "debt monetisation" support, the world moves one step closer to the debasement of fiat currencies as a medium of exchange and a new regime characterised by higher inflation.

Since the GFC, Coolabah has argued that the "QE to infinity" paradigm would end in a protracted period of elevated consumer price inflation as nation states opted for the easy path of seeking to inflate their way out of their fixed nominal debts. With the double-whammy of a 1-in-100 year pandemic that has necessitated extreme fiscal spending that has further undermined credit metrics that were already poor as a result of the GFC, nation states now have no choice but to coerce their central banks to finance these costs. The latest incarnation of this impulse is the "modern monetary theory" (MMT) fad.

The alternative would be a huge increase in government bond yields that would make debt servicing problematic for many countries and ultimately propagate sovereign debt crises. What this means is that increasingly non-independent central banks will be subjugated to the myopic and populist political imperatives of the day, which are defined by the idea that more debt and public spending are a solution to every problem. This logic is in turn motivated by policymakers' belief that all recessions are an inherently bad thing that must be eliminated at almost any cost (and any output losses recovered). The days of credible actors arguing for austerity are long gone.

The contrary perspective that creative destruction is an essential element of freely-functioning markets—and capitalism more generally—appears to hold no sway today. Put differently, central banks are aggressively buying an unprecedented range of privately traded assets because they are trying to thwart price signals that are telling us that bad businesses need to be replaced by more productive concerns. The politicians want to keep unprofitable and highly leveraged zombie companies alive and completely eliminate the volatility that is inherent in the business cycle that is characteristic of any dynamic, market-orientated economy.

Strategy commentary cont'd: What does this mean for portfolio construction? As we've argued for years, investors need to build portfolios that can continue to perform during periods of high inflation. The last 100 years of data shows fairly convincingly that interest rate duration as an equities hedge tends to only work during deflationary shocks. In periods of high inflation, duration becomes positively, not negatively, correlated with equities.

In the month of August, Coolabah's institutional daily liquidity, zero duration long/short credit strategies were up by between 90 and 109 basis points (bps) before fees depending on the solution. The AusBond Floating-Rate Note Index returned 10bps in August, ahead of the RBA cash rate's 2bps return and the miserly 1bps offered by the AusBond Bank Bill Index. As yields increased, the AusBond Composite Bond Index struggled, dropping by 42bps.

A stand-out in August was the ASX hybrid market, with the market-wide index returning 83bps in August before franking credits as the credit spread on five-year major bank hybrids compressed to about 323bps above the bank bill swap rate (generating capital gains as prices climbed). While this accords with Coolabah's expectations for ongoing mean-reversion in hybrid spreads, it is still well wide of the pre-COVID-19 level of around 275bps and recent 2019 tights of circa 260bps. The hybrid market should offer some attractive new primary supply opportunities with the likes of NAB, Challenger, Bendigo and Bank of Queensland all expected to issue new securities in 2020 to refinance maturities.

NAB's landmark unlisted hybrid security has continued to perform well, further compressing in credit spread terms from its 400bps initial margin to about 365bps at the time of writing. (Coolabah was a cornerstone investor in this transaction.)

Another driver of returns in August was the subordinated bond market, which has in recent months become a key active position for Coolabah. The credit spread on five-year major bank Tier 2 bonds contracted from 201bps at the end of July to 178bps by end August despite a torrent of new supply. In the final two weeks of the month there were no less than five different Tier 2 issues from IAG, QBE, ANZ, Suncorp and CBA. NAB also issued in US dollars. Coolabah participated in all save NAB and QBE, both of which struggled post issue.

One laggard in August was the major banks' senior bonds, which Coolabah had exited in July. The spread on five-year senior bonds actually increased from 42bps to 47bps over the month as bank balance-sheets sought to take profits into a bid that was weak to say the least.

Following the end of the month the RBA announced it would further expand its important Term Funding Facility, which will now be increased by $57 billion to provide three-year funding of up to $200 billion to all Australian banks at a cost of just 0.25% annually. This is allowing banks to avoid having to issue more expensive senior bonds to replace their existing maturities in Australia and overseas. It will also put more pressure on savings and deposit rates as the banks can access cheaper and longer-term funding via the RBA.

The net result will be an amplification of the search for yield dynamic, both by investors and bank balance-sheets themselves. Banks have to pledge collateral to draw-down on the TFF, and they will ideally want to find liquid, high-grade assets that pay attractive spreads above government bonds and which are eligible collateral under the RBA's repo facilities. This has been one driver of demand for higher-yielding semi (or state) government bonds, which is another active position Coolabah has accumulated in recent times.

Turning to some of the key risks to the outlook, the Victorian COVID-19 trajectory is tracking nicely in line with Coolabah's projections, which were originally published in early July and forecast a late July peak (the ultimate peak in the Victorian second wave was 31 July). You can read Coolabah's forecasts for free here. The risk now is with other second waves emerging across the Australian continent, although this is not our central case. Our heterodox view remains that effective vaccines will emerge this year, and start public distribution initially to emergency service professionals before the end of 2020 with mass-market roll-outs commencing by the end of the first quarter in 2021. The lingering risks to this perspective concern the safety of the Moderna and Oxford vaccines, the longevity of their efficacy, and what proportion of users they actually protect.

Strategy commentary cont'd: Another worry for many has been the Australian housing market. Since March Coolabah has held the contrarian view that the market would surprise with its resilience with national prices only falling by between 0% and negative 5%. While this projection did not account for the surprising Victorian second wave, the market is behaving as expected. Auction clearance rates in Sydney have been very strong, and improving in recent weeks. More significantly, the daily hedonic house price indices published by CoreLogic indicate that the Sydney, Brisbane, Perth and Adelaide markets may now be starting to recover with a reduction in the rate of house price declines in August and outright stability in many cities (eg, Brisbane, Adelaide and Perth). Nationally across the eight capital cities, home values have only fallen by 2.5% from their April 2020 peak. Coolabah expects the house price boom that began in June 2019 to reassert itself by the first quarter of next year.

One significant concern relates to record unofficial arrears in illiquid and subordinated bonds comprising “securitised” portfolios of Australian home loans, SME loans and consumer loans that are packaged up and sold to investors through residential mortgage-backed securities and asset-backed securities.

Coolabah is particularly anxious about RMBS and ABS issued by non-bank lenders that are not actively supervised by Australia’s tough banking regulator, which mandates minimum lending standards for deposit-takers.

Non-banks typically target borrowers who cannot get finance from normal banks, which often means consumers with higher default risks. If around 10% of all bank borrowers have been forced on to loan repayment holidays, it is reasonable to assume that non-banks will be suffering from similar, if not worse, arrears.

At the peak of the US sub-prime crisis, the 90-day default rate on very low quality US home loans hit about 10% of all borrowers, which is disturbingly similar to where the unofficial Australian default rate is right now if you included borrowers not making repayments.

These repayment holidays are not being recorded as arrears (or defaults), but the Australian Prudential Regulation Authority has said lenders will have to do so by the end of their deferral periods.

Our analysis indicates that this means that RMBS and ABS arrears should start spiking in March and April next year. (Technically, under an Australian mortgage agreement, once you miss a repayment you are legally in default, although banks rarely exercise their rights until you have missed many months of payments.)

Most RMBS/ABS bonds have “step-down” provisions that mean if the reported 60 days arrears rate climbs beyond a threshold (normally 4%), the lower-ranking, or junior, bonds will stop receiving repayments of principal from their borrowers (they only receive interest), with these cash flows diverted to the highest-ranking, or senior, bonds.

(An ABS or RMBS issue is normally broken up into three to six different bonds delineated by their ranking and entitlement to the cash flows paid on the loans.)

This means that the expected life of the subordinated bonds could blow out as principal repayments are deferred. Among other things, this could reduce both the liquidity and price of these RMBS and ABS securities.

Similar risks apply to the warehouse facilities that are extended to non-banks prior to securitising a loan portfolio via the sale of RMBS and ABS. Coupled with the soft housing market, it does not make for a comforting picture.

Don't forget to listen to Coolabah Capital's popular Complexity Premia podcast. You can listen on your favourite podcast app, or you can find it on Apple Podcasts or Podbean here.

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