



July 2021

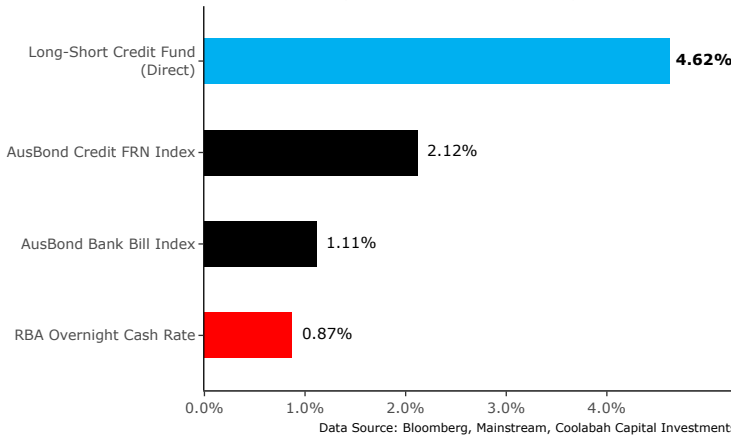
**Objective:** An absolute return fixed-income strategy focused on exploiting long and short mispricings in credit markets that targets high-yield like returns above the Reserve Bank of Australia (RBA) cash rate plus 4% to 6% p.a. over rolling 3 year periods with volatility of less than 5% p.a. after Management Fees, Administration Fees and Performance Fees.

**Strategy:** We add value via active asset-selection using a range of valuation models with the aim of delivering superior risk-adjusted returns, or alpha, to traditional hedge funds. We primarily invest in senior and subordinated debt securities, hybrids and derivatives issued by Australian entities domestically, although we can invest in these securities when they are issued overseas, or by overseas entities (into Australia or offshore). The Fund can use gearing and targets holding the majority of its portfolio in investment-grade securities. It is managed by Coolabah Capital Investments.

Period Ending	Gross Return (Direct)	Net Return (Direct) <sup>†</sup>	RBA Cash Rate	Gross Excess Return <sup>‡</sup>	Net Excess Return (Direct) <sup>†‡</sup>
2021-07-31*					
1 month	0.14%	0.04%	0.00%	0.14%	0.04%
3 months	-1.50%	-1.40%	0.01%	-1.51%	-1.41%
6 months	0.47%	-0.01%	0.01%	0.46%	-0.03%
<b>1 year</b>	<b>8.28%</b>	<b>5.77%</b>	<b>0.06%</b>	<b>8.22%</b>	<b>5.71%</b>
2 years pa	6.16%	4.03%	0.31%	5.85%	3.72%
3 years pa	7.23%	4.95%	0.68%	6.54%	4.26%
<b>Inception pa Aug. 2017</b>	<b>6.76%</b>	<b>4.62%</b>	<b>0.87%</b>	<b>5.88%</b>	<b>3.75%</b>

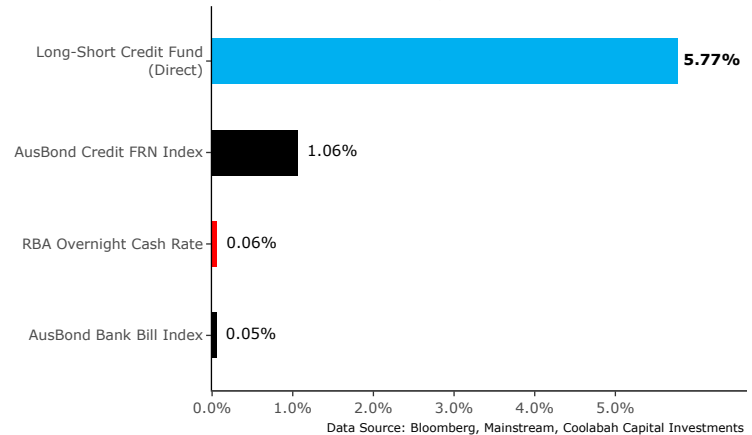
**Long Short Credit Fund Returns (Net) vs Benchmark (pa)**

Annualised Returns Since Inception in August 2017 to 31 July 2021



**Long Short Credit Fund Returns (Net) vs Benchmark**

12 Month Return to July 2021

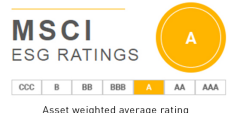


\* Most recent month returns in this report are estimated. † Net returns are calculated from the historic gross returns using the current fee structure as displayed in the Product Disclosure Statement. ‡ The Excess Return columns represent the gross and net return above the RBA cash rate.

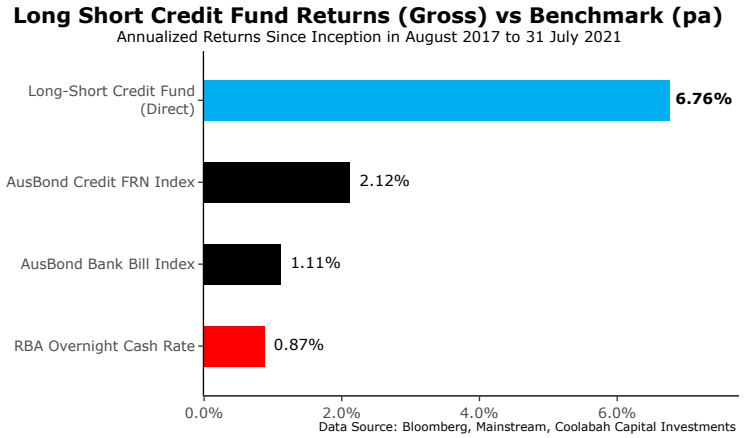
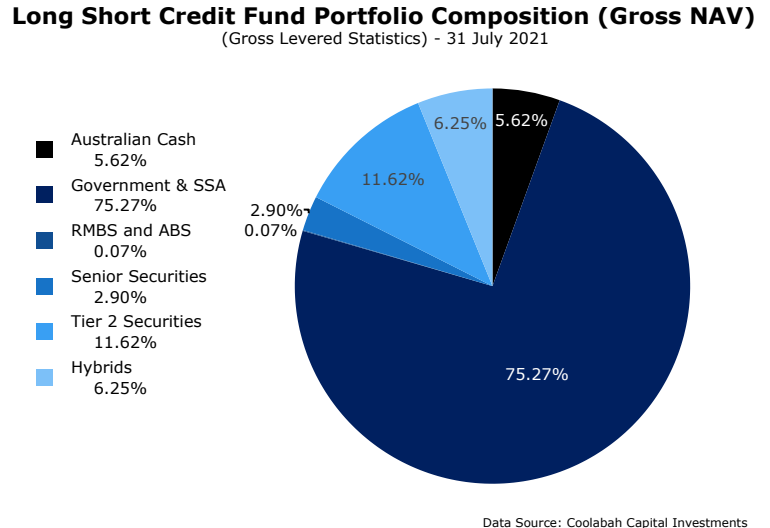
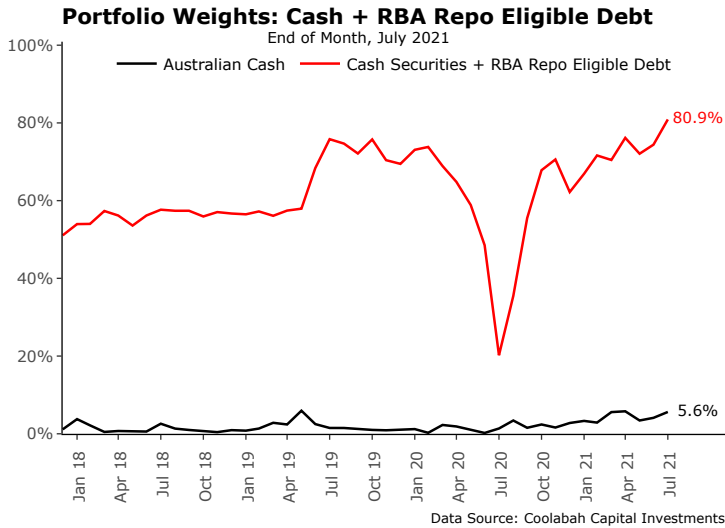
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Net Monthly Returns > RBA Overnight Cash Rate	79%	Permitted Gearing	Yes
Gross Portfolio Weight to Cash Securities	5.6%	1 Year Av. Gross Portfolio Weight to Cash	3.5%
Gross Portfolio Weight to Bonds	96.1%	Gross Portfolio Weight to AT1 Hybrids	6.3%
Av. Portfolio Credit Rating	AA-	Gross Cash Securities + RBA Repo-Eligible Debt	80.9%
Portfolio MSCI ESG Rating	A	Gross Portfolio Weight to ABS/RMBS	0.1%
No. Cash Securities	4	Net Credit Spread Duration Ex Govt	3.21 years
No. Notes and Bonds	83	Net Annual Volatility (since incep.)	3.13% pa
Av. Interest Rate (Gross Running Yield)	4.05%	Gross/Net Sharpe Ratio (since incep.)	1.81x/1.20x
Modified Interest Rate Duration	0.07 years	<b>Awards:</b> FE Alpha Manager 2019: Christopher Joye; <b>Ratings:</b> Lonsec available to advisers; Recommended (Atchison); 'Superior More Complex' (Foresight Analytics)	

Signatory of:



Asset weighted average rating



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The since inception gross (net) return of 6.76% pa gross (4.62% pa net) is the total annual return earned by the fund since Aug. 2017, including interest income and movements in the price of the bond portfolio after all fund fees (assuming net returns are calculated from the historic gross returns using the current fee structure as displayed in the Product Disclosure Statement). The net return quoted applies to the Smarter Money Long-Short Credit Fund - Direct Investor Class, with quarterly distributions reinvested. Each investor's return will vary depending upon their own investment date and any top-ups and withdrawals they make. The annualised volatility estimate of 3.13% pa is based on the standard deviation of net daily returns since inception, which are then annualised, attributable to the Smarter Money Long-Short Credit Fund - Direct Investor Class.

Portfolio Managers	Christopher Joye, Ashley Kabel, Dr Stephen Parker, Dr Nick Campregher (Coolabah Capital Investments)		
APIR Code	SLT2562AU	Fund Inception	31-Aug-17
ISIN	AU60SLT25623	Distributions	Quarterly
Morningstar Ticker	41597	Unit Pricing	Daily (earnings accrue daily)
Asset-Class	Alternatives/Hedge Funds	Min. Investment	\$1,000
Target Return	Net 4.0%-6.0% pa over RBA cash rate	Withdrawals	Daily Requests (funds normally in 3 days)
Investment Manager	Coolabah Capital Investments (Retail)	Buy/Sell Spread	0.00%/0.05%
Responsible Entity	Equity Trustees	Mgt. & Admin Fee	1.00% pa
Custodian	Mainstream Fund Services	Perf. Fee	20.5% of returns over RBA cash rate + 1.00% pa



Asset weighted average rating

**Portfolio commentary:** In July, the zero-duration and daily liquidity Long-Short Credit Fund (LSCF) returned 0.14% gross (0.04% net), outperforming the benchmark RBA Overnight Cash Rate (0.00%) by 0.14% gross (0.04% net). LSCF ended July with a weighted-average credit rating of AA-, a portfolio weighted average MSCI ESG rating of A, and a running yield of 4.05%. Over the previous 12 months, LSCF returned 8.28% gross (5.77% net), outperforming the benchmark RBA Overnight Cash Rate (0.06%) by 8.22% gross (5.71% net).

Since the inception of LSCF 3.9 years ago in August 2017, it has returned 6.76% pa gross (4.62% pa net), outperforming the benchmark RBA Overnight Cash Rate (0.87% pa) by 5.88% pa (3.75% pa net). LSCF's since inception Sharpe Ratio, which measures risk-adjusted returns, has been 1.81x (1.20x) gross (net). While LSCF's return volatility since inception has been low at around 3.13% pa (measured using daily returns), 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:** July was yet another month of cross-currents in fixed-income markets that furnished some attractive opportunities.

The stand-out was the big rally in interest rate duration as long-term bond yields declined further with the fixed-rate (rather than floating-rate) benchmark AusBond Composite Bond Index appreciating by a strong 1.76% in July, outperforming even the Aussie sharemarket's 1.06% return.

**Coolabah's Active Composite Bond Strategy, which is now available in active ETF format under the ticker FIXD, outperformed the benchmark, delivering a net 1.84% return in July after all retail fees.**

**Over the year to July, the AusBond Composite Bond Index furnished a much more modest 0.53% return as the increase in long-term interest rates following the initial COVID-19 crisis last year hurt long-duration strategies. In comparison, Coolabah's Active Composite Bond Strategy outperformed, providing a net return of 2.05%, which was 1.52% above the benchmark after all fees.** (Please read the PDS for risks and note past performance does not assure future returns.)

The duration rally in July was fuelled by a fall in the Australian 10-year government bond yield, which slumped from 1.53% to 1.18% over the month on the back of markets pricing-out the hysteria earlier in the year about the threat of a spike in inflation (or "reflation").

It has been a punishing trade betting on higher long-term yields (or for those short-selling interest rates), with the 10-year Aussie government bond yield now a stunning three-quarters of a percentage point below its 1.92% peak in February 2021.

The actual catalyst for the bond rally appears to have been a combination of greater confidence that central banks will combat any inflation outbreak, the absence of any rush for central banks to taper their bond purchase programs (or to do so in a hasty fashion), and the positioning of investors in the market. In respect of the latter, the preponderance of investors short-selling duration (ie, interest rates) coupled with the ensuing bond rally, which has inflicted losses on short-sellers, seems to have created the mother-of-all short squeezes. This has forced the short-sellers to cover their positions by buying-back the bonds (and/or interest rates futures), amplifying the rally.

**Strategy commentary cont'd:** In Australia, the June inflation data remained incredibly benign notwithstanding the spike in the headline inflation numbers due simply to the payback from previous deflation during the COVID-19 shock last year. Over the year to June, core inflation in Australia printed at about 1½% while on a six-month annualised basis core inflation has been running at 1¾%, both of which remain well-below the mid-point of the RBA's target 2%-3% band.

**Across the rest of the local fixed-income markets, performance was more subdued in July. Coolabah's proprietary indices that track credit spreads on a constant-maturity basis had 5-year major bank senior bond spreads tightening from 49 basis points (bps) to 46bps over the month. It seemed that this was partly explained by banks looking for paper to put into their Committed Liquidity Facility books (see more on this below).**

**One step down the capital stack, 5-year major bank Tier 2 bond spreads also tightened a bit from 129bps to 127bps over the quarterly bank bill swap rate (BBSW). After a robust return in June, the ASX hybrid market was much more subdued in July with 5-year major bank AT1 hybrid spreads effectively moving sideways from 248bps to 249bps (although 3-year spreads tightened from 217bps to 212bps). After the end of the month, Macquarie Bank announced a new \$500 million hybrid issue, which should be well-received.**

**In the State government bond sector, there was greater consolidation after a dramatic increase in the cost of capital the States pay above the Commonwealth government bond curve in June. In July, for example, 10-year Victorian government bond spreads above the cost of Commonwealth government bonds were basically unchanged at 30.8bps.**

In contrast, NSW government bonds continued to get beaten-up as the market moved spreads wider on the back of the large debt funding surprise revealed by the NSW government following its otherwise impressive Budget in June. As the RBA highlighted in its Board minutes, this funding shock shunted NSW bond spreads materially higher in June, dragging the spreads of all other State government bonds with them.

In the case of NSW, its 10-year cost of capital jumped from as low as 18.4bps above Commonwealth government bonds in May to 32.4bps in June and 36.3bps in July. That's almost \$200 million per year in extra annual interest repayments on NSW's \$100.6 billion of debt outstanding (as it matures over time and is replaced with new issues at this higher cost).

While we plan on publicly discussing the circumstances surrounding the NSW's funding shock in greater detail at a later date, it was not driven by any underlying problems with NSW's budget. The actual cash budget deficit was some \$12 billion smaller than NSW expected in FY2021, as Coolabah had projected. The extra debt that NSW is proposing to raise this year, and over the forward estimates, is entirely discretionary and was planned to be used for making investments in speculative financial assets.

**We remain confident that a variety of forces, including rating agencies, banks, the bond market, and senior political leaders will determine that this extra discretionary borrowing is not now necessary. We further believe that the large \$12 billion to \$13 billion capital injection NSW will reap from the sale of the second half of WestConnex in a few months' time will be applied to funding its deficits, and reducing gross debt issuance, in preference to the current proposal to invest this money in speculative equities strategies.**

In theory, NSW will be sitting on about \$27 billion of liquid assets held in the NSW Generations Fund's Debt Retirement Fund (once WestConnex is sold), which is, under the relevant legislation, meant to be used to repay debt, maintain NSW's AAA credit rating (it was lost in December last year), and to reduce the cost of NSW government debt. The NSW government has, therefore, powerful options up its sleeve should it choose to use this money for its legislated purposes, which could quite radically reduce its debt issuance needs.

Having said that, the NSW lockdown, and shorter lockdowns amongst other States (e.g., VIC, SA, QLD) in July, soured the near-term economic outlook, with economists now forecasting substantially negative GDP growth in the third quarter. Lockdowns do eventually work, although the Delta strain of COVID-19 is demonstrably far more transmissible, and potentially fatal, than its predecessors.

**Strategy commentary cont'd:** The Commonwealth government has acted quickly to provide substantial economic support to individuals and businesses impacted by lockdowns. Prime Minister Scott Morrison and Treasurer Josh Frydenberg have delivered JobKeeper 2.0, lifting the weekly disaster payment to NSW individuals who have had their work cut 20 hours or more from \$600 to \$750, which is the same as the original JobKeeper payment. For those who have had work cut by between eight and 20 hours, Morrison and Frydenberg boosted their compensation from \$375 to \$450. Workers on income support also get an extra \$200 per week under the Fed's upgraded program if they have lost more than eight hours of work. Finally, the PM and Treasurer have substantially increased their support for NSW businesses that have suffered a decline in revenue of 30% or more, lifting the maximum weekly payment from \$10,000 to \$100,000.

**One surprise after the end of the month was the RBA's decision at its August board meeting to stick to its previous plan of tapering its bond purchase program from \$5 billion/week to \$4 billion/week in September. The strong consensus was that the RBA would reverse this decision, which the RBA said had been a line-ball call made at its June meeting on the heroic assumption the Sydney lockdown would be short and sharp. In August the RBA maintained the taper, although it did caution that it would carefully revisit this plan at its September (and subsequent) Board meetings in light of the impact of the pandemic on the economy. The RBA has also stressed that the \$4 billion/week is flexible and open-ended, and can be dialled-up or dialled-down depending on the data.**

**We think there may be some other elephants in the room influencing the RBA. In particular, what APRA and the RBA do with the banks' all-important Committed Liquidity Facility.**

It appears that RBA may be somewhat exercised about capacity constraints on its bond purchase program (QE), whereby if it does not taper it could end-up owning more than 40%-50% of key government bonds, putting it near the upper-bound of global central bank peers.

There are clear solutions to this: extending beyond buying 5–10-year bonds (ie, including 10–20-year bonds) and boosting purchases of State government bonds, both of which would open-up a lot of QE capacity for the RBA.

The capacity problem the RBA faces is of course of its own making: it has chosen to only buy 5–10-year bonds, and only spend 20% of QE on State government bonds when States are doing about 45% of the annual fiscal stimulus right now. These self-imposed limits can be rapidly remedied. That implies they may not be the binding constraint.

**The elephant in the room is what happens to the banks' Committed Liquidity Facility (CLF), and the banks' buying of government bonds more generally.**

First, we know:

- (1) bank balance-sheets are growing quite quickly again, which means they need to buy more "high quality liquid assets" (HQLA) to hold against the liabilities they are using to fund their balance-sheet growth, and
- (2) the major banks are still getting substantial deposit inflows (ie, big increases in their short-term liabilities). This latter point is very significant: inflows of deposits, especially business deposits, attract a very hefty liquidity charge from APRA in the form of something called the Net Cash Outflow (NCO).

In short, banks have to buy a lot of HQLA to hold against flighty deposits because they have high NCOs (ie, they are assumed to rush out the door in a funding crisis). HQLA comprises only Commonwealth government bonds, State government bonds, and cash on deposit at the RBA (known as the RBA's "exchange settlement account" (ESA) balances).

So, we know that growing bank balance-sheets funded by deposits are going to fuel the need for more HQLA.

**Strategy commentary cont'd:** Another big tailwind would be any change to the banks' CLF entitlement (as determined by APRA and the RBA). The CLF is a \$139 billion portfolio of so-called alternative liquid assets, or ALAs (specifically home loans, bank bonds, and RMBS). These ALAs only exist because Australia historically did not have enough HQLA. Before the GFC, the government bond market almost shrank away to nothing.

But with over \$300 billion sitting on deposit at the RBA in ESA balances (ie, cash banks hold with the RBA) plus more than \$1.2 trillion of Commonwealth and State government bonds, there is, all else being equal, no longer a need for the CLF.

And APRA has repeatedly written to the banks stating that the CLF will be phased-out over time. If banks are not carrying excess liquidity (as defined by their official Liquidity Coverage Ratios being around 125% or less), phasing out the CLF means that the banks have to issue new debt to buy HQLA to replace the CLF with Commonwealth and State government bonds (or cash on deposit at the RBA).

At this time of the year APRA typically sends a letter to the banks about what is going to happen to the CLF. If the expected letter reconfirms that the CLF is to be phased out over the next year or so, which is our base-case, it would, all else being equal, drive demand for Commonwealth and State government bonds – potentially to the tune of \$100 billion or more – assuming:

- (1) that the banks are not carrying excess liquidity (while some banks still are, CBA and Westpac have reported LCRs near their lower-bounds), and
- (2) that the returns on government bonds are higher than the returns from holding cash on deposit at the RBA.

Cash at the RBA currently pays 0.0%, but it does avoid a 0.06% annual wholesale big bank levy that buying government bonds carries. This implies that government bonds need to comfortably beat 0.06% pa to be preferred over cash at the RBA on a purely income generation basis for bank balance-sheets in the case of the four majors and Macquarie only (only the four majors and Macquarie pay this levy – other banks do not, and therefore prefer government bonds over cash at the RBA).

Now the RBA is responsible for advising APRA on how much CLF the banks need. This calculation is determined by the total value of government bonds outstanding relative to the liquid assets banks require.

One potential game-changer is the cash on deposit at the RBA, or ES balances. This is a liquid asset, but the RBA has historically excluded it from the CLF calculation because there was not much surplus money in ES balances. We think there is a good chance that the RBA includes some or all of the excess cash on deposit at the RBA in the next calculation of the CLF because:

- (1) it is technically HQLA and should be in the numbers (the RBA recently confirmed this in a Bulletin paper), and
- (2) the RBA now knows that the cash banks have on deposit with it, which is driven by the amount of RBA QE related and TFF balance-sheet expansion, is likely to remain high for many years to come. While the repayment of the RBA's Term Funding Facility (TFF) over the next 3 years will shrink its balance-sheet, the stock of bonds bought via QE continues to increase it.

**So, the RBA presumably knows what the future of the CLF looks like, given it calculated the numbers. And if the RBA thinks the banks are going to have to buy \$100 billion + of HQLA over the next 12-18mths (noting that bank demand for liquid assets will be continuously growing as balance-sheets expand) – which would, based on past history, be skewed to buying higher-yielding State government bonds (vs lower-yielding Commonwealth government bonds) – this would provide some reason to avoid the \$5 billion/week pace of its own QE program, and the ensuing capacity constraints, given the banks might de facto be doing QE for it via their HQLA purchases.**

One other related indication that APRA is heading in this direction is the fact that it has recently released a brand-new "[contingent liquidity proposal](#)" that requires banks to hold 30% of their LCRs in the form of "self-securitised" home loans. In practice, self-securitised loans are normally one of the biggest, and most return on equity friendly, assets that banks hold in their CLF portfolios.

**Strategy commentary cont'd:** Crucially, it looks like APRA is using this new contingent liquidity proposal to pave the way for the CLF to be wound-back.

If the banks are meeting their liquidity requirements through holding HQLA, and for whatever reason need some extra emergency liquidity, they can use this new contingent liquidity, and the self-securitised home loans they have ready to roll, as collateral with the RBA, and borrow off the central bank.

We should learn a lot more about the future of the CLF in the next month or so.



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