



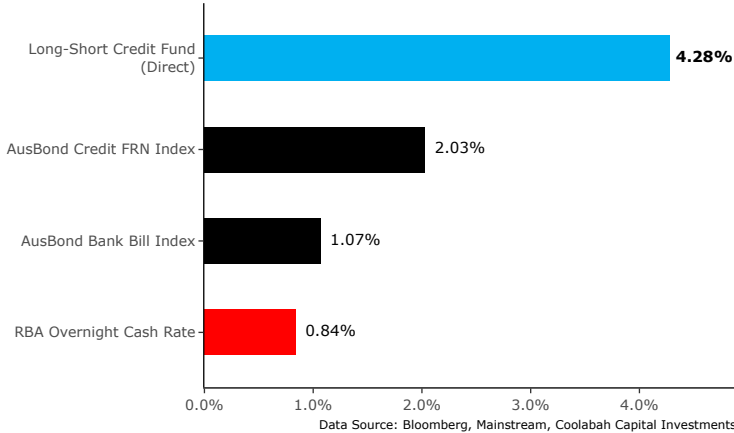
September 2021

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.

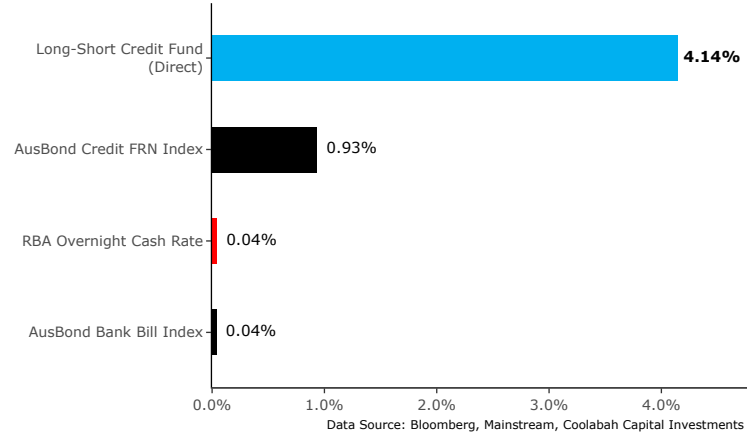
Strategy: We add value via active asset-selection using a range of valuation models with the aim of delivering superior risk-adjusted returns, or alpha, to traditional hedge funds. We primarily invest in senior and subordinated debt securities, hybrids and derivatives issued by Australian entities domestically, 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) [†]	RBA Cash Rate	Gross Excess Return [‡]	Net Excess Return (Direct) ^{†‡}
2021-09-30*					
1 month	1.10%	1.01%	0.00%	1.10%	1.01%
3 months	-0.31%	-0.56%	0.01%	-0.32%	-0.57%
6 months	-1.32%	-1.55%	0.02%	-1.33%	-1.57%
1 year	6.37%	4.14%	0.04%	6.33%	4.10%
2 years pa	6.05%	3.89%	0.23%	5.82%	3.66%
3 years pa	6.58%	4.39%	0.61%	5.97%	3.78%
Inception pa Aug. 2017	6.35%	4.28%	0.84%	5.51%	3.44%

Long Short Credit Fund Returns (Net) vs Comparisons (pa)
Annualised Returns Since Inception in August 2017 to 30 September 2021



Long Short Credit Fund Returns (Net) vs Comparisons
12 Month Return to September 2021

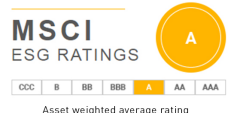


* Most recent month returns in this report are estimated.

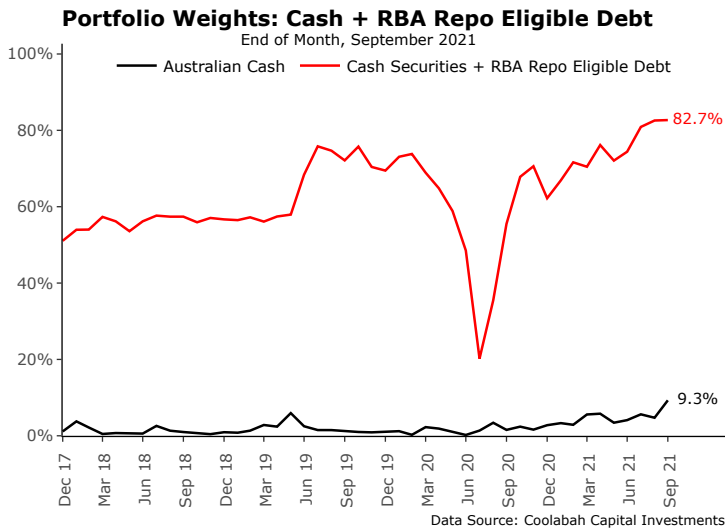
Disclaimer: Past performance does not assure future returns. Returns are shown net of all Management and Performance fees unless otherwise stated. All investments carry risks, including that the value of investments may vary, future returns may differ from past returns, and that your capital is not guaranteed.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

Net Monthly Returns > RBA Overnight Cash Rate	78%	Permitted Gearing	Yes
Gross Portfolio Weight to Cash Securities	9.3%	1 Year Av. Gross Portfolio Weight to Cash	4.3%
Gross Portfolio Weight to Bonds	89.7%	Gross Portfolio Weight to AT1 Hybrids	5.3%
Av. Portfolio Credit Rating	AA	Gross Cash Securities + RBA Repo-Eligible Debt	82.7%
Portfolio MSCI ESG Rating	A	Gross Portfolio Weight to ABS/RMBS	0.0%
No. Cash Securities	4	Net Credit Spread Duration Ex Govt	2.41 years
No. Notes and Bonds	79	Net Annual Volatility (since incep.)	3.12% pa
Av. Interest Rate (Gross Running Yield)	2.70%	Gross/Net Sharpe Ratio (since incep.)	1.71x/1.10x
Modified Interest Rate Duration	0.05 years	Awards: FE Alpha Manager 2019: Christopher Joye; Ratings: Lonsec available to advisers; Recommended (Atchison); 'Superior More Complex' (Foresight Analytics)	

Signatory of:

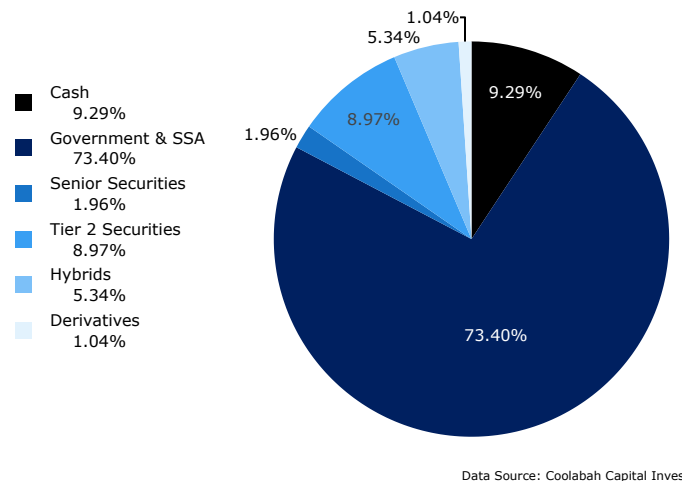


Asset weighted average rating



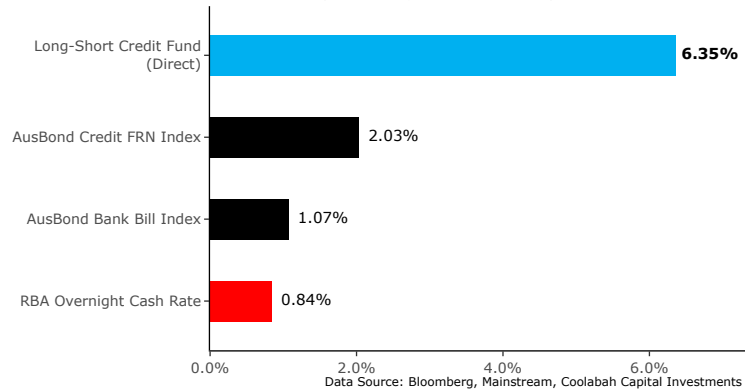
Long Short Credit Fund Portfolio Composition (Gross NAV)

(Gross Levered Statistics) - 30 September 2021



Long Short Credit Fund Returns (Gross) vs Comparisons (pa)

Annualized Returns Since Inception in August 2017 to 30 September 2021



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The since inception gross (net) return of **6.35% pa gross (4.28% 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 3.12% 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

Portfolio commentary: In September, the zero-duration and daily liquidity Long-Short Credit Fund (LSCF) returned **1.10% gross (1.01% net)**, outperforming the AusBond Credit FRN Index (-0.06%), the AusBond Bank Bill Index (0.00%), and the RBA Overnight Cash Rate (0.00%). It was noteworthy that in the month, the AusBond FRN Index lost 0.06%, the AusBond Composite Bond Index declined by 1.51%, and global equities suffered a 3.04% correction. LSCF ended September with a weighted-average credit rating of AA, a portfolio weighted average MSCI ESG rating of A, and a running yield of 2.70%. Over the previous 12 months, LSCF returned **6.37% pa gross (4.14% pa net)**, outperforming the AusBond Bank Bill Index (0.04% pa), the RBA Overnight Cash Rate (0.04% pa), and the AusBond Credit FRN Index (0.93% pa).

Since the inception of LSCF 4.1 years ago in August 2017, it has returned **6.35% pa gross (4.28% pa net)**, outperforming the RBA Overnight Cash Rate (0.84% pa), the AusBond Bank Bill Index (1.07% pa), and the AusBond Credit FRN Index (2.03% pa). LSCF's since inception Sharpe Ratio, which measures risk-adjusted returns, has been 1.71x (1.10x) gross (net). While LSCF's return volatility since inception has been low at around 3.12% 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: September was an unusually interesting month principally because of the correlation convergence. Whereas Coolabah's portfolios generated robust outperformance in terms of returns, both the fixed-income and equities asset-classes struggled for a range of different reasons.

Global equities slumped in September, falling 3.04%, on the back of rising discount rates as the US 10-year government bond yield increased from 1.31% to 1.49% (see our research on [the risks of a US equity market correction earlier in the year here](#)). This ostensibly hurt fixed-rate, as opposed to floating-rate, bonds (where fixed-rate bond prices decline as yields rise).

Australia's main bond proxy, the fixed-rate AusBond Composite Bond Index, which APRA uses to benchmark superannuation fund's fixed-income performance, declined by a chunky 1.51% in September (placing it in the worst 3% of months on record) as Aussie 10-year government bond yields leapt from 1.16% to 1.49%.

Coolabah's Active Composite Bond Strategy outperformed the index by 0.39% in September net of retail fees and has generated total excess returns over the index of 0.94% in the 12 months to September (post fees).

The large decline in the Composite Bond Index in September reasserted a positive, rather than negative, correlation between interest rate risk, or so-called "duration", and equity returns, reversing out the negative correlation between duration and equities that has often held since the GFC. Coolabah has repeatedly argued that investors should expect a positive (negative) correlation between duration and stocks in inflationary (or deflationary/disinflationary) periods.

A triple-header of sorts was capped off by the near-zero duration AusBond Floating-Rate Note (FRN) Index recording a relatively rare 0.06% loss in September (placing it in the worst 3% of months since 1999) for completely different reasons: the increase in senior-ranking bank bond credit spreads that Coolabah had been positioning to capitalise on for some time (see our research on this earlier in the year [here](#), and more recently [here](#)).

As a result of Coolabah's decision to avoid assets that are likely to suffer from significantly wider credit spreads in the future, including [senior-ranking bank bonds and residential mortgage-backed securities \(RMBS\)](#), and our focus on assets that will likely experience tighter spreads, including higher-yielding government bonds (see our research on why banks will have to buy between \$250bn and \$450bn of government bonds [here](#)), Coolabah's near-zero duration portfolios materially outperformed both floating-rate and fixed-rate bond benchmarks in September.

Strategy commentary cont'd: In the month, we estimate on a preliminary basis that the Opportunistic Credit Alpha Strategy returned 1.24% gross (this is an insto-only product with confidential fee terms) followed by the Long Short Credit Fund, which delivered a 1.10% gross or 1.01% to 1.04% net return after retail fees; the active full capital structure ETF, HBRD, which returned 0.48% franked (or 0.23% unfranked) net after retail fees; the Smarter Money Higher Income Fund, which returned 0.22% gross or 0.15% to 0.19% net after retail fees; and the Smarter Money Fund, which returned 0.20% gross or 0.14% to 0.18% net after retail fees.

Coolabah's uncorrelated alpha in September was driven by a number of core contrarian insights. These included, amongst other things, the following:

1. **Avoiding investing in bonds issued by entities based in and/or controlled by non-democratic countries on an ESG basis;**
2. **A larger-than-expected QE3 program as the RBA insures against downside risk;**
3. **APRA closing-down the \$139bn Committed Liquidity Facility (CLF) much faster than banks and investors expected with positive (negative) consequences for government (bank) bonds; and**
4. **Capitalising on unusually cheap State government bonds that were likely to mean-revert.**

1. Avoiding investing in bonds issued by entities based in and/or controlled by non-democratic countries on an ESG basis

The financial market topic of the day seems to be China Evergrande Group (aka Evergrande), and the news on 15 September 2021 that China's Ministry of Housing and Urban-Rural Development had informed lenders that Evergrande—the second largest property developer in China—will not be making its principal and interest payments on outstanding debt from 21 September 2021.

This entire episode echoes the default risk dramas that swirled around another large USD bond issuer, China Huarong Asset Management, in April 2021 when its failure to lodge its accounts on time triggered speculation that it would renege on its debts.

The fears are amplified by the fact that both Chinese companies were perceived to be implicitly government-guaranteed, or too-big-to-fail (Huarong is 64% owned by China's Ministry of Finance), and have issued higher-yielding debt in global markets that has been gobbled up by many brand-name fund managers.

Coolabah has a very fundamental and yet far-reaching Environmental, Social & Governance (ESG) criterion, which is that we cannot invest in securities issued by companies based in non-democratic countries. As basic as this sounds, we are not aware of many, if any, other investors applying it. This prevents us from allocating to bonds issued by any Chinese entities even though they often pay attractive interest rates, seem to be ostensibly low risk, and frequently have appealing growth prospects.

A further well-documented concern for us has been extreme geo-political risk, and, more specifically, the possibility of major power conflict in the Indo-Pacific region between China, the US, and its allies, including Australia, Japan, and the UK, amongst others. We handicap this depressing scenario at a toss-of-the-coin probability, which is in the ball-park of most of our China advisers (see our research on this [here](#), [here](#), [here](#) and [here](#), and [here](#)).

While in the event of a full-scale, high-intensity major power conflict, most asset-classes are likely to be adversely affected, and real hedges are going to be hard to find, it is instructive for investors to think through the consequences of these contingencies ahead of time. One obvious second-order risk is Chinese entities walking away from their foreign liabilities, and the spectre of the US potentially cancelling liabilities held by its adversaries.

And yet it is not hard to find via a quick Bloomberg search that most large active and passive fixed-income managers, including many ETFs, have substantial exposures to non-democratic states, including China, which also features prominently in global bond indices.

Strategy commentary cont'd:

2. A larger-than-expected QE3 program as the RBA insures against downside risk

Contrary to market hopes for a hard taper of the RBA’s bond purchase program (aka quantitative easing or “QE”), which would involve only circa \$50bn to \$100bn of government bond purchases in the RBA’s third round of QE, Coolabah had [since February 2021 consistently projected that QE3 would amount to more than \\$100bn](#). At the time, few if any analysts were predicting any QE3 at all.

The final QE3 program announced by the RBA at its September board meeting involved a slower taper from \$5bn of bond purchases per week to \$4bn per week through to February 2022, which implied total government bond purchases well north of \$100 billion.

Depending on the final glide path the RBA adopts, and the policy optionality it wishes to retain, [Coolabah estimates that QE3 should involve total purchases of up to \\$147 billion](#) (the likely range is somewhere between \$113bn and \$147bn). This QE3 program was substantially larger than the “hard taper” proponents had assumed (eg, CBA at \$50bn and NAB and UBS at \$75bn).

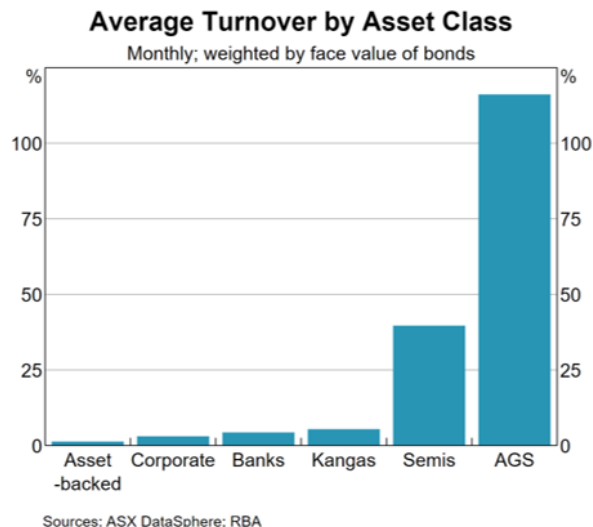
3. APRA closing-down the \$139bn Committed Liquidity Facility (CLF) much faster than banks and investors expected with positive (negative) consequences for government (bank) bonds

Whereas almost all banks and analysts argued that APRA would not shut-down the \$139 billion CLF quickly, and keep it open for years to come, Coolabah’s analysis clearly demonstrated that there was no longer any need for the CLF (see [here](#) and [here](#)). This in turn implied that APRA would shut the CLF much faster than market participants assumed: Coolabah’s modelling indicated it could easily do so [over a 2 year period](#).

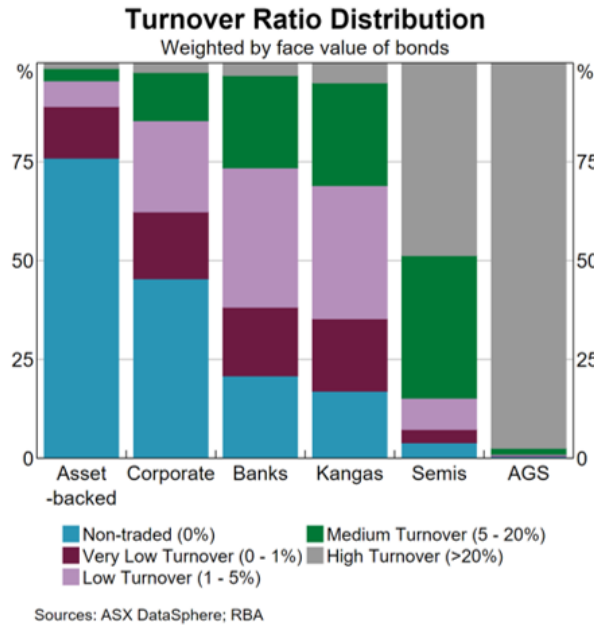
By way of background, the CLF is an emergency liquidity portfolio that banks can in theory draw-on if there was ever a liquidity crisis. It was created in 2015 as a substitute for banks holding government bonds when APRA and the RBA determined that Australia’s government bond market was not big enough to provide the banks with the emergency liquid assets, which are normally government bonds, that are required for regulatory purposes. Importantly, this was a global exception to the international banking regulatory standards, known as Basel 3, which prioritised banks holding government bonds as the preferred form of so-called “Level 1” high quality liquid asset (or HQLA1).

So instead of buying government bonds, the CLF allowed banks to use their own, much higher yielding, but almost perfectly illiquid internal loans as an emergency liquidity asset (these internal loans historically represented between 70% and 80% of the total CLF).

For the RBA and ultimately taxpayers, this created both wrong-way credit risk (in a crisis the RBA would be accepting a bank’s internal loans rather than arms-length government bonds as collateral against which the RBA would loan emergency funding to the struggling bank) and liquidity risk. In respect of the latter, the RBA’s research shows that internal loans, senior bank bonds, and RMBS [have a fraction of the secondary liquidity of government bonds](#) (see the RBA’s charts on this below).



Strategy commentary cont'd: The CLF also permitted banks to buy other banks' senior bonds and bank and non-bank-issued RMBS, which like the banks' internal loans paid much higher yields than government bonds, albeit with radically inferior liquidity (see charts above). By buying one another's bonds, banks could both reduce their own cost of funding and maximise their returns on equity relative to the alternative of holding lower-yielding government bonds.



The COVID-19 shock eliminated the need for the CLF by triggering a huge increase in government debt issuance from both the Commonwealth and the States. When forced to hold government bonds, banks tend to have a strong preference for State government issued securities, known as "semis", because they offer much higher yields than Commonwealth government bonds. In recent months, State government bonds have paid as much as 45 to 50 basis points annually above Commonwealth government bonds at the 10 year maturity.

The universe of eligible government bonds that the RBA assesses can be accessed by banks for the purposes of emergency liquidity has jumped to \$1.6trn according to Martin Place's latest estimates, highlighted in the table below. Assuming that banks can hold up to 35% of all outstanding government bonds, this implied that there was about \$563bn of these securities available for them to buy, which meant that there was no need for the CLF (see the CLF column below is blank in 2022).

	Projection of HQLA securities outstanding ^(a)	Locally incorporated LCR ADIs		
		Reasonable holdings of HQLA securities ^(a)	LCR requirements ^(b)	CLF Amount ^(b)
31 Dec 2015	700	175	449	274
31 Dec 2016	780	195	441	246
31 Dec 2017	880	220	437	217
31 Dec 2018	905	226	474	248
31 Dec 2019	898	225	468	243
31 Dec 2020 ^(c)	1340	362	550	188
31 Dec 2021	1488	446	586	140
31 Dec 2022	1608	563		

Aussie banks seemed a bit tone deaf to these dynamics. Despite APRA repeatedly writing to them and warning that they should assume the CLF would disappear in the "foreseeable future", banks boldly dumped about \$110bn of government bonds between June 2020 and June 2021, actually reducing their ownership share of this market its lowest level since late 2018. At the same time, banks were buying between 54% and 87% of their peers' bond issues, boldly highlighting their efforts to exploit the internationally anomalous regulatory arbitrage afforded by the opportunity to load-up on higher yielding assets via the CLF.

Strategy commentary cont'd: On 10 September 2021, APRA shocked the banks with the announcement that the \$139bn CLF had to be closed by the end of 2022, and that APRA expected the banks to “to purchase the HQLA necessary to eliminate the need for the CLF” by this time. While this was consistent with Coolabah’s forecasts, it was a slightly more aggressive timetable than our proposed 2 year timeframe.

Banks will need to raise cash to buy the government bonds they need to replace the CLF. And much of this will have to come via banks issuing additional debt. Coolabah’s detailed modelling shows that Aussie banks are going to issue about \$168bn a year of wholesale debt, on average, for the next 3yrs as a result of:

1. APRA shutting the \$139bn CLF; and
2. The need to repay the RBA the \$188bn it very generously lent—at between 0.25% and 0.1% per annum—the banks under the ultra-cheap, 3-year Term Funding Facility (TFF).

The CLF currently counts towards the banks' all-important Liquidity Coverage Ratios (LCRs). The LCR represents the amount of HQLA banks hold relative to the net cash outflows (NCOs) they would suffer in a 30 day liquidity crisis. HQLA includes government bonds and cash on deposit at the RBA.

The quantum of government bonds required by the banks to hit their 125% LCR buffers (or just a bit above the 100% minimum LCR mandated by APRA) will increase as banks repay the \$188bn they borrowed from the RBA under the TFF, because this repayment process mechanically disappears an equivalent amount of excess cash that is currently on deposit at the RBA, and which is counting towards the banks' LCRs.

We are already watching the banking system make decent headway into both debt funding and government bond buying. Since APRA announced the shuttering of the CLF on 10 September 2021, there have been a raft of new public and private wholesale bond issues launched by the banks, including:

- A\$2.8bn of a dual-tranche covered bond issued by Westpac in Europe;
- A\$500m of a CBA green senior bond, which due to its very tight (41bps) spread only attracted \$875m of demand;
- A\$1.1bn of a Westpac RMBS issue, which was the smallest since 2012 and attracted just a \$1.1bn book (compared to the \$2.75bn RMBS issue Westpac completed in January 2020 on the back of a book north of \$4bn);
- A\$900m Macquarie GBP senior bond issue; and
- Just under A\$1 billion of private placements from CBA, Westpac, and ANZ.

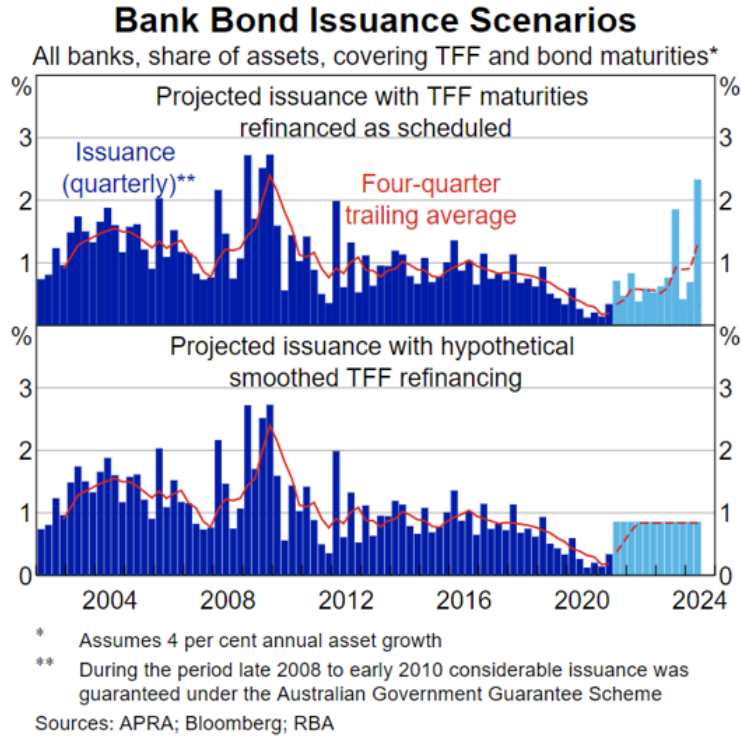
The RBA has [recently published its own forecasts of the banks' likely wholesale debt issuance over time to repay the TFF](#), which are broadly similar to our own and are outlined in the two charts below. Here the RBA comments:

According to liaison, banks' current plans are to raise a sizeable amount of funds to repay TFF funding (on or before maturity) from wholesale debt markets, thereby at least partly reversing the process whereby debt issuance declined as TFF drawdowns increased. The bulk of scheduled TFF maturities occur in the September 2023 and June 2024 quarters. If banks issue new debt to replace TFF drawdowns in the quarter of maturity, this would require quarterly issuance as a share of assets at levels not seen in over a decade.

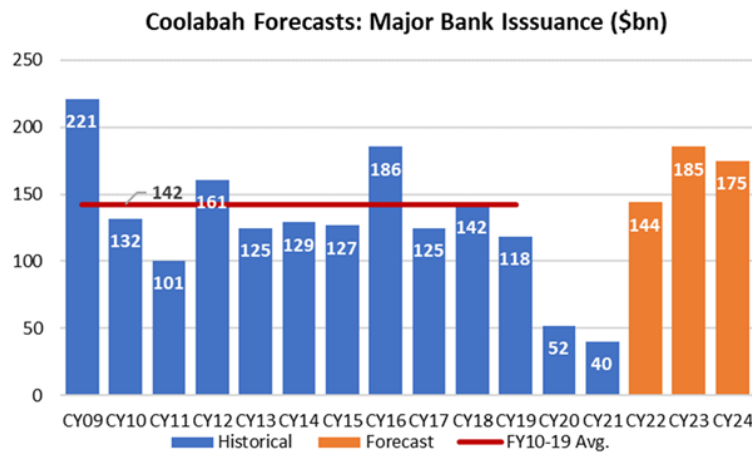
However, banks are unlikely to refinance their TFF drawdowns right at the time they are scheduled to mature. In liaison, banks have flagged plans to issue bonds earlier than scheduled TFF maturities ('pre-funding'). Banks can also terminate TFF repos early without any additional cost. Indeed, some banks have indicated willingness to terminate early and issue bonds at around the same time. These strategies would allow banks to spread the refinancing task over a period of time

Strategy commentary cont'd:

This would serve to reduce the effect of refinancing on market conditions as well as offset the effect of approaching TFF maturities on their regulatory liquidity ratios.



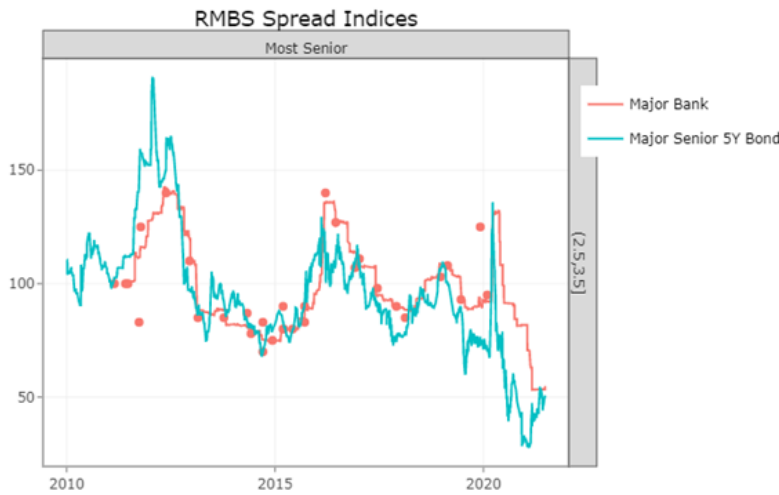
Coolabah's forecasts for major bank wholesale debt issuance, including certificates of deposit, project about \$168bn per year over the next 3-4yrs compared to the \$141bn average for the 10yrs to 2020. This includes both the debt issuance required to replace the CLF and buy government bonds plus the funding needed to repay the \$188bn TFF (see chart below). In preparing this analysis, we account for the banks' current funding positions, including any excess cash, and assume balance-sheet growth of 5% pa in concert with deposit growth of 4% pa.



All of this wholesale debt issuance will help normalise the credit spreads on both bank senior bonds and RMBS back to around the average levels evidenced in the post-GFC period, if not somewhat higher. This upward pressure on credit spreads on senior paper and RMBS will be amplified by the fact that banks will no longer be able to get away with the ruse of buying their own bonds under the CLF.

Strategy commentary cont'd: As we've previously forecast, this will mean that 5yr major bank senior bond spreads have to climb from circa 45bps over the quarterly bank bill swap rate (BBSW) today to somewhere between 60bps and 80bps. The clearing level might be a bit higher given the dramatically reduced bank balance-sheet bid. (We sold our 5yr major bank senior paper at around ~35bps over BBSW in late 2020.)

Since RMBS prices off the benchmark asset that is the major banks' 5yr senior bonds (see chart below), we should likewise see major bank issued, 3yr RMBS increase in spread from ~55bps today to somewhere between ~70bps and ~90bps (if not a touch higher). This overdue repricing will provide all investors with attractive entry points (we sold most of our RMBS in late 2020). Once the new clearing level for bank senior and RMBS spreads emerges, it should provide the banks with much deeper investor demand and associated funding opportunities.



Coolabah's analyst team has more formally modelled Australian banks' demand for HQLA as a function of a range of factors, including, but not limited to:

- The RBA's bond purchase program, which creates new digital cash in the form of cash on deposit at the RBA (known as exchange settlement account, or ESA, cash). (When the RBA buys a bond, it deposits cash into the banks' ESA accounts.) This ESA cash counts towards the banks' HQLA;
- APRA closing the CLF by the end of 2022, which needs to be replaced by some form of HQLA if banks are below their LCR targets, which can include: (1) ESA cash on deposit at the RBA, (2) Commonwealth govt bonds, and (3) State govt bonds;
- The banks repaying the RBA the \$188bn it lent them under the TFF, which mechanically destroys this same quantity of ESA cash (again when the RBA lends money under the TFF, it deposits cash in the banks' ESA accounts);
- Bonds that the RBA has bought under its QE program than then mature over time, which also destroys ESA cash;
- The change in the Net Cash Outflows (NCOs) that are a key determinant of the amount of HQLA a bank has to hold (where banks target holding HQLA worth about 125% of their NCOs). The NCOs are the expected cash-outflows banks would suffer during a liquidity crisis over a 30 day period; and
- Other variables, such as notes and coins, and HQLA held overseas.

The table below shows the results for future HQLA demand through to December 2024 across all Australian banks. Note this assumes a very slow RBA QE taper dropping from \$4bn/week of bond buying in February 2022 to \$3bn/week in the following quarter, then \$2bn/week and \$1bn/week in the final two quarters. A faster RBA taper would bring-forward the banks' HQLA demand.

Strategy commentary cont'd: Observe that the HQLA forecasts are presented as a function of the banks' LCRs (vertical axis) and the NCO growth they experience (horizontal axis). Higher NCOs create much greater HQLA demand. Generally speaking, NCOs will be positively related to the banks' balance-sheet growth: so greater credit growth will drive higher NCOs, all else being equal (ie, assuming no change in the funding mix).

What we find is that accounting for the CLF closing, the TFF being repaid, the RBA creating new ESA cash via QE3, and many other factors, Aussie banks will probably want to buy between \$250bn and \$450bn of HQLA over the next 3yrs over and above the HQLA that they currently hold. Given the supply on offer via the Commonwealth and the States, that should be quite straightforward to execute.

CCI Forecast HQLA1 Demand (\$bn): 31-Jun-21 to 31-Dec-24

		Forecast NCO Growth qoq				
		0.5%	1.0%	1.5%	2.0%	2.5%
Forecast LCR	122.5%	182	245	313	385	462
	125.0%	200	265	334	407	486
	127.5%	218	284	354	430	510
	130.0%	236	303	375	452	534
	132.5%	254	323	396	474	557

Coolabah's estimates of \$250bn to \$450bn of HQLA demand are much higher than what the banks' sell-side analysts have estimated. We've seen some suggesting that the banks will not have any HQLA shortage due to the RBA's QE program. Yet we have accounted for a very large, \$147bn QE3 schedule in our numbers above. We've also heard some sell-side analysts suggest that the HQLA shortage might only be in the order of \$40bn, which is almost one-tenth the size of what we have estimated.

It is true that the banks have time on their side: the HQLA demand really ramps-up much more sharply in about 12 months. Having said that, banks tend to be very conservative, and normally seek to get ahead of these regulatory hurdles. This is precisely why they are so busy issuing wholesale debt right now, and why they have started buying government bonds.

One counter-argument is that banks could issue all this wholesale debt and sit it in ESA cash earning 0.0% interest pa. While this is true, the revenue drag compared to the alternative of holding positive yielding government bonds is likely to be unacceptable for most. Furthermore, APRA does appear to be imploring the banks to "purchase" HQLA, presumably on the basis that the excess ESA cash on deposit at the RBA will disappear over time as the TFF is repaid and QE bonds mature.

4. Capitalising on unusually cheap State government bonds that were likely to mean-revert

In May 2021 Coolabah took profits on a significant share of its State government bond holdings, but retained an exposure to the sector on the basis of our forecasts for three key events:

1. First, smaller-than-expected Commonwealth and State government budgets, which met our projections over May and June (NSW, for example, reported a \$12bn smaller than it originally forecast budget deficit for FY2021);
2. Second, the larger-than-expected size of the RBA's QE3 program, which was validated in September (ie, \$113bn to \$137bn vs hard taper estimates of \$50bn to \$75bn); and
3. Finally, APRA shutting the CLF much more quickly than the banks/market assumed, which was revealed in September (ie, by end 2022 vs consensus views that the CLF would not change materially).

As has been [well documented](#), in June Coolabah was the first to unearth a proposal for the NSW government to take-on extra taxpayer debt worth as much as \$20bn and \$47bn to allow its investment agency to bet on stocks, junk bonds, private equity and hedge funds. This unprecedented idea of a government undertaking a huge, leveraged equities "carry trade" would have been a disaster for NSW taxpayers if interest rates were to ever climb off their record lows while equity markets corrected materially downwards from their record highs (care of rising discount rates), which may be a process that we are watching unfold right now.

Strategy commentary cont'd: Subsequent to Coolabah launching an activist “environmental, social and governance” (or ESG) campaign on this topic, NSW’s Treasurer (now Premier), Dominic Perrottet, resolved in September to **repay \$11 billion of taxpayer debt** to alleviate burgeoning fiscal risks due to the impact of the one-in-100-year pandemic, which had sent NSW’s public debt soaring to in excess of \$100bn. Long-time market participants cannot recall any Australian government pre-emptively repaying debt to reduce fiscal risk in this manner since possibly Victoria in the mid-1990s.

As **we relayed**, credit rating agency Moody’s commended Perrottet, assessing that NSW’s debt retirement would “support the state’s AAA credit rating”. “As a result, the state’s borrowing requirements will materially reduce over the next two-to-three years,” it said.

The head of at least one state government debt issuance agency was immediately asked by his treasurer to explain why they couldn’t do something similar. The fundamental difference with NSW was Perrottet’s foresight, back in 2018, to create a massive fiscal shock absorber called the NSW Generations Fund, which he seeded with \$3bn of surpluses and \$7bn from the **sale of the first half of WestConnex**.

This money is held by a subsidiary called the Debt Retirement Fund, which under legislation Perrottet managed to pass in 2018 requires its capital to be used to reduce state debt and to be managed in a way that maintains NSW’s AAA credit rating, lowers debt servicing costs and avoids inequitably burdening future generations with unnecessary liabilities.

Since June NSW had been forced to pay higher interest rates on its debt than any other major Australian state, which had not happened before. After the news, the market compressed NSW’s cost of capital inside South Australia and Victoria.

The ostensible trigger for the decision was Perrottet’s sale of the second half of WestConnex, which crystallised \$11bn in cash. While technically this must be deposited in the Debt Retirement Fund, Perrottet declared that it would be “used to retire an equivalent amount of debt”. NSW’s debt issuance arm, TCorp, subsequently clarified that this would be in the “next 12 to 24 months”.

One thing NSW cannot do is simply let its bonds mature, which it would have to repay with new debt. For the \$11bn to retire debt, either the Debt Retirement Fund has to buy back the bonds or it could subscribe to a new NSW bond issue to allow the state to repay them.

Perrottet concurrently announced a \$5bn commitment to building infrastructure in Sydney’s west, which has been hit hardest by the lockdowns. After speculation this would be netted off against the \$11bn in debt retirement, TCorp explained it was entirely independent of it.

This money could easily be reallocated from the existing \$20bn in NSW capex that was slated for this financial year and has been underutilised. Alternatively, since the Debt Retirement Fund has \$3bn in accrued profits, and had more than \$2bn of taxpayer revenue allocated to it last year that was replaced with debt, it could subscribe for a new NSW bond that would pay for the \$5bn in WestInvest money, should this be needed.

This brings us to an important point that has been overlooked. NSW has been diverting royalties and state-owned corporation dividends to the Debt Retirement Fund, which have to be replaced by new debt because the budget is in deficit. (This is not legislated, just a policy choice.)

Perrottet’s inspiration for establishing the fund, Peter Costello, who created the Future Fund, says that governments should divert cash to sovereign wealth funds only when their budget is in surplus. It would certainly be oxymoronic for the Debt Retirement Fund to repay \$11bn of debt while diverting billions in state revenue to it that must then be replaced with additional debt. In NSW’s 2022 budget, there was \$7.2bn of revenue allocated to funds in 2022 and a further \$13bn over the forward estimates.

As Perrottet is transitioning the Debt Retirement Fund from its savings accumulation phase when he was delivering surpluses into the current fiscal risk reduction strategy as deficits mount, there is clearly a case for the revenues being funnelled into it to be returned to the state until the budget is in surplus, in line with Costello’s maxim.

Strategy commentary cont'd: Future NSW governments should aspire to replenish Perrottet’s fiscal shock absorber with asset sales and structural budget surpluses to ensure it continues to serve as a globally unique counter-cyclical tool.

The main goal of Coolabah’s ESG campaign was to highlight the risks of the original leveraged equities carry trade proposal and put forward the alternative case for the Debt Retirement Fund to be used for the purpose Perrottet had in mind when he created it – to reduce, rather than aggressively increase, fiscal risk.

The core “governance” (or ES'G') concern here was **the extreme “moral hazard”** associated with having a state government issue mountains of debt implicitly guaranteed by the Commonwealth, and which the RBA was buying, to enable fund managers and bankers to line their pockets in a “heads if stocks go up they win, tails if stocks go down taxpayers lose” dynamic. All power to Perrottet for ensuring NSW taxpayers avoided this fate.

Activist campaigns are never easy. You end up upsetting a lot of people: TCorp doles out as much as \$100bn to fund managers, including Coolabah's peers and those owned by Coolabah's largest shareholder, Pinnacle (ASX: PNI); banks lose out on highly lucrative debt issuance fees and any NSW bonds they were short-selling; and many warned that Coolabah would be punished with inferior allocations on new bond issues, although this has never actually happened.



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](#).

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