



August 2022

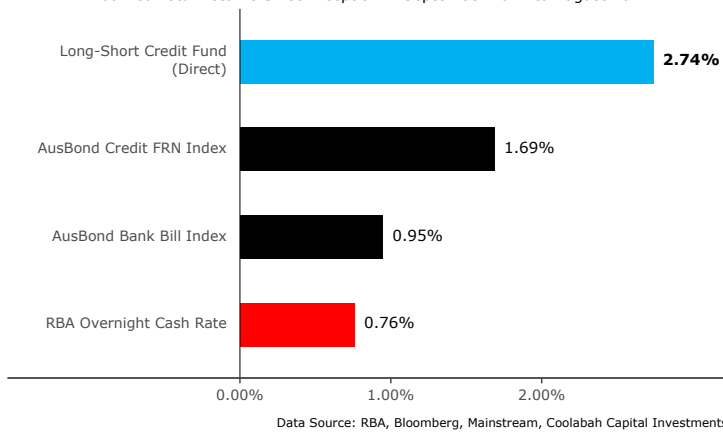
Objective: An absolute return fixed-income strategy focused on exploiting long and short mispricings in credit markets that targets high-yield like returns above the Reserve Bank of Australia (RBA) cash rate plus 4% to 6% p.a. over rolling 3 year periods with volatility of less than 5% p.a. after Management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

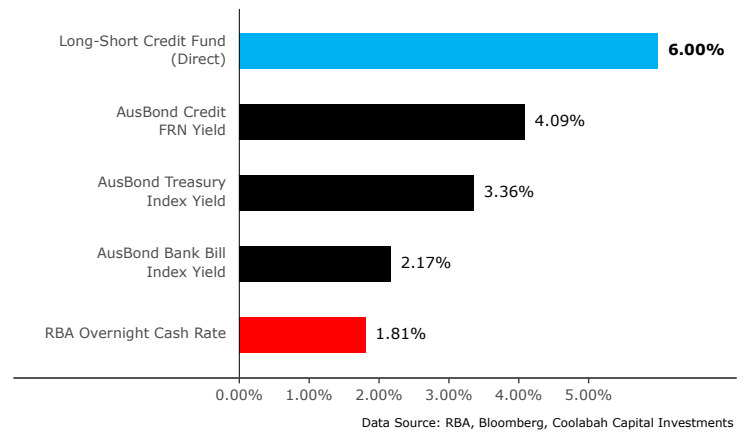
Period Ending	Gross Return (Direct)	Net Return (Direct) [†]	RBA Cash Rate	Gross Excess Return [‡]	Net Excess Return (Direct) ^{†‡}
2022-08-31					
1 month	0.32%	0.23%	0.16%	0.16%	0.08%
3 months	-1.64%	-1.87%	0.31%	-1.95%	-2.18%
6 months	-1.98%	-2.46%	0.34%	-2.33%	-2.80%
1 year	-1.57%	-2.55%	0.36%	-1.94%	-2.91%
2 years pa	1.99%	0.37%	0.21%	1.78%	0.17%
3 years pa	3.15%	1.40%	0.30%	2.85%	1.10%
4 years pa	4.29%	2.42%	0.57%	3.72%	1.85%
5 years pa	4.60%	2.74%	0.76%	3.84%	1.98%
Inception pa Sep. 2017	4.60%	2.74%	0.76%	3.84%	1.98%

Long Short Credit Fund Returns (Net) vs Comparisons

Annualized Total Returns Since Inception in September 2017 to August 2022



31 August 2022 Gross Running Yield



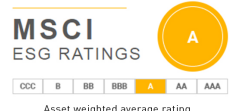
[†] Net returns are calculated from the historic gross returns using the current fee structure as displayed in the Product Disclosure Statement. [‡] The Excess Return columns represent the gross and net return above the RBA cash rate.

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](#).

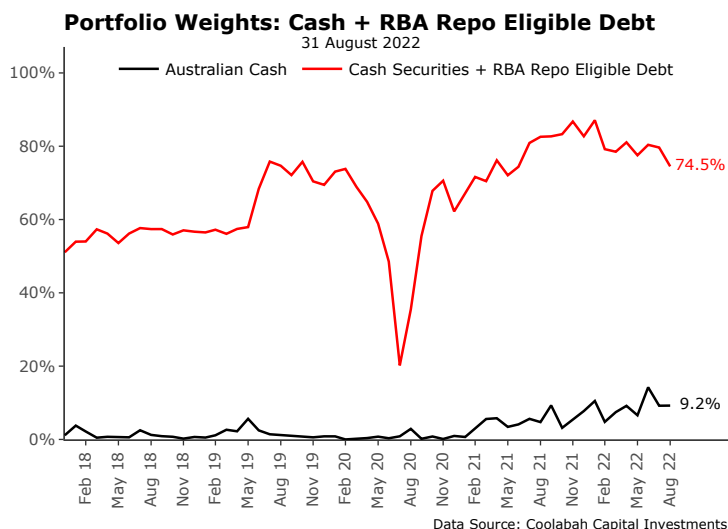
Note: all portfolio statistics other than running yield reported on gross levered value

Net Monthly Returns > RBA Overnight Cash Rate	73%	Average Interest Rate (Gross Running Yield)	6.00%
Gross Portfolio Weight to Cash Securities	9.2%	Modified Interest Rate Duration	0.13 years
Gross Portfolio Weight to Bonds	89.7%	Gearing Permitted?	Yes
Average Portfolio Credit Rating	AA-	1 Year Average Gross Portfolio Weight to Cash	8.1%
Portfolio MSCI ESG Rating	A	Gross Portfolio Weight to AT1 Hybrids	5.0%
No. Cash Securities	18	Gross Cash Securities + RBA Repo-Eligible Debt	74.5%
No. Notes and Bonds	119	Net Annual Volatility (since incep.)	3.19%

Awards: FE Alpha Manager 2019: Christopher Joye; **Ratings:** Lonsec available to advisers; Recommended (Atchison); 'Superior More Complex' (Foresight Analytics)

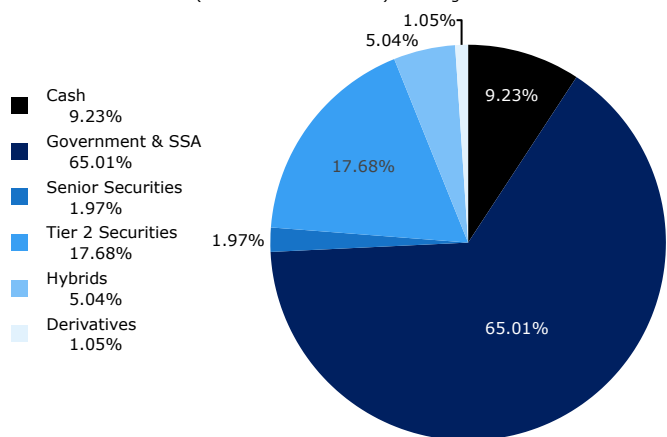


Asset weighted average rating



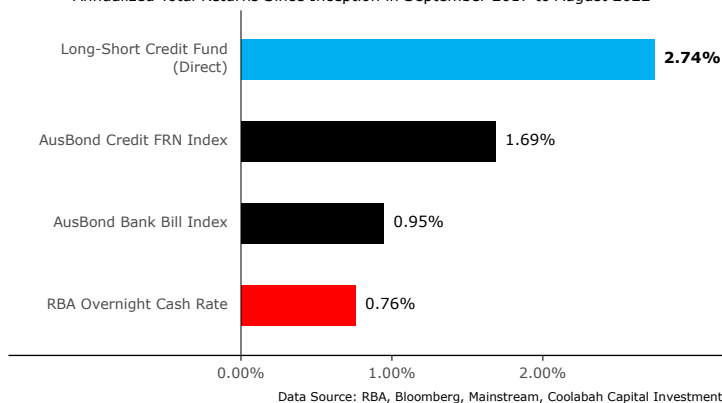
Long Short Credit Fund Portfolio Composition (GAV)

(Gross Levered Statistics) - 31 August 2022



Long Short Credit Fund Returns (Net) vs Comparisons

Annualized Total Returns Since Inception in September 2017 to August 2022



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The since inception gross (net) return of 4.60% pa gross (2.74% pa net) is the total annual return earned by the fund since Sep. 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 3.19% 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: The zero-duration and daily liquidity Long-Short Credit Fund (LSCF) ended August with a running yield of 6.00%, a yield to call/maturity of 12.24% (assuming current funding costs), a weighted-average credit rating of AA-, and a portfolio weighted average MSCI ESG rating of A. In August, LSCF returned 0.32% gross (0.23% net), compared to the AusBond Bank Bill Index (0.15%), the RBA Overnight Cash Rate (0.16%), and the AusBond Credit FRN Index (0.35%).

Since the inception of LSCF 5 years ago in September 2017, it has returned 4.60% pa gross (2.74% pa net), outperforming the RBA Overnight Cash Rate (0.76% pa), the AusBond Bank Bill Index (0.95% pa), and the AusBond Credit FRN Index (1.69% pa). While LSCF's return volatility since inception has been low at around 3.19% 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: After a strong month of July, Coolabah's strategies continued to perform robustly in August driven by ongoing mean-reversion in the credit spreads of key portfolio positions, including both bank bonds and government bonds. The month was nonetheless a tale of two halves. Over the first 16 days, US equities soared 4.5% before accounting for dividends. And yet in the second half, the S&P500 slumped a stunning 8.1%, closing below 4000 index points.

This was primarily driven by the market successfully anticipating a hawkish pivot by the world's most important central bank, the US Federal Reserve, which was delivered via a hard-hitting opening address from the Fed's chair, Jay Powell, at the annual Jackson Hole conference on August 26.

Powell signalled that the Fed could lift interest rates by another super-sized 75 basis points (bps) at its next meeting in September subject to future data flows, and reiterated that its central case was a terminal cash rate just shy of 4%.

Powell further reinforced the perspective that crushing both elevated core consumer price pressures and inflation expectations was the Fed's paramount priority even if that came at cost of a recession (without explicitly articulating this trade-off). Coolabah's models have been forecasting a US recession since the start of the year (see more below).

The message was that aggressive interest rate increases today will spare the economy much greater pain in the future if inflation were to become even more entrenched. This is a narrative that most developed world central banks, including the RBA, are now spinning, which optically provides political cover through collective action.

Hiking Rates Becomes Politically Popular

While Coolabah has argued for over a decade that the post-GFC policy reflexes of QE-to-infinity and zero interest rates in response to every shock would ultimately propagate a regime-changing inflationary cycle, we have been surprised by one feature of the current episode.

And that is how massive interest rate increases in the name of price stability have suddenly become politically popular. The multi-decade peak in inflation has understandably created profound community concerns around cost-of-living constraints, which voters have in turn blamed on the government of the day. This attribution is in part a function of the extreme fiscal stimulus governments decided to inject into their economies to mitigate the pandemic combined with the widespread lockdowns imposed on populations that then created supply-chain blockages.

Expedient politicians have unsurprisingly sought to shift the crosshairs on to the central banks, which, after all, typically have the legislated responsibility for assuring price stability. Most central bankers have spent the last 20-30 years of their careers crowing how the inflation-targeting policy paradigm - first embraced in the early 1990s - has furnished the long period of low and stable inflation that characterised economic conditions up until the 1-in-100 year pandemic materialised.

Strategy commentary cont'd: The ensuing surge in consumer price inflation has absolutely been an artefact of a perfect storm of temporary demand- and supply-side influences. But with politicians eagerly opening the door to central banks burnishing their inflation-fighting credentials, the monetary policy mandarins have embraced that opportunity.

This helps explain the recent experience with seemingly coordinated jumbo rate increases across Western central banks. With many of the supply-side pressures (eg, oil prices, freight prices, timber prices, delivery times etc) abating and demand starting to deteriorate, the risk is that central banks hike too far in the name of fighting last year's battle. The ongoing casualties are likely to be asset prices and economic growth.

In the month of August, floating-rate bond strategies outperformed their fixed-rate counterparts. Whereas the AusBond Floating-Rate Note Index returned 35bps, the fixed-rate AusBond Composite Bond Index lost 254bps after a stellar prior month of July when it returned 336bps. The poor performance of fixed-rate bonds was explained by the jump higher in long-term interest rates before and after the Fed's hawkish pivot with Australia's 10-year government bond yield climbing sharply from 3.06% to 3.60% over August (ie, by about 54bps). Note that this is still significantly below the 4.20% peak that Aussie 10-year yields touched in June.

Coolabah's RBA cash plus 150bps strategy, the Smarter Money Higher Income Fund, returned 49bps gross (41bps to 45bps net, 47bps USD unit class net) in August while our long-duration (or fixed-rate) Active Composite Bond Strategy managed to outperform the index by 15bps gross (13bps net). (Past performance is no guide to future returns and investors should read the product PDS to better understand its risks.)

In August, senior-ranking bank paper performed, with 5-year major bank senior spreads compressing from 95bps above the quarterly bank bill swap rate to 84bps based on Coolabah's constant maturity index. Tier 2 performed even more strongly with 5-year major bank spreads plunging sharply from 263bps to 235bps (Coolabah has been an aggressive buyer). One notch further down the capital structure, the ASX listed hybrid market also experienced reasonable spread compression with 5-year major bank spreads contracting from 308bps to 296bps over the month.

August also saw an extension of very firm bank buying of State (or semi) government bonds. Indeed, sell-side researchers have belatedly caught up to [Coolabah's analysis last year](#) which revealed for the first time that Aussie banks will have to [buy between \\$315 billion and \\$570 billion](#) of government bonds to fill an emerging regulatory liquidity hole that grows quickly between 2022 and 2024.

Coolabah showed that this hole was created by a range of complex factors, including the 2022 closure of the \$140 billion Committed Liquidity Facility, which [we forecast ahead of other analysts](#), banks repaying the RBA the \$188 billion it lent them under the Term Funding Facility, the maturity of government bonds off the RBA's balance-sheet, ongoing bank balance-sheet growth, which fuels additional liquidity needs, the need to maintain bank Liquidity Coverage Ratios around 130% (contrary to silly claims banks could just slash their LCRs to 120-125%), and the likelihood that the modelled Net Cash Outflows that underpin the LCR calculations would not decline, as some bank traders alleged in response to our analysis.

More than 11 months after we had published our numbers, NAB belatedly estimated the HQLA demand to be \$300 billion. Other banks have tendered similar estimates, including UBS pointing to a \$275-375 billion hole (ANZ and CBA's analysts have proposed \$250-300 billion using excessively low—or optimistic—LCR assumptions). Since banks typically spend 70% of their HQLA capital on semis, Coolabah's HQLA hole estimates imply buying demand of between \$220-440 billion over the next few years juxtaposed against annual semi supply of only circa \$60-70 billion.

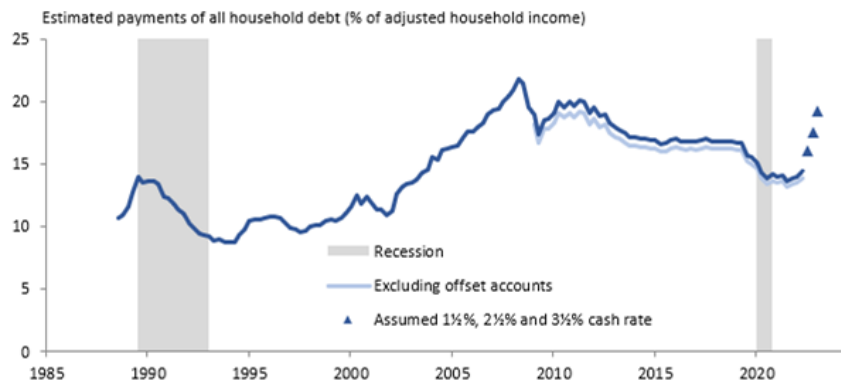
As we have long asserted, floating-rate cash is once again proving to be the best possible inflation hedge. In fact, we established Coolabah in 2011, over a decade ago now, as a floating-rate specialist precisely to cater for a world in which interest rates were likely to eventually rise in response to a period of very high inflation.

Strategy commentary cont'd: The RBA has clearly signalled that it will continue to hike rates to quell the current bout of elevated inflation - and all-important consumer inflation expectations, which have drifted up - with financial markets now pricing in a peak RBA cash rate around 3.6%.

In August, the RBA lifted its cash rate by 50bps to 1.85%, which was then succeeded by an unprecedented, fourth consecutive 50bps rate increase in September as the cash rate rose further to 2.35%. This notably places the cash rate close to the mid-point of the RBA's target inflation band, which indicates that, after controlling for the RBA's long-term forecast inflation rate of 2-3%, the cash rate would be close to zero in real, or inflation-adjusted, terms.

Since current core and headline inflation in Australia have been running at 6.1% and circa 4.6% respectively, the RBA's cash rate is still deeply negative in real, inflation-adjusted terms compared to consumer price movements over the last 12 months.

The 225bps of cash rate increases - with more to come - are the biggest interest rate shock Australian borrowers have had to wear since the mid-1990s. Back then the ratio of household debt to incomes was only 80%, or a fraction of the current 187% ratio. On Coolabah's modelling, the increase in household indebtedness has been so great in recent times that an RBA cash rate of 3.5% would be similar to the 6-7% cash rate before the GFC in terms of the share of incomes that households must sacrifice to repay both the principal and interest on their debt (see chart below).



RBA Risks Repeating Past Mistakes

As the RBA's governor, Phil Lowe, has acknowledged, there are a range of profound uncertainties that currently confront monetary policy. The RBA does not know where the true "neutral" cash rate lies and will ultimately be guided by the economy's reaction (after the long and variable lags between interest rate changes and their effects over many years).

The RBA equally does not know where the natural unemployment rate rests and has highlighted that current wage growth in Australia - using the compositionally-adjusted wage price index measure - remains modest at 2.6% and well-below the growth in labour incomes evidenced in countries like the US. It is also below the 3-4% pace the RBA has claimed is required to generate sustainable inflation within its target 2-3% band.

While these known unknowns are important, the RBA also does not know how much of the current high inflationary episode is attributable to temporary supply-side factors that will pass (and could in theory be overlooked) as distinct from more fundamental demand-side drivers that are artefacts of the extreme fiscal and monetary policy stimulus that central banks and treasuries poured over their economies in response to the pandemic.

Further, the RBA is more or less in the dark about the impact of the adverse wealth effects flowing from what will probably be the biggest housing correction in history (a topic that we will return to shortly).

After undershooting the lower-bound of its target inflation band for much of Governor Phil Lowe's first term, badly mishandling the exit from its yield curve targeting policy in 2021, and then imposing enormous interest increases on borrowers in 2022 (after de facto promising in 2020 and 2021 not to hike until 2024), the RBA has come in for some heavy criticism.

Strategy commentary cont'd: We think it is fair to critique the RBA for its sanguine initial assessment of the pandemic in late Feb/early March 2020, delays in its subsequent decisioning (eg, QE deferred until Nov 2020), and for the manner in which it suddenly dumped the yield curve targeting policy, which was a reputational disaster as the RBA has conceded. Having said that, the commendable suite of pandemic policy responses that were ultimately implemented - and the outstanding economic recovery that followed as a consequence - are something that the RBA can certainly claim some credit for.

The RBA and Treasury were right to take-out aggressive insurance on the extreme downside risks presented by the pandemic, which is what Coolabah publicly and privately argued in February and early March 2020 was the policy choice of least regret.

A counter-factual involving any further policy inertia could have been catastrophic. And the RBA should be applauded for focussing on obtaining full employment, which it appears to have helped deliver after many years of failing to do so.

We also agree that it is appropriate to promptly normalise policy to mitigate against the possibility of consumer expectations becoming unmoored, which the RBA has done, although reasonable people can debate where the neutral rate lies.

The government's looming broad-based review of the RBA could focus on a range of specific matters, including:

- the inherent contradiction between repeatedly telling the public the RBA does not know where the neutral cash rate lies and then claiming it is above 2.5%;
- the relentless claim the RBA is on no pre-set path while it hikes rates four times consecutively at 50bps per meeting, or a total of 225bps over five meetings, in a deterministic trajectory;
- the error in the RBA statements following its board meeting when it asserted it was taking a "further step in the withdrawal of the extraordinary monetary support that was put in place to help the Australian economy during the pandemic" when the cash rate prior to this statement was, in fact, above its pre-pandemic level;
- the seemingly heavy reliance on forecasts for inflation, unemployment, wages and growth to justify rate hikes when those forecasts have proven to be highly unreliable (the alternative would be far greater data-dependence);
- the apparent analytical indifference to the spectre of a profound regime-change in the economy's elasticity to rate hikes given the huge increase in household debt (manifest in the RBA cherry-picking data to support the notion that (rich) households will be able to comfortably bear these enormous interest rate increases);
- the RBA's historical revisionism and persistent lack of intellectual humility when it comes to policy errors, which seems to be compounded by an extraordinarily insular, hierarchical, and tenure-based culture that is riddled with group-think; and
- the absence of any sense of accountability given the RBA's ostensibly weak board, which it normally controls, and the power the RBA exercises over the media that is frequently beholden to it for insights and policy leaks.

Hunting Zombies

Since 2019 Coolabah has been warning about the rise of "zombie companies" kept alive by perpetually cheap money in the period following the GFC. The worry is that as interest rates now normalise, many of these zombies could fail to survive, creating waves of corporate defaults the likes of which have not been seen since the 1991 recession in Australia and during the GFC in the US.

We have, therefore, updated our quantitative zombie detection models to cover both Australia and the US. And we have stress-tested some of the definitions of what is, and is not, a zombie.

The standard definition for a zombie is a company that meets two tests: it has existed for more than 10 years; and it has an interest coverage ratio (ICR) of less than one for three years in a row.

Strategy commentary cont'd: The ICR is defined as the ratio of a company's earnings before interest and tax (EBIT) relative to the interest (note, not principal) repayments on the debt.

If the firm's ICR is less than one, it is not earning sufficient income to repay the interest due on its debt. Hence, the "zombie" moniker.

Using this definition, Coolabah finds that over 13% of all ASX companies are zombies, which is actually slightly above the number of zombies we find in the US (just under 10% of all listed firms). Our US analysis includes all NYSE and NASDAQ listed companies.

The age constraint on a zombie does not make a great deal of sense. Just because you are a young, high-growth firm, if you are not generating sufficient profit to service your debts you are still technically a zombie.

In our first adjustment, we remove the minimum 10-year age criterion, and simply focus on all firms that have reported ICRs less than one for three years in a row.

In Australia, an incredible 34% of all ASX companies would be classified as zombies as judged by their inability to produce sufficient EBIT to cover their interest repayments.

This is up from the 13% of zombies we estimated when imposing a minimum 10-year age requirement. In the US, there is also a jump in the market share of zombies from 9.6% to 18.9% once we remove the age criterion.

As a final exercise, we classify companies as zombies using the data from their last financial year alone, as opposed to requiring them to have ICRs less than one for three years in succession. Using this definition, the zombie share rises further to 39% in Australia and 37% in the US.

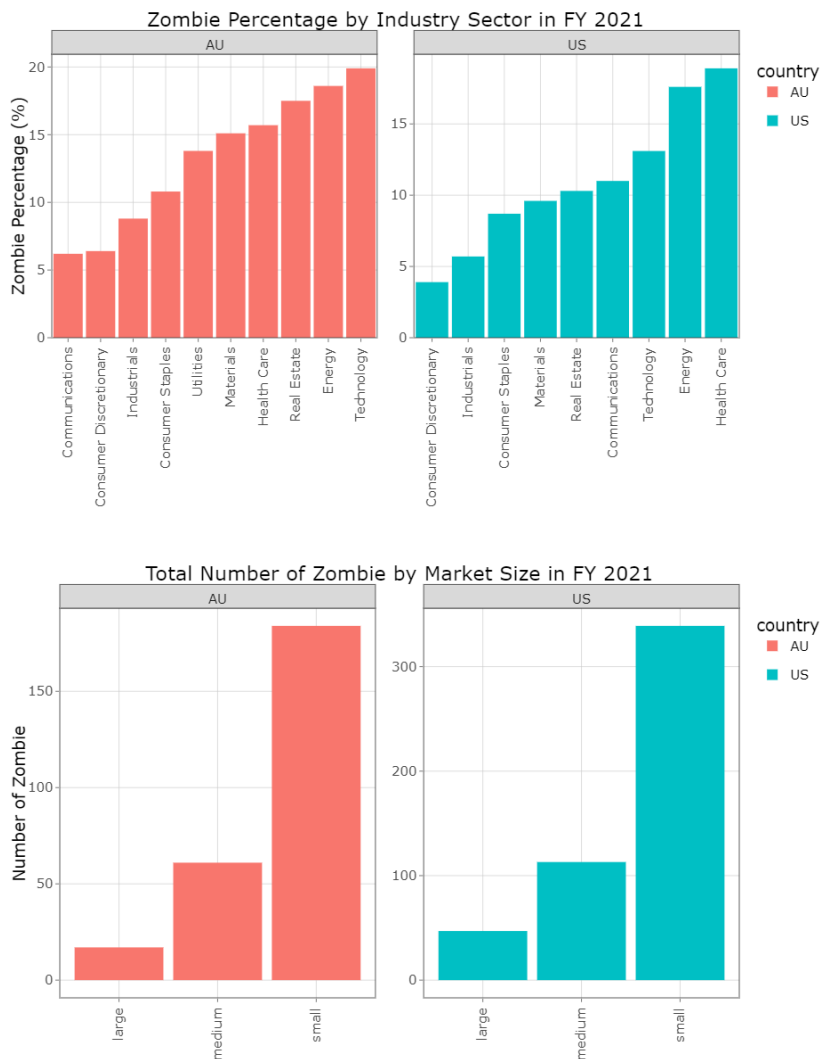
>10yr Old Zombies that have ICR <1 for 3 years in a row				
FYE	Country	Num Zombies	Num Corporate	Zombie Perc (%)
30/06/2021	AU	195	1471	13.26
31/12/2021	US	374	3904	9.58

Zombies that have ICR <1 for 3 years in a row				
FYE	Country	Num Zombies	Num Corporate	Zombie Perc (%)
30/06/2021	AU	696	2045	34
31/12/2021	US	896	4733	18.9

Zombies that have ICR <1 in FY21				
FYE	Country	Num Zombies	Num Corporate	Zombie Perc (%)
30/06/2021	AU	790	2045	38.6
31/12/2021	US	1752	4733	37

After identifying the zombies, we then studied their propagation across both industry sectors and by size or market capitalisation. This analysis reveals that zombies tend to be small-to-medium-sized companies. They are also found in greater numbers in the technology, energy, healthcare, real estate, and materials industry sectors.

Strategy commentary cont'd:



One final point is that if you distribute firms by their ICRs, you find that there are a lot of very risky zombies contrasted against a significant number of incredibly low-risk firms, and not as much in between. It seems that in the corporate world, you are either a good guy or a bad guy! Or maybe what we are saying is that there are a lot of deep value stocks and also loads of junk-like growth wannabes. Given the outlook for interest rates, it is hard to imagine that there will be much global growth for the next year or two: recessions are more likely.

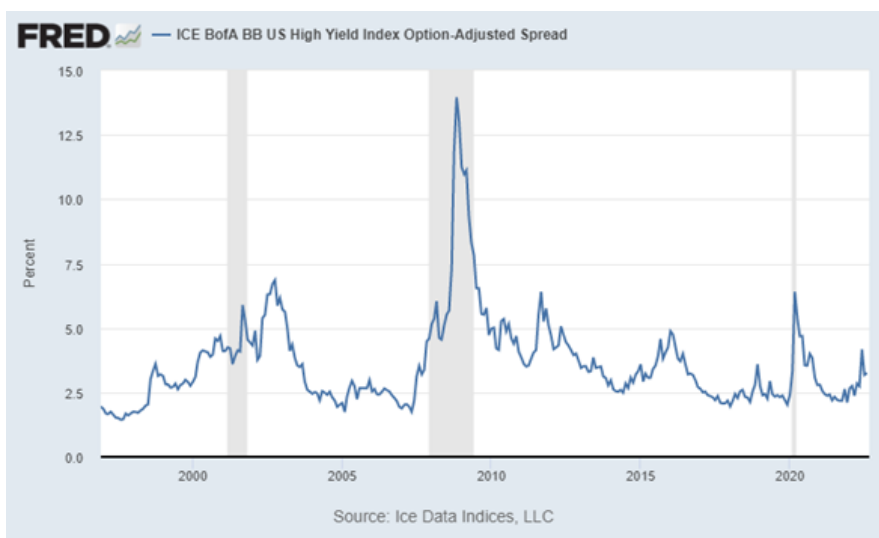
This has implications for markets. As interest rates continue to climb, we are likely to see the first interest rate-led default cycle in Australia since 1991. In the early 1990s, ANZ and Westpac almost went bankrupt because of their loan exposures to the commercial property sector.

Since the 1991 recession, we have also seen a big increase in "non-bank" lenders, many of whom provide finance to zombies and don't have the risk management experience of lending during the 1991 recession, the tech-wreck or even the GFC.

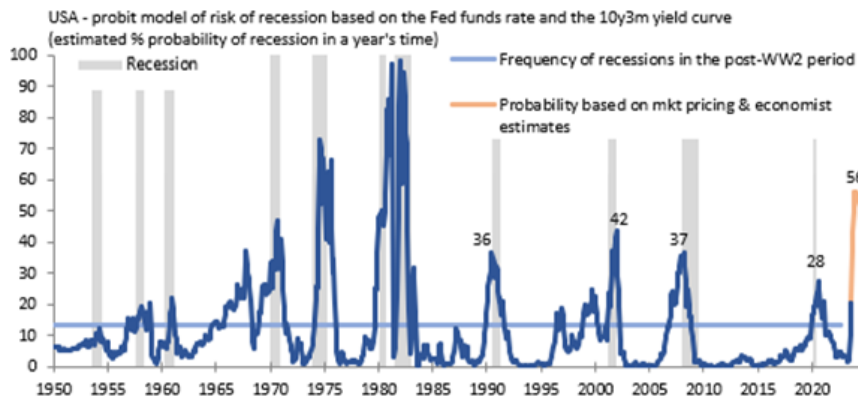
Whereas highly rated bond markets (eg, BBB to AAA rated securities) have generally repriced substantially and are trading on credit spreads that are starting to look quite cheap compared to historical benchmarks, high-yield and sub-investment grade debt markets still appear rich.

As one example, consider the credit spreads on US high-yield bonds rated B and BB. These spreads remain well inside the much wider levels that emerged in prior shocks, including 2020, 2015-2016, 2011-12, 2008 and 2002.

Strategy commentary cont'd:



We have developed and utilise automated global high-yield bond default forecasting models, and they are pointing to a substantial increase in high-yield defaults. Our US recession forecasting models are likewise signalling a strong likelihood of a US recession, as they have been doing for many months. All this means that high-yield spreads are likely to have to move a lot higher, crushing many of their zombie companies.



Another market where you are likely to find zombies is Aussie housing, where about half of all borrowers are not more than one month ahead on their mortgage repayments.

Strategy commentary cont'd:

Record Housing Correction

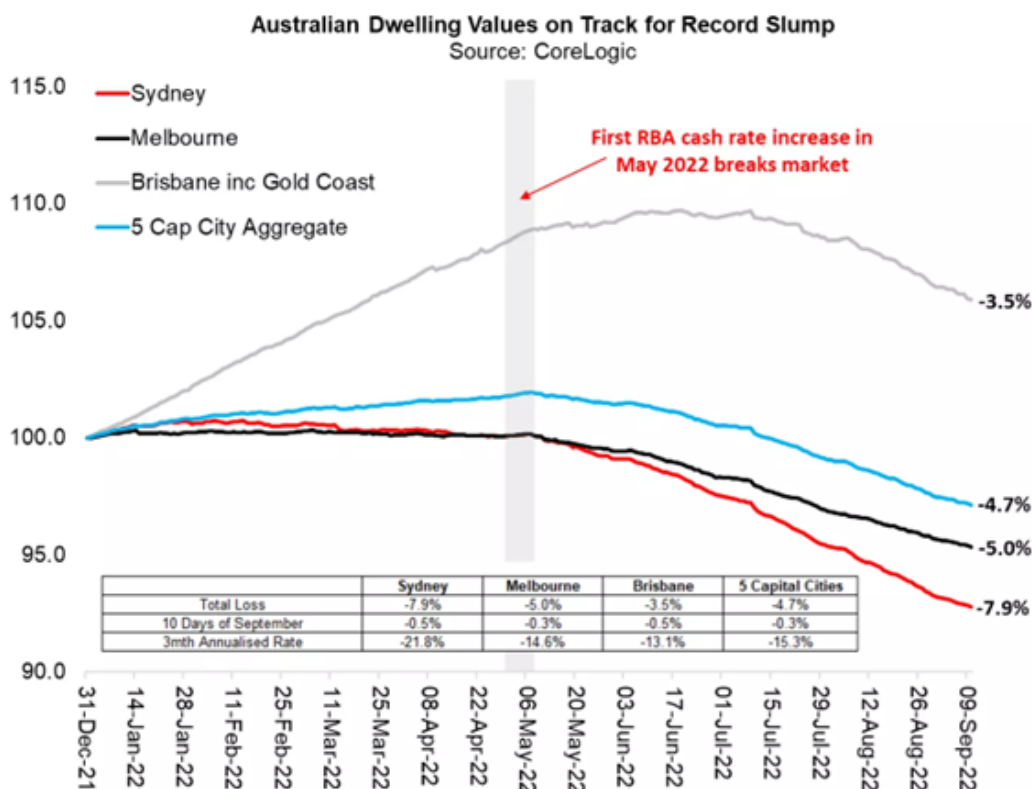
Australian home values are now shrinking at an annualised rate that exceeds 15% based on the three months of CoreLogic compositionally-adjusted index data to 10 September. In Australia's largest city, Sydney, the annual pace of house price depreciation has stabilised at a hefty 22% since late August. Property values in the nation's second largest metropolis, Melbourne, are falling at 14-15% annualised clip.

While the two biggest conurbations have led what is bound to become a record housing correction since the RBA started lifting interest rates in May 2022, there is nascent evidence that the third largest city, Brisbane, is quickly catching up.

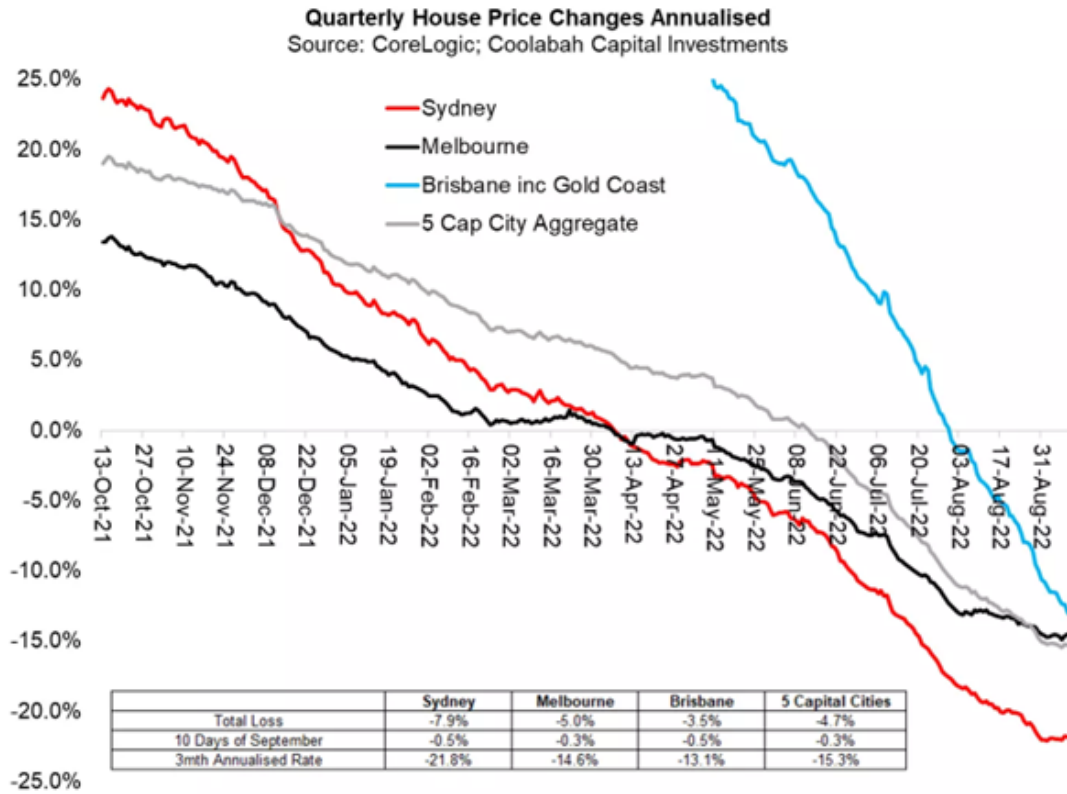
In the month of August, Sydney home values tumbled by 2.3%, the worst monthly loss since the early 1980s. Brisbane property suffered a similar fate, plunging 1.9% in August, which was the poorest monthly outcome since records began 40 years ago in 1980.

Over the first 10 days of September the speed at which Brisbane dwelling prices are contracting has slightly exceeded the draw-down realised in Sydney. In the month to date, Brisbane home values have dropped by a chunky 0.51%, a shade worse than the 0.46% retrenchment registered in Sydney.

Sydney home values have now fallen by about 8% from their recent peak based on data covering the period to September 10 according to CoreLogic. The Melbourne market is maintaining a circa 1% per month rate of house price declines with peak-to-trough losses passing through the 5% mark in September. Across Australia's capital cities, cumulative house price losses should also breach 5% this month.



Strategy commentary cont'd:



While these developments might come as a surprise, they have been highly predictable, as we explained last year. And our [October 2021 housing forecasts remain unchanged](#). That is, after the RBA implements its first 100 basis points of rate hikes, which it has now done, national home values will fall 15-25%. This forecast range was quite explicitly designed to capture the RBA hiking rates by more than 100 basis points. Most economists have embraced this projection in 2022.

Using the RBA's own internal housing model, we have [previously shown](#) that if the central bank hikes to a very extreme 4.25% cash rate, which is higher than we allowed in our forecast range, the RBA's research implies that Aussie house prices would have to decline by 30-40%. This is not, however, our central forecast.



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