



September 2022

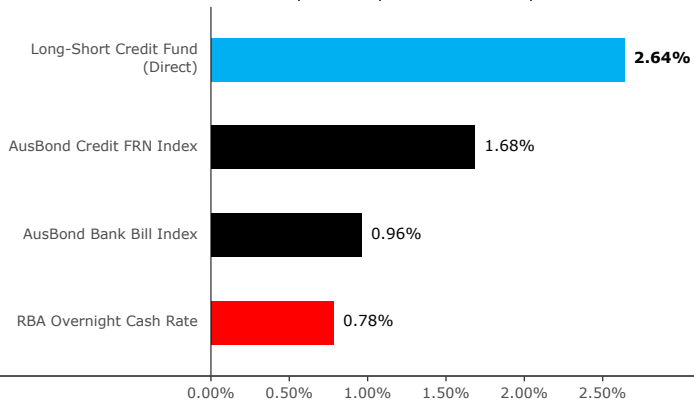
Objective: An absolute return fixed-income strategy focused on exploiting long and short mispricings in credit markets that targets high-yield like returns above the Reserve Bank of Australia (RBA) cash rate plus 4% to 6% p.a. over rolling 3 year periods with volatility of less than 5% p.a. after Management 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 2022-09-30	Gross Return (Direct)	Net Return (Direct) [†]	RBA Cash Rate	Gross Excess Return [‡]	Net Excess Return (Direct) ^{†‡}
1 month	-0.20%	-0.28%	0.18%	-0.38%	-0.46%
3 months	1.55%	1.31%	0.43%	1.11%	0.88%
6 months	-2.95%	-3.41%	0.52%	-3.47%	-3.93%
1 year	-2.84%	-3.80%	0.54%	-3.38%	-4.34%
2 years pa	1.66%	0.09%	0.29%	1.37%	-0.20%
3 years pa	3.00%	1.26%	0.33%	2.67%	0.93%
4 years pa	4.14%	2.28%	0.59%	3.55%	1.69%
5 years pa	4.46%	2.61%	0.77%	3.69%	1.84%
Inception pa Sep. 2017	4.48%	2.64%	0.78%	3.70%	1.86%

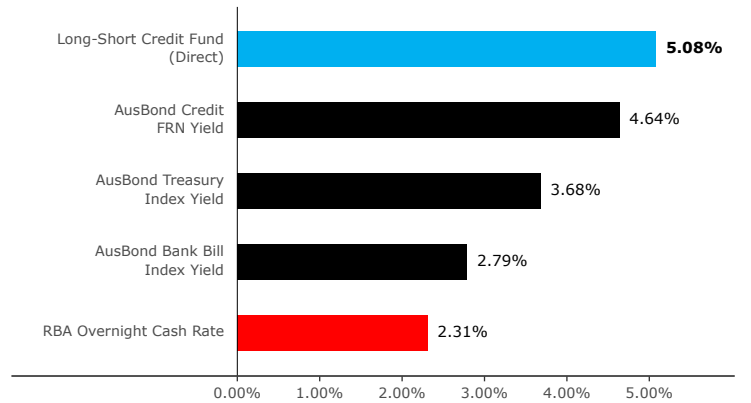
Long Short Credit Fund Returns (Net) vs Comparisons

Annualized Total Returns Since Inception in September 2017 to September 2022



Data Source: RBA, Bloomberg, Mainstream, Coolabah Capital Investments

30 September 2022 Gross Running Yield



Data Source: RBA, Bloomberg, Coolabah Capital Investments

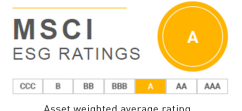
[†] Net returns are calculated from the historic gross returns using the current fee structure as displayed in the Product Disclosure Statement. [‡] The Excess Return columns represent the gross and net return above the RBA cash rate.

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](#).

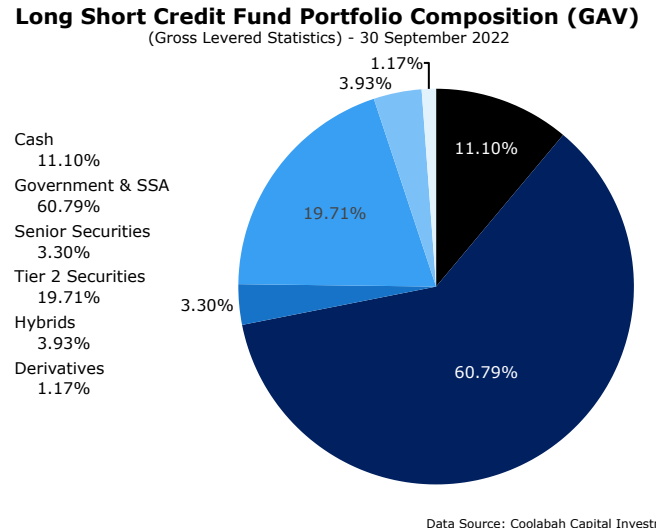
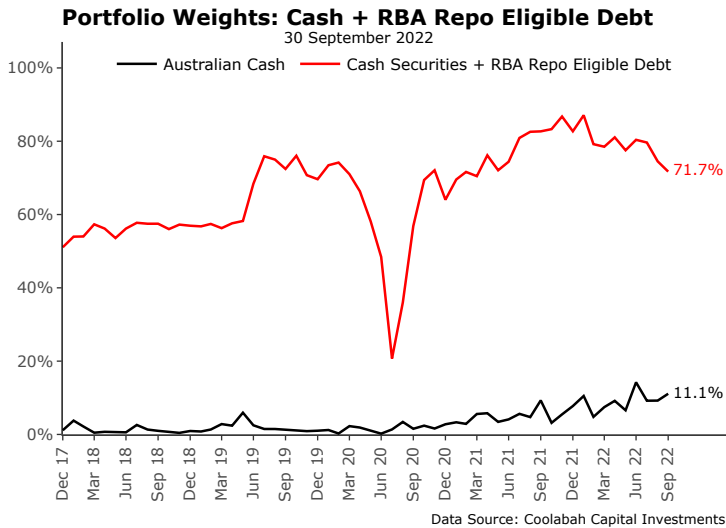
Note: all portfolio statistics other than running yield reported on gross levered value

Net Monthly Returns > RBA Overnight Cash Rate	72%	Average Interest Rate (Gross Running Yield)	5.08%
Gross Portfolio Weight to Cash Securities	11.1%	Modified Interest Rate Duration	< 0.1 years
Gross Portfolio Weight to Bonds	87.7%	Gearing Permitted?	Yes
Average Portfolio Credit Rating	AA-	1 Year Average Gross Portfolio Weight to Cash	8.2%
Portfolio MSCI ESG Rating	A	Gross Portfolio Weight to AT1 Hybrids	3.9%
No. Cash Securities	19	Gross Cash Securities + RBA Repo-Eligible Debt	71.7%
No. Notes and Bonds	125	Net Annual Volatility (since incep.)	3.20%

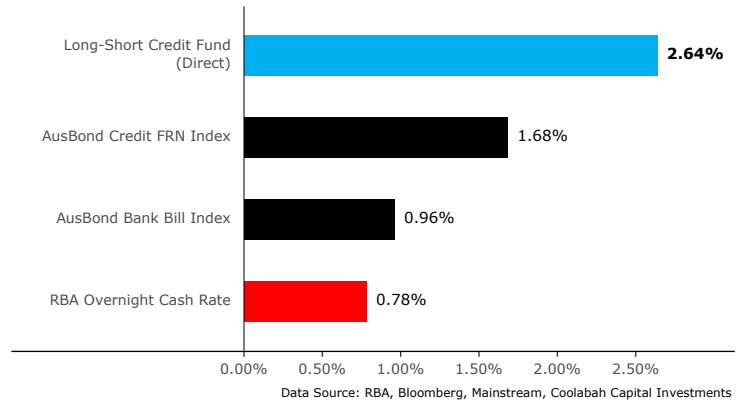
Awards: FE Alpha Manager 2019: Christopher Joye; **Ratings:** Lonsec available to advisers; Recommended (Atchison); 'Superior More Complex' (Foresight Analytics)



Asset weighted average rating



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The since inception gross (net) return of 4.48% pa gross (2.64% 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 3.20% 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 September with a running yield of 5.08%, a yield to call/maturity of 11.59% (assuming current funding costs), a weighted-average credit rating of AA-, and a portfolio weighted average MSCI ESG rating of A. In September, LSCF returned -0.20% gross (-0.28% net), compared to the AusBond Credit FRN Index (0.12%), the AusBond Bank Bill Index (0.15%), and the RBA Overnight Cash Rate (0.18%).

Since the inception of LSCF 5.1 years ago in September 2017, it has returned 4.48% pa gross (2.64% pa net), outperforming the RBA Overnight Cash Rate (0.78% pa), the AusBond Bank Bill Index (0.96% pa), and the AusBond Credit FRN Index (1.68% pa). While LSCF's return volatility since inception has been low at around 3.20% 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 another turbulent month for financial markets with US equities shedding significant value as long-term government bond yields continued their march higher given protracted inflation pressures. In the month, the S&P500 lost 9.6% while the Nasdaq Composite Index declined by 10.3%. Since their peak in 2021, the S&P500 has now fallen by 25.6% and the Nasdaq has lost 34.8%.

In December last year, Coolabah published the contrarian argument that US equities would slump by more than 30% as a result of sharply higher government bond yields, powered by the US Federal Reserve hiking its short-term policy rate above 2.5-3.0% to quell persistent inflation problems. (Although the Fed has now hiked to 3.00-3.25%, market expectations for the Fed's peak cash rate back in December 2021 were not much above 1%.)

At that time, we asserted that the US 10-year government bond yield would climb above 3.2% (it was sitting around circa 1%). In September 2022, the US 10-year yield appreciated sharply from 3.26% to 3.83% - with an intra-month peak of 3.97% - as the Fed surprised the market by releasing even more hawkish interest rate projections than expected via its so-called "dot plots".

As a consequence of rising government bond yields, the fixed-rate (rather than floating-rate) benchmark AusBond Composite Bond Index declined by 1.36% in September. The RBA lifting its target cash rate to 2.60% has boosted the AusBond Floating-Rate Note (FRN) Index, which outperformed and returned a healthy 0.12% in the month.

Hybrids Outperform

The big stand-out in September was the ASX hybrids market, which delivered a spectacular 1.07% in the month as the credit spread on 5-year major bank hybrids compressed from 297 basis points (bps) to 274bps (ie, 23bps tighter) above the quarterly bank bill swap rate (BBSW). The maturity of the \$1.3bn WBCPE hybrid in September likely afforded a nontrivial tail-wind to the sector. There is also currently limited future supply on the horizon save CBA's upcoming hybrid issue to replace the maturing CBAPD security in December. In 2023, there is just one major bank maturity: the \$0.97bn ANZPF in March.

One key contributor to the performance of ASX hybrids has been the demand for high-yielding, floating-rate assets with proven liquidity. Hybrid yields have benefited from rising interest rates (the BBSW benchmark has climbed from 0.01% in 2021 to 2.91% today) and the wider spread levels seen in the June quarter when 5-year spreads blew out over 100bps. Back in 2021, 5-year major bank hybrids were paying a running yield of about 2.10% compared to 5.65% today. The current average 5-year major bank yield-to-call is an even higher 6.85% because it accounts for future RBA rate hikes. This compares favourably with the franked dividend yield on CBA equities of just 5.75%.

Looking ahead to the fourth quarter of 2022, we have the maturity of the jumbo \$3bn CBAPD hybrid due in December. We expect this to be net positive for the ASX hybrid market as investors reinvest the cash into existing ASX hybrids and we do not expect CBA to refinance this hybrid to the full \$3bn size. In practice, they are likely to print only around \$2bn. As such, we have seen the demand (and price) for CBAPD increase as investors build-up positions in hope of obtaining better allocations in the new issue.

Strategy commentary cont'd:

Strong Performance From Tier 2

One step up the capital structure, major bank Tier 2 bonds performed in September with the 5-year credit spread above BBSW compressing from 241bps to 239bps. The spread premium earned on ASX hybrids over Tier 2 bonds, which was 1.14 times as at 30 September, is now close to the tightest level ever recorded and well inside its 1.85 times average. We have, as a consequence, been pivoting up the capital stack.

The major banks' 5-year Tier 2 spreads have been trading at a 2.6 times multiple of the equivalent 5-year senior bond spread, which is above the historical 2.3 times average. All of these are indicators that Tier 2 may be one of the cheapest sectors in the Australian fixed-income market right now.

Senior Bonds and RMBS Struggle

At the top of the capital structure, 5-year major bank senior bond spreads drifted wider over the month with Coolabah's proprietary 5-year curve appreciating from 87bps to 93bps over BBSW, perhaps in anticipation of new supply as three of the four big banks completed their financial years on 30 September.

As expected, the residential mortgage-backed securities (RMBS) market continued to struggle in the month with Coolabah's benchmark 3-year weighted-average life index of non-bank RMBS rising from 157bps to 169bps over 1-month BBSW (the tights in September 2021 were around 72bps). The sector is afflicted by a paucity of demand coupled with substantial selling of Aussie RMBS by accounts that may be concerned about the record correction in national house prices and/or seeking to raise liquidity. The latter objective most likely applies to UK-based Liability Driven Investors (LDIs) that were substantial buyers of Aussie RMBS and have been selling down their holdings almost every single day.

Semis Perform on a Spread to Swap Basis

With unprecedented buying of State-government bonds (semis) by banks keen to Hoover up these securities for their regulatory liquidity portfolios, semis performed well on a spread to swap basis compressing from 20bps to 16bps over the month. There was a different story on a spread to Commonwealth bonds (or spread to futures) basis as swap spreads blew-out aggressively. This dragged semi spreads to Commonwealth bonds up in the final week of the month, as they have had a curious tendency to do over the last year. Over the month, semi spreads to Commonwealth bonds net increased from 62bps to 65bps, putting them now wider than their average levels observed during the pandemic shock in March 2020. The move in swap spreads could be related to banks seeking to window-dress their portfolios as they come into quarter- and year-end by tightening up semi spreads to swap.

Twilight Zone Between Two World Orders

For better or worse, we live in a twilight zone spanning two worlds. First, there is the old world, where interest rates were to remain low-for-long, the cost of borrowing was the cheapest it had ever been, and central banks and fiscal treasuries could immediately alleviate every financial ill with ever more extreme forms of stimulus and money printing (aka quantitative easing) to bid up the value of all assets.

For years we have argued that state interventions that manipulated financial market processes to adjust price signals so that capital and labour were allocated as the state (not the collective wisdom of the crowd) dictated **undermined the very source of capitalism's prosperity-producing machine** – that is, creative destruction.

There is, of course, a role for governments to intervene temporarily when markets fail because of the asymmetric information induced by extreme shocks, like the one-in-100-year pandemic. But the elixir of zero rates, endless unfunded fiscal spending, and "QE-to-infinity" has been the ultimate panacea for both politicians and central banks desperate to satisfy the hedonistic masses.

New World

Strategy commentary cont'd: All that changed when the inevitable inflation shock arrived. This brings us to the new world. The mother of all inflation pulses was unavoidable precisely because the aforementioned unconditional policy stimulus programs would be continuously rolled out to solve every conceivable economic problem, until they generated their own binding constraint in the form of unacceptably high consumer price pressures.

The pandemic was an unusually potent melting pot for the inflation shock because it precipitated both intense supply-side and demand-side influences. Goods and services suddenly became hard to access. Concurrently, global unemployment rates fell to the lowest levels in more than half a century. It was the perfect storm for nascent wage/price spirals.

Myopic politicians unleashed the inflation-fighting beast when they shifted the crosshairs onto their central bankers, whom they had legislated responsibility for vouchsafing price stability. Blame the monetary policy mavens.

After burying their heads in the sand throughout the post-GFC period, the putative high priests of “inflation-targeting” suddenly transformed from zero-rate QE junkies into uber hawks care of the political cover provided by prime ministers and presidents desperate to hold someone else accountable for the cost of living crises they had all been partly culpable for engineering.

It still feels like most people are oblivious to this new world and its far-reaching consequences. We face the spectre of high-interest rates for a potentially protracted period of time. Even when economies inevitably retreat into recessions, central banks will be reluctant to relieve too much pain by cutting rates to zero again and restarting QE given that these were some of the key causes of the demand-side inflationary problems in the first place.

Bailing-Out Borrowers

Arguably the biggest concern has been the conditioning of businesses to rely on the low-rates-for-long paradigm. The last sub-prime crisis was triggered by vast volumes of high-risk, non-bank lending to residential property borrowers. The catalyst for this was the “Greenspan put” whereby the US Federal Reserve experimented with extreme monetary policy stimulus by slashing its policy interest rate from 6.5% in 2000 (just before the “tech wreck”) down to 1% by 2003 in response to the ensuing recession.

This crazy-cheap-money triggered an extreme housing boom, which encouraged unregulated non-bank lenders to furnish vast waves of asset-based (as opposed to income-based) finance to sub-prime borrowers that could only ever repay these loans on the assumption that house prices always appreciate, which everyone did assume.

When the Fed tried to normalise the price of money by lifting its policy rate from 1% to 5.25% in 2006, sub-prime arrears rates surged at the same time as US house prices started declining (they would ultimately crash about 25%). The eventual failure of many of these non-bank lenders as their access to finance evaporated – coupled with the enormous mark-to-market losses on once AAA-rated sub-prime mortgage portfolios as their underlying default rates rocketed – ignited a chain reaction across the global financial system that required most over-leveraged banks to be bailed out by taxpayers via equity injections, loans, and government guarantees.

The response to this global financial crisis was once again even cheaper money in the form of zero or negative interest rates and asset purchases by public central banks of many privately traded securities, including government bonds, corporate bonds, and equities. This playbook was extended even further to address the pandemic.

In the ashes of the GFC, regulators turned the screws on the banking system, forcing deposit-takers out of many riskier, non-core activities and massively enhancing the quality of their lending standards. The absence of any inflationary pressures in an increasingly indebted world also allowed policymakers to continuously lean on zero/negative rates and money printing to bid up the value of all assets at the first sight of adversity.

Strategy commentary cont'd: Near-zero bank deposit rates created the great “search for yield”, which central bankers actively encouraged. After most non-banks were killed off during the GFC, a new variety emerged in the form of a resurgent high-yield bond market, which was the non-bank lender of choice to companies that could not get similar terms from a now very conservative banking system. The high-yield market was further augmented by the advent of fund managers specialising in offering loans to small-to-medium-sized companies that were not being courted by conventional banks.

Zombie Apocalypse

All this cheap money massively **expanded the proportion of “zombie” companies** that were listed on global stockmarkets. Coolabah’s systems track zombies across the US, UK, European and Australian exchanges. From 2010 to today, their numbers as a share of all listed firms have almost doubled. The definition of a zombie is a firm that does not have sufficient earnings before interest and tax to pay the interest bill on debt for three years in a row. Our research suggests that zombies account for about 15% of all listed companies in the US, UK, Europe, and Australia.

The zombies were protected by zero rates and QE-to-infinity. But many may now be torched by inflation and expensive money in what could become the next great sub-prime crisis. The more existential issue for all asset prices is that extremely low-risk and liquid investments are suddenly offering very high returns.

We’ve spent the last couple of weeks meeting global investment banks, and have been surprised to hear the same line trotted out by virtually every single one: why would you buy equities or high-yield loans when an A-rated, senior-ranking bank bond from a leading US or European bank is paying you interest rates of 7% or 8% annually? With risk-free cash deposit rates marching past 3%, the minimum required returns on all assets must increase sharply. And the only way that can happen is via lower prices. Cash is once again king. Long live the king.

Bloodbath on Threadneedle Street

Another driver of the September bloodbath has been new UK prime minister Liz Truss blowing up her own bond market and the pension funds that invest in it with **profligate fiscal stimulus** that required an extra £45 billion (\$75 billion) in public debt issuance.

Back in December 2021, the 30-year British government bond, known as a “gilt”, was paying an interest rate of just 0.8%. In price terms, the 30-year gilt was trading at £111. Fast-forward nine months and the interest rates on 30-year gilts hit about 5% at one point in September, up almost 200 basis points from 3.2% 27 days prior (or up 420 basis points from December).

It has been a truly astonishing move that has cratered the price of the 30-year gilt down by an incredible 61% from £111 to £43.

Coolabah doesn’t bet on interest rate changes or shifts in central bank policy rates, and we hedge all our interest rate risk into floating-rate, rather than fixed-rate, format.

We had, however, commenced aggressively hedging and shorting “credit”, which includes bank and corporate bonds, immediately after Fed chair Jay Powell’s Jackson Hole speech on August 26, and upped the size of these hedges/shorts to over US\$700 million following the surprisingly high core US inflation print and the release of the Fed’s hawkish dot plots that quantify the central bank’s expectations for rate changes.

Since US and Euro credit spreads had moved sharply wider in September, these shorts/hedges had accumulated material gains by Wednesday, and we started taking profits. Then the Bank of England tape bomb hit the screens.

The huge increase in gilt yields, and the even more striking reduction in gilt prices, had inflicted massive losses on UK investors. This was forcing them to sell other, more illiquid, assets around the world, including their holdings of Aussie residential mortgage-backed securities (RMBS), to meet margin calls on derivative exposures, creating a chain reaction across all markets. There was fevered speculation that some UK investors could default on these derivatives as a result of their inability to sell the illiquid collateral backing them.

Strategy commentary cont'd: The Bank of England shocked investors with a sudden intervention in response, announcing that it would buy up to £5 billion of 20-plus-year gilts every day until October 14, taking £75 billion of long-dated debt supply out of the market. This was conveniently much more than the £45 billion debt shock triggered by Truss's tax cuts.

The BoE further stated it would buy whatever quantity of bonds was required to restore order and liquidity to the otherwise unprecedented volatility in the gilts market, which furnishes the risk-free rate for all UK business and household borrowings. The huge swings in the interest rates on gilts was making it hard for UK banks to price mortgages, which in turn risked morphing into a credit rationing crisis.

The BoE was careful to explain that this was a temporary financial stability intervention that would ultimately end up with the central bank selling the bonds it bought back to the market once conditions normalised.

It argued that it was not seeking to provide funding for the politicians' deficits nor targeting a specific level of long-term yields. It was simply focused on the financial stability risks of Truss blowing up the UK pension system.

The truth, however, is that all central banks are trying to set both short- and long-term borrowing rates through their monetary policy levers. While the BoE adjusts its short-term bank rate in the same way the RBA does its cash rate to influence both variable and fixed rates along the government bond yield curve, it's worth noting that longer-term borrowing levels are more important to central banks like the BoE and the Fed in economies dominated by fixed-rate, rather than floating-rate, debt. In Australia, most loans are floating-rate, which means the RBA's monetary policy changes are inherently more focused on shorter-term, rather than longer-term, interest rates.

The gilts crisis had massively increased long-term rates beyond the BoE's expectations, and in time it could choose to de facto target a long-term yield that is more congruent with its monetary policy preferences. In this way, the BoE could continue to hike its short-term bank rate aggressively (which it is bound to do in the months ahead) while having the option to do more bond buying (or quantitative easing) further out the curve to secure a level of rates that is still highly restrictive, just not so punitively punishing that it exceeds the BoE's objectives.

Remaining Macro Risks

On the macro front, one thing to be wary of is denial. We see it everywhere. In equities, especially, everyone has been glass-half-full. We are only just starting to see the post-GFC buy-the-dip reflex properly degrade. You see it in crypto. If Bitcoin breaks below US\$17k, crypto will shift to a new, materially lower regime. We see it in certain luxury property markets, which agents claim will be immune to the current correction. It is uber evident in private loan market where illiquidity allows fund managers to pretend there is nothing to see here. We feel more comfortable with pricing in fixed-income duration and credit markets, where significant bad news is now embedded.

We remain very negative equities. Beyond the massive equity repricing necessitated by higher discount rates, the earnings channel has yet to be smashed. We've been forecasting a US recession since the start of the year, which seems all but assured (we've already had the two quarters of negative GDP). In January, we wrote that US equities would likely return to their pre-pandemic level, which was a very contrarian call at the time. We are not far away now.

We remain super negative European investment-grade credit and, to a slightly lesser extent, US investment-grade credit, even though spreads appear attractive here. There is a disconnect between credit default swap (CDS) indices and cash credit pricing: CDS looks extremely cheap, and has underperformed cash, although the long-term CDS regime has been supported by the buy-the-dip reflex in equities, which could disappear. There was also a nontrivial reduction in USD/EUR IG credit supply in September, which is a gap that will be filled at some point. In Australia, the majors have not issued decent senior volumes in some time, which will presumably crank up again soon. The majors' 5-yr senior curve looks very cheap for them (expensive for us) in AUD, which raises the likelihood of them hitting the AUD market. We think they will be generous with new issue concessions given the AUD levels on offer.

Strategy commentary cont'd: We are mentally limit short bearish European and US high-yield (and have expressed this practically via CDS index shorts in HY in USD/EUR) on the basis of several factors, including: (1) the advent of a serious interest rate led global default cycle, which we have not really seen since 1991 or 2002; (2) the effective closure of the primary HY markets in the US and Europe with scant issuance in recent months; (3) the losses banks have incurred on bridge loans to HY borrowers, which is now impairing their ability to lend (eg, Citrix), and (4) the likely very poor credit quality of many of these assets given the proliferation of “zombies”.

We continue to worry about unknown unknowns, which the recent UK fiscal policy disaster is a classic example of. Russia/Ukraine is of course another one. The strong US dollar could create enormous stresses in emerging markets while compelling developed world central banks to hike harder at the margin to avoid importing more inflation. There are so many discrete, jump-like non-linearities out there.

We think the sudden shift in the position of global defined benefit pension funds from deficits to surpluses is potentially very important, and could in turn precipitate a global shift out of equities and other riskier, search-for-yield asset classes like commercial property, infrastructure, and PE/VC into high-grade bonds given the interest rates on offer in government bond and high-grade credit.

We remain super negative the Australian and global residential/commercial property markets. By extension, we are also super negative global RMBS/ABS (there should be terrific, distressed buying opportunities in 12-24mths).



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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