



December 2022

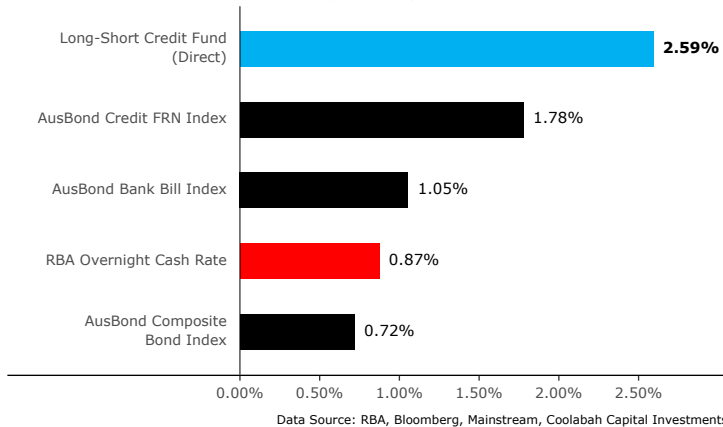
Objective: An absolute return fixed-income strategy focused on exploiting long and short mispricings in credit markets that targets high-yield like returns above the Reserve Bank of Australia (RBA) cash rate plus 4% to 6% p.a. over rolling 3 year periods with volatility of less than 5% p.a. after Management 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) ^{†‡}
2022-12-31					
1 month	1.70%	1.62%	0.24%	1.45%	1.38%
3 months	0.68%	0.43%	0.69%	-0.01%	-0.26%
6 months	2.24%	1.75%	1.12%	1.12%	0.63%
1 year	-2.96%	-3.90%	1.22%	-4.18%	-5.12%
2 years pa	-0.30%	-1.42%	0.62%	-0.93%	-2.05%
3 years pa	2.74%	1.09%	0.50%	2.24%	0.60%
4 years pa	4.43%	2.51%	0.67%	3.77%	1.84%
5 years pa	4.14%	2.37%	0.83%	3.30%	1.53%
Inception pa Sep. 2017	4.40%	2.59%	0.87%	3.52%	1.72%

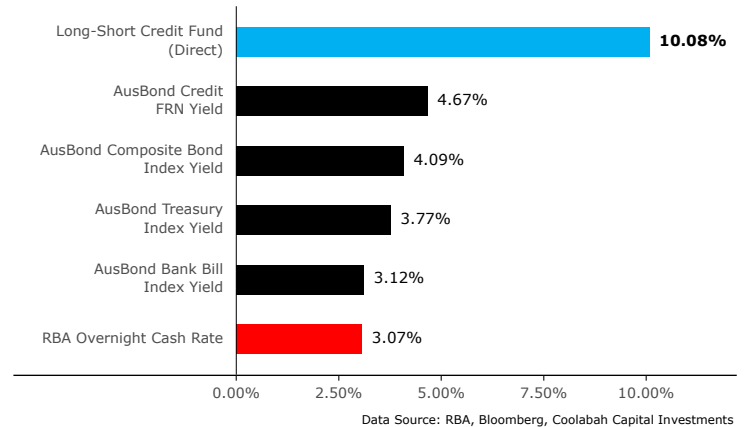
Long Short Credit Fund Returns (Net) vs Comparisons

Annualized Total Returns Since Inception in September 2017 to December 2022



Annualised Yield to Call/Maturity

31 December 2022



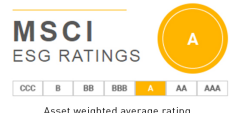
[†] Net returns are calculated from the historic gross returns using the current fee structure as displayed in the Product Disclosure Statement. [‡] The Excess Return columns represent the gross and net return above the RBA cash rate.

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](#).

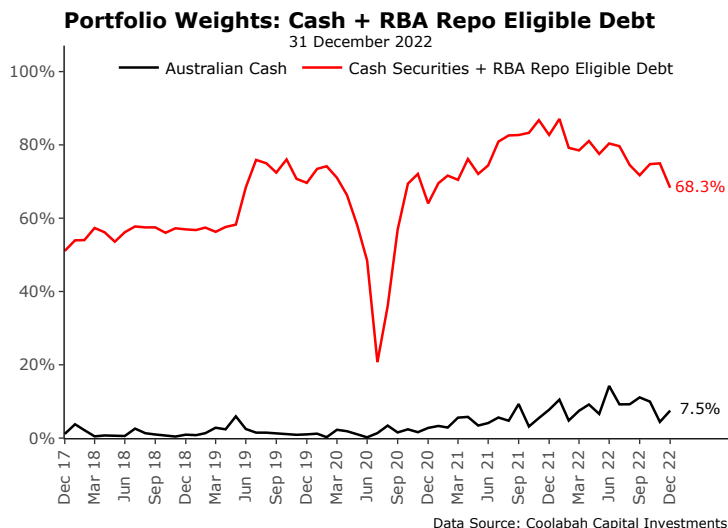
Note: all portfolio statistics other than running yield reported on gross levered value

Net Monthly Returns > RBA Overnight Cash Rate	72%	Av. Interest Rate (Gross Running Yield)	4.66%
Gross Portfolio Weight to Cash Securities	7.5%	Modified Interest Rate Duration	0.20 years
Gross Portfolio Weight to Bonds	88.8%	Gearing Permitted?	Yes
Av. Portfolio Credit Rating	AA-	1 Year Av. Gross Portfolio Weight to Cash	8.7%
Portfolio MSCI ESG Rating	A	Gross Portfolio Weight to AT1 Hybrids	0.7%
No. Cash Securities	18	Gross Cash Securities + RBA Repo-Eligible Debt	68.3%
No. Notes and Bonds	107	Net Annual Volatility (since incep.)	3.46%

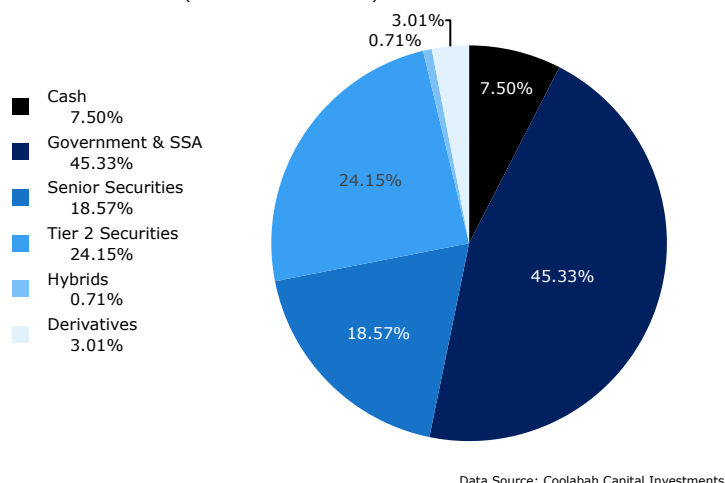
Awards: FE Alpha Manager 2019: Christopher Joye; **Ratings:** Lonsec available to advisers; Recommended (Atchison); 'Superior More Complex' (Foresight Analytics)



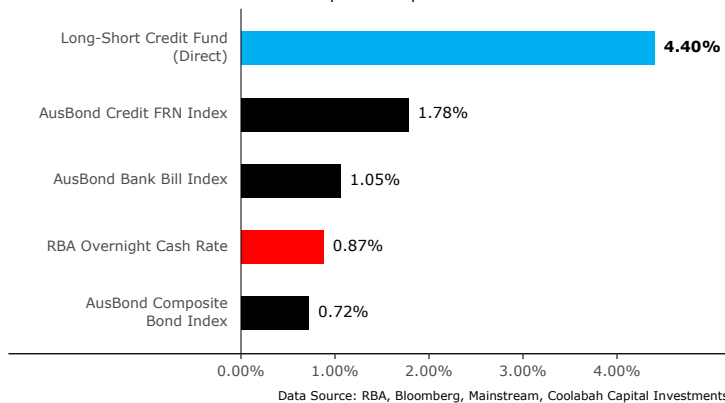
Asset weighted average rating



Long Short Credit Fund Portfolio Composition (GAV)
(Gross Levered Statistics) - 31 December 2022



Long Short Credit Fund Returns (Gross) vs Comparisons
Annualized Total Returns Since Inception in September 2017 to December 2022



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The since inception gross (net) return of **4.40% pa gross (2.59% 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 3.46% 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, Roger Douglas, 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	APEX 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 December with a yield to call/maturity of 10.08% (assuming current funding costs), a weighted-average credit rating of AA-, and a portfolio weighted average MSCI ESG rating of A. In December, LSCF returned 1.70% gross (1.62% net), outperforming the AusBond Composite Bond Index (-2.06%), the RBA Overnight Cash Rate (0.24%), the AusBond Bank Bill Index (0.25%), and the AusBond Credit FRN Index (0.34%).

Since the inception of LSCF 5.3 years ago in September 2017, it has returned 4.40% pa gross (2.59% pa net), outperforming the AusBond Composite Bond Index (0.72% pa), the RBA Overnight Cash Rate (0.87% pa), the AusBond Bank Bill Index (1.05% pa), and the AusBond Credit FRN Index (1.78% pa). While LSCF's return volatility since inception has been low at around 3.46% 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: In December, Coolabah's portfolios generated robust excess returns as a function of ongoing mean-reversion in historically elevated credit spreads across a spectrum of core assets, which was a continuation of a dynamic that has asserted in recent months as investors have come to recognise these material mispricings.

Returns have also been powered by a dramatic increase in our portfolios' yields, or the weighted-average internal rate of return on the bank and government bonds we hold. In our lowest-risk cash enhanced strategies, for example, the annual yield to maturity has leapt from circa 1% pa last year to over 5% pa at the time of writing.

Recall Coolabah exited its credit hedges/shorts in mid 2022, which we introduced in late 2021, on the basis of our contrarian projections for a sustained widening in credit spreads triggered by a striking increase in both short and long-term global interest rates in response to persistent inflation problems.

Back in December 2021, we argued that aggressive central bank tightening would precipitate major risk-off events across equities, government bonds, credit, crypto and property, amongst other sectors (see also our December 2021 and January 2022 analysis [here](#), [here](#), [here](#), [here](#) and [here](#)).

Having been very negative on our own asset-class for much of 2021 and 2022, we started re-acquiring bank bonds that had become historically very cheap in both spread and outright yield terms. Indeed, all-in yields as high as 6-7% pa have become available on some major bank bonds, which is the most attractive fixed-income return offered by these explicitly and implicitly government-guaranteed banks in over a decade

Our portfolios' excess returns in December were especially encouraging given the significant challenges experienced by other sectors, including equities and fixed-rate bonds. In the month, the S&P500 Index slumped 5.9% while the NASDAQ Composite Index lost 8.7%. Even the comparatively resilient Australian equities market, as proxied by the All Ordinaries Index, fell 3.5% in December.

The risk-off mood in stocks was partly attributable to hawkish global central bank rhetoric that propagated a sharp increase in fixed-rate government bond yields (or long-term risk-free interest rates). In Australia, the 10-year government bond yield jumped from 3.53% at the end of November to 4.05% by 30 December 2022. In the US, 10-year government bond yields also climbed from 3.61% to 3.87% over the same period.

Higher interest rates reduce the value of fixed-rate, as opposed to floating-rate, bonds, and this was reflected in the very poor performance of the benchmark AusBond Composite Bond Index, which only holds fixed-rate securities. In December, the Composite Bond Index declined by a sizeable 2.06% in total return terms. By way of comparison, the AusBond Floating-Rate Note (FRN) Index returned a healthy 0.34%.

Strategy commentary cont'd: Almost all of Coolabah’s strategies have been designed as floating-rate, or “zero interest rate duration”, solutions to outperform fixed-rate bonds, or “long duration” strategies, during periods in which interest rates are rising. Since 2011, we have held the view that the post-GFC epoch would ultimately conclude in a very strong inflation cycle attributable to excessively easy fiscal and monetary policy that would need to be unwound via an acute tightening of monetary conditions (ie, much higher rates).

In December, Coolabah’s lower-risk RBA cash rate + 1.5% strategy, called the Smarter Money Higher Income Fund, returned 0.68% gross (0.63% net), which followed similarly robust returns in November. This fund holds bonds with a weighted-average rating of A+, has a yield to maturity of 5.3% pa (up from only around 1% a year ago), and carries little-to-no interest rate duration risk.

At the higher risk end of the spectrum, Coolabah’s Long Short Credit Fund returned 1.70% gross (1.62% net) in December, extending November’s even stronger returns. This fund holds bonds with a weighted-average AA- credit rating, has an annual yield to maturity of 10.1% (up from 2-3% last year), and carries near-zero years interest rate duration risk, although it can use repurchase agreements to enhance returns.

On 5 December 2022, we launched a new strategy, called the Coolabah Floating-Rate High Yield Fund, which has an average A credit rating and a target yield to maturity in excess of 10% pa. Notwithstanding the partial month, Coolabah’s Floating-Rate High Yield Fund returned a healthy 1.03% gross (0.96% net) in December.

Our sole “long duration” (or fixed-rate) strategy, called the Active Composite Bond Fund, which carries more than 5 years of fixed-rate interest rate duration risk, outperformed the Composite Bond Index by 0.82% gross (0.79% net) in December, as it did in November.

December Spread Moves

As a value-based “quantamental” investor, we are constantly searching for bond mispricings, which means finding assets that are paying excessively high credit spreads after adjusting for their risk profile (eg, the credit rating, term to maturity, liquidity, position in the capital structure, and so on). As these bonds mean-revert via spread compression to our quantitative fair value targets, we earn capital gains, all else being equal. This in turn means we can generate total returns that are not purely a function of chasing risk, or yield.

Coolabah’s proprietary constant maturity index that tracks the credit spreads on 5-year major bank senior bonds tightened from 110 basis points (bps) to 103bps over the quarterly bank bill swap rate (BBSW) in December. These senior bond spreads remain well-wide of their post-Basel-3 average spread level of about 79bps over BBSW, as we have argued they should do since APRA closed the banks’ Committed Liquidity Facility (see our research predicting this would happen [here](#)).

One step down the capital structure, 5-year major bank Tier 2 bond spreads compressed from 245bps to 234bps over BBSW in December after they had moved as wide as 280bps in 2022. These Tier 2 bonds spreads look especially attractive compared to major bank Additional Tier 1 capital hybrids, which sit below Tier 2 in the capital structure, have a lower credit rating, and generally expose investors to much higher probabilities of loss. Tier 2 spreads remain miles above their long-run, post-Basel-3 average around 189bps over BBSW.

In December, 5-year major bank hybrid spreads contracted conspicuously from 279bps to 227bps, notably inside safer Tier 2 spreads from the same issuer with the same maturity, which must be a global first of sorts. We do not expect this mispricing to last very long, especially considering hybrid spreads are a lot skinnier than the post-Basel-3 average for a 5-year major bank security of 346bps. (These hybrids normally pay about 1.8x to 2.0x the spread offered on maturity-matched Tier 2 bonds.)

Strategy commentary cont'd: In the State government bond (semis) market, spreads over Commonwealth bonds were broadly stable over the month, and currently sit around 72bps for a 10-year, NSW government security. This is more than double the average NSW 10-year spread over Commonwealth bonds, which has typically traded around 33bps since APRA introduced its Basel 3 Liquidity Coverage Ratio (LCR) rules requiring banks to hold both State and Commonwealth bonds as a high quality liquid asset (HQLA) that can be transferred to the central bank during a funding crisis.

Despite the advent of both a new RBA bond purchase program under which the central bank bought \$56bn of semis between 2020 and 2022, and [Coolabah unearthing the fact that Aussie banks need to buy \\$300bn-\\$500bn of semis \(and Commonwealth bonds\) for regulatory liquidity needs](#), semi spreads remain much higher than both their long-term average trading levels and the stressed marks observed during dislocated periods, such March 2020 when 10-year NSW spreads averaged about 60bps over Commonwealth bonds. (It is worth noting that Aussie banks already own ~55% of the ~\$500bn semis market.)

A Cataclysmic Year

In 2022, arguably the single-best performing liquid asset-class was cash and highly-rated floating-rate bonds, which outperformed anything that was being accurately marked-to-market. (Illiquid investments such as private equity or private credit might report superficially superior returns simply because their required returns are not being accurately revalued against liquid equivalents.)

Whereas the fixed-rate Composite Bond Index lost an incredible 9.71% in 2022, its floating-rate sibling, the AusBond FRN Index, gained 1.28%, just pipping the return on the RBA's cash rate, which was 1.22%.

The catalyst was the unprecedented increase in both overnight cash rates and long-term expectations for the path of those central bank rates as proxied by government bond yields. Back in December 2021, the Aussie and US 10-year government bond yields sat at 1.67% and 1.51%, respectively. By the end of 2022, they had shot up to 4.05% and 3.87%.

The higher cost of risk-free capital hammered US equities in 2022. The S&P500 Index lost 19.7% in price terms while the NASDAQ Composite Index plunged 33.1% on the same basis. With the help of the pandemic-buoyed commodities complex, Aussie shares outperformed: the All Ordinaries Index shed (only) 7.2%.

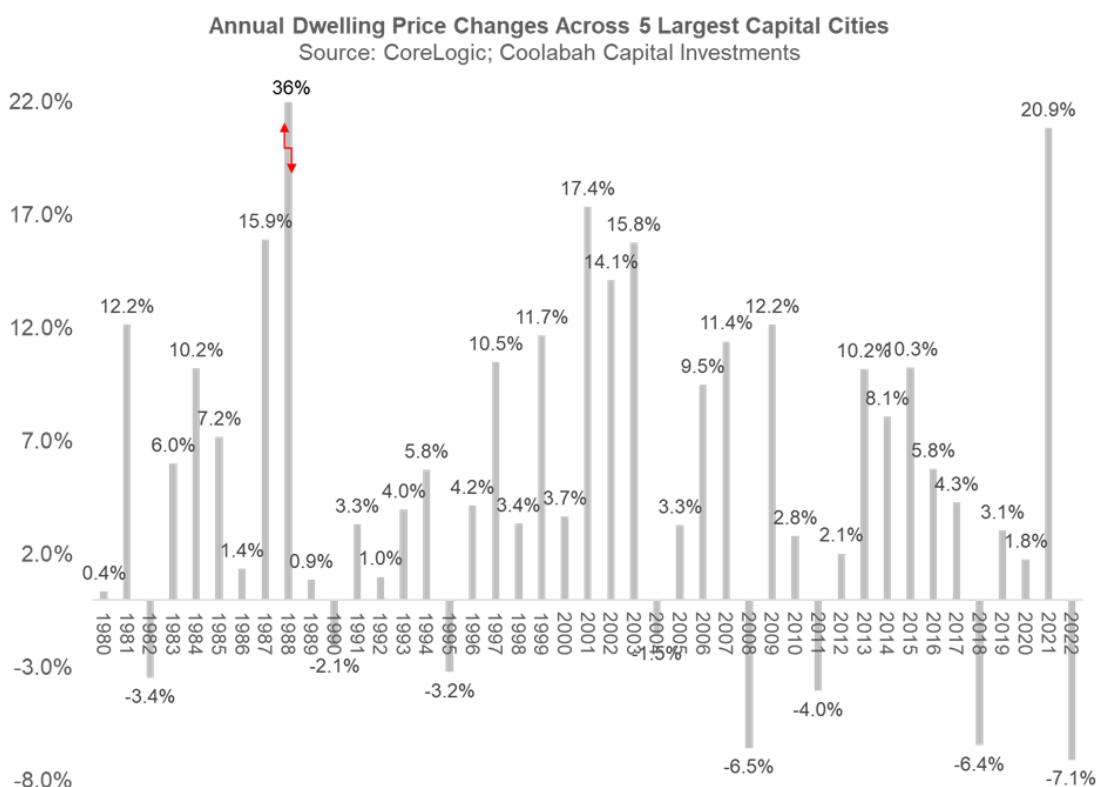
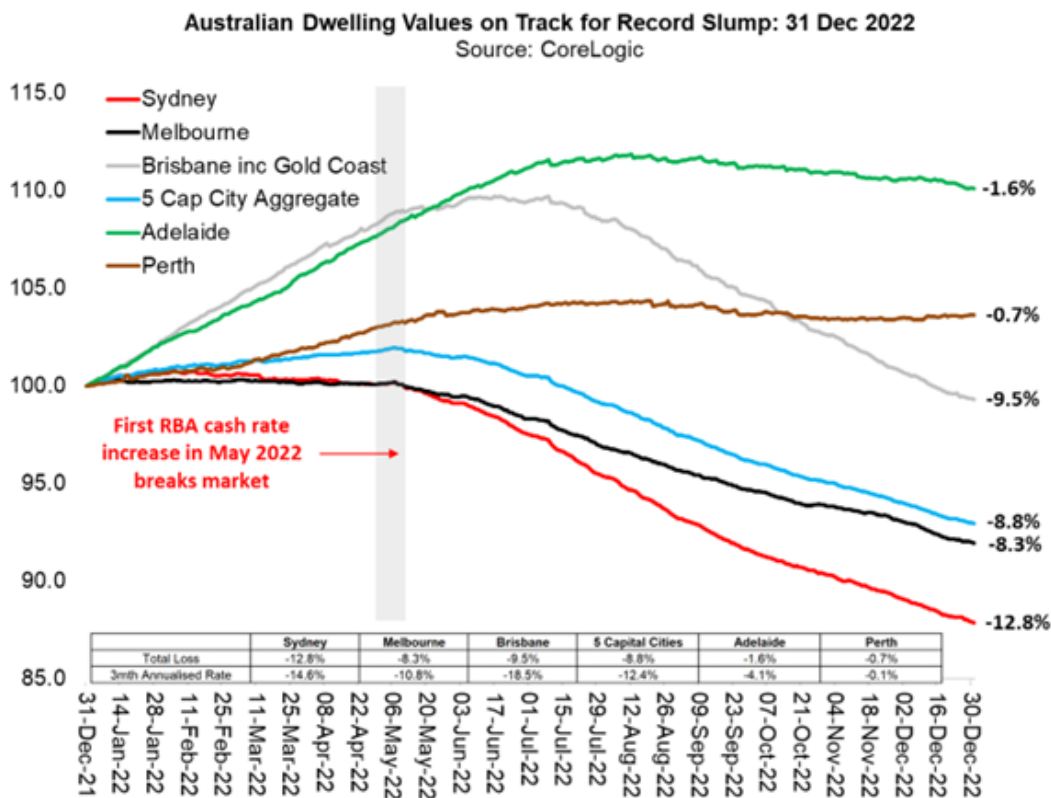
This was, of course, small beer relative to the plight of ponzi-like cryptocurrencies. Bitcoin finished 2022 at \$16,579, some 76% down from its US\$67,734 peak in November 2021, as we had repeatedly flagged was a risk [late last year](#) and in [January 2022](#).

Investment-grade credit spreads were not spared. At the end of 2021, 5-year major bank senior and Tier 2 bonds were trading close to their post-GFC tightness around 27bps and 140bps over BBSW, respectively. We sold all of our bank senior paper in early 2021, and in the second half of that year and the first half of 2022 were actively shorting bank credit spreads globally. As senior and Tier 2 spreads inevitably normalised higher, they would record intra-year peaks of circa 123bps and 280bps over BBSW. Accordingly, 5-year major bank senior and Tier 2 bond spreads would move about 100bps and 140bps, respectively, higher over the course of 2022, eventually making them very attractive acquisition targets. They finished the year at 103bps and 234bps over BBSW, which are historically attractive levels.

In 2022, Aussie home values slumped by their largest margin since CoreLogic started collecting data on the 5 biggest capital cities in 1980. On a peak-to-trough basis, the 5 capital city index lost 8.8% in 2022. In calendar year terms, it fell 7.1%, besting the previous calendar year record set during the GFC in 2008.

This has been driven by a record increase in the cost of borrowing to buy a home, which has leapt from about 2.4% pa in April 2022 prior to the first RBA rate hike in May to around 5.3% pa today. Since May 2022, the RBA has lifted its target cash rate by 300 basis points, which is unprecedented in the modern inflation-targeting period that began in the early 1990s. As a result of the huge jump in mortgage rates, the purchasing power of new home buyers has been slashed by roughly one-third.

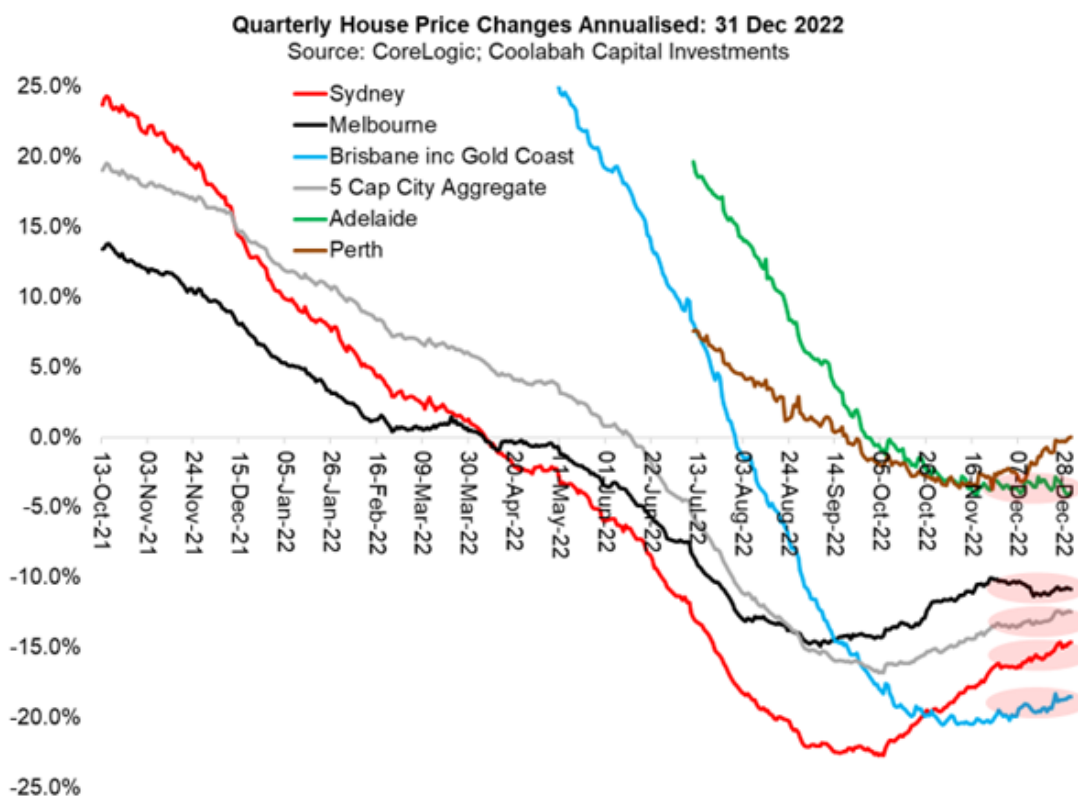
Strategy commentary cont'd: As we have previously explained, other influences on house prices, such as robust population growth, brisk wage growth, and a striking fall in new building approvals, will have very little impact on residential valuations in the short-term as the enormous shifts in interest rates and purchasing power absolutely dominate the price discovery process. And this has indeed been the way things have played out since the great Aussie housing correction commenced at exactly the same time Martin Place started lifting rates in May 2022.



Strategy commentary cont'd: The monthly pace of house price depreciation remained extremely rapid in December 2022 with the 5 city index losing another 1.2%, led by Sydney (-1.4%), Brisbane (-1.4%), and Melbourne (-1.2%). The most resilient conurbations remain, unsurprisingly, relatively cheap areas like Adelaide, which lost only 0.4% in December, and Perth, which actually ground-out a small capital gain (0.1%) in the month.

On a peak-to-trough basis, dwelling values in Sydney declined the most (-12.8%) in 2022, followed by Brisbane (-9.5%), the 5 capital city index (-8.8%), and Melbourne (-8.3%). In comparison, Adelaide (-1.6%) and Perth (-0.7%) have suffered only very modest moves.

With the RBA signalling that it wants to lift its 3.1% cash rate further in 2023 to around 3.5%, Aussie housing is on track to cheapen by a total of 15-25% from its peak, which is consistent with our original forecast outlined in October 2021. We have had no reason to adjust our views since that time.



The Great Regime Change: Growth and Cheap Money Are Dead

This has been the year of the great regime change or inflexion point—call it what you will. The search for yield is dead because lofty risk-free interest rates on cash, and cash-like investments, are suddenly plentiful.

Why buy a Sydney or Melbourne apartment yielding 4% before hefty transaction and maintenance costs, when term deposits offer a superior rate of return?

After decades of disinflation, ultra-low rates, and never-ending money printing (aka quantitative easing), we finally, belatedly, welcomed the inflation crisis that was the predictable consequence of myopic politicians and policymakers hedonistically pouring cash on every problem that ever presented itself. After all, if cash is costless, you can spend unlimited amounts.

When inflation was never a binding constraint, you could cut interest rates to zero (or even negative levels), run massive budget deficits that were very cheap to fund, and then have your central bank print hundreds of billions—if not trillions—of dollars of fresh moolah to bid up the value of all asset classes by slashing discount rates to record lows.

Strategy commentary cont'd: Remember the low-rates-for-longer paradigm? It's gone the way of the dodo.

We recall an incredibly talented interest rate trader at a US investment bank telling us that he would never see an interest rate increase from the RBA during his lifetime.

The absence of a decent risk-free rate of return rationalised the proliferation of numerous high-yielding, and often more illiquid, income solutions in equities, property, and fixed income. And the illiquidity was appealing precisely because it concealed the much greater underlying risks.

That party is now over: all investments need to offer attractive risk premiums over 4 to 5% cash rates and government bond yields. Some sectors, like the liquid equities and bond markets, have adjusted immediately.

More illiquid areas, like housing, commercial property, private equity, venture capital, and the high yield loan space, could take years before they fully reprice. Concurrently, investors will discover the price of that illiquidity, which will be borne out by, among other things, a withering default cycle.

Even in listed equities, there is a case that cyclically adjusted price/earnings multiples are still far too high and not fully pricing in the global recession that is bound to come. To be sure, equities have likely adjusted to the change in discount rates—it is, however, unlikely that they are reflecting the retrenchment in future earnings growth.

For the time being, anything that promised growth is basically dead. And this is taking with it the pandemic meme trades of tech, crypto, fintech, and the entitled attitudes of Millennials who were conditioned to being always able to find well-paying jobs.

When cash paid you no return at all, or a negative return, spruikers could push “digital currencies” such as bitcoin as an alternative on the basis that it was a great inflation hedge, a safe store of wealth, a portfolio diversifier against other assets such as equities, and a medium of exchange for buying and selling stuff.

Of course, bitcoin has proven to be none of these things: all these claims were bogus. And most, if not all, cryptocurrencies will end up being zeroes.

In late 2021 and January 2022, we laid out some core hypotheses regarding what the future might hold for a range of asset classes. Our key proposition was that persistently stubborn inflation pressures would force the US Federal Reserve to lift its cash rate to multiples of the very modest 1% high watermark that was being priced by bond markets in December last year.

This would in turn push US 10-year government bond yields beyond 3.2%.

And we argued that the big jump in discount rates would force US equities down by at least 30%, trigger a US recession, precipitate a massive crypto crash, hammer fixed rate (rather than floating rate) bond prices (as yields soared), and push investment-grade credit spreads at least 100 basis points wider.

In October 2021, we also projected a record 15-25% Aussie housing draw-down after the RBA commenced raising rates in mid-2022. We were pretty much negative everything.

All these things have come to pass, or appear likely to do so. The outstanding questions are whether we get a US recession, which our modelling implies is highly probable, and the magnitude of the great Aussie housing crash.

Perhaps the more interesting issue is what surprised in 2022. Our biggest miss was not anticipating that high inflation would become a cost-of-living crisis that would transform preternaturally dovish politicians that always want cheaper money, into interest rate hawks.

This opened the door for the inflation-fighting zealots inside the central banks to raise rates with unprecedented speed and global synchronicity.

Strategy commentary cont'd: We had thought that politicians would throw sand in the wheels of interest rate increases, slowing down the central banks. Instead, they became an accelerant, although this is unlikely to last as the cost of much higher interest rates—via job losses—becomes much more visceral in 2023.

Our main conviction for next year is that the economic and financial impact of the interest rate shock will be worse than people think. Central banks are implacably committed to engineering the slowdowns required to crush the strongest consumer price pressures in 40 years. This means job losses, defaults, corporate closures, and much weaker wage growth.

It also means the death of the hordes of predominantly real estate and tech zombie businesses that have thrived on the availability of cheap credit for decades without actually having the earnings to service their debts.

We have previously highlighted the sobering RBA analysis that shows that 15% of all borrowers could end up with negative disposable income if Martin Place lifts the cash rate to 3.6%, which is not far from its current 3.1% mark.

While it is all but certain that central banks will have to reverse course at some point in 2023 or 2024, cash rates are likely to remain structurally higher than they have in the post-GFC period. This is because the experiment with zero rates and “QE-to-infinity” is dead for the time being.

Central bankers have been badly scarred by completely missing the corollary of their cheap money policies, as have politicians who have for years run profligate spending programs in the name of bribing punters to keep their sorry behinds in power.

Crucially for investors, this means that all asset prices need to adjust permanently lower to reflect higher interest rates on cash. And it means that investors should not expect the ebullient bounce in asset prices that they became accustomed to seeing in the post-GFC period.

Future asset price growth may be dictated more by sluggish income growth than interest rates, simply because the option of cutting rates to zero and printing money to bid up the value of everything has been taken away from the central bankers by this inflation crisis.

The world may never look the same. We are going to have to rewire the neurology of both business and the capital markets that fund them to account for a permanently higher cost of capital, which in turn reflects the lurking presence of inflation risks that investors, politicians, and policymakers had simply assumed did not exist.

Our best advice is to continuously remind yourself that the last 30 years of data could be a bum steer for this new reality.

We are going through a structural break—a fundamental shift in the way things work. In some ways, this definitionally makes the future even harder to predict because we cannot rely on the empirical experience of decades past.



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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Ratings Disclaimer:

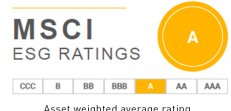
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