

**September 2023**

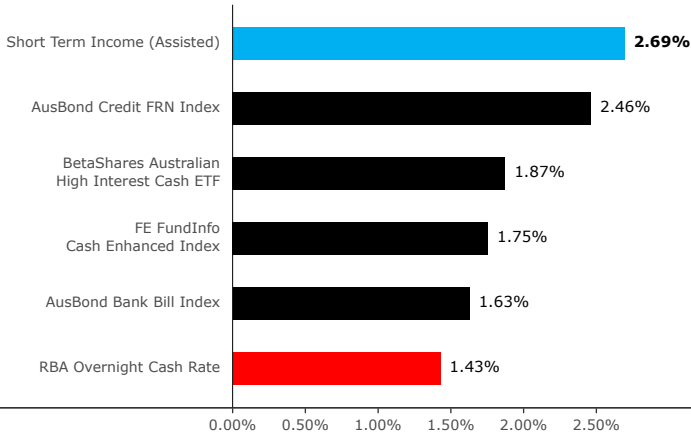
**Objective:** An independently-rated/recommended strategy targeting low-risk cash and fixed-income returns that exceed the RBA's cash rate by 1.5%-3.0% pa after fees, over rolling 12 month periods.

**Strategy:** We actively invest in a diversified portfolio of Australian deposits, investment grade floating-rate notes and hybrid securities with a weighted-average "A" credit rating. We do not invest in fixed-rate bonds (unless interest rate risk is hedged), direct loans, use leverage, or take currency risk. We add value via active asset-selection using a range of valuation models with the aim of (1) delivering lower portfolio volatility than traditional bond funds and (2) providing superior risk-adjusted returns, or alpha, without explicitly seeking interest rate risk, credit risk or liquidity risk. The strategy is managed by Coolabah Capital Investments, which is a specialist active credit manager.

Period Ending	Gross Return (Assist.)	Net Return (Assist.) <sup>†</sup>	RBA Cash Rate	Gross Excess Return <sup>‡</sup>	Net Excess Return (Assist.) <sup>†‡</sup>
<b>2023-09-30</b>					
1 month	0.49%	0.43%	0.32%	0.18%	0.12%
3 months	2.01%	1.73%	1.00%	1.01%	0.73%
6 months	3.90%	3.33%	1.94%	1.96%	1.39%
<b>1 year</b>	<b>6.25%</b>	<b>5.21%</b>	<b>3.47%</b>	<b>2.78%</b>	<b>1.74%</b>
3 years pa	2.85%	1.96%	1.34%	1.51%	0.62%
5 years pa	3.17%	2.22%	1.16%	2.01%	1.06%
<b>Inception pa Oct. 2014</b>	<b>3.67%</b>	<b>2.69%</b>	<b>1.43%</b>	<b>2.24%</b>	<b>1.27%</b>

**Coolabah Short Term Income Fund Returns (Net) vs Comparisons**

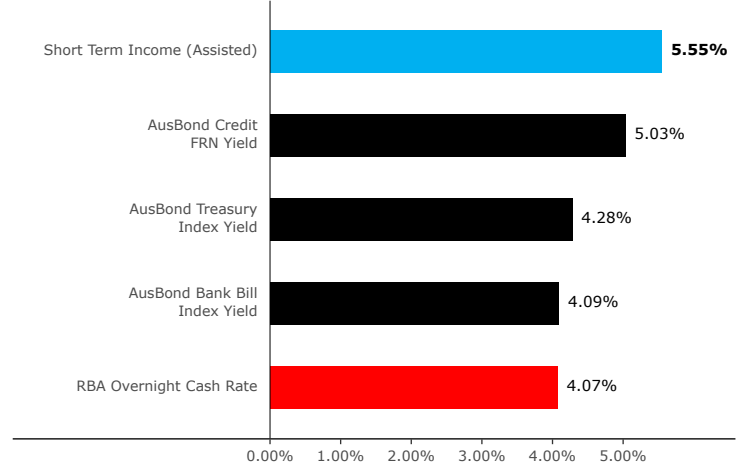
Annualized Total Returns Since Inception in October 2014 to September 2023



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

**Annualised Yield to Call/Maturity**

30 September 2023



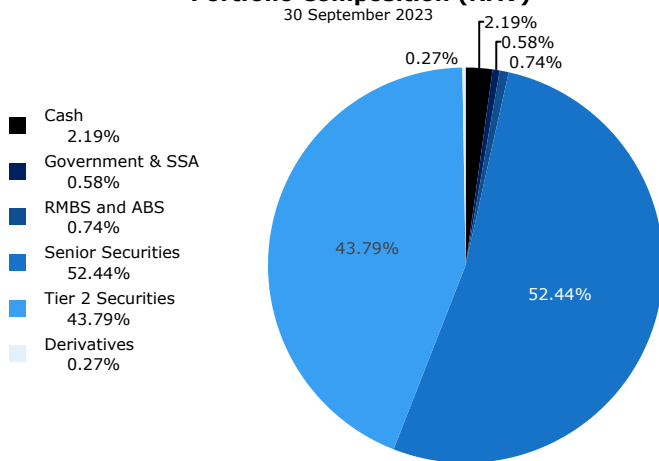
Data Source: RBA, Bloomberg, Coolabah Capital Investments

<sup>†</sup> Net returns are calculated from the historic gross returns using the current fee structure as displayed in the Product Disclosure Statement. <sup>‡</sup> 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.

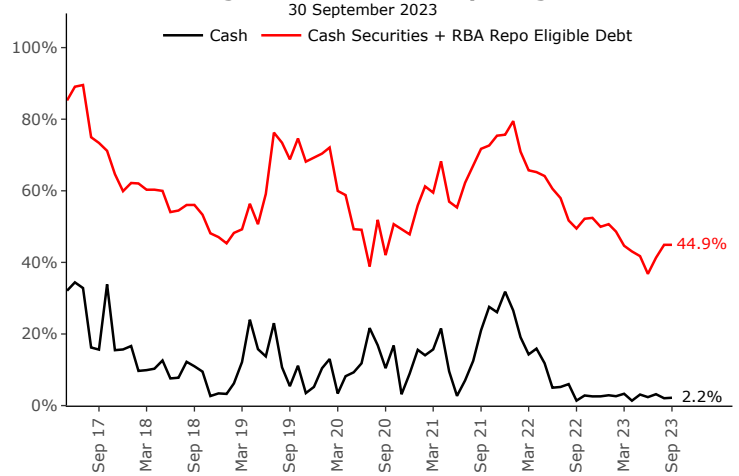
Net Monthly Returns > RBA Overnight Cash Rate	78%	Modified Interest Rate Duration	0.11 years
Portfolio Weight to Cash Securities	2.2%	Gearing Permitted?	No
Portfolio Weight to Bonds	97.5%	1 Year Av. Portfolio Weight to Cash	2.6%
Av. Portfolio Credit Rating	A	Portfolio Weight to AT1 Hybrids	0.0%
Portfolio MSCI ESG Rating	AA	Cash Securities + RBA Repo-Eligible Debt	44.9%
No. Cash Securities	12	Net Annual Volatility (since incep.)	0.84%
No. Notes and Bonds	116	Net Sharpe Ratio (since incep.)	1.50x
Av. Interest Rate (Gross Running Yield)	5.46%	<b>Awards:</b> FE Alpha Manager 2019: Christopher Joye; <b>Ratings:</b> Recommended (Lonsec); 'Superior Relatively Simple' (Foresight Analytics)	

**Coolabah Short Term Income Fund  
Portfolio Composition (NAV)**



Data Source: Coolabah Capital Investments

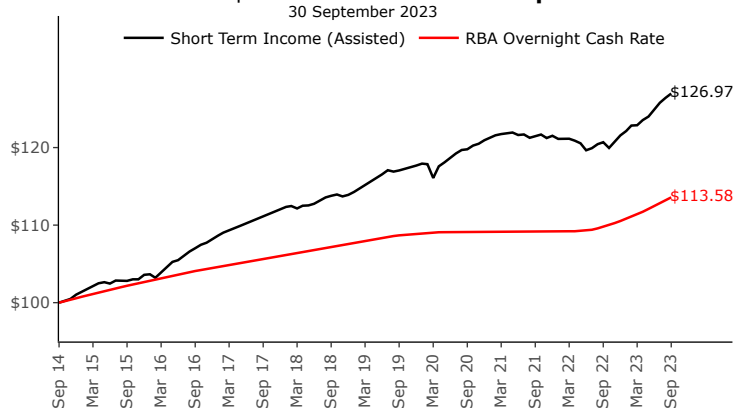
**Portfolio Weights: Cash + RBA Repo Eligible Debt**



Data Source: Coolabah Capital Investments



**Value of \$100 Invested since Inception**



Data Source: Bloomberg, Coolabah Capital Investments

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The since inception gross (net) return of 3.67% pa gross (2.69% pa net) is the total annual return earned by the fund since Oct. 2014, 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 Coolabah Short Term Income Fund - Assisted 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 0.84% pa is based on the standard deviation of net daily returns since inception, which are then annualised, attributable to the Coolabah Short Term Income Fund - Assisted Investor Class.

Portfolio Managers Christopher Joye, Ashley Kabel, Roger Douglas, Dr Nick Campregher (Coolabah Capital Investments)

APIR Code	SLT0052AU	Fund Inception	30-Sep-14
mFund Code	SMF02	Distributions	Quarterly
Morningstar Ticker	40536	Unit Pricing	Daily (earnings accrue daily)
Asset-Class	Short-Term Fixed-Interest	Min. Investment	\$1,000
Target Return	Net 1.5%-3.0% pa over RBA cash rate	Withdrawals	Daily Requests (funds normally in 3 days)
Investment Manager	Coolabah Capital Investments (Retail)	Buy/Sell Spread	0.00%/0.025%
Responsible Entity	Equity Trustees	Mgt. & Admin Fee	0.69% pa
Custodian	APEX Fund Services	Perf. Fee	22.5% of returns over RBA cash + 2.19% pa

*The Fund was previously known as the Smarter Money Higher Income Fund ARSN 601 093 485. On 5 September 2023, it was renamed to the Coolabah Short Term Income Fund to coincide with the launch of the quoted "(Managed Fund)" Class (CXA: FRNS). The investment strategy, objectives and terms remain unchanged.*

**Portfolio commentary:** The zero-duration daily liquidity Coolabah Short Term Income Fund (FRNS) ended September with an annualised yield to call/maturity of 5.55% pa, a weighted-average credit rating of A, and a portfolio weighted average MSCI ESG rating of AA. In September, FRNS returned 0.49% gross (0.43% net), outperforming the FE Cash Enhanced Index (0.23%), the RBA Overnight Cash Rate (0.32%), the BetaShares High Interest Cash (AAA) ETF (0.33%), the AusBond Bank Bill Index (0.34%), and the AusBond Credit FRN Index (0.37%). Over the previous 12 months, FRNS returned 6.25% pa gross (5.21% pa net), outperforming the RBA Overnight Cash Rate (3.47% pa), the AusBond Bank Bill Index (3.56% pa), the BetaShares High Interest Cash (AAA) ETF (3.65% pa), the FE Cash Enhanced Index (4.04% pa), and the AusBond Credit FRN Index (4.63% pa).

Since the inception of FRNS 9 years ago in October 2014, it has returned 3.67% pa gross (2.69% pa net), outperforming the RBA Overnight Cash Rate (1.43% pa), the AusBond Bank Bill Index (1.63% pa), the FE Cash Enhanced Index (1.75% pa), the BetaShares High Interest Cash (AAA) ETF (1.87% pa), and the AusBond Credit FRN Index (2.46% pa). Since inception, FRNS's Sharpe Ratio, which measures risk-adjusted returns, has been 2.59x gross (1.50x net). While FRNS's return volatility since inception has been low at around 0.84% 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:** While September was a very tough month for both risky asset-classes like equities and fixed-rate bonds as a result of a substantial increase in long-term government bond yields (and hence discount rates), it proved to be yet another prosperous experience for high-grade floating-rate credit. We have long argued that floating-rate credit will outperform fixed-rate bonds during the transition period to structurally higher interest rates, which commenced at the start of 2022 and now looks to be approaching its apogee. Coolabah's active investment strategies also continued to outperform.

The US 10-year government bond yield surged from 4.11% to 4.57% in the month and is at the time of writing trading around 4.80% as financial markets belatedly come to terms with the higher-rates-for-longer reality that Coolabah has been advocating since late 2021. More specifically, our strategists prepared detailed modelling documented in formal presentations in December 2021 that suggested the US Federal Reserve needed to lift its cash rate from near-zero% at the time to between 5-6%, which is where it currently resides.

Let there be no doubt that the sharp increase in long-term discount rates will apply ongoing pressure to the value of all risky asset-classes, including listed equities, venture capital, commercial property, high-yield debt, and private credit. Illiquidity is a real problem here and will only delay the required downward valuation adjustments.



Christopher Joye: Forget equities, bonds will outperform over the next 2-3 years

Strategy commentary cont'd:



Joye pulls no punches amid soaring bankruptcies, low productivity and the zombie apocalypse

You can watch two interviews with Coolabah’s CIO on this topic that were published by Livewire [here](#) and [here](#).

Equity markets have been arguably delusional for much of 2023, and are now only reluctantly capitulating in the face of the much higher cost of capital ruthlessly asserting itself. In September, the S&P500 fell by 4.78% in total return terms and is off another 1.3% to start October (the Eurostoxx 50 declined by 2.85% in September while the All Ordinaries Accumulation Index lost 2.82%).

In contrast, floating-rate bonds performed with the AusBond Floating-Rate Note (FRN) Index rising by 0.37% in the month and Coolabah’s zero duration (or floating-rate) strategies generating higher returns again. For example, our Long Short Credit Fund returned 0.84% gross (0.70% net) in September and has delivered 10.53% over the last 12 months net of fees.

Coolabah’s Short Term Income Fund (ETF: FRNS), which was previously known as the Smarter Money Higher Income Fund, returned 0.49% gross (0.43% net) in September compared to the RBA cash rate’s 0.32%. Over the last 12 months, FRNS has returned 5.21% to 5.42% net of fees compared to the RBA cash rate’s 3.47%. In September, we listed Coolabah’s Short Term Income Fund as a liquid, short-duration credit ETF on the CBOE exchange under the ticker FRNS.

Higher government bond yield hurt fixed-rate bonds in September with the Bloomberg Global Aggregate Corporate Index declining by 2.72%. There was a secular rise in long-term government bond yields in the month: 10-year German bund yields increased by 37 basis points (bps) from 2.47% to 2.84%; Italian 10-year yields jumped from 4.12% to 4.78%; and 10-year Australian government bond yields climbed from 4.03% to 4.49%. With a much lower exposure to credit relative to the Bloomberg Global Aggregate Corporate Index, the AusBond Composite Bond Index declined by a relatively more modest 1.53% in September.

Coolabah’s Active Composite Bond Fund, which trades under the ETF ticker FIXD, outperformed by about 10bps, which is consistent with its historic alpha in months when the Composite Bond Index has a negative return. FIXD has beaten the Composite Bond Index by a total of 3.99% over the 12 months to 30 September 2023 (5.60% net vs 1.61%).

In September, synthetic or derivative credit spreads drifted wider with investment-grade massively outperforming high-yield (or junk), as expected. US investment-grade credit default swap (CDS) index spreads increased 3bps while European IG CDS spreads rose by 4bps. In the high-yield market, European CDS spreads widened by 20bps while US HY CDS spreads increased by 26bps. These trends continued in October.

In the physical bond markets, we observed 5-year senior-ranking bond spreads from the major banks creep from 89bps to 93bps in AUD and from 101bps to 107bps in USD. Conversely, 5-year Tier 2 bond spreads on major bank securities tightened in September from 198bps to 193bps in AUD and from 248bps to 245bps in USD. On the ASX, 5-year major bank AT1 hybrid spreads compressed sharply from 295bps to 253bps, which remains empirically a very tight level for these securities.

**Strategy commentary cont'd:**

Turning to non-financial corporate spreads, Bloomberg indices reported that AUD corporate bond spreads contracted from 158bps to 152bps in September, echoing a move in EUR corporate spreads, which declined from 155bps to 153bps. By way of contrast, US corporate spreads drifted from 118bps to 121bps.

Morgan Stanley has highlighted a further deterioration in the fundamentals (eg, earnings, leverage, liquidity, etc) of sub-investment grade – or high-yield – bond issuers and private loans in the US. High-yield cash bond spreads have widened about 40bps from their August tights.

Within Morgan Stanley’s high yield companies database, earnings growth of the median company has decelerated. After peaking in late 2022, interest coverage has been declining by ~0.4-0.5x each quarter, as the increase in interest expenses continues to outpace earnings growth.

Gross leverage remains high at 3.75x and continues to trend upwards. Liquidity, as measured by the cash/debt ratio, has decreased quarter-on-quarter and year-on-year, with the excess cash accumulated by companies post-COVID mostly depleted by now.

The riskier left tail cohort, with sub-1.5x interest coverage and sub-10% cash/debt, also continued to increase to 5%, which is a record high post-GFC. And similar trends were evident within private debt loans. Coolabah has long warned about the coming default cycle, which is likely to be the worst since the GFC globally and the 1991 recession in Australia.

**Valuing bank equities versus bank bonds**

Coolabah has constructed measures of the value of bank equities relative to bank bonds. These measures suggest US bank shares are very expensive relative to bonds, euro area bank shares are broadly in line, and Australian bank equities are expensive. Mindful that valuation mismatches can last a long time, a scenario analysis suggests Australian bank equities would have to fall about 16-17% to restore fair value relative to bank bonds, although in practice fair value could be achieved by a mix of lower equities and lower bond yields.

The recent large sell-off in government bonds has seen some analysts highlight that US corporate bond yields now exceed the earnings yield on US stocks for the first time in years.

For example, the earnings yield for the S&P500 of 5.25% is exceeded by both the Aaa corporate bond yield of about 5.5% and the Baa corporate bond yield of about 6.5%.



*Some analysts have highlighted the convergence in yields across asset classes*

The comparison between the earnings yield and a corporate bond yield has its roots in the equity risk premium, where the premium is commonly measured by subtracting the government bond yield from the earnings yield, with analysts replacing the risk-free rate with a corporate bond yield.

**Strategy commentary cont'd:**

However, there are drawbacks to this approach.

One is that the earnings yield is a real concept, such that it should be compared with a real bond yield rather than a nominal bond yield.[1]

Another drawback is that the stock market can have a very different industry mix to a corporate bond yield.

Coolabah has addressed these issues in constructing simple equity/bond relative valuation measures for the US, euro area and Australia, focusing on the banking sector.

This involved comparing like with like by analysing the margin of bank earnings yields over real bank bond yields, where:

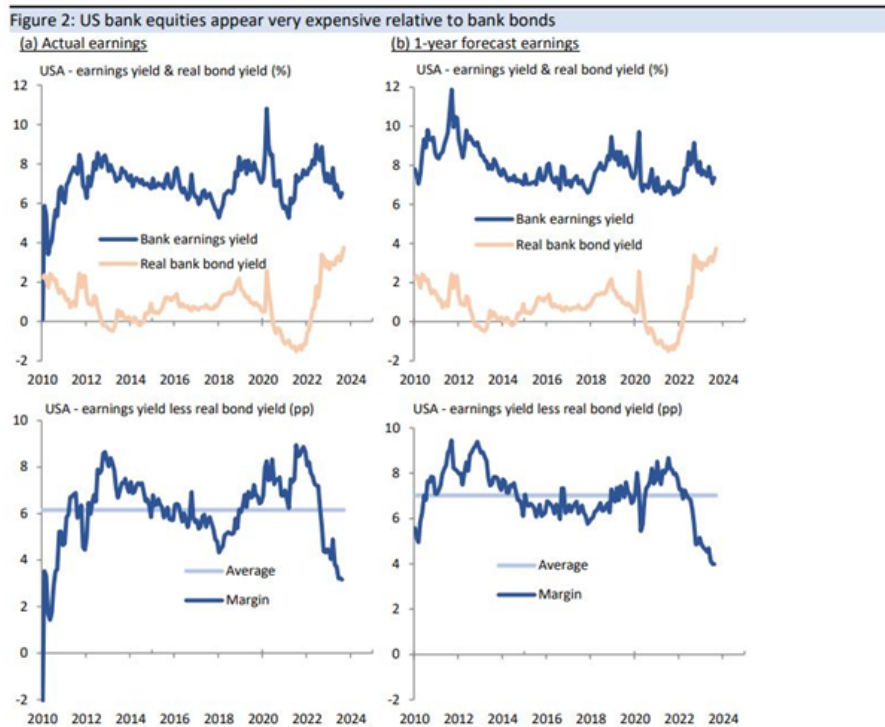
- Bank earnings yields were proxied by financial sector earnings yields; and
- Real bond yields were bank bond yields constructed by CCI's Data Science Team less swap pricing of expected inflation.

CCI also measured the earnings yield-real bond yield margin using both actual earnings and 1-year-ahead analyst forecast earnings (aka "forward" earnings).

On this basis, bank equities appear very expensive relative to bank bonds in the US, with the smallest gap between the earnings yield and real bond yield using both actual and forecast earnings since the US was recovering from the global financial crisis.

In contrast, bank equities in the euro area appear fairly valued relative to bank bonds, in that the gap between the earnings yield and real bond yield is closer to its admittedly short historical average.

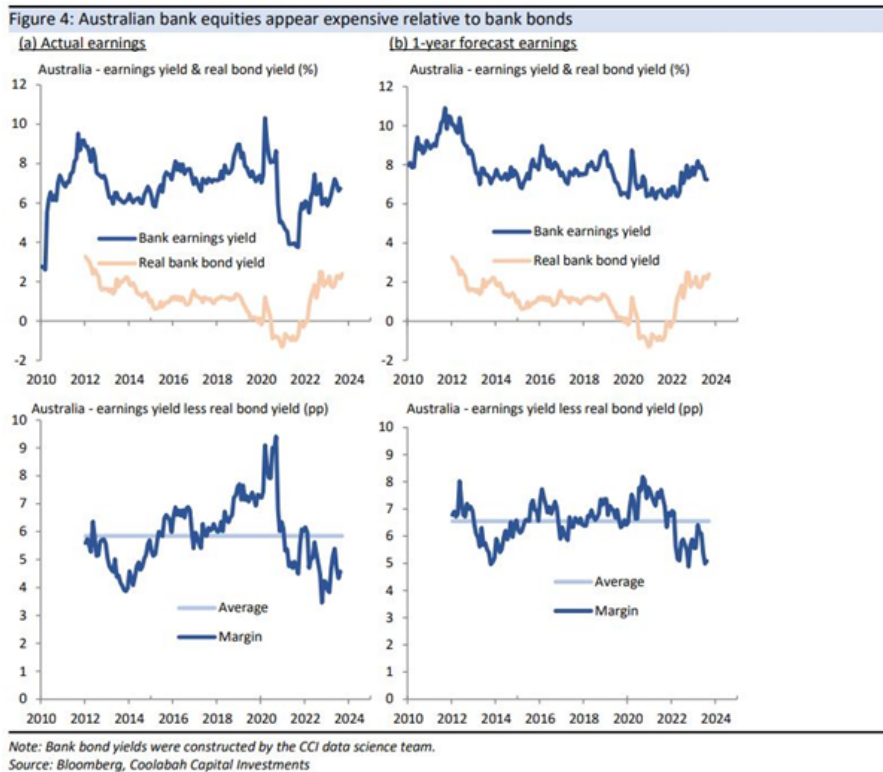
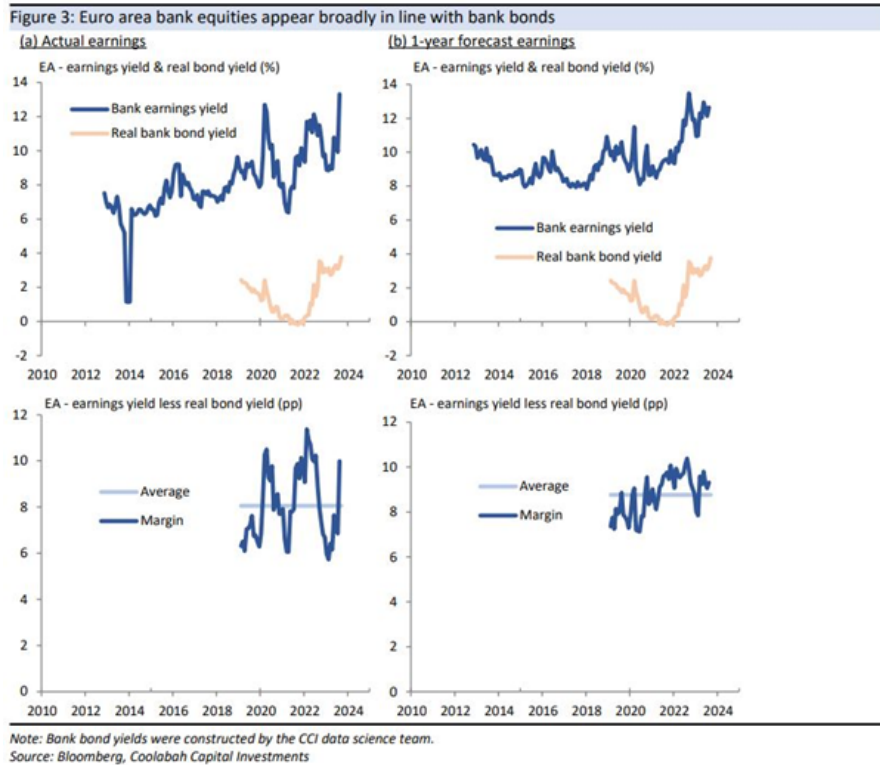
In Australia, bank equities appear expensive relative to bank bonds, with the earnings yield-real bond yield gap broadly at its lowest level in about a decade for both actual and forecast earnings.



Note: Bank bond yields were constructed by the CCI data science team.  
 Source: Bloomberg, Coolabah Capital Investments



Strategy commentary cont'd:



Importantly, these simple measures of the value of bank equities relative to bank bonds show that over- and under-valuations regularly persist for some time, with no quick reversion to the mean.

Mindful of this issue, we used the measures to explore what might happen in a scenario where there was an equity market correction in Australia.

**Strategy commentary cont'd:** At present, the bank earnings yield-real bond yield gap is 1.3pp below its historic average using actual earnings and 1.5pp lower using forecast earnings.

In a scenario where the equity market corrected to fully restore margins to their historical averages, the earnings yield would increase by 1.3pp, or 1.5pp using forecast earnings.

Rising earnings yields mechanically mean that bank price-earnings ratios would decline, with these adjustments suggesting that bank equities are about 16% expensive relative to bank bonds using actual earnings and about 17% expensive using forecast earnings.

In practice, though, the margins could also be restored by a mix of lower equity prices and lower real bond yields.

Note:

[1] For example, the earnings yield =  $1/(\text{price/earnings ratio}) \times 100 = \text{nominal earnings/nominal price} \times 100$   
 =  $(\text{earnings/CPI})/(\text{price/CPI}) \times 100 = \text{real earnings/real price} \times 100$ .

**Falling commercial real estate prices**

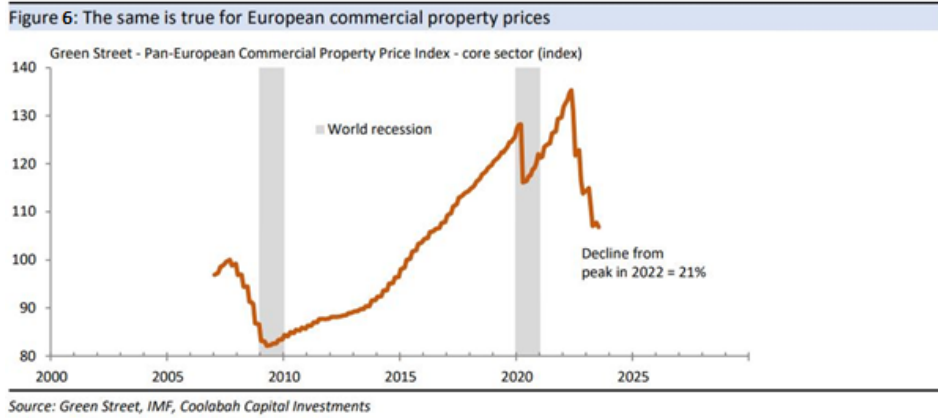
As central banks have lifted policy rates to their highest levels in years, commercial property prices have fallen sharply in both the US and Europe. The **Green Street** measure of US prices has fallen about 16% to date from the record high reached last year, eclipsing the 11% decline seen during the 2020 recession at the height of COVID. Similarly, **Green Street's** pan-European price series has fallen about 21% to date from its all-time high reached last year, exceeding the 9% fall seen in the 2020 recession.

To highlight the valuation challenges that higher risk-free rates are posing, consider this recent summary from a leading investment bank:

*The rise in US 10-year bond yields to 4.8% is causing havoc among leveraged, growth, rate-sensitive cyclical and bond proxy exposures. For US commercial real estate (CRE), the mark-to-market valuation adjustments are significant. Whereas appraisal values point to 10% downside to the Fed's official benchmark for CRE prices, our proprietary valuation framework based on 10-year real yields and credit availability points to 23% (real) downside. We also see Australian real estate stocks as 15% expensive relative to the market and macro, and are Underweight the sector.*



Strategy commentary cont'd:



**Strong unit labour costs challenge the RBA**

Inflation peaked last year and has fallen this year, but there is still significant uncertainty around how much time it will take for inflation to sustainably return to the RBA's 2-3% target.

One key risk revolves around unit labour costs - which are labour costs adjusted for labour productivity – continuing to grow strongly, underpinning high services inflation and making the RBA's job more difficult.

This risk comes up repeatedly in RBA commentary, most recently in this week's policy [press release](#), where the RBA stressed that:

*"Wages growth has picked up over the past year but is still consistent with the inflation target, provided that productivity growth picks up."*

The risk was also brought home in today's national accounts, which showed a mix of modest economic growth and continued strong growth in unit labour costs, which CCI's analysis shows has accounted for most of the high domestic inflation over the past year or so.

Nominal unit labour costs increased by about 1.5% in Q2 to be 7.5% higher than a year ago, which, excluding the distortions caused by COVID-related policies, is the fastest growth since 1990, three years before the RBA adopted its 2-3% inflation target.

Hourly wages remain very volatile on a quarterly basis and are up about 3.25% over the past year (wages per employee grew more strongly at about 6% given a wedge created by employees working more hours over the past year).

However, hourly labour productivity remains in terrible shape, driving the strength in unit labour costs that poses the ongoing risk to inflation.

Labour productivity is difficult to measure, but fell again in Q2 to be down about 3.5% over the past year.

Some of this weakness reflects an unwinding of the temporary boost to productivity during the pandemic, but the trend remains dismal with the level of productivity now at its lowest point since early 2016.

CCI's analysis has shown that Australia's poor productivity performance predated the pandemic and reflects firms persistently underinvesting in their workers and failing to take full advantage of global technological innovations.

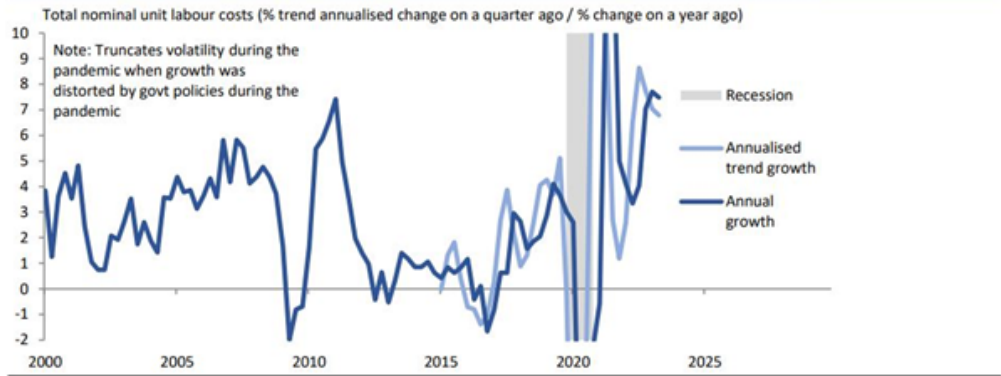
Although companies have started to invest again, turning the trend around in productivity could take a long time, such that unit labour costs could continue to grow at a rate that delays the sustained return to low inflation.

The RBA no doubt realises the scale of this challenge and will likely be aiming for a cyclical improvement in productivity, where companies cut hours worked, which raises a clear risk of some eventual job losses.



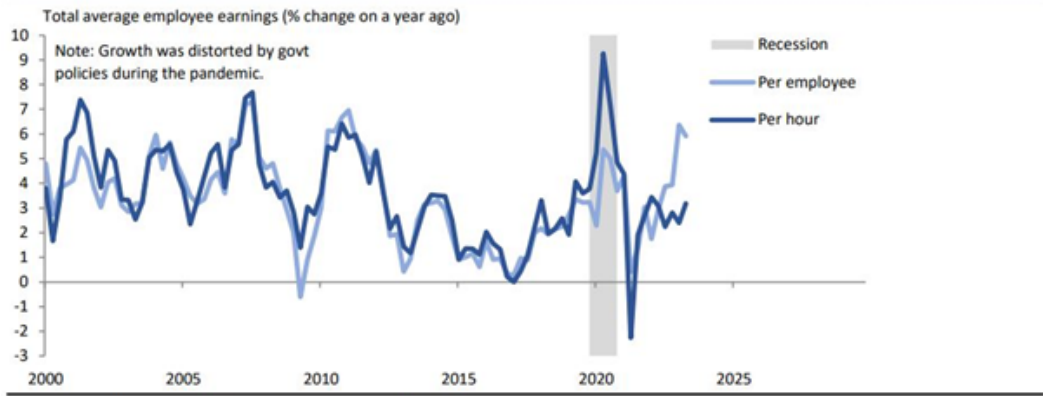
Strategy commentary cont'd:

**Figure 7: Nominal unit labour costs continue to grow strongly ...**



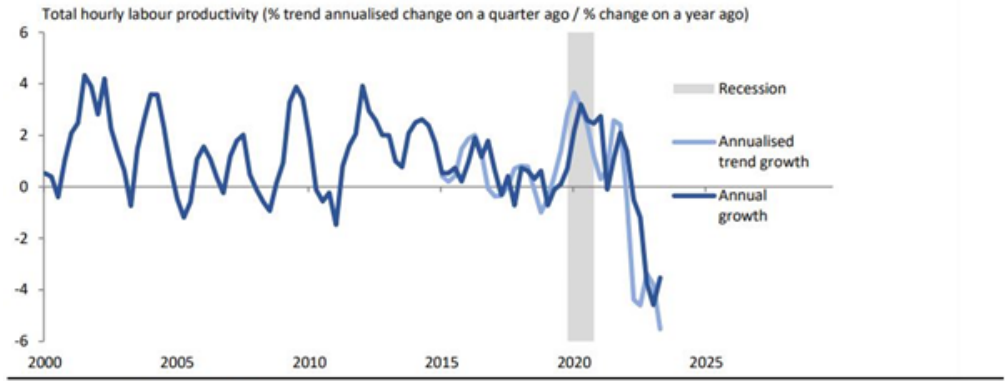
Note: Trend estimates are calculated by CCI.  
Source: Australian Bureau of Statistics, Coolabah Capital Investments

**Figure 8: ... reflecting solid wages growth ...**



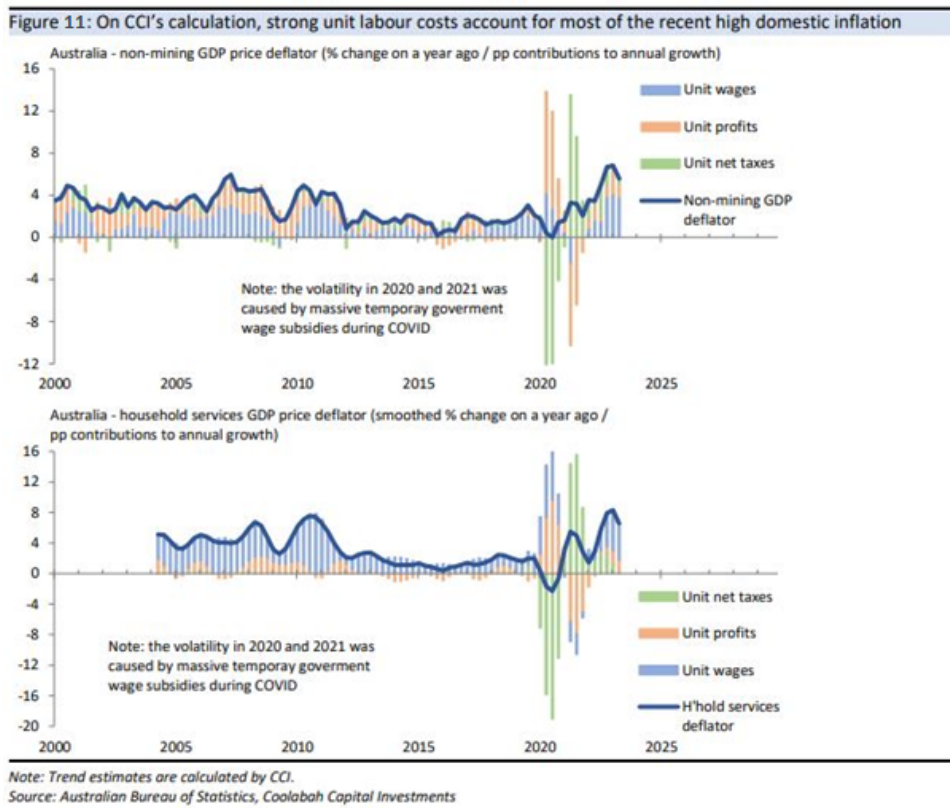
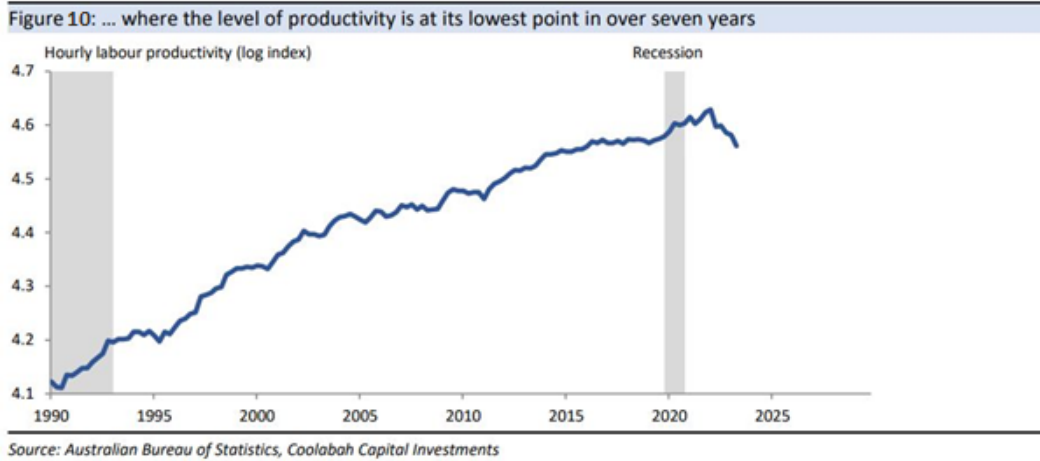
Source: Australian Bureau of Statistics, Coolabah Capital Investments

**Figure 9: ... and dismal productivity ...**



Note: Trend estimates are calculated by CCI.  
Source: Australian Bureau of Statistics, Coolabah Capital Investments

Strategy commentary cont'd:



**Higher yielding hybrids are coming**

The Australian Prudential Regulation Authority has announced a detailed consultation process on how to improve the functioning of the hybrid securities market.

There is much to applaud about this effort, and some shortcomings. Let's start with the positives.

APRA is running a constructive process with submissions due by November 15. They will then consult on any prospective changes next year. This implies that a new prudential standard could be completed by the end of 2024 for implementation thereafter.

APRA has made it clear that any modifications will be grandfathered like the Basel 3 banking rules, which means they will not affect current (or future) [hybrid issues until the new standard applies](#). This makes sense for what is an essential, \$40 billion plus market that Aussie banks and insurers have depended on for decades.

**Strategy commentary cont'd:** APRA tenders several interesting suggestions. Arguably the most significant is the possibility of increasing the common equity tier one capital (CET1) level at which hybrids automatically convert into ordinary equity. Back in 2007, Commonwealth Bank had a CET1 ratio of 4.7%. Today it is 12.2%.

The Basel 3 hybrids APRA introduced in 2013 (the regulator designs these securities) had a higher CET1 equity conversion level of 5.125% plus the ability for APRA to switch them into equity if a bank ever became “non-viable”. APRA notes that while many countries have a 5.125% equity conversion level, others have higher thresholds of 7%.

A loftier CET1 conversion trigger would increase the probability of hybrids becoming shares. APRA reasonably wants to avoid this conversion occurring only once a bank or insurer is already cactus. We support lifting the trigger on these new hybrids, which would come to replace existing listed securities (the risks on the latter do not change).

Higher equity conversion probabilities would be reflected in an increase in yields (or spreads). Banks would not love this because it raises their funding costs. But there is merit in considering lifting the threshold to 7% or higher.

This would compel Standard & Poor’s to lower the credit rating on major bank hybrids, which are currently BBB-, to a sub-investment grade band that would limit much institutional demand.

APRA also argues that it is important hybrids serve as “going concern”, or equity-like, capital during periods when the banks are losing money through the non-payment of hybrid coupons. Banks are not allowed to pay dividends on shares if they don’t pay hybrid coupons. It is a testament to our banking system’s strength that a hybrid distribution has never been missed.

Under existing rules APRA restricts an institution’s ability to pay equity dividends and hybrids distributions once their CET1 ratios fall below 10.25%. Specifically, if a major bank’s CET1 ratio declines between 10.25% and 8.8%, APRA restricts 40% of its earnings from being used for equity/hybrid distributions.

If the CET1 ratio drops to between 8.8% and 7.4%, 60% of earnings are garnished. If it falls below 7.4%, 80% of earnings are escrowed. Below 5.9%, a bank cannot pay distributions.

These rules force hybrids to work like equity insofar as coupons (and dividends) would not likely be paid if a major bank’s CET1 ratio fell below, say, 8.8%.

APRA could consider forcing future hybrids to convert into ordinary shares if a bank is instructed to raise CET1 and does not do so within a specific period. This could lift the de facto CET1 trigger further above any newly elevated threshold (eg, 7%), which would shunt bank funding costs higher again.

APRA asserts that Aussie banks tend to issue more hybrid capital than peers, but it is not clear this analysis is correct. If APRA was concerned about banks over-relying on hybrids, it could switch its current minimum target for hybrid capital, which is 1.5% of risk-weighted assets, to a maximum of 2.5%, which is what New Zealand does.

There are shortcomings with APRA’s observations. The first is the claim that the Aussie hybrid market is mostly retail, which it says makes a hybrid’s role as going-concern capital more complex to manage. Here APRA approvingly cites the UK corporate regulator’s ban on the distribution of hybrids to mums and dads.

Yet ASIC has followed the same path with the introduction of the very tough design and distribution obligation regulations in late 2021, which have resulted in banks refusing to offer hybrids to retail investors.

Since then, banks have been incredibly strict in only distributing hybrids to wholesale investors unless an individual receives full personal financial advice explaining the risks of these securities and actively recommending them.

The government is further working to materially tighten up the income and asset valuation tests in the legislated wholesale investor definition, which will make it even harder for quasi-retail investors to touch the market.

**Strategy commentary cont'd:** It is, however, preposterous to, on the one hand, permit retail investors to buy 15-20 times leveraged bank shares, which are far more complex and uncertain for investors to price – and statistically three times more volatile than bank hybrids – and yet concurrently restrict them from investing in demonstrably less risky hybrids and bonds (the UK ban also applies to Tier 2 bonds).

A huge policy focus in Australia has been on improving retail investor access to the fixed-income market, especially given our super funds' globally anomalous portfolio biases to equities.

Forcing hybrids to trade in minimum \$500,000 parcels, and shifting them into the over-the-counter market, would simply result in mums and dads buying more managed funds and ETFs that could acquire these securities. Great for fund managers, but it would be awful for main street.

The listed fixed-income ETF market has exploded: it is worth \$25 billion and growing rapidly. This renders the distinction between listed and unlisted fixed-income redundant. And there is strong data showing that listing Tier 2 bonds and hybrids on the ASX – as banks have done under both Basel 2 and 3 – actually improves these securities' liquidity during times of distress relative to what would occur if they were only traded in the OTC domain.

A final flaw in APRA's analysis is the claim that in the case of Credit Suisse's failure the write-down of hybrids occurred too late in the resolution process and further shut down the global hybrid market.

We were short-selling Credit Suisse senior bonds in 2022 and had a blanket ban on long exposures from May 2021, so we know a bit about this drama.

No less than \$890 million of Aussie listed hybrids traded in March 2023 [at the time Credit Suisse collapsed](#). Aussie hybrid credit spreads widened, but only modestly. One month later in April 2023, more than \$500 million of Aussie hybrids traded in orderly conditions.

By May 2023, CBA had launched a huge \$1.55 billion hybrid issue at a cheap 3% spread above bank bills. To say that Credit Suisse's write-down of its hybrids shut down the market is totally wrong.

The worst blow-out in hybrid spreads in history was in March 2020, when the pandemic forced them to 8.5% above bank bills – even higher than the levels reached during the global financial crisis.

In an astonishing affirmation of the liquidity of the listed hybrid market, an extraordinary \$1.22 billion of hybrids traded on the ASX in March 2020 alone. That was more than the entire OTC corporate bond market, which was closed.

Much of this trading was done by institutional investors, who have increasingly come to dominate Aussie hybrid flows during times of stress.

Credit Suisse's collapse was precipitated by a speculative attack by hedge funds manipulating its security prices in an ultimately successful attempt to engineer a Silicon Valley Bank-style high velocity digital deposit run.

Regulators had never seen these high velocity deposit outflows before (SVB lost \$US42 billion in one day), and were not prepared to combat them. All the Swiss government had to do was to confirm all Swiss bank deposits were government guaranteed, as the US authorities did after SVB. Following Credit Suisse's sale, this is precisely how the German government prevented a run on Deutsche Bank.

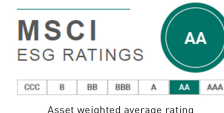
Yet the Swiss dithered for a week, by which time Credit Suisse needed to be quickly sold to UBS (ironically, the Swiss ensured that no Credit Suisse deposits, senior bonds, or Tier 2 bonds suffered losses).



**Strategy commentary cont'd:** Importantly, the regulators were able to enact the Credit Suisse hybrids' ability to be written-off to facilitate the bank's recapitalisation and sale in just days. Regrettably, they did so while not imposing 100% losses on lower-ranking bank shares, which they were meant to do so under the Basel 3 rules that stipulate that capital structure priorities are sacrosanct.

Years ago, we repeatedly warned APRA that its occasional approval of bank/insurer hybrids with only write-off features (ie, no equity conversion) could precipitate exactly this scenario, where hybrids were wiped out ahead of equity (the latter of whom would actively seek this outcome). Of course, all bank executives are shareholders.

Since this time, Swiss banks have discarded all write-off features in their hybrids, and ensured that they can only convert into equity, enshrining equity's role as the very first line of defence ahead of hybrid capital.





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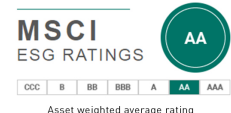
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CCC	B	BB	BBB	A	AA	AAA
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Asset weighted average rating