# **Preserving Capital** and earning low risk yield in a higher rates world.

## Introducing:

the Arculus Preferred Income Fund;
the Arculus Fixed Income Fund; and

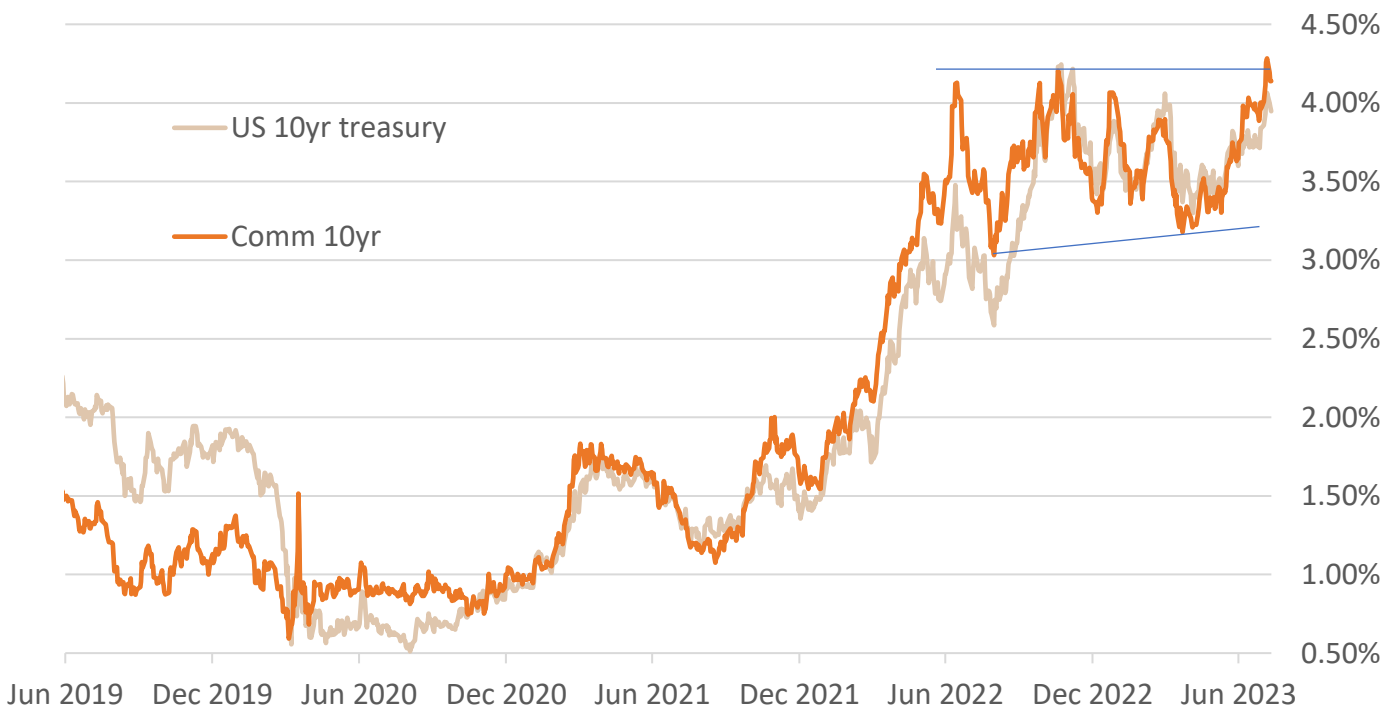
Arculus Funds Management

Arculus Funds Management Pty Ltd
www.arculus.com.au

# Current markets – Interest rates

## Interest rates

- Rates break out to the upside from 12m trading range – market still expects rate rises as economy shows resilience.
- Persistent inverse yield curve in US, rates market still expects a recession.
- Recession forecasts pushed out. Employment strong.
- Banks tighten credit provision post banking collapses – impact on SME




## When to go Fixed rate?

- Not just yet, FRN yields keep rising, stay low duration.
- Long rates still rising
- Inverse yield curve could flatten (long rates rise).
- Take 6% don't risk zero return

## Australian country risks rise

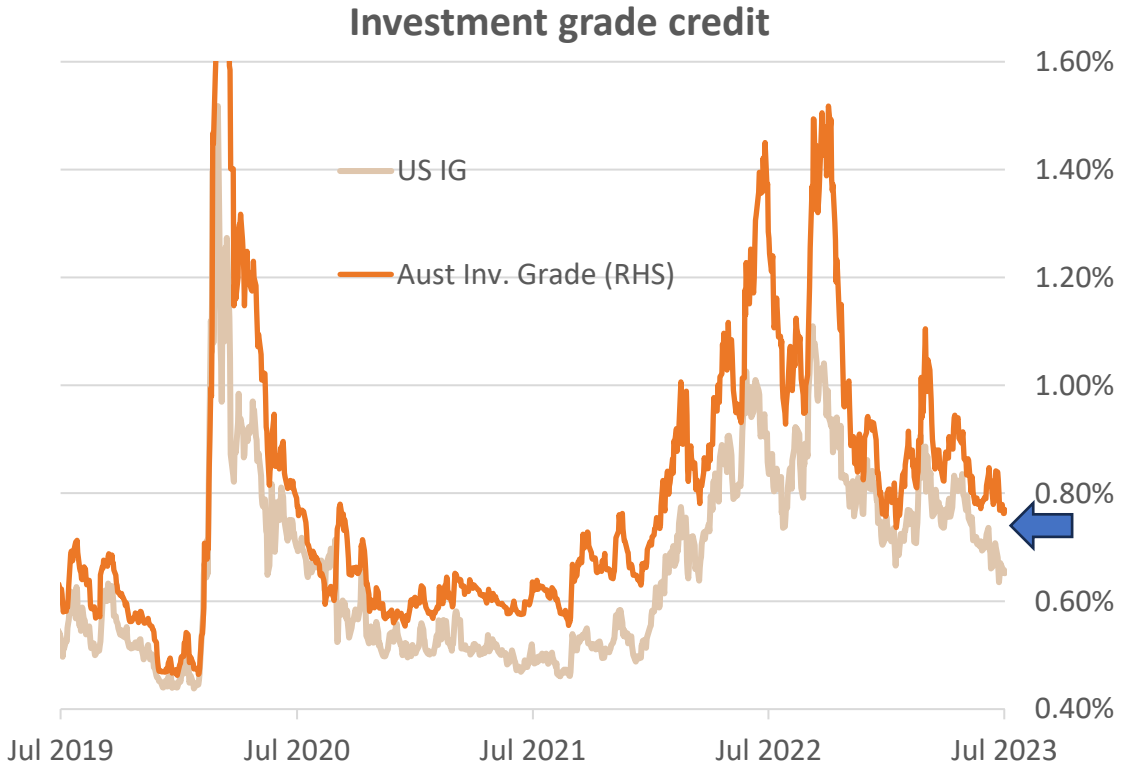
- RBA continue to raise rates, behind others
- Yield curve now inverse
- China weakening
- Energy costs rising strongly
- Building sector struggling

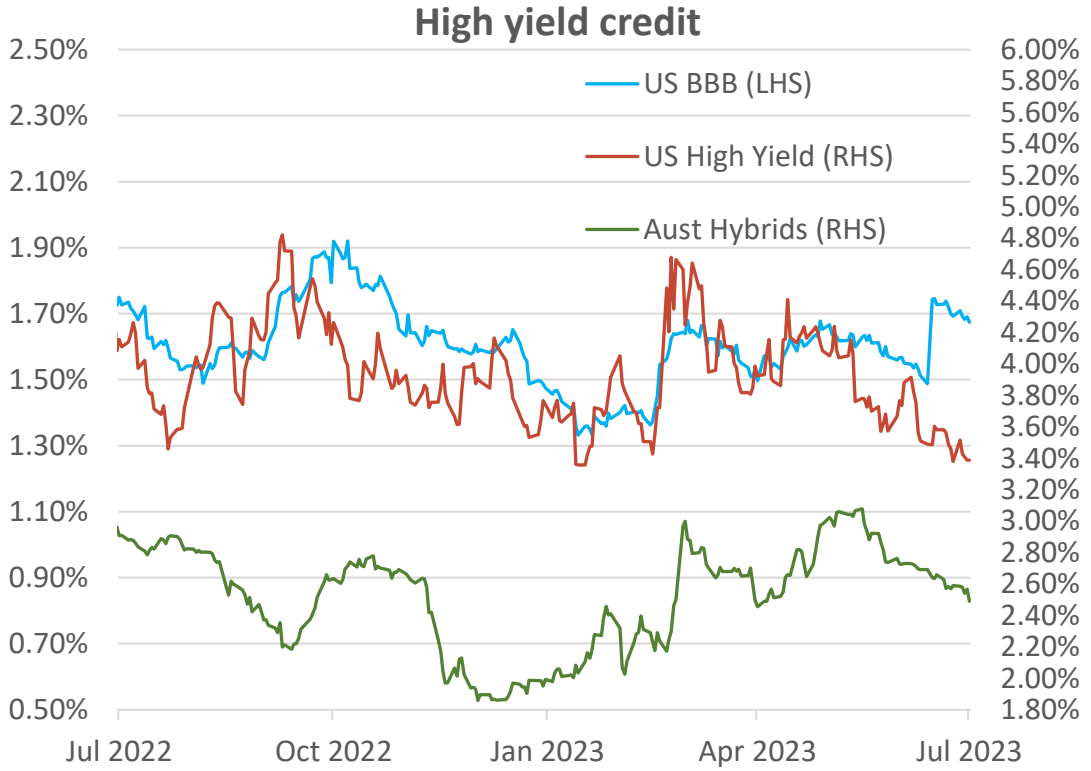
*Sources: Refinitiv, Arculus*

# Current markets - credit

## Credit markets

- Volatile but currently very strong (see arrow), bonds reborn with higher rates, credit securities getting solid support
- Credit markets sensitive to bad news, margins can spike quickly
- High grade Australian bank credit offers good yield: major bank senior 5%, sub notes 6.2%

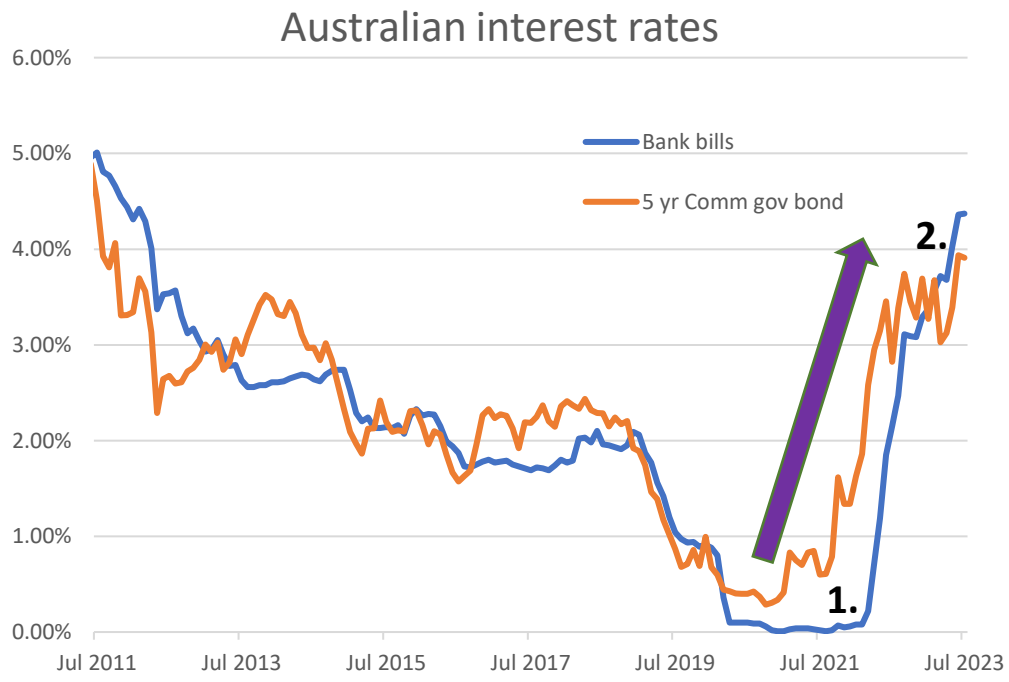


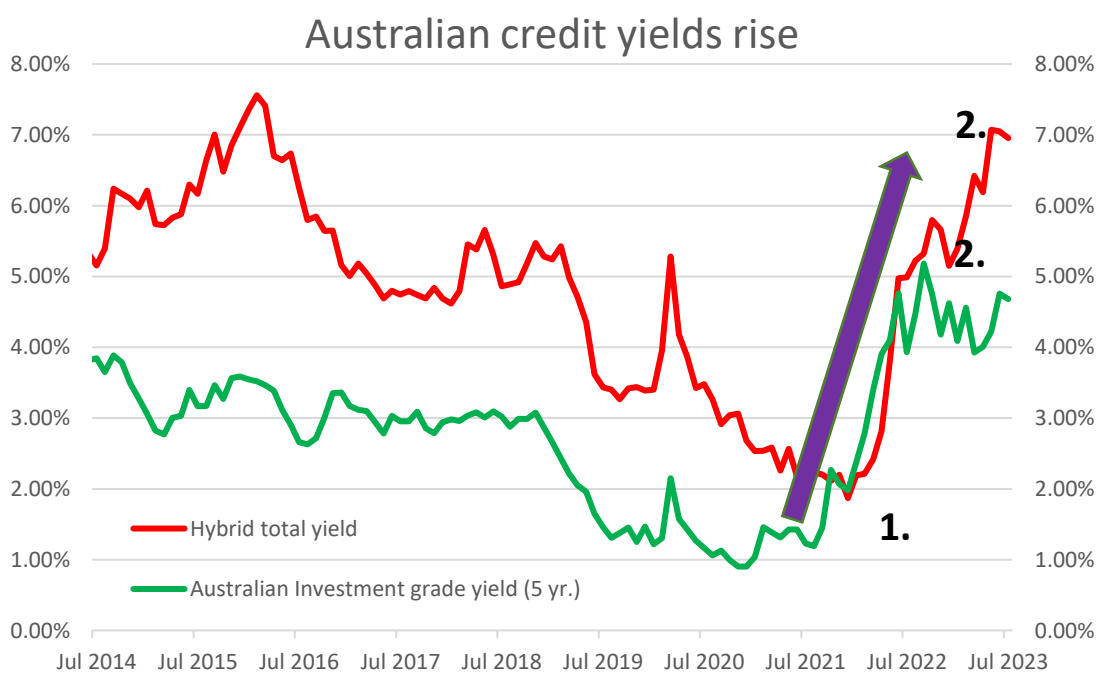




*Sources: Refinitiv, Arculus*

# The good news is that higher yield is here

Rather than having to chase yield when rates were low, now higher yield can be gained with lower risk.




**BASE RATES HIGHER -** great for floating rate securities.

**CREDIT SPREADS WIDER** – more yield for less risk

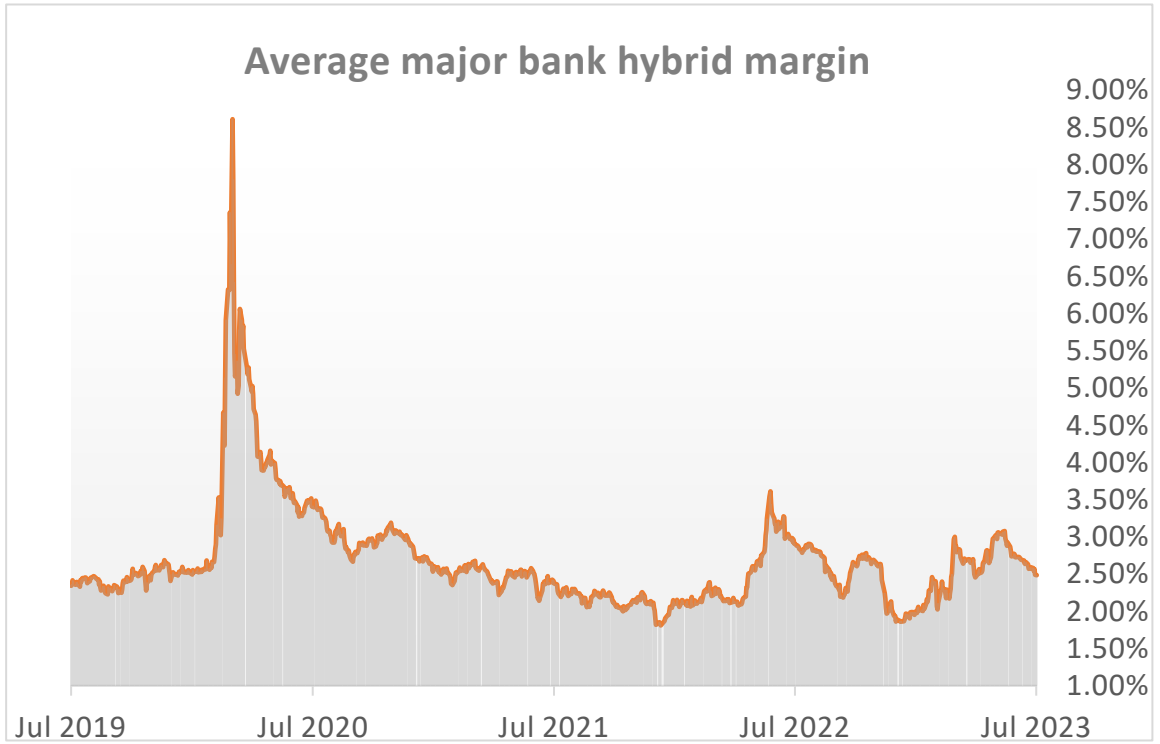
**1/. Jan 2022: cash at zero + "A" credit at 1.5% margin = 1.5% total yield**
**2/. Jan 2023: cash at 3% + "A" credit at 2.0% margin = 5.0% total yield**

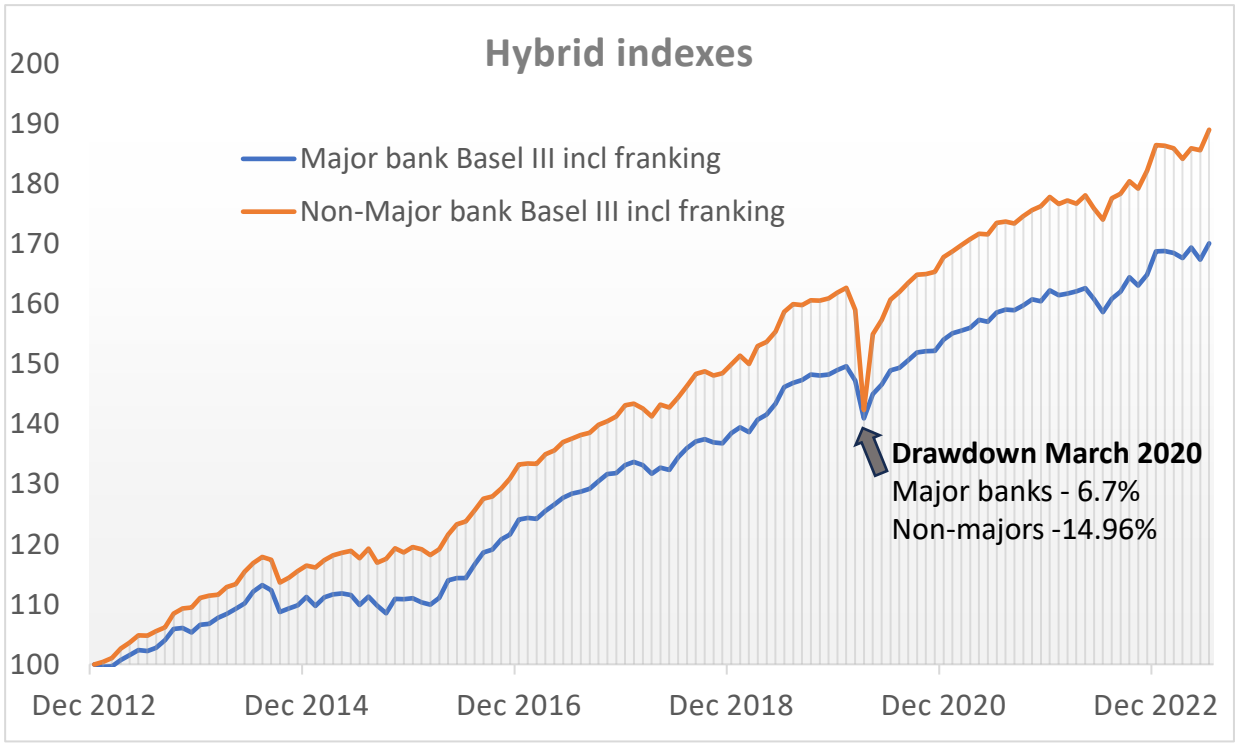
*Sources: Refinitiv, Arculus*

# Hybrids – great for yield but can have tough times

## Current state

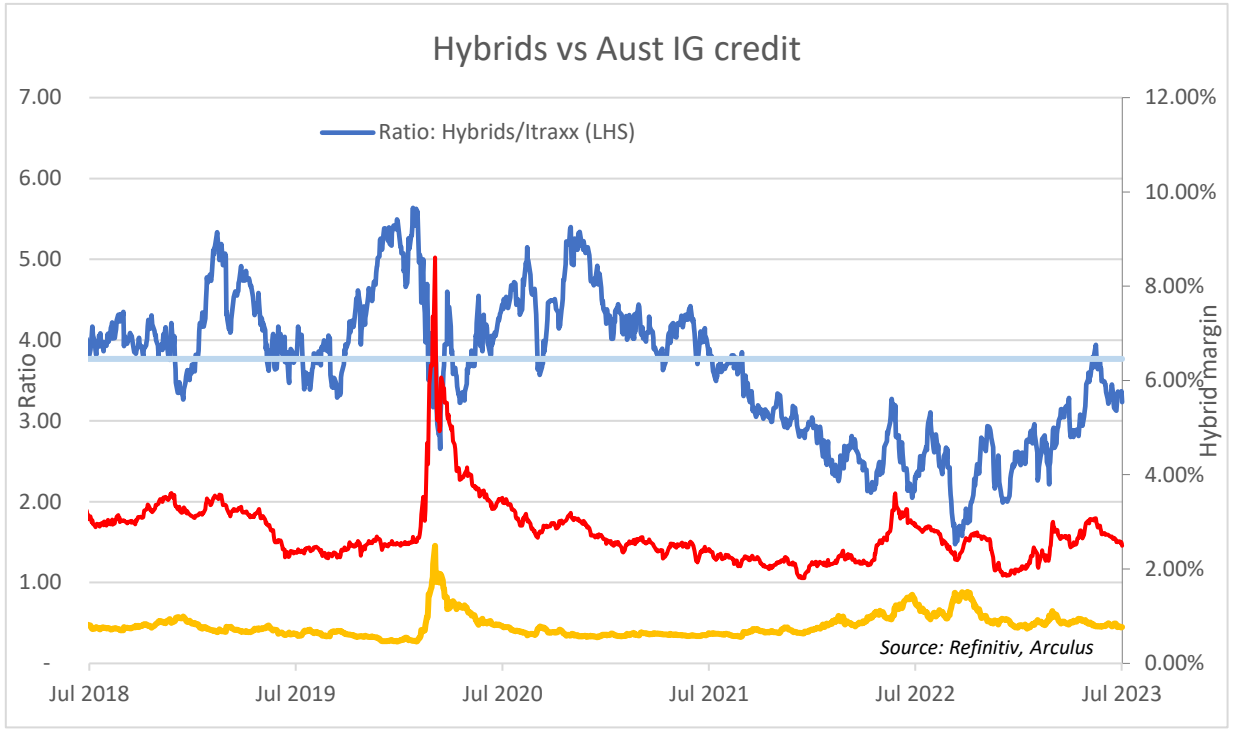
- In past 12m higher rates (esp. BBSW) has created better yield. One of the few ASX ways to get exposure to rising rates.
- Recent CBA issue pushes average margin out 35 bps. Margins have since recovered but make point about liquidity
- Price can be savaged in large risk-off markets, however bank balance sheets are good. Watch property.
- Since 2012 major bank hybrids returned incl. franking +5.48% pa (volatility 3.56%) and non-majors + 6.14% (vol 5.39%)
- Margins can have large variations - creates trading opportunities.
- Liquidity issues around IPO's and trading.

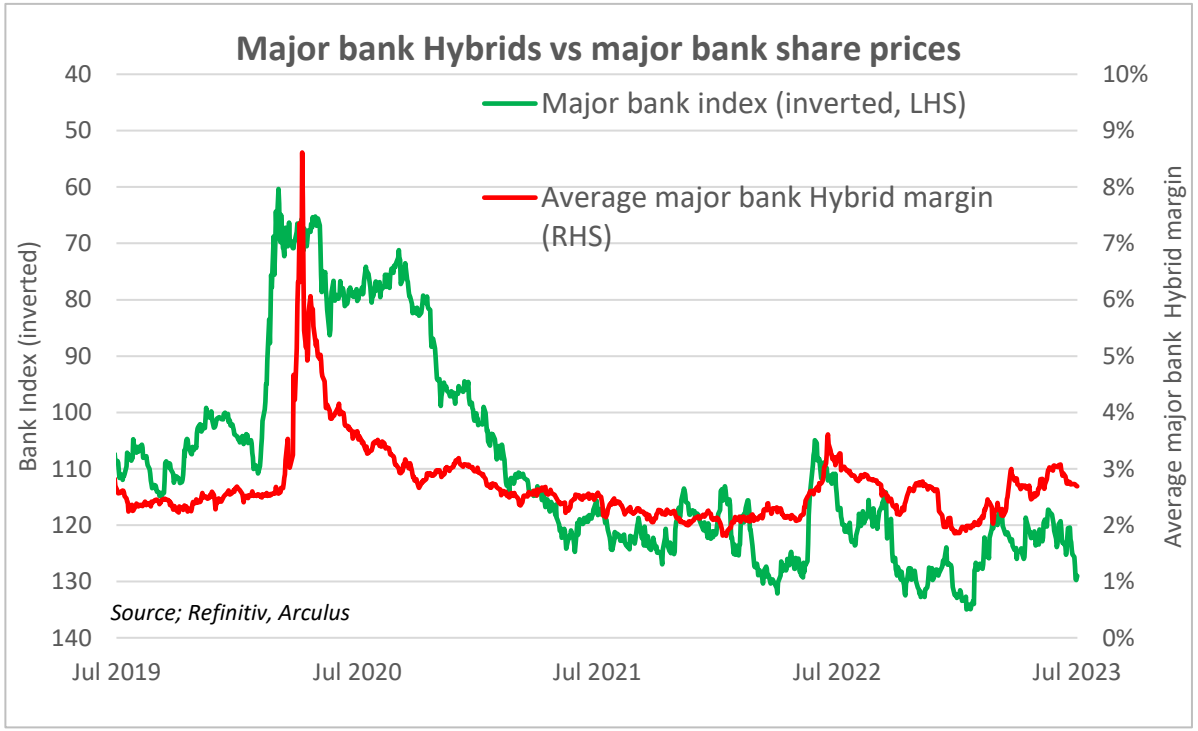



*Sources: Evans and Partners, Arculus*

# Hybrids – current yardsticks




**Current state**

- Compared to credit, hybrids just under the long-term average ratio, broken 18m range: implies fair value, however the lower range was as a result of cash rate rises.
- Which is the best range, recent 12m or long term?
- Recent CBA issue pushes average margin out 35 bps; artificial?
- Message: watch credit markets especially if large margin rises

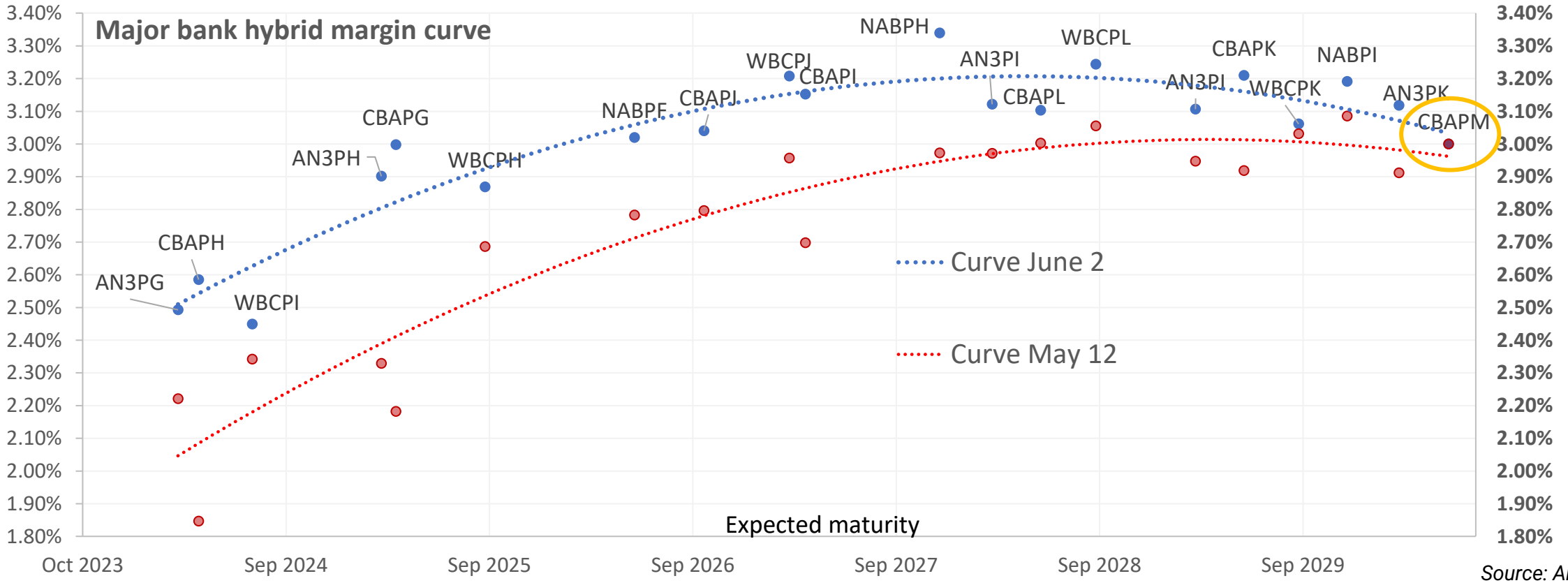
**Current state**

- Compared to bank share prices, hybrids wide in spread (Rsq 0.55)
- Bank share prices rally in July – hybrids lag
- Versus Bank implied volatility, hybrids cheap to fair
- Typically a quick large fall in bank share prices is needed to shake hybrids.

# Hybrids – margin scatter diagram is the value guide

## Comparative value reveals all

- Hybrid margins should slope upwards with maturity expectation
- Scatter shows relative valuations in May 2023 – deviations from the curve indicate best trades
- Whole curve rises after May CBA issue
- The whole curve can move but can often be distorted driven by liquidity
- Special situations often arise, check pricing models




*Source: Arculus*

# Global High Yield – get out of the way!

## Too many negative indicators

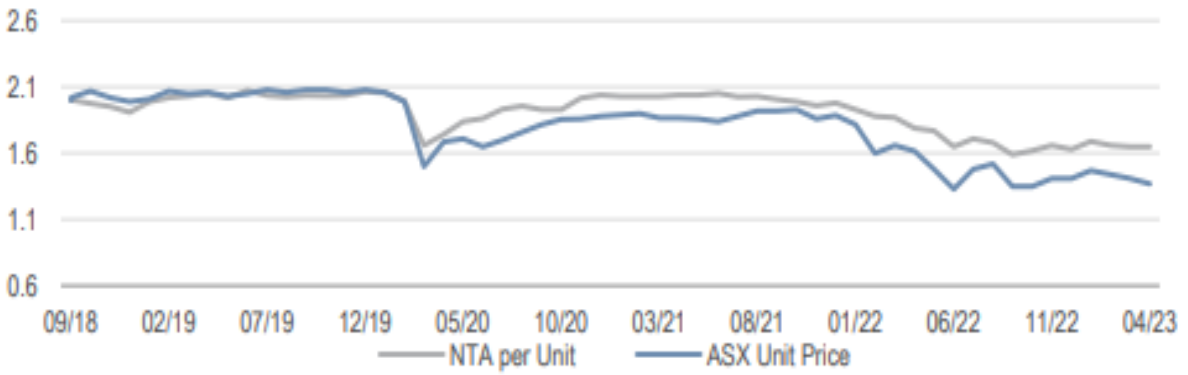
- Global HY has performed well but now many indicators are pointing downwards;
  - Defaults starting to rise; US HY April default rate 7.3%, was 2.3% for 2022
  - CCC bonds diverge into bad and good groups
  - Potential credit contraction as a result of US banking crises; higher rates will ultimately bite refinancing rates
  - For HY to perform equity markets must be in good shape. Recent strong equities have held up HY.
- ASX listed trusts trading under NTA with little response to good HY index days. Such trusts can trade under NTA
- NBI: well managed, RY 11.56% (9.56% on NTA), trading price discount to NTA at 28%


PERFORMANCE BASED ON NTA (NET)[2]

| 30 April 2023 | 1 Mth | 3 Mth | 6 Mth | 1 Year | 2 Year | 3 Year | Since Inception[3] |
|---|---|---|---|---|---|---|---|
| Total Return (%)[4] | 0.49 | -0.80 | 4.87 | -1.92 | -4.32 | 4.07 | 1.53 |

Past Performance is not a reliable indicator of future performance. Periods less than one year are not annualized.

NTA PER UNIT / ASX UNIT PRICE PERFORMANCE




*Sources; Refinitiv, NBI*

# How yield investing can be approached

There are three principles to diversify, gain portfolio flexibility and generate low risk yield

**1.**

Consider all fixed interest rate sector sub asset classes, not just one

**2.**

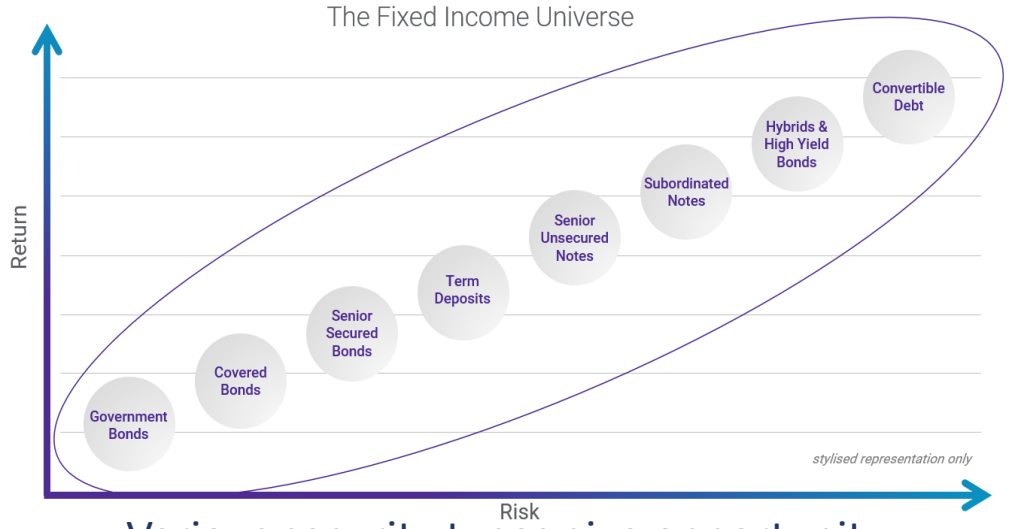
Predominately use floating rate bonds to remove poor bond repricing due to interest rate rises

**3.**

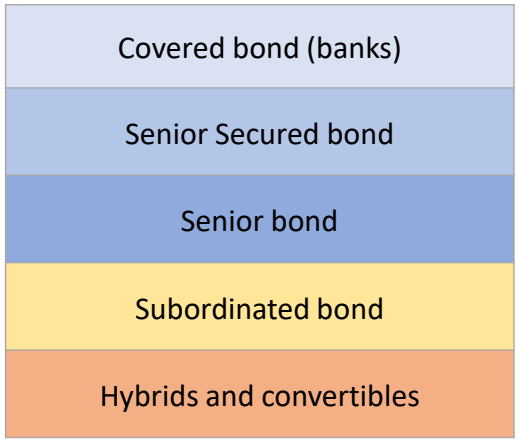
Consider and use the parts of a company's capital structure

(excl. equity)

There is a time for fixed coupon debt but not now




Various security types give opportunity




There is value in a company's debt layers

# Arculus Fixed Income Fund – protective high-grade yield

*formally the GCI Capital Stable Fund, managed by Arculus (formally GCI Australia) since 2015*

- **Aim; capital preservation with yield above bank bills. Target BBSW + 1.5%.**
- **Holds only AUD Investment grade Senior ranking corporate and bank debt plus Sovereign debt. All holdings must be REPO eligible.**
- **No leverage. No shorting.**
- **Typical public unit trust structure. Invest directly or via most platforms.**
- **Current Fund fee 0.40%. No performance fee.**
- **Liquid - all redemptions met by T+5.**

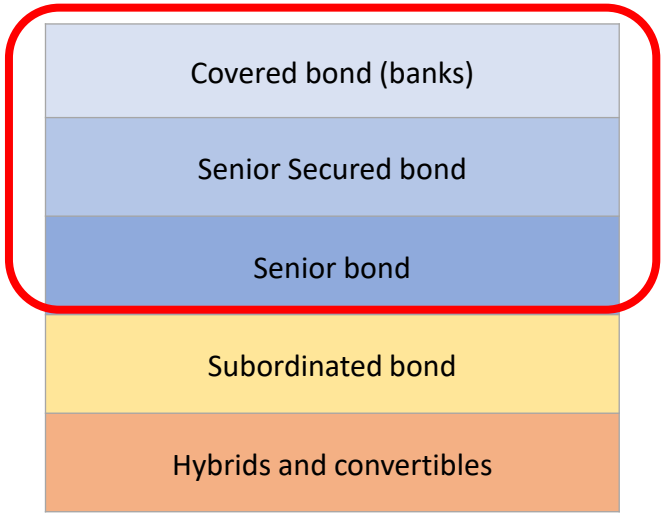
**Currently;**

- Current RY 5.12%, YTM 5.30%
- Credit duration 0.48 Modified duration 0.91
- Consistently a low interest rate duration portfolio (very low revaluation risk to rising rates, avoid interest rate volatility).

## Performance to 30 Jun 2023 (annualised)

| | 1M | 3M | 6M | 1Y | 2Y | 3Y | 5Y | Since inception |
|---|---|---|---|---|---|---|---|---|
| **Total Return** | **0.17%** | **0.63%** | **2.36%** | **3.50%** | **-0.89%** | **-0.42%** | **0.70%** | **0.80%** |
| Cash Distribution | 1.03% | 1.03% | 1.92% | 2.84% | 1.95% | 1.64% | 1.83% | 1.88% |
| +/- Growth | -0.85% | -0.40% | 0.44% | 0.66% | -2.84% | -2.06% | -1.13% | -1.08% |
| **Index** | 0.30% | 0.903% | 1.70% | 2.89% | 1.48% | 1.01% | 1.17% | 1.24% |

*Fund returns are net of all fees – may not sum due to rounding



# Arculus Fixed Income Fund

Arculus Funds Management

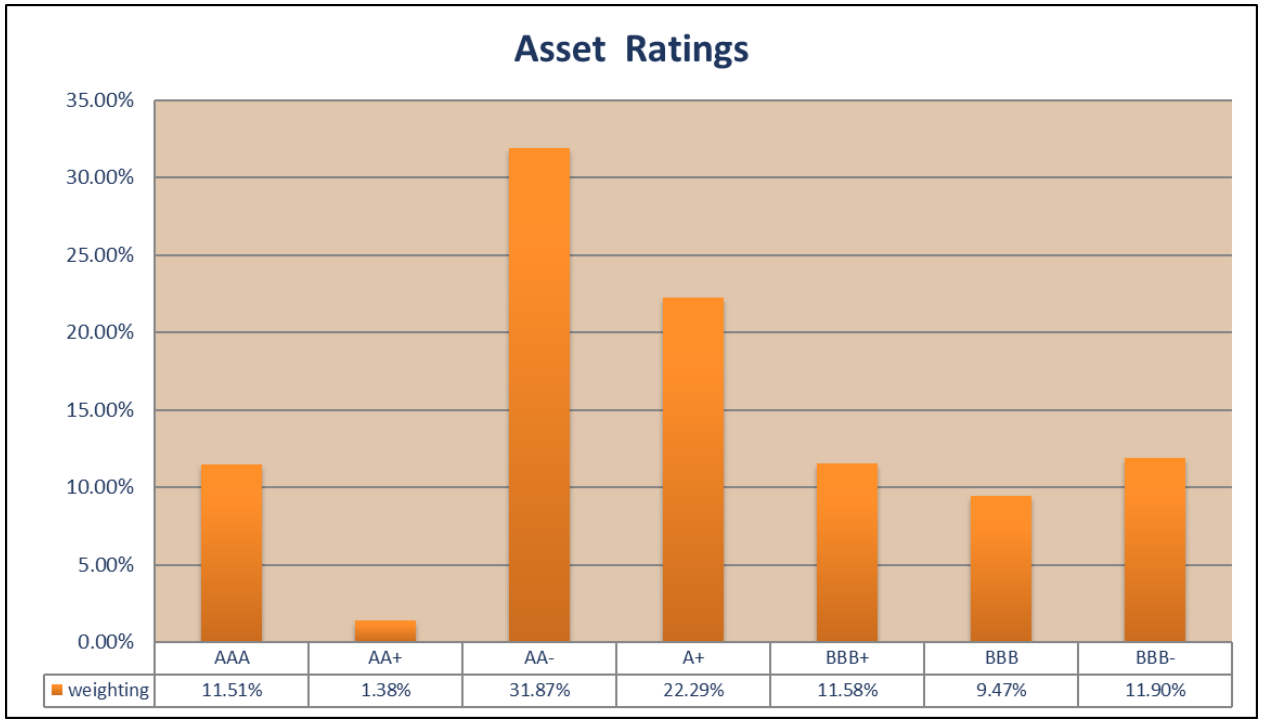
## Income, capital stability and a high degree of liquidity in all market conditions

### Portfolio metrics:

The expected yield is high combined with the benefits of strong credit ratings

**Portfolio Characteristics**

| | |
|---|---|
| *Running Yield* | 5.12% |
| *Yield to Maturity* | 5.30% |
| *Average Margin* | 0.95% |
| *Average Years to Maturity* | 2.17 |
| *Number of Securities Held* | 39 |
| *Floating* | 75.55% |
| *Fixed* | 22.45% |
| *Cash* | 2.00% |
| *Modified Duration* | 0.48 |
| *Credit Duration* | 0.91 |




Sensitivity to both interest rate increases and credit spread rises are small.

# Arculus Preferred Income Fund (PIF) – hybrid like yield

*Est. 2007, formally the DDH Graham Preferred Income fund, managed by Arculus (formally GCI Australia) since2015*

- **A multi sector Fixed Interest fund paying quarterly income – typical public unit trust structure. Invest directly or via most platforms.**
- **Mandate: Cash + 3.5% in all market conditions.**
- **No leverage. No shorting. Any security subscription fees passed into fund cash.**
- **Liquid - all redemptions met by T+5 in past 5 years, $2000 minimum.**
- **Current Yield > 6% cash. Flexible and very active portfolio.**
- **Current Fund fee 0.75% (+GST). No performance fee.**

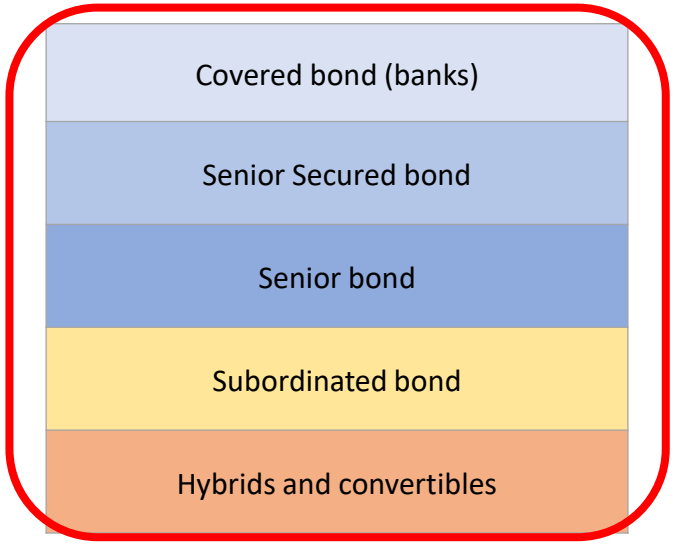
**In particular -**

- The fund can hold all major interest rate security types, not constrained to one sub sector; Gov bonds, senior and subordinated bonds, ASX securities.
- Rating weights; minimum 70% investment grade and cash, maximum 30% non-investment grade. Currently 70.67% Investment grade.
- Consistently a low interest rate duration portfolio (very low revaluation risk to rising rates, avoid interest rate volatility).
- The Preferred Income Fund at $174m is big enough to get access to all market opportunities but nimble enough to take advantage of smaller ideas.
- Little or no exposure to the property sector. No RMBS or property financing securities.

## Performance to 30 Jun 2023 (annualised)

| | 1M | 3M | 6M | 1Y | 2Y | 3Y | 5Y | Since Inception |
|---|---|---|---|---|---|---|---|---|
| **Total Return** | **0.54%** | **0.74%** | **2.06%** | **5.55%** | **1.37%** | **2.81%** | **3.10%** | **4.35%** |
| Cash Distribution | 1.29% | 1.29% | 2.56% | 4.37% | 3.77% | 3.55% | 3.67% | 5.34% |
| +/- Growth | -0.76% | -0.55% | -0.50% | 1.19% | -2.40% | -0.74% | -0.57% | -0.99% |
| **Index** | 0.30% | 0.90% | 1.70% | 2.89% | 1.48% | 1.01% | 1.17% | 3.33% |

*Fund returns are net of all fees – may not sum due to rounding



# Arculus Preferred Income Fund

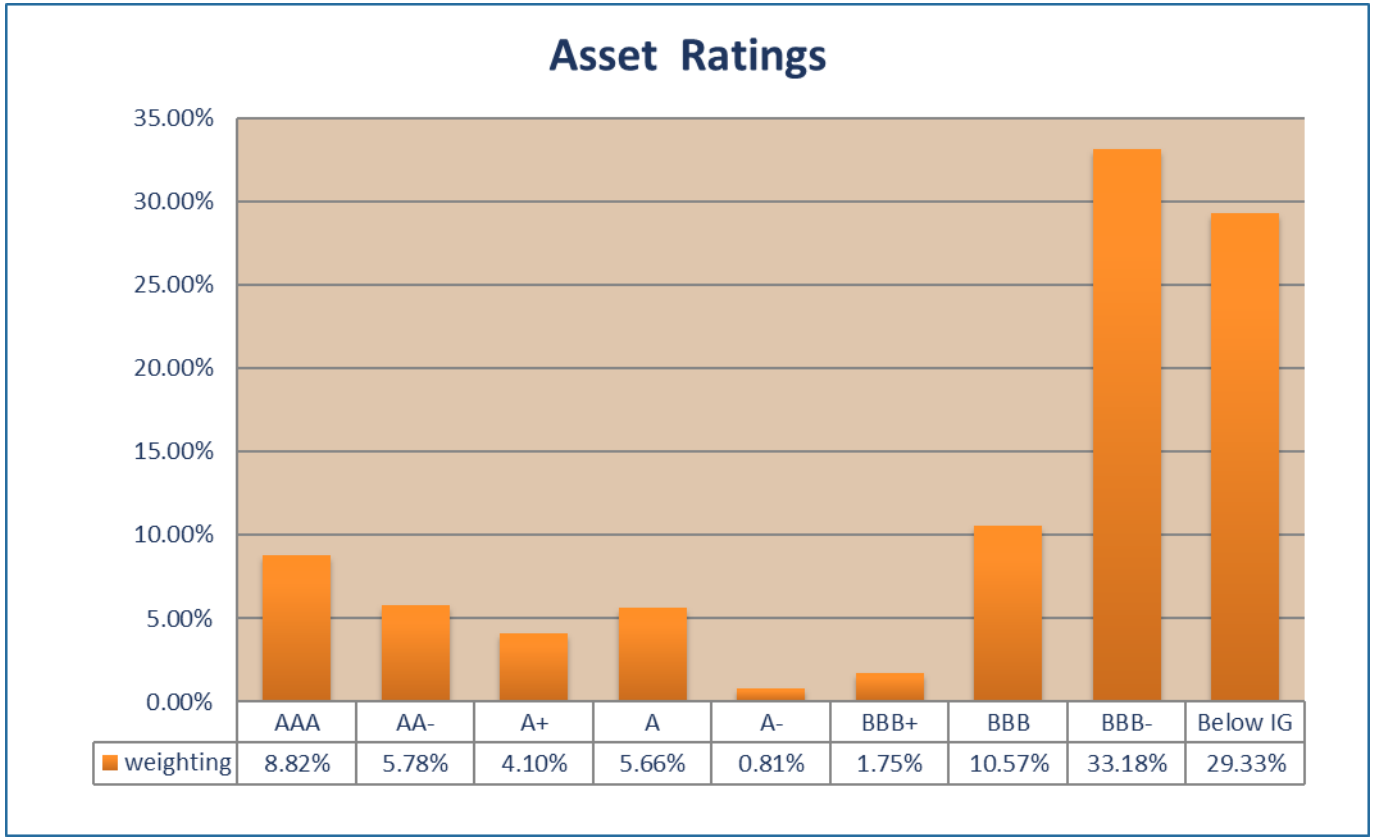
Arculus Funds Management

**Portfolio metrics:**

Despite a risk averse stance, the expected yield is high combined with the benefits of diversification

## Portfolio Characteristics

| | |
|---|---|
| *Running Yield* | 6.66% |
| *Yield to Maturity* | 7.45% |
| *Average Margin* | 3.10% |
| *Average Years to Maturity* | 2.58 |
| *Number of Securities Held* | 38 |
| *Fixed* | 27.51% |
| *FRN* | 69.32% |
| *Cash* | 3.18% |
| *Modified Duration* | 0.83 |
| *Credit Duration* | 1.98 |

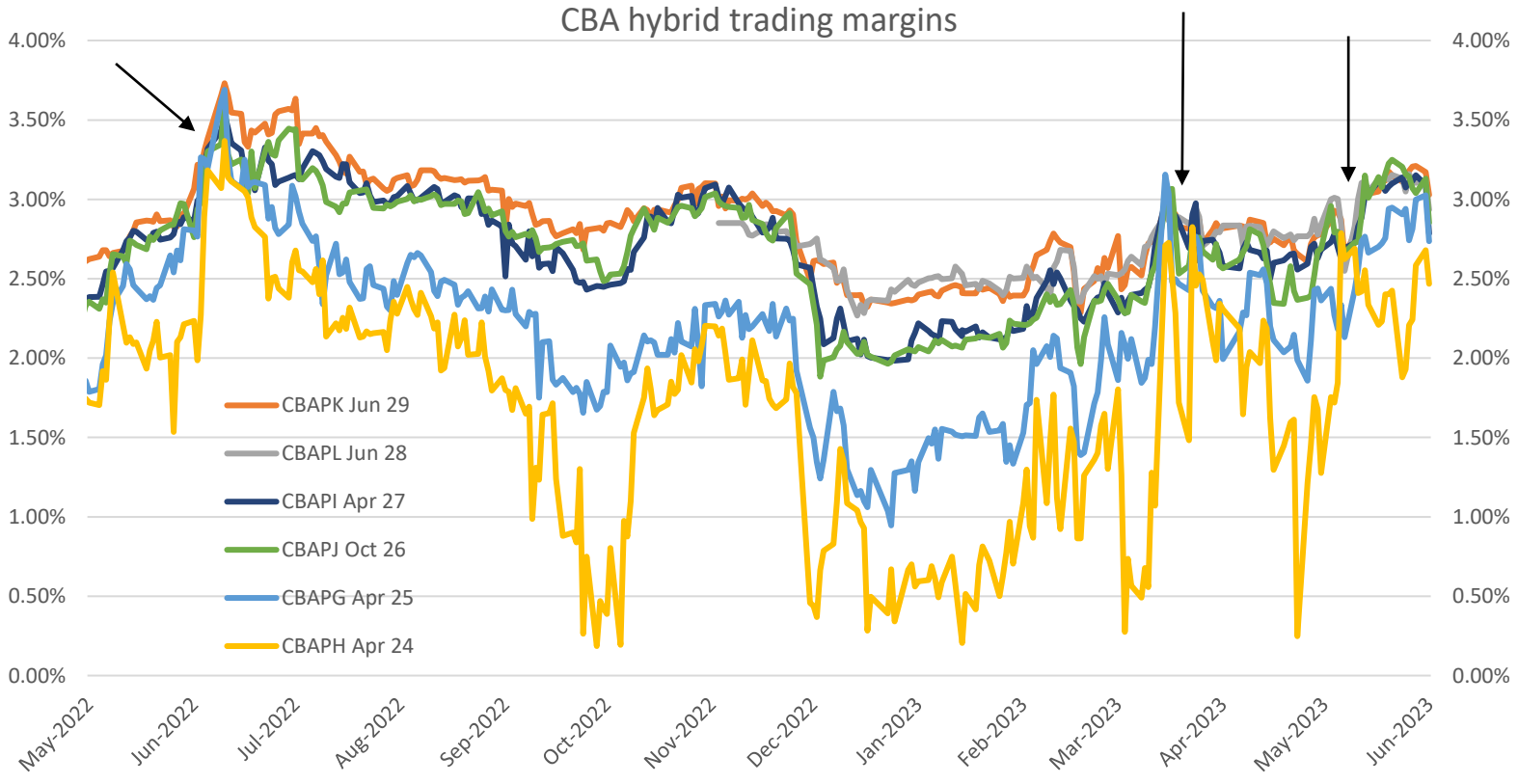



Sensitivity to both interest rate increases and credit spread rises are small.

# Arculus Preferred Income Fund – adding value

## Diversification via traditional sources combined with risk mitigation and return enhancing tactics

We constantly monitor security pricing and liquidity looking for opportunities to add return with equal or lower risk.




CBA currently have six listed hybrids (note NAB has OTC versions too) with a spread of maturity dates. Varying maturity requires different margins. In the chart above there should be a consistent gap between issues, however at various times there is large mispricing. The arrows show points in time where all issues have the same margin. This creates switching opps. On May 15 we bought $5m CBAPH at $101.90 a margin of 3.60% for 11 months exposure. These were sold at prices above $102.50 2 weeks later.

## Practical Risk Mitigation tactics

**The fund contains a variety of levers to lower risk and extract yield;**

- Varying subsector exposure as both:
  - (a) a major sector preference choice, and
  - (b) an intra-company/industry optimisation tool.
- Using a range of comparative tools to extract best yield for a unit of risk across a company's capital structure.
- Consistent searching to find yield opportunities;
  - Specialist skills in balance sheet assessment and individual security analysis.
  - daily surveillance of interest rate markets for opportunities with deep market contacts for liquidity.
  - Deal in both wholesale and ASX markets, vast experience and expertise in both.
  - Understanding leading and lagging factors for various interest rate securities.

# Preferred Income Fund comparison to Hybrids

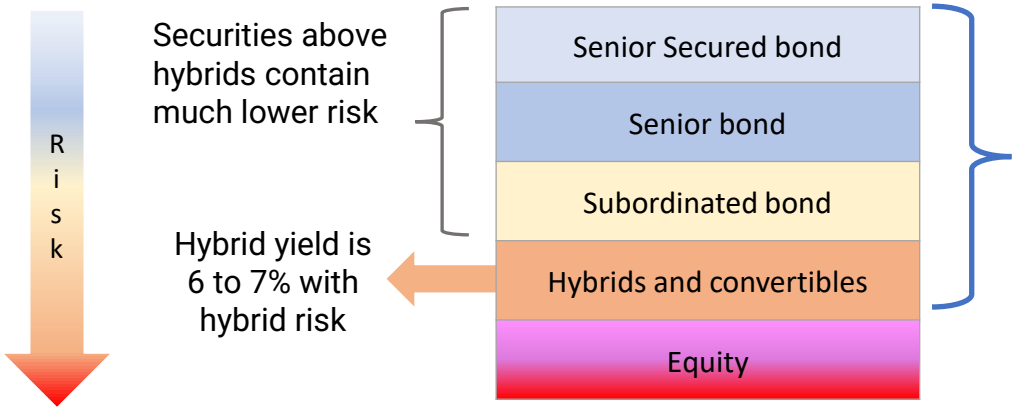
**The PIF does use hybrids from time to time but does not advocate their constant use.**

**Same yield (cash yield higher) with superior portfolio – less NTA variation and better protection in any correction with liquidity**

Bank and Insurance hybrids are commonly used for de facto yield in the Australian financial markets and are idiosyncratic;

- In the capital structure hybrids sit just above equity and below all forms of debt as shown below.
- The hybrid market can have poor liquidity. Pure hybrid funds have no chance to move large portfolios at times of stress.
- A 7% hybrid yield is 4.20% cash plus franking. PIF currently paying 6% cash and rising due to cash rate rises.

**Typical Capital Structure**.
Seniority for all payments flows top-down.




The PIF contains lower risk from its predominant weighting higher up the capital structure. Despite this, the PIFs return is higher than hybrids with equal yield

The Preferred Income Fund;

**Gain higher return with lower risk than hybrids**

- The PIF is a pool of interest rate securities that rank above hybrids
- Typical PIF weights:
  - senior bond holdings 20-30%,
  - subordinated bonds 50-60%
  - redeemable convertible notes 0-5%
- The Preferred Income Fund does invest in hybrids from time to time when hybrid margins are historically wide or when mispricing occurs, creating short term yield opportunities
- The yield on the PIF has been consistently well above the yield on hybrids despite the PIF being a much more risk averse portfolio.

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