

Clean Air For Tier 1's

30th May 2016

The Realm High Income Fund has gradually built a tactical overweight in AT1 securities (commonly referred to as Bank Hybrids) over the last eighteen months.

In mid to late 2014 the fund maintained negligible exposure to this market. However this changed as a number of issuers created a supply side distortion which has only recently shown any real signs of dissipating.

This led to the sector comparing favourably versus other fixed income and capital securities on price for risk using our in-house risk/return modelling. This has been a position which we have needed to justify almost constantly, given the higher volatility of these assets and of course the performance of the AT1 sector, which at times has looked diabolical.

The weakness was pronounced with a number of 2014 minted issues seeing the lower reaches of 90 cents on the dollar, with the odd one exploring the mid 80's.

This was all too much for hybrid investors who had understood these instruments to be fixed income like investments and indeed the advisers that guide them. This led to a capitulation of sorts that was fuelled by conflicted parties within the media and other fixed income managers for whom the hybrid market was perceived as being a competitor for client demand.

Ultimately our position has always been that, these securities are complex, however the ambiguity of the instruments is overstated, very often while the safety and simplicity of the rest of the fixed income complex is fundamentally understated. We have always chosen to focus on the risks and the price.

While our quantitative metrics have long put a line in the sand around our fair market level, it is the qualitative aspects of the market which are leading to an alignment of stars that are likely to provide a strong tailwind to this market.

- Deflationary forces will continue to provide a drag for inflation, this will continue to deliver a headwind to interest rates rising.
- Supply side factors are likely easing and could even reverse from here as domestic tier 1 supply is reduced and banks once again open their foreign funding curves.
- New sources of demand have availed themselves to the market with institutional investors seemingly setting up camp.
- Europe's corporate bond buying program will crunch spreads tighter, and likely lead to a global reach for yield.
- The equity market is losing the confidence of income investors in being able to deliver stable outcomes.

Just as rates continue to plummet and concerns rise around equity market performance and dividend payouts, the AT1 market is beginning to look like a veritable three course meal. Add to this the fact that term deposits are rolling off into this low rate environment and you have fertile ground for a capped equity type outcome to be gobbled up by income hungry retirees who are just horribly short of options.

The bad news for domestic retail investors is that institutional investors have now set up camp and are likely here to stay for a while. This was particularly evident to many in the scaling of demand in the recent Westpac Hybrid which saw retail investment adviser bids savaged.

Additionally, it seems that 2016 will see the major Australian banks once again head overseas for their AT1 capital needs. The ANZ seems to be exploring a USD AT1 issue in the current year, which will effectively reverse a 5-year trend of foreign issues being rolled over into Australia and increasing supply to breaking point.

In a yield starved global market this issuance is likely to be well received and will mean that retail investors are likely to have to share less and less supply among themselves just as rates continue to plunge headlong into un-chartered territory.

For our part we have anticipated this supply demand dynamic reversing and are well positioned to capitalise. The Realm High Income Fund maintains exposure of approximately 20% to the Australian AT1 market across 18 separate issues. This provides the fund with a diversified exposure of longer duration names which allow the manager to benefit from any outperformance, while the diversity and smaller average size allows us to maintain the liquidity that is necessary to lock in profit through a reduction of exposure when the time is ripe.

While our AT1 Holding has remained a position of high conviction for over a year now, it is important for investors to understand that we are not tied to this allocation, indeed our long-term strategic allocation sits at closer to 15%, furthermore if and when the sector trades at fundamentally expensive levels, you can expect to see the allocation reduce below the strategic level.

All of that said we have shown a great deal of patience in holding this position and are pleased to say that the stars seem to be finally aligning from a supply side perspective for the sector.

Realm Investment House, Level 17, 500 Collins St, Melbourne, VIC, 3000, AUS

T: +613 9008 7290

W: www.realminvestments.com.au

E: ClientServices@realminvestments.com.au

Realm Investment Management Pty Ltd ACN 158 876 807, a corporate authorised representative number 424705 of Realm Pty Ltd ACN 155 984 955 AFSL 421336 (**Realm**) is the investment manager of the Realm High Income Fund (ARSN 159 673 533), the Realm Cash Plus Fund (ARSN 622 892 844) and the Realm Capital Series Fund (ARSN 624 861 589) collectively the **Funds**. One Managed Investment Funds Limited (ABN 47 117 400 987) (AFSL 297042) is the responsibility entity of the Funds (**OMIFL**). The information contained in this document was not prepared by OMIFL but was prepared by other parties. While OMIFL has no reason to believe that the information is inaccurate, the truth or accuracy of the information contained therein cannot be warranted or guaranteed. Anyone reading this report must obtain and rely upon their own independent advice and inquiries. Investors should consider the product disclosure statement (**PDS**) issued by OMIFL before making any decision regarding the Funds. The PDS contains important information about investing in the Funds and it is important investors obtain and read a copy of the PDS before making a decision about whether to acquire, continue to hold or dispose of units in the Funds. You should also consult a licensed financial adviser before making an investment decision in relation to the Funds.

A copy of the Ordinary Units and Wholesale Units PDS, Adviser Units PDS, Additional PDS for the Realm High Income Fund (ARSN 159 673 533) (Dated 5 October 2017), Ordinary Units for Realm Cash Plus Fund (ARSN 622 892 844) (Dated 12 December 2017) and Realm Capital Series 2018-1 Units for the Realm Capital Series Fund (ARSN 624 861 589) (Dated 4 April 2018) and continuous disclosures may be obtained from <http://oneinvestment.com.au/realm/> or <http://www.realminvestments.com.au/>. Realm believes that the information contained in this document is accurate when issued. Realm does not warrant that such information or advice is accurate, reliable, complete or up-to-date, and to the fullest extent permitted by law, disclaims all liability of Realm and its associates.

Realm is authorised to give general advice to WHOLESALE investors (within the meaning of section 761G of the Corporations Act 2001 (Cth)) only. The information on this document has been prepared on this basis and is for use by such wholesale clients only and no other persons. If you are a RETAIL investor, we are not authorised by our AFSL to give any advice to you, or distribute any research, media and any content, in any form to you, including allowing you access to this website. We highly recommend you seek independent financial advice via a financial planner.

Realm did not take into account the investment objectives, financial situation and particular needs of any individual person. The information contained in this document must not be copied or disclosed in whole or in part without the prior written consent of Realm, and Realm accept no liability whatsoever for the actions of third parties in this respect. It is presented for informational purposes only and is not to be construed as a solicitation or an offer or recommendation to buy or sell any securities. Any opinions expressed in this document may be subject to change. Realm is not obliged to update the information. The information must not be used by recipients as a substitute for the exercise of their own judgment and investigation. Neither Realm nor any of their directors, employees or agents accept any liability for any loss or damage arising out of the use of all or part of, or any omission, inadequacy or inaccuracy in, this document. OMIFL and Realm do not guarantee the performance of the Fund or the repayment of any investor's capital. To the extent permitted by law, neither OMIFL nor Realm, including their directors, senior executives, employees, consultants, advisers, officers or authorised representatives, are liable for any loss or damage arising as a result of reliance placed on the contents of this document.

Realm, its officers, employees, agents and associates ("Associates") from time to time hold interests in securities of corporations or investment vehicles referred to in documents provided to clients. All information contained herein is confidential and proprietary to Realm and, accordingly, this material is not to be reproduced in whole or in part or used for any purpose except as authorised by Realm. It is to be treated as strictly confidential and not disclosed directly or indirectly to any other person, firm or entity. Some of the products and services will only be offered to wholesale clients as defined in section 761G of the Corporations Act (Cth).

This document is not, and is not intended to be, an offer or invitation for subscription or sale, or a recommendation, with respect to any securities, nor is it to form the basis of any contract or commitment. This document does not purport to identify the nature of the specific market or other risks associated with these products. Before entering into any transaction in relation to the products, the investor should ensure that it fully understands the terms of the products and the transaction, relevant risk factors, the nature and extent of the investor's risk of loss and the nature of the contractual relationship into which the investor is entering. Prior to investing in these products, an investor should determine, based on its own independent review and such professional advice as it deems appropriate, the economic risks and merits, the legal, tax accounting characteristics and risk, and the consequences of an investment in them. This is not a substantive commentary or analysis by Realm and has not been prepared as a research product or comments by a research analyst.

Past performance is not indicative of future performance. Information in this document is current as at 30 May 2016.