Realm High Income Fund

April 2017

Investment Objective

- Provide a Net Return of 3% over cash.
- Preserving the value of your investment.

Net Performance

Period	Ordinary Units (incl. franking)	Wholesale Units (incl. franking)	RBA Cash Rate
1 Month	0.23%	0.25%	0.11%
3 Month	1.04%	1.13%	0.36%
6 Months	2.31%	2.53%	0.73%
1 Year	5.66%	6.12%	1.56%
2 Years p.a	4.39%	4.85%	1.78%
3 Years p.a	4.54%	5.01%	2.00%
4 Years p.a	5.43%	N/A	2.14%
Since Inception p.a*	5.83%	5.54%	2.27%

Past performance is not indicative of future performance.
*Ordinary units Inception 26 September 2012. Wholesale units Inception 2 October 2013.
Adviser Units Inception 8 September 2016

Fund Statistics

Running Yield	3.86%
Volatility†	0.62%
Interest rate duration	0.60
Credit duration	2.03
Average Credit Rating	A
Number of positions	115
Average position exposure	0.68%
Worst Month*	-0.47%
Best Month*	1.22%
Sharpe ratio†	3.20
Information Ratio†	3.24

Calculated on Ordinary Units unless otherwise stated
*Since Inception 26 September 2012
†Trailing 12 Months Calculated on Daily observations

Fund Update

Our **cash weighting** increased to just above 24% at month end, in addition short term liquidity sits at close to 9%. The main change was in the funds Bank AT1 allocation which was reduced meaningfully from around 11.5% to approximately 7.5%. Portfolio risk was reduced considerably over the month with targeted volatility reducing from 1.1% to 0.97%.

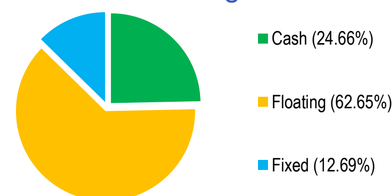
The fund is maintaining an **interest rate duration** position of approximately 0.5 years into month end, with our technical overlay moving the position between 0.4 and 0.6 of a year. Rates ground tighter over the month as a combination of geopolitical factors maintained the bid tone. On our metrics US data momentum remains above trend albeit moderating slightly, European data is well above trend and Chinese data momentum is now also moderately positive. On our numbers bonds are starting to look expensive again, the data is not marrying up with the performance of the rates market, and while Trump's reflation trade has lost momentum, strength is more than adequate to justify yields rising over the back end of the year. While various threats to the global economy persist, be it North Korea or a burgeoning Chinese debt load, the fact remains that data has come a long way from the trough of 09/10. As core CPI normalizes and in some cases exceeds expectations and with employment in a healthy state in most major economies, it becomes more and more difficult to rationalize rates that are still reflective of the lognormal environment post the US and European crisis. Our fair value estimates around long US bonds sit at approximately 2.8% for the 10 year and just under 3% here in Australia, which is approximately 0.40% above current levels.

Our **corporate** and **subordinated debt** allocation reduced moderately over the month by approximately 1%, as short dated bank senior matured out of the portfolio. We did increase our corporate non-bank exposure with approximately 1.5% invested into the most recent Telstra issue, and 2% into Seek holdings new issue. We passed on a number of regional bank senior debt issues although we did add 2% to a short dated MEB 2019 line. There was a short window where credit softened intra month as tensions on the Korean peninsula rose and French election nerves struck markets, however as these concerns subsided credit snapped back in the second half of the month. On our screens, we are still not seeing a lot of value in this part of the market. Indeed bank subordinated debt is expensive in our opinion, in addition there is real risk of an increase in supply on the back of APRA's decision to move ahead of with what it constitutes "unquestionably strong" which we believe could increase supply side pressures for bank subordinated debt. A good portion of our exposure is in senior names with between 3 and 18 months until maturity which reflects our defensive mindset.

Our **AT1** exposure decreased over the month by approximately 4.0%. Fundamentally the market is moderately dear, however our real concern is that a change in regulatory perspective is likely to lead to a need to increase Bank AT1 issuance or core equity. We note that the rights issues of early 2015 did seem to put pressure on the hybrid market, as AT1 was used as a funding source for rights by retail investors. Equally the regulator has spoken to the likelihood of elevating the importance of rating agency measures, such as the S&P RAC ratio, in an effort to validate the Australian banking system as being unquestionably strong. Some of these total leverage ratios include bank AT1 under the measure of total capital. Meaning that issuing hybrids could act as a cheaper alternative to raising more core equity. We don't anticipate an explosion in supply, however we wouldn't be surprised if the majors all added a couple of deals over and above maturities over the next 2 to 3 years. This will effectively neutralize the supply-shortage which has acted as a tailwind for the sector over the last twelve months. We need to see this market widen from current levels to become constructive again.

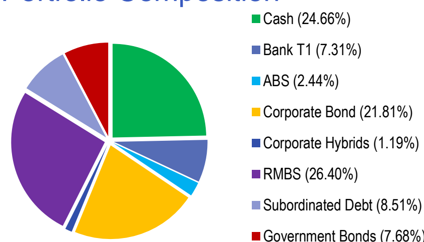
Our **RMBS** allocation reduced by a further 1% to 26.57%. We note that excluding short dated AAA securities our exposure is lower still, sitting at approximately 23.5% as at the end of April. There is a further 2.5% of mezzanine RMBS which is maturing over the next 6 months. All in all the weighted average credit rating is at a high investment grade rating. This market has rallied strongly as Japanese demand has soaked up a good deal of this year's market supply, and this seems to have spilled over into secondary demand with the street paying overs for good chunks of our book. While we are quite cautious at present, (this has been reflected in us increasing our loss assumptions for a tail event and increasing the minimum credit rating that is investable for a number of issuers), we are not abandoning the sector. Very simply the decision to reduce our exposure meaningfully has been a function of price strength, at a time where risks have clearly risen. We are happy to stay patient and wait for the market to come to us as current exuberance subsides.

Fixed and Floating Breakdown



The fixed rate exposure is calculated based on the portfolios interest duration expressed as a percentage of the Bloomberg 0+yr Composite Bond Index.

Portfolio Composition



Sector limits

	Asset Allocation Range	SAA Target
Cash	0% - 100%	10%
Government Bonds	0% - 100%	10%
Corporate Bonds	0% - 60%	10%
Corporate Hybrids	0% - 10%	5%
Bank Tier 1 Hybrids	0% - 25%	15%
Sub Debt Hybrids	0% - 25%	15%
RMBS	0% - 60%	30%
ABS	0% - 20%	5%

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APIR Code: OMF0018AU- Adviser

Fund Outlook

Australian credit CDS indices ended close to where they started the month, North Korea and the French elections spurred a grab for synthetic insurance which quickly subsided as North Korean rhetoric was toned down and Macron emerged as a clear favorite in the French election.

The key event over the month was once again regulatory. More specifically we felt that Wayne Byres speech to the AFR Australian Banking and Wealth Summit on the 5th of April set the tone for a number of our markets over the next year or so. The decision to push ahead with an Australian regulatory agenda has become a necessity given that the Basel committee is now being frustrated by a push back from the likes of the Bundesbank and the Fed. This may well lead to the global regulatory environment becoming disjointed, which in the opinion of APRA makes it more important than ever for the Australian system to take action in defining itself as unquestionably strong. What this means is that APRA will need to push ahead with an Australian regulatory agenda. In his speech Mr Byers indicated that this would mean that our banks need to almost solve for the highest common denominator, which is essential given our heavy reliance on foreign capital. In the absence of a standardized approach, the APRA head noted that rating agency accepted approaches could once again find prominence. If this is the case we expect that the leverage ratio and the S&P RAC ratio could be elevated in importance. In addition it is likely that we will need to play catch up with the Europeans around increasing bail-in able capital. In our opinion this will all likely result in more AT1 and some new notion of bank senior subordinated debt. In plain English, we expect more supply. In our opinion the potential for a supply side disruption is not being priced in by the market. If anything we feel these markets are fundamentally expensive in their own right.

This view has led to us reducing our market exposure to bank credit beta, especially in its subordinated forms. Given the asymmetric value presented by these markets at present and the possibility of a regulatory catalyst in the short term to drive underperformance we feel comfortable that our view to build up liquidity is the right one. It is our expectation that as the regulatory landscape evolves it should present the opportunity we are looking for the re-build our risk exposure at more attractive prices.

Outside of that concerns relating to Australian housing continue to create fantastic copy. The concentration of risk within Australian mortgages in our financial system is undeniable, it is sensible that APRA increases the cost of capital for this, however the view that a broader capitulation is imminent is a bridge too far.

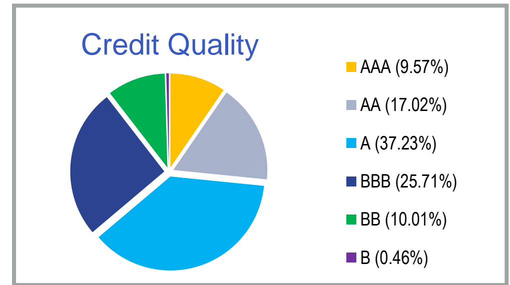
In our modelling we assume that the arrears cycle has bottomed and that it increases substantially from where we are now over the next 2 to 5 years. This is reflected in our book value assumptions for Australian banks and our fair value estimates for all forms of credit. That said while we think that provisioning will play a much more prominent part in bank results over the next 5 years it is difficult for us to construct a more severe scenario that is plausible.

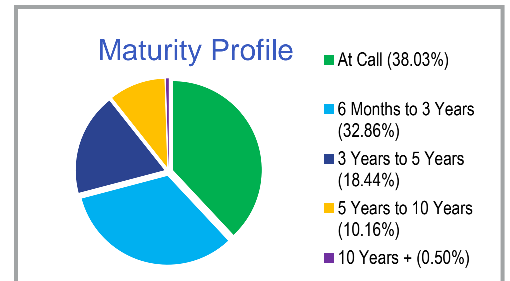
Our transition to default matrix which is built around understanding how a system transitions from normality to a stress event indicates that on current metrics we would need a significant event or point of ignition to make the environment deteriorate **quickly** enough to make Australian housing a real problem in the shorter to medium term.

While we expect that the environment will deteriorate, and indeed this period might be as soft as we have seen here in Australia since the early 1990's, the numbers just don't play out the ugly tail scenario a lot of pundits speak of. The fact that the central bank has the capacity to use rates, or unconventional policies, in addition to the fact that FIRB can relax property ownership rules (as they did for apartments recently) at a moment's notice speak to the continued existence of buffers that can be engaged to manage and avert a decent into crisis.

All of that said a geopolitical event of consequence or a disorderly descent into economic crisis in China could overwhelm those barriers pretty quickly; however in the absence of something going wrong of that magnitude, we feel it is fair to suggest the concerns are over-stated. As we said in our previous monthly, APRA's actions are likely to take the edge off in the shorter to medium term, which coupled with a moderate improvement in domestic economic outcomes should keep things reasonably benign.

Credit markets are still expensive and are not providing adequate compensation for the risk, which leads us to maintaining a defensive posture as we have in the life of the fund. We feel that basis points of yield have as much risk attached to them right now as has been the case in the funds almost 5 year life, as such it is an easy decision to reduce portfolio risk and make ourselves a smaller target. That said we are keeping busy trying to harvest what we can, however as this stellar market run continues the right thing to do is to continue to reduce total portfolio risk all other things being equal.





Fund details

- Distribution Frequency: Monthly
- Liquidity: Daily
- Ordinary Units Management Fee: 1.20% (inc. GST)
- Wholesale Units Management Fee: 0.77% (inc. GST)
- Adviser Units Management Fee: 0.77% (inc. GST)
- RE: One Managed Investment Funds Ltd
- Custodian: JP Morgan
- Unit Pricing and Unit Price History: www.realminvestments.com.au/media/4

Platform Availability

- BT Wrap
- Macquarie Wrap IDPS
- Powerwrap
- Hub24
- IAS
- UBS
- Credit Suisse (HSBC)
- CFS FirstWrap (Private Label)
- Netwealth
- Praemium

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