# Realm High Income Fund

November 2016

## 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 | 0.38% | 0.42% | 0.12% |
| 3 Month | 1.25% | 1.36% | 0.37% |
| 6 Months | 3.11% | 3.33% | 0.79% |
| 1 Year | 5.49% | 5.95% | 1.78% |
| 2 Years p.a | 4.32% | 4.78% | 1.96% |
| 3 Years p.a | 5.09% | 5.58% | 2.14% |
| 4 Years p.a | 5.92% | N/A | 2.30% |
| Since Inception p.a* | 5.93% | 5.58% | 2.34% |

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 | 4.14% |
| Volatility* | 1.08% |
| Interest rate duration | 0.51 |
| Credit duration | 2.62 |
| Average Credit Rating | A- |
| Number of positions | 89 |
| Average position exposure | 1.12% |
| Worst Month* | -0.47% |
| Best Month* | 1.22% |
| Sharpe ratio* | 3.43 |
| Information Ratio* | 3.44 |

Calculated on Ordinary Units unless otherwise stated
*Since Inception 26 September 2012

## Fund Update

Our **cash** weighting increased moderately, by approximately 1.7% to 17.31% as at month end, there were reductions to the funds subordinated debt and corporate bond allocation, we also increased the funds government bond exposure through the month.

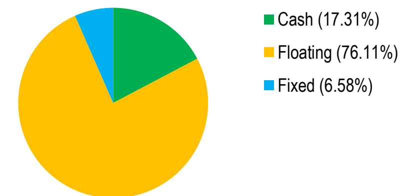
We inched towards half a year in interest rate duration through November within our **Fixed Rate** position. The long end of the Australian curve sold off by a further 40 basis points this month, with Australian 10 year rates having moved from 1.8% to close to 2.9% in early December. Over the month our fair Australian 10 year rate decreased by close to 20 basis points. As housing and construction softens, the Realm nominal rate estimate here in Australia has meaningfully detached from consensus and current numbers, on our estimates we now see Australian nominal growth sitting between 3.5 and 3.75% over the next 6 months, this underpins our modelled fair value view of 2.4% for Australian 10 year bonds. We remain of the view that the global economy is limited by structural factors and debilitating levels of total debt in addition we are still in the dark around what a Trump presidency means for global order. In such an environment rates provide an additional layer of utility to our portfolio. If rates continue to sell off, we are likely to continue to incrementally increase our total rate exposure.

Our **corporate bond** and subordinated debt allocation decreased by approximately 5% over the month. We exited our long in Transurban Queensland while also liquidating our position within the subordinated debt of Suncorp group. At the same time we made small additions to older type subordinated bank paper with less than 12 months to call. Bank paper and subordinated debt seems to have hit a wall of sorts, with Australian big bank senior unsecured debt widening by 5 to 10 points, meanwhile bank subordinated debt also seems to have settled around current levels. We would characterize the bank tier 2 market as expensive around current prices, meanwhile the senior market still seems to be in a relative state of flux, with changes to the supply/demand dynamics of short term markets seemingly having an impact on Australian unsecured curves more generally. The allocation to corporate and subordinated debt sits at close to 23%, a good portion sits between 3 and 5 years in senior unsecured bank debt and could be broadly characterized as being low beta. This is also evident within the weighted rating of our portfolio which now stands at just below an A rating.

Our **AT1** exposure remained broadly in line through the month. We expect that by the end of this calendar year our AT1 exposure would have reduced back below the strategic asset allocation level of 15%, this is the first time this has been the case since the end of 2014. The long end of the curve presents the best value within the broader AT1 market on our estimation, this was clear over the month with more recently issued paper outperforming on a relative basis. The fund now maintains significant spare capacity to increase its exposure to this market in the event of weakness and volatility, however if the opposite remains true (which remains our base case), we would anticipate continuing to reduce our total exposure to the sector.

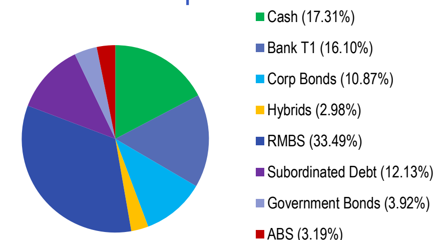
Our **RMBS** allocation remained in line over the month, with shorter dated AAA paper maturing and re-allocated towards a securitization issued by the ANZ bank. This was big news of sorts within RMBS markets. It has been 12 years since ANZ had come to market, which made this deal noteworthy, bigger news still was the decision by the ANZ to issue their mezzanine notes (these are debt capital type instruments). It had been close to a decade since a major Australian bank had made such a decision. The deal was particularly well supported increasing from its initial size of $700million to closer to $2 billion by launch, in addition the deal saw strong interest from

## 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



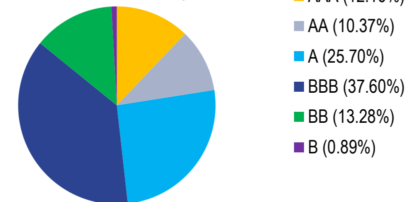

## Sector limits

| | 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% |

## Fund Update Continued

foreign investors which provides a clear illustration that the appetite for big bank Australian RMBS is robust, this is likely to support issuance out of the rest of the big 4. The other big news over the month was a decision by APRA to relax capital requirements for holdings of higher rated mezzanine RMBS. Banks have historically been heavily penalized for holding RMBS mezzanine debt (these securities can be rated between AAA and B). APRA have announced that the AAA and AA rated notes will now no longer be penalized with a deduction in capital which opens the door to banks to hold certain mezzanine notes as part of their repo programs and potentially even their trading books. This is unquestionably positive as it could provide a moderate level of market liquidity through intermediation.

## Credit Quality




## Fund Outlook

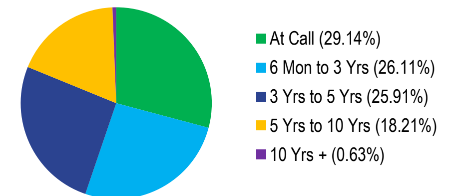
Credit spreads remained broadly flat over the month, just as fixed income indices plummeted on the back of a savage move in interest rates. Credit struggled to move tighter with Australian 5 year senior bank spreads widening by approximately 10 basis points. Anecdotally we continue to see axes across the Australian bank curve, with banks generally better sellers in most markets. The exception to this has been the tier 2 market, which has seen bank subordinated debt trading tight versus senior markets. In addition the AT1 market continued to plough forward, with primary issuance enjoying significant overs in support. It was IAG's turn this time around with their replacement tier 1 covered over three times. Our positioning within AT1 markets has predominantly sat within higher coupon longer dated names, this part of the AT1 market has performed particularly strongly, as the rally has matured we have brought our risk position back to our benchmark. Barring any market shocks we expect supply demand dynamics to continue to drive this market higher.

The big story over the month from a markets perspective was of course the sell off in rates, with the long end of the curve in Australia and the US selling off by approximately 40 basis points over the month. We note that data has continued to improve in the US and China however the move in rates has surpassed anything that could be explained by this. Ultimately rates are now speaking to a very different future reality than was the case as recently as August. While the Trump factor cannot be discounted, the reality is the sell off had begun prior to this. A changing narrative out of central banks around the in effectiveness of rates as well as the fact that low absolute rates were endangering the financial system seems to have been the initial driver of this change in narrative, however this has undoubtedly found another leg of strength since the election of Donald Trump. The combination of tax cuts with an infrastructure expenditure booster has the markets attention. The specter of 1994 still remains fresh in many minds, ultimately if Trump delivers on his promises and is successful in creating inflation within the US economy, one could comfortably prognosticate how US rates could reach materially higher than current levels.

Australian data has weakened notably of recent months, as weakness in house starts combined with weak business investment and anemic wage growth to paint a negative picture. Our near term estimates for nominal growth have now reduced to 3.7% which is well below consensus. From a portfolio perspective we are cautious on rates, while the long end here in Australia is now showing as cheap, long US rates show as fair at best. Given the high correlation between long bonds in the US and Australia it can be assumed as a general rule that as US rates continue to sell off, Aussie rates will join them in sympathy. In this kind of environment we are likely to continue to increase our holdings of Government and Semi Government securities, building towards our strategic benchmark of 10%. We note the benefit that fixed rates deliver to a credit portfolio due to their negative correlation to risk assets more generally.

Our portfolio is being dynamically adjusted to reflect the changing market environment, the emphasis being on the positive regulatory changes out of RMBS and the sell off in rates, at the same time our exposure to bank subordinated debt has been markedly reduced and bank tier 1 has been reduced to a little under our long term strategic weighting. All in all the portfolio is well balanced and positioned to deliver the targeted portfolio return, meanwhile we also maintain the headroom within higher beta markets to increase our exposure in the event of weakness. The fund continues to be repositioned to reflect recent market movements, the objective being to lock in returns driven by the outperformance out of the AT1 and Tier 2 sector, while also positioning the fund for growth by taking advantage of the sell off in rates and widening in RMBS mezzanine spreads.

## Maturity Profile




## 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 (Private Label)
- Praemium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