Realm High Income Fund Commentary - June 2022

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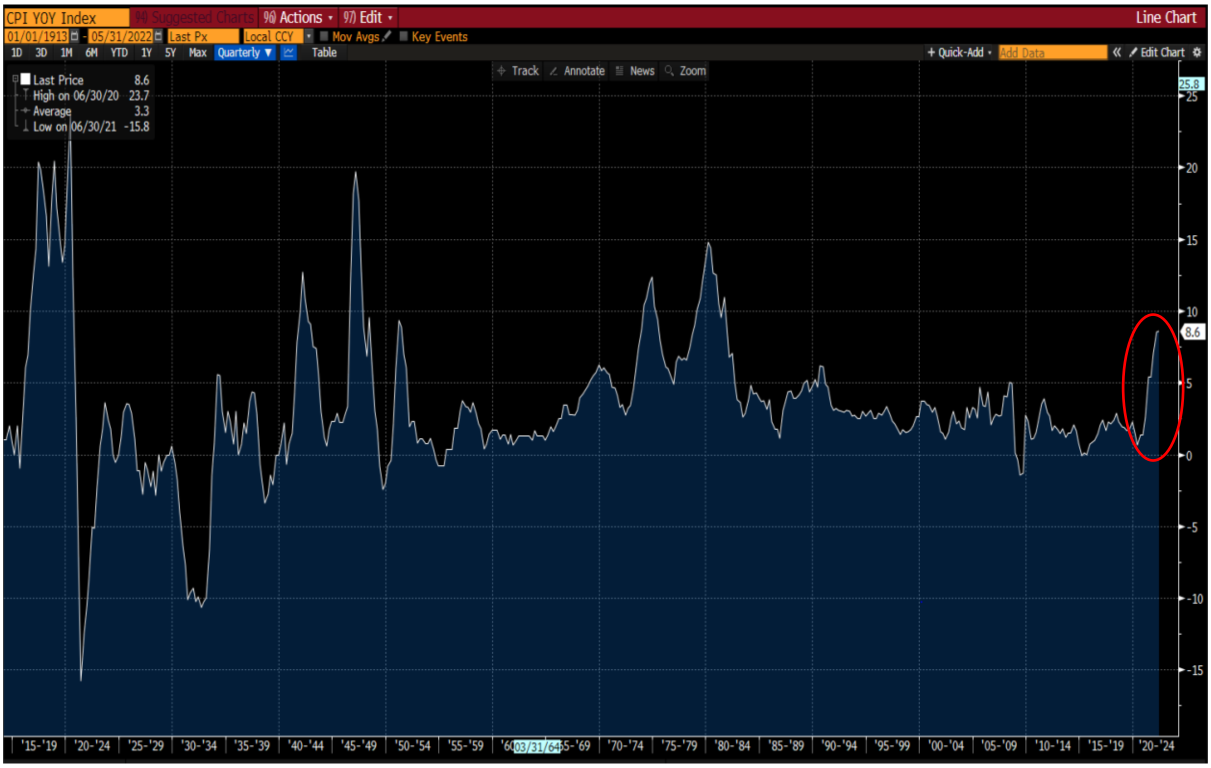
In the first instance it's important to understand what has driven the negative return over the last 12 months for the Realm High Income Fund. The chart below is of US CPI year on year. Put simply, you need to go back to the 1970's and early 1980's to provide any kind of recent comparison to what we are experiencing today, prior to that it was the 1940's. Then as now commodity prices and more specifically energy were the driving factor.

It is important to understand that when we are talking about credit and fixed income performance that we understand the current event in this context.



Source Bloomberg

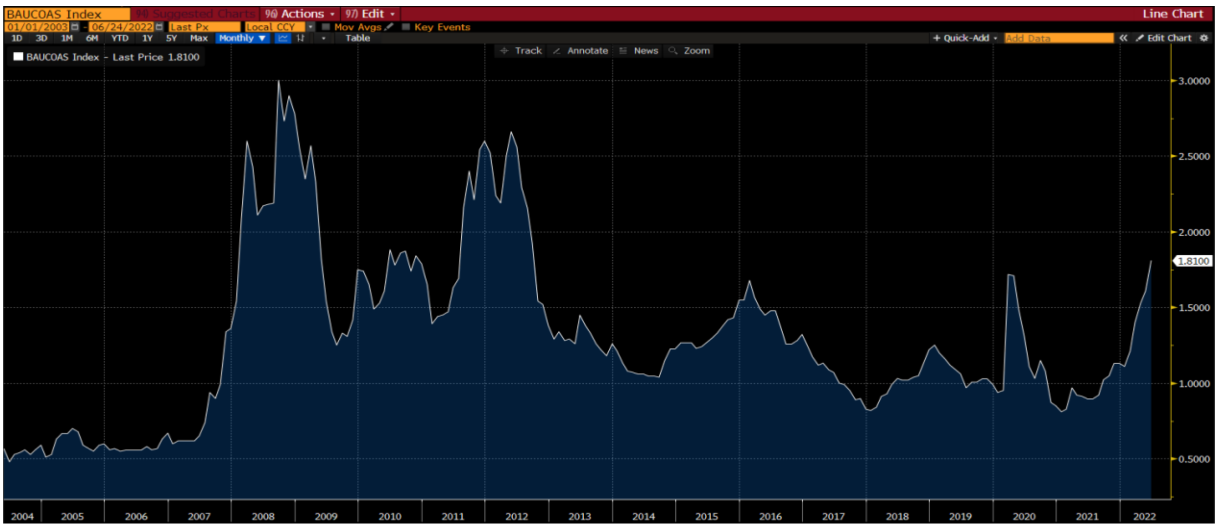
As we know central banks have a very limited tool kit when dealing with inflation. It really just comes down to increasing interest rates, with a view that this will reduce demand which in turn moderates the rate of price rises.

The chart below references the medium-term outlook of interest rates, it is illustrating where the market is pricing bank borrowing rates to be by mid-2023. What should be apparent from the graphic is that the explosion higher in rates is unprecedented in the last 30 years. We have literally gone from all-time lows (zero) to a decade high expected cash rate of 4% in about 6 months!

What is important to understand is that a significant rise in the cash rate is now in the price.

Source Bloomberg

The other part of the fixed income equation relates to the credit market. As a refresher the credit spread is the amount the market expects for taking the risk that a company defaults. Naturally this number increases as the outlook of the economy deteriorates and gets smaller as people feel more comfortable with the outlook. The chart below expresses how much the highest quality borrowers in the Australian market need to pay, over and above the base interest rate in percentage terms. The current level of 1.81% has now surpassed the peak set by COVID as well as the more prominent market sell offs of the last decade. Only the peaks around the GFC and the Euro crisis saw spreads wider, at that time the market was pricing for the possibility of total financial system collapse. The repricing of the market has been a key driver of weakness for credit and fixed income funds.



Source Bloomberg

For fixed income funds, the current event is actually worse from a return perspective than both the Euro crisis and the GFC. The chart below shows Australian 10-year interest rates (orange) with the credit spread paid by the best companies in the Australian credit index (white). If we look at the GFC period you will notice that even though credit spreads skyrocketed, interest rates plummeted, meaning that losses from credit were off-set by the profits from interest rates. This is again observable in 2011/2012 during the Euro crisis, 2015/2016 (China hard landing) and during COVID.

Normally when credit market spreads rise (white), interest rates (orange) plummet to reflect the deterioration in the economy. This means that portfolios lose money from credit, but benefit from interest rates falling, which buffers the return. This negative correlation normally protects the portfolio. This time however, portfolios are losing money simultaneously from interest rates & credit. We are dealing with interest rates rising more than they have at any point in the last thirty years, while credit markets simultaneously price in a recessionary environment.

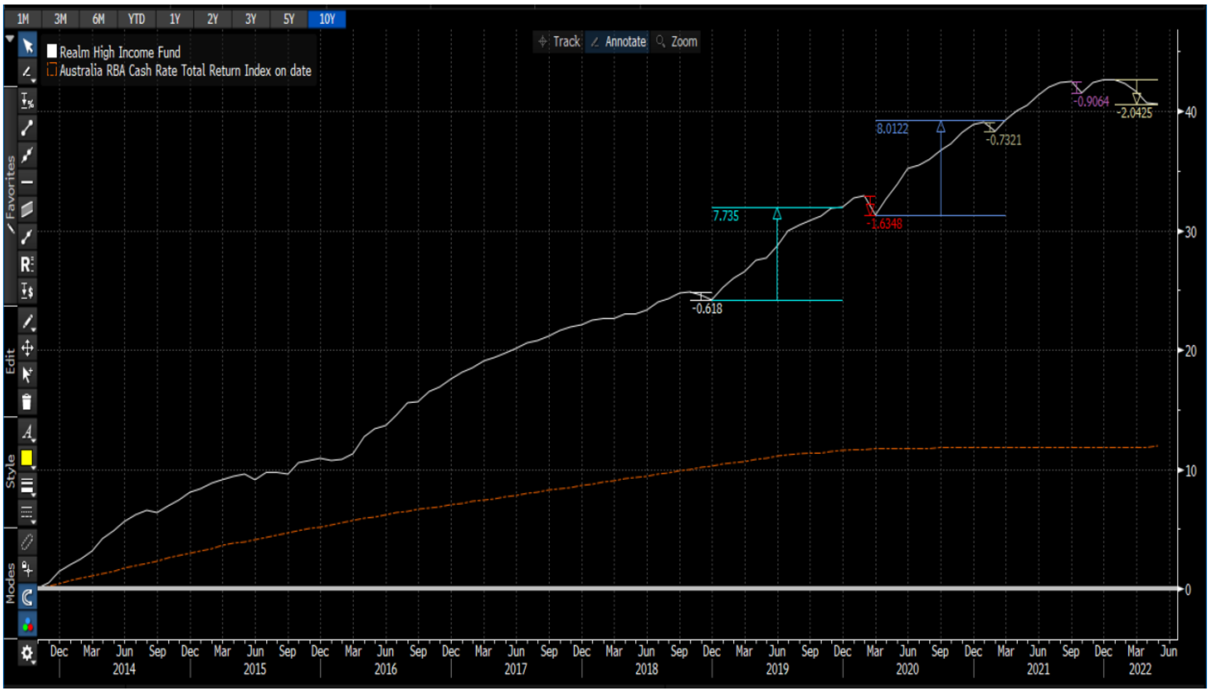
Source Bloomberg

To illustrate the magnitude of this move we have provided a chart of the US high grade corporate index. Going back 34 years, we can see that the biggest negative periods for the index were the recession of the early 1990’s (index declined 4.4%), the GFC of course (index declined 7.8%) and the current situation which sees the index off a whopping 14.6%. For fixed income markets this is an enormous once in a career event (fingers crossed).

More to the point, this event is now in the price. Yields have risen meaningfully on the back of both interest rates and credit spreads, meaning that fixed income portfolios are now delivering yields that have not been seen in a decade.

Source Bloomberg

Never Waste a Crisis – Over the last decade the Realm High Income Fund has faced a number of meaningful market events. While the Realm High Income Fund has not been immune from losses during these more extreme events, the portfolio has performed better than peers through these periods. More importantly, we have demonstrated again and again over the last decade the ability to position the portfolio through these times to strongly counter punch out of these market events. In late 2018, a fund drawdown of -0.618% was followed by an annual return of 7.7%. While the COVID drawdown which delivered a -1.6% return, was followed by an annual number a little above 8%. The current market event at -2% is as large as the fund has experienced in a decade. That being said, the fund has again navigated this period well versus peers and perhaps more importantly, the fund has been repositioned through this period to deliver a strong return. This is a feature of the fund's active approach.



Source Bloomberg

In December 2021 fund positioning was clearly defensive, the value presented by credit markets did not justify risk seeking behaviour. Accordingly, fund risk sat at 0.83%, which could be thought of as being very low in a historical context.

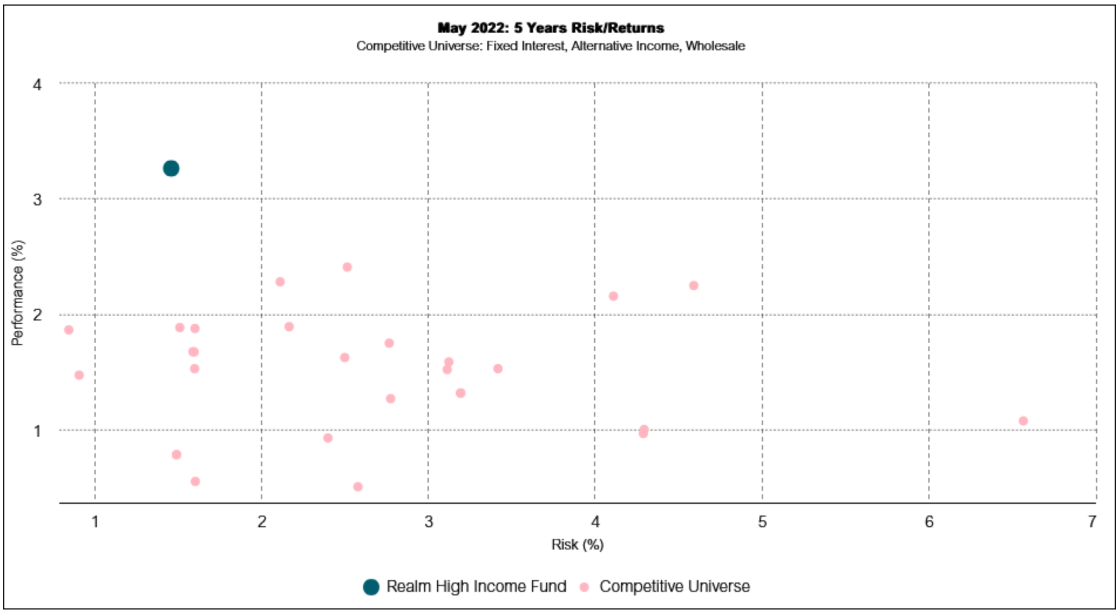
Targeted risk across the Fund: ↓ Targeted portfolio risk decreased from 0.97% to 0.83% as we reduced credit duration and increased our cash holdings. The fund remains compliant with the Portfolio ESG risk limits.

"We remain defensively postured with high liquidity levels." – December 2021 Update.

Portfolio positioning going into this event was tight, which saw the fund trade resiliently on a relative basis. Since then, the fund has been positioned to deliver a rate of return that exceeds the product target of cash +3% for the medium term. Indeed, the portfolio will benefit strongly from any moderation in interest rate or credit expectations.

Metric	Dec-2021	Current
Tracking Error	0.83%	2.45%
IRD	0.99	1.46
CD	1.85	3.46
Yield to Maturity	2.53%	4.93%
Rating	BBB+	BBB

Below you can see the risk adjusted returns of the Realm High Income Fund vs Lonsec respective peer universe over the past 5-year period. The aggressively repositioned portfolio has underperformed over the last quarter vs its target return, however the fund is now poised to turn the corner strongly as markets stabilise. While market volatility always creates a level of discomfort, being aggressive in these markets is essential in delivering strong through the cycle returns. This formula has been effective for a decade and will in our view continue to see the Realm High Income Fund deliver excellent risk-adjusted returns versus peers.



Source Lonsec

In conclusion, the portfolio has been well positioned to buffer the recent volatility in markets and is now poised to take advantage of compelling opportunities in the broader credit market. Risk in the portfolio has been increased markedly now the level of compensation is strong. RHIF currently has 3.46 yrs of credit duration from 1.85 yrs in December of last year, and the yield to maturity is now sitting at a healthy 4.93% up from 2.53% at the end of December 2021. The portfolio will also benefit from rising interest rates as BBSW continues to reflect the rising cash rate. **Investors can take some solace from the fact that the most severe event in four decades is now in the price.** What is more if our view of interest rate moderation materialising and the credit market recovering from recessionary levels, investors might also anticipate some level of capital growth over the next couple of years and strong above trend performance.

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