Fund Objective

The fund aims to provide a superior stream of income and capital stability over the medium term while aiming to outperform its benchmark through market cycles.

Fund Application

Investors seeking to enhance their overall fixed income returns with a higher yielding, predominantly investment grade (IG), absolute return-oriented global fixed income portfolio.

Fund Details

APIR code	HOW0165AU
Inception date	31 May 2007
Fund size	AUD 3173mil
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.26yrs
Credit spread duration	2.75yrs
Average credit rating	A-
No of issuers	102
Yield to maturity	2.65%

Fund Guidelines

Target return	cash plus 2-3%
Target volatility	less than 1.5% annualised
Duration limits	-2 to +2 years
Credit quality	>85% investment grade

Steve Goldman
Portfolio Manager

Dan Siluk
Portfolio Manager

March 2022

Performance (%)	1 month	3 months	1 year	3 years p.a.	5 years p.a.	Annualised since inception
Fund Return (before fees and sell spread)	-0.38	-0.39	0.22	1.60	2.39	4.63
Fund Return (after fees, before sell spread)[1]	-0.42	-0.50	0.20	1.15	1.94	4.28
Fund Return (after fees and sell spread)[2]	-0.42	-0.50	-0.20	1.12	1.93	4.27
RBA Cash Rate	0.01	0.02	0.10	0.42	0.85	2.74
Active return[3] (before fees and sell spread)	-0.39	-0.42	0.12	1.18	1.54	1.90
Active return[3] (after fees and sell spread)[2]	-0.42	-0.52	-0.30	0.70	1.08	1.54
Bloomberg AusBond Bank Bills Index	0.00	0.01	0.04	0.46	1.02	2.96

Past performance is no guarantee of future results. After fee returns are inclusive of 0.41% annualised total expenses for class I units. Fund inception date 31 May 2007. No allowance is made for tax. Numbers may not add due to rounding. 1) For a continuing investor the actual return experienced based on the NAV performance of the Fund, after accounting for management fees. 2) The return experienced by a redeeming investor, based on the exit price performance of the Fund which accounts for the end of period sell spread of 0.07% and management fees. 3) Active return of the Fund compared to Benchmark (RBA Cash Rate).
Source: Fidante Partners Limited, 31 March 2022.

Performance Commentary

While relative to the broader fixed income sector our portfolio displayed strong resilience, we were unable to avoid a modest negative return of -0.42% for March, which puts us at -0.50% for the calendar-year-to-date period (after class I unit fees). Coupon income remained consistently positive, though this was offset by credit spread widening, and rising sovereign yields also detracted from performance.

The combination of a number of widely reported factors have caused highly volatile financial markets in the 2022 year-to-date period; Russia's invasion of Ukraine, accelerating inflation, rising yield curves globally, the beginning of a hiking cycle from the Federal Reserve (FED), anticipation of Quantitative Tightening (QT), as well as an inversion of the US 2s10s yield curve (a beloved indicator for financial market participants which suggests a recession is looming). Losses were seen across most asset classes; equities, credit and sovereign bonds all suffering. The only exception was seemingly commodities, where energy, metals and agricultural goods all saw gains, largely driven by the conflict in Ukraine as opposed to strong growth prospects. The Bloomberg AusBond Composite Index lost a further -3.75% in March and is now down -5.90% calendar-year-to-date, highlighting the enormous challenge for traditional fixed income investors.

Market Commentary & Outlook

Vladimir Ilyich Ulyanov, better known by his alias Lenin, was a Russian revolutionary and politician, the head of government in Soviet Russia between 1917-1924. Lenin once said *"there are decades where nothing happens, and there are weeks where decades happen"*. This statement certainly rings true when describing the events of recent weeks, both geo-politically and economically. The dissolution of the USSR in 1991 marked an end to the Cold War and brought a decade or so of steadiness within the former-USSR, and also in regards to relations between Russia and the West. Today, however, Putin continues to oversee a military regime change in the region which has seen him exert his influence in Georgia (2008), annexing Crimea (2014) and more recent atrocities in Ukraine. This has been met with an economic regime change by the West. In an attempt to undermine's Russia's economy and creditworthiness the West has imposed punitive economic sanctions and plan to wean themselves off Russian energy, a time consuming yet equally punitory process.

From an economic perspective, concerns have shifted from pandemic-induced inflation, which largely impacted supply chains, to conflict-induced inflation, which is having a greater influence on energy and food prices. The latter, being more salient components of a consumers' basket, we expect will lead to a drop in discretionary spending and confidence and ultimately a slowdown in growth. Despite the approaching economic slowdown, central banks believe they face a greater risk of policy mistake in not combating inflation, than they do from slower growth, and will therefore continue with their aggressive rate policy normalisation over the coming months. Financial market uncertainty as measured by volatility (both realised and implied) is higher today than for most of the post-global financial crisis cycle and we expect this theme to continue. We believe volatility will be structurally higher going forward, which implies yields and credit spreads too, will ultimately settle at structurally higher levels. For the moment, this means maintaining a low-duration position within portfolios, but at some point front-end carry and roll down will be too attractive to pass on.

Turning to US economic data, labour market tightness continues with non-farm payrolls beating expectations and both unemployment (3.8%) and underemployment (7.2%) trending lower and approaching historic lows. The FED hiked rates for the first time this cycle with a 25 basis point increase to 0.5% (at the upper bound), with Chair Powell highlighting that price stability is the Board's number one priority. Given headline consumer price index (CPI) and personal consumption expenditures (PCE) printed 7.9% and 6.4% respectively, and continue to climb, the FED have a long way to go before they can claim any credibility on the inflation fighting front. The dot plot released at the March Federal Open Market Committee (FOMC) meeting implied a 1.75% increase in cash rates over the course of the calendar year, up from 0.75% at the December meeting. James Bullard, the most hawkish of FOMC members, was the only voter to favour a move higher by 50 basis points and continues to call for an even more rapid removal in accommodation, with suggestions of 3% cash rates by year end. The front end of the Treasury curve sold off aggressively over the month with the 2-year Treasury up +90 basis points to 2.33%, while the 10-year rose +51 basis points to 2.34%.

Europe is quite a different region today compared to the one which saw an economically damaging sovereign crisis envelop during 2011-12, leading to fiscal austerity, ultra loose monetary policy, no yield for savers and anaemic levels of growth. Today Europe has a larger current account surplus and a healthier corporate balance sheet. As such, the response to Russia/Ukraine has been more cohesive than we would have expected a decade ago. Decisions to sanction the Russian economy, plans to reduce reliance on Russian energy and the re-settling of millions of Ukrainian refugees will pose problems for Europe in the near term, not least a deceleration in an otherwise sanguine growth environment of recent years, ushering in a prolonged period of higher inflation and fiscal injections required to meet social welfare needs. Some European Central Bank (ECB) members, such as Olli Rehn of Finland, suggest withdrawing too early from stimulus measures, before the impact of Russia/Ukraine is known, poses a risk to European growth. Nonetheless, ECB President Lagarde did announce that the taper of asset purchases has been brought forward to the third quarter this year, paving the way for rate hikes toward the end of the year, yet stressing data dependence and optionality. German 2-yr government bond yields rose 46 basis points -0.07%, while the 10-yr rose +41 basis points to 0.55%.

In Australia, the Reserve Bank of Australia (RBA) met early in the month, keeping policy rates on hold. Governor Lowe maintains that while inflation risks are to the upside, the Board believe inflation and wage price dynamics differ in Australia to other jurisdictions globally and therefore *"patience"* is warranted. Unemployment dipped to 4%, the lowest level since 2008 and we wonder whether the legacy Governor Lowe desires to be known for is seeing unemployment below 4% for the first time in half a century. GDP growth ended the 2021 calendar year at 4.2%, slightly above expectations, boosted by household spending as the economy emerged from lockdowns. While the RBA can point to domestic conditions as driving monetary policy, the reality is Australian yield curves continue to exhibit a high correlation to US yields, in particular the front-end. The yield on the 3-year Australian Government Bond rose +80 basis points to 2.34%, while the 10-year rose +70 basis points to 2.84%.

Portfolio Strategy

The portfolio yield-to-maturity rose sharply over March, to well over 3%, driven by a combination of factors including i) the move higher in risk-free rates ii) the shift wider in credit spreads and iii) the addition of attractive opportunities, particularly USD-denominated credit. Overall portfolio liquidity remains high at ~13% for *'Level 1'* investments (cash, commercial paper, term deposits, government, semi-government, and supranationals) and ~15% in *'Level 2'* investments (less than 1 year investment grade bonds). We anticipate reducing *'Level 1'* liquidity to 10% (normal range being 5-10%) as we use a backdrop of volatility from FED rate hikes, tapering, possible balance sheet run-off and geopolitical risks to gradually add discounted credits.

Spread duration ex SSGA increased to ~2.44yrs from 2.28yrs reflecting additions of new issues. Macro volatility provides good opportunity to add credit with idiosyncratic mispricing, and we have been adding credits where a significant new issue concession exists, or where we believe the secondary market is mispriced. We are aiming to incrementally increase our spread duration as credits cheapen, shifting from an underweight to a more neutral credit positioning. This places us in a strong position to provide a stable and appealing income stream, well insulated from the various headwinds faced, and maintaining a yield in the mid 3% range, higher in a spread sense than for several years.

This is possible as a result of the more acute barbell-shaped strategy we've pursued in the portfolio for some time to limit losses and provide liquidity at opportune points. This approach (1) underweights longer dated A-rated credits and overweights shorter dated lower rated credits (mainly BBB assets), assets with equal carry but less spread compression providing greater resilience in sell-offs, and (2) invests in a small bucket of higher spread assets to subsidise an overweight position in liquid assets which provide the ammunition to add cheap new credits.

The credit protection strategies we employed during January have paid dividends, dampening volatility of physical assets and hence driving some positive return contribution. As such, we have largely taken profits on the remaining two-thirds of protection positions in a disciplined and systematic manner.

From a spread per unit of risk perspective, the excess yield the portfolio is able to earn above the risk-free rate remains near historical highs, highlighting the robustness of the portfolio and underscoring confidence in being able to deliver to our return objective on a forward looking 'over the cycle' basis.

In terms of asset allocation, the portfolio can be split across three major 'buckets'; financials (~35%), corporates (~40%), and asset and mortgage-backed securities (<15%) with the residual in cash and liquids. By currency, we currently have a 90%/10% split between Australian & New Zealand and international issuers, adding around 5% to foreign currency denominated bonds during the month, mostly USD-denominated, given attractive spreads and above average new issue concessions.

Rate markets continue to be volatile. The MOVE index, a measure of implied volatility across a number of points on the US Treasury yield curve, continued to rise throughout the back half of March despite volatility across traditionally riskier asset classes, equity and foreign exchange, trending lower over that period. We don't believe the market has reached peak-hawkishness and as such maintain a low duration portfolio, closing the month with ~1/3rd of a year in overall interest rate exposure.