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 2062.47
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	0.86yrs
Credit spread duration	1.61yrs
Average credit rating	A-
No of issuers	77
Yield to maturity	6.04%

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

Dan Siluk
Portfolio Manager

Dylan Bourke
Portfolio Manager

December 2023

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)	0.91	2.18	6.28	2.24	2.59	4.54
Fund Return (after fees, before sell spread)[1]	0.87	2.06	5.83	1.81	2.14	4.18
Fund Return (after fees and sell spread)[2]	0.87	2.07	5.83	1.83	2.12	4.18
RBA Cash Rate	0.34	1.04	3.85	1.73	1.33	2.76
Active return[3] (before fees and sell spread)	0.58	1.14	2.43	0.52	1.25	1.79
Active return[3] (after fees and sell spread)[2]	0.54	1.03	1.98	0.10	0.79	1.42
Bloomberg AusBond Bank Bills Index	0.37	1.06	3.89	1.71	1.40	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 December 2023.

Performance Commentary

The fund enjoyed one of its strongest months on record in December, returning 0.87% (after class I unit fees). This is consistent with the theme we've been highlighting for some time that the higher yield environment and the strategy's inherent richer credit spread has combined to powerful effect. In addition, there was support from market movements with yields falling dramatically as the market shifted focus to a potential easing cycle globally. Credit spreads narrowed because of this and also with improving odds of a soft landing. This took returns for 2023 as a whole to 5.83% after fees, the highest calendar year return since 2012 and some 183bps above cash, a very pleasing result given the defensive stance of the portfolio with high liquidity and low volatility maintained throughout the period.

Market Commentary

The soft landing thesis gaining prominence was the key market theme in the last month of 2023. Inflation is generally returning to target much more quickly than central banks anticipated, with goods inflation having reverted to a below-target rate in many regions and only the services side lagging. This has opened up the idea that with central banks easing rates, inflation fears have receded, rather than the economy having slid into recession, or seeing sharp rises in unemployment. Bond yields fell dramatically in December as a result, as the focus shifted from rate hikes to rate cuts. US 2yr yields fell by 43bps, with 10yr yields down a larger 45bps. Australia and Europe saw similar sized falls. The UK had even larger declines of over 60bps across the curve, as a sharp slowing in inflation was revealed. NZ had smaller declines of 23bps at the 2yr part of the curve, as the Reserve Bank of New Zealand communicated it was not comfortable with the pace of decline locally.

This is something of a Goldilocks scenario for risk markets. Rates being lowered from their currently restrictive stance takes some pressure off interest payments for businesses, which if combined with an economy still holding firm means top line revenue won't suffer significantly either. Equity markets were buoyed by this scenario, with the S&P 500 up another 4.4% in December to be 15% above the late October lows. Credit spreads narrowed in line with this, with both US physical spreads (Bloomberg Corporate Aggregate OAS) and US synthetic investment grade spreads compressing by 5bps this month.

However, the soft landing scenario is not assured nor universal. Unlike the US where yearly GDP growth of 2.9% remains above trend, economic activity in almost all other developed market regions is below the level normally consistent with unchanged unemployment rates. Economic activity across the Eurozone has not risen over the past year and is below average in the UK, Australia, NZ and Canada. This has seen unemployment turn a corner and move higher across the world, with Canada's and Germany's unemployment rate some 0.9% above the lows of 2022. The current rates of unemployment are still reasonably low by historical standards and if anything, the rise would be a welcome development to take pressure off labour markets and wages growth. However, if the increases were to continue then this weakness could be something to prompt central banks to take rates below neutral at the appropriate time.

It should also be noted that the tightening cycle may not be over everywhere. There may still be another rate hike from the Reserve Bank of Australia if inflation surprises to the upside, given that its inflation forecast does not quite reach its goal of the midpoint of the target range by the end of the forecast horizon. Japan may also see further monetary policy tightening, as the Bank of Japan has understandably been a slow mover in the global tightening cycle.

Outlook

Contrary to many forecasts at the start of 2023, bond yields finished the year at levels very close to where they started, while equities, by and large, were higher across key developed markets. Tightening cycles continued and only turned towards easing in the last two months of the year, with economic growth remaining solid and supporting risk market valuations. This coming year is very unlikely to see the same outcome.

We would argue that 'The Year of the Bond' is far more likely in 2024, given the high underlying level of yields and greater certainty around the future direction of monetary policy. The possibility of cuts as soon as early 2024 means further capital appreciation could be a big tailwind. However, the strength of that force depends on whether central banks simply cut rates to move back towards a more neutral setting in a soft landing scenario or move towards a stimulatory stance in a hard landing scenario. Either way, increasing your exposure to fixed income in 2024 is likely to pay dividends.

Whilst there is a greater certainty around fixed income, the outlook for risk markets is far less clear. If we get the soft landing that markets are currently pricing, then equities would likely see new highs in 2024 as earnings growth continues with economic growth. If the lagged impact of rate hikes is such that the hard landing scenario plays out, then risk markets may fall significantly along with the economy. The key variable to consider for 2024 is therefore likely to be the amount of exposure to risk markets in your portfolio.

Portfolio Strategy

A defensive posture has been beneficial for most of 2023 but with the business cycle at something of a turning point we turned less defensive in December.

With the central bank tightening cycle globally appearing to be at an end in many jurisdictions and approaching it elsewhere, it makes sense to take our rates exposure from the low side of average in early 2023 to at least average by the end of 2024. To that end duration was increased from around 0.7yr to close to 0.9yr at the end of 2023. This actually understates the exposure due to some very near-term short positions pushing against the idea of rate cuts in Q1 or early Q2. In terms of jurisdiction, we maintained our US long duration position and increased exposure to the Euro area, reflecting that inflation is close to target in that region (like the US) and that economic activity is below trend. We also introduced a short position in Australia, reflecting that there may still be rate hikes from the Reserve Bank of Australia and the market has instead moved to price in a cut by June. The intention remains to increase the exposure to rates market as the tightening cycles comes into sharper focus, as well as when market pricing has less immediate and sharp rate cuts in early 2024.

The portfolio's physical spread duration remained fairly stable below 2yrs, with CDX protection further reducing it to a net spread duration of ~1.5yrs, resulting in the portfolio continuing to have a lower sensitivity to spread change than we have historically targeted (when spread duration was closer to 2.75-3yrs). The high coupon continues to provide a return robustness which hasn't been seen for around a decade. The quality of this coupon is strong given it is comprised of a higher than average credit spread, despite being focused on shorter dated assets. Given this high coupon we remain cautiously optimistic.

In terms of asset allocation, the portfolio can be split across three major 'buckets'; financials (~1/2), corporates and REITs (~1/3), and asset and mortgage-backed securities (<15%) with the residual in cash and liquids. Close to ~90% of the portfolio is held in Australian & New Zealand names, and by currency <5% is held in non-AUD denominated securities.

Portfolio liquidity remains high and reduced slightly over the month as we deployed to take advantage of carry (and limited issuance over the seasonally quiet period) with 'Level 1' liquidity at ~12% (cash, commercial paper, SSGA) and at the high end of the range for 'Level 2' liquidity at ~19% (<1yr investment grade). We believe this mix provides the flexibility to buy when credit is cheap.