Alexander Funds

The Alexander Perspective

Quarterly Update
March 2023

www.alexanderfunds.com.au
1300 138 401
info@alexanderfunds.com.au
AFSL 476697

CEO's Update

Welcome to the latest quarterly update from Alexander Funds.

There has been a flurry of market activity this quarter. A rebound in January was undermined by strong economic data in February, causing markets to reassess their expectations for global interest rates. Of course, this was before shockwaves were sent through markets following the collapse of Silicon Valley Bank in March. Add in the prevailing geopolitical uncertainty and it would appear that market volatility and inflationary uncertainty will continue to create challenges for markets and investors over the course of 2023.

Our investment team have been hard at work to adapt to these dynamic market conditions and I am happy to report that our funds have exceeded their benchmark returns throughout the quarter. Our high allocation to floating rate assets continues to benefit both of our funds, with the Credit Income Fund and Credit Opportunities Fund achieving annualised returns to 31 March 2023 of 4.56% and 5.86% respectively.

Outside of markets, in February we appointed our first distribution team member in Sydney. I'm delighted to welcome James Curnow as Regional Distribution Manager, NSW and QLD. James has worked for many different businesses in the Australian wealth market in the past, and his background provides him unique insight into the provision of multi-asset portfolios for both retail and wholesale advice firms. As the market for advisors continues to adapt in the wake of the royal commission, James and our Head of Distribution, Chris Inifer, are adding valuable insights to our investor experience.

In the following pages, our investment team delve into the current economic landscape and how they are positioning our portfolios. As always, we are deeply committed to maintaining open lines of communication with our investors and welcome your feedback and suggestions as we work to achieve quality investment outcomes. Thank you for your continued support and dedication to Alexander Funds, and I look forward to updating you next quarter.

Warm Regards

Rachel Shirley
CEO

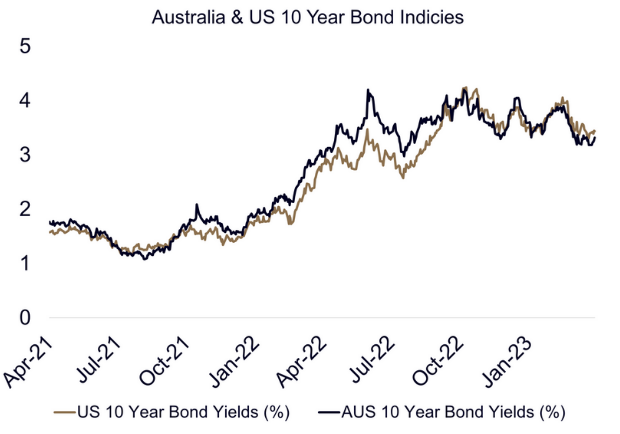
Market Commentary

What happened over the quarter?

Risk markets have already faced some significant challenges to date in 2023, with the common thread between the various flash points being a connection to the substantial rise in interest rates seen across most of the developed world over the past 12 – 18 months.

As a reminder, the combination of extremely accommodative monetary and fiscal policy enacted in response to the drop in activity created by the COVID pandemic resulted in a sustained rise in inflation. Central banks initially classified the lift in inflation as temporary and were therefore slow to adjust monetary policy settings as reported inflation rose. As a result, monetary policy effectively "fell behind the curve" and in order to bring inflation lower and back towards the level targeted by central banks (around 2-3%), the required adjustment in interest rates has been significant and swift (as per charts 1 and 2).

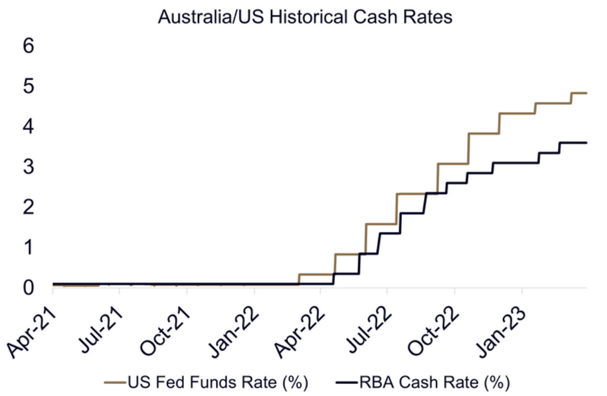
Chart 1



Source: Bloomberg

The ripple effects from a dramatic shift in the prevailing level of rates is typically substantial and difficult to predict. In the March quarter, some of those ripple effects became self-evident through multiple bank failures (which we explore in detail below), once again putting monetary and regulatory authorities into crisis mode.

Chart 2



Source: Bloomberg

US Regional Banks

In the US, the failure of Silicon Valley Bank (SVB), the 18th largest bank in the US a week before bankruptcy, brought the health of the entire regional banking sector into question. SVB had some unique characteristics including;

- A concentrated deposit base versus a typical consumer bank (only 3% of its deposits were under the $250k specifically insured by the Federal government);
- A large portion of its assets were held in government bonds (as opposed to making loans) whose carrying value was impacted by the sudden rise in rates discussed above.

These 2 factors resulted in a situation where;

- The carrying value of SVB's assets suffered a significant decline on a mark to market basis (notwithstanding the fact that ultimately the chance of the US government not repaying its debt is effectively zero) and the company was forced to try and raise equity to cover the decline. It's worth noting that if SVB had been lending funds, outside of specific impairment on individual loans, they would not have suffered the same decline in asset values.
- The concentration of its deposit base meant that when customers started to leave, as they were concerned about the impact to their "uninsured" deposits, it created a fast and dramatic run on SVB's funds.

Market Commentary

Given banking has largely moved online and the dissemination of information is almost instantaneous via online news and social media, SVB's insolvency played out in a matter of days.

While the SVB situation has some unique elements, not surprisingly, consumers and investors began asking the question "who's next?" and the entire regional bank complex in the US came under similar pressures.

As background, the US banking landscape is quite different to the Australian market, which is dominated by a few large players. While the US has large banks as well (JP Morgan, Morgan Stanley, Wells Fargo etc.), it also has over 4,000 regional banks generally serving a specific region (state of city) or industry. The large US banks fall under a regulatory regime that is defined globally for systemically important banks and was tightened considerably post the GFC (major Australian banks also broadly operate under this regime). However, the US regional banks fall under a mix of state and federal legislation and oversight that can be less prescriptive and potentially viewed as less secure.

SVB's failure brought this issue into focus and regional banks began to suffer huge deposit withdrawals as consumers flocked towards either large banks or short-term money market funds. This led to a further bank failure 2 days later (Signature Bank) before the FDIC stepped in to effectively insure all deposits from SVB as well as creating an additional liquidity facility for banks to access during times of funding stress. In the short term, this has helped relieve some of the pressure caused by deposit flight within regional banks.

Additional Tier 1 (AT1) & Credit Suisse (CS)

CS did fall under the regulatory regime for large banks discussed above and its balance sheet was constructed in compliance with all requirements right up until the point it was sold to UBS under a forced agreement from the Swiss National Bank. CS's troubles were different to that of SVB, a litany of poorly managed risks over the past 15 years (Archegos Capital, Greenshill to name a few) left the bank with a questionable reputation that had resulted in deposit outflows well ahead of SVB.

However, these accelerated post SVB's failure to a point where CS could no longer guarantee solvency. Putting aside the question of how such a large institution can effectively disappear so quickly, one of the key issues for credit market relates to how CS's sale was implemented and the decision by the SNB to write down all CS AT1 bonds to zero in the process.

What are AT1 bonds?

Post the Global Financial Crisis, banking regulators created additional layers of capital within a bank balance sheet ultimately designed to provide more protection to deposit holders (and by extension taxpayers who implicitly back the banking system during times of stress). One of these layers was Additional Tier 1 Capital (AT1). AT1 was designed to sit directly above equity but with debt characteristics and unique features in its structure that acts as a buffer to senior bond holders and depositors during times of stress. In the event of the bank issuing the AT1 bonds being deemed insolvent, the documentation allows a range of potential outcomes (at the regulators discretion) including conversion to equity. In the domestic market, the ASX listed hybrids offered by the banks are considered AT1 bonds.

Holders of CS AT1 bonds discovered that governing documentation also allows for ATI to be completely written off even if equity capital still persists. This outcome, seemingly at odds with the normal hierarchy of a bank's capital structure, led to a reset of AT1 bond pricing as the market began to digest questions such as;

- Do the actions of the SNB create precedent for how other central banks will react in similar circumstances?
- What is the appropriate premium for AT1 bonds over senior bonds from the same issuer?

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Market Commentary

In response to the first question, the Bank of England and European Central Bank made statements reiterating their stance that AT1 bonds ranked senior to common equity in the event of bank insolvency.

The second question will be influenced (as always) by prevailing market conditions at the time, however, particularly in Europe, the ability for banks to issue new AT1 bonds would appear to be challenging in the short term.

In Australia, under a similar scenario, hybrids would be converted to ordinary equity and thus don't face the same risk of having their position effectively subordinated to shareholders at the point the bank is deemed insolvent. However, the practical reality is that in the event of a bank insolvency the most likely outcome for equity is also a complete write off.

Alexander Funds has historically held no exposure to AT1 bonds (and continues to have no exposure), primarily based on the relative value for risk on offer in AT1 versus other bank bonds (i.e. senior and Tier 2). This lack of value is most stark in the local market due to the unique supply/demand dynamics in the ASX listed hybrid market. Retail investors in Australia have traditionally had limited options to access fixed income securities directly. ASX listed hybrids allow individuals to access an income producing security in companies they recognise and trust (i.e. major banks) through a mechanism they understand (i.e. trading via the ASX).

These factors combine to create strong ongoing demand for bank issued, ASX listed hybrids which ultimately leads to them (in our view) being expensively priced relative to the full universe of opportunities for institutional investors. In addition, holding these securities effectively adds equity market beta into an asset class that is often tasked with the role of providing diversification from equities at a whole of portfolio level. While we recognize there is a price for everything and don't rule out participating in AT1 bonds in the future, we would require a significant relative pricing adjustment from current levels to do so.

Update on our key focus areas for 2023

In the previous edition of The Alexander Perspective, we outlined some key focus areas for 2023 that were influencing how we constructed our portfolios. The key narrative was;

- The RBA has tightened monetary policy significantly in a (relatively) short amount of time.
- The Australian consumer is generally over-levered after years of sustained growth in house prices.
- The large amount of very low, fixed rate mortgages issued under emergency COVID funding measures predominantly roll off in the back half of 2023 and create a delay to the normal transmission of monetary policy.
- These factors combined create a material risk of a monetary policy mistake that pushes the domestic economy into recession.

Over the quarter, we've seen the RBA add another 50bps to the cash rate, before pausing in April on the back of some slowing of domestic data and the impact of heightened volatility created by the issues in the global banking industry discussed previously.

While the pause in monetary tightening from the RBA does offer some potential respite, our view remains that the risk of a material slowdown in the domestic economy is significant and our portfolios continue to be positioned accordingly.

Sector Performance & Fund Positioning

Debt Capital Markets

After rallying into the end of 2022 debt capital markets continued to trade positively in 2023, with new issues predominantly coming from the financial sector. The market was willing and able to digest new issues, with one of the highlights being the issue of Tier 2 bonds with a 10 year call date (typically these bonds are issued with a 5 year call), with the initial bond from ANZ rallying ~65 bps within a week of being printed. Early March proved problematic on the back of SVB and Credit Suisse, however, central bank support mechanisms in the US and swift deal making in Switzerland helped restore market liquidity in the third week of the month.

After a significant hiatus, the market began to see some primary issuance from corporates (corporate issuance in the Australian market was down 70% in 2022). Telstra led the way with a well received 5 year transaction that priced inside of major bank senior bonds with a similar maturity. Given the relatively tight pricing, we did not participate in the Telstra transaction. Our investment within DCM over the quarter was focused on short dated Senior and Tier 2 financial bonds.

Private Assets

The opportunity to deploy capital in private funding warehouses for Non-Bank Financial Institutions remains robust and offers the best risk adjusted return across the full spectrum of our universe. The demand from non-banks for warehouse funding continues to grow in excess of the supply available and our deal pipeline is full of opportunities with established lenders at credit ratings firmly within investment grade. In addition to increasing capacity for some existing investments, we have several new transactions to finalise over the course of Q2.

Our portfolio and opportunity set in this market covers a broad range of lending types, including residential mortgages, equipment finance, consumer autos, SME lending, commercial mortgages and specialist consumer lenders.

Structured Credit

Issuance in structured credit markets remained persistent and generally well supported over the quarter, with several deals being upsized and note tranches being oversubscribed. Despite the increased investor appetite there was no sustained rally in pricing, suggesting that the market has found an equilibrium for now.

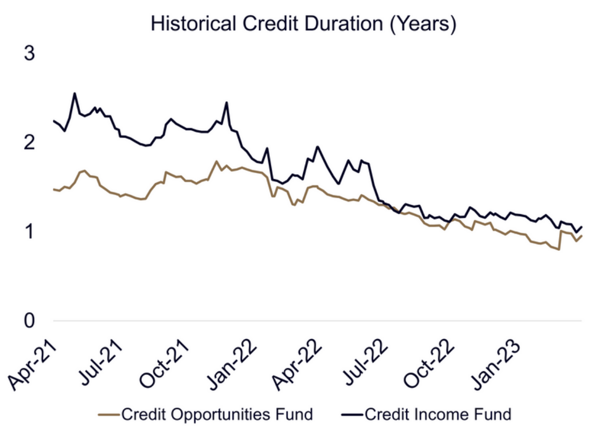
Within RMBS and ABS markets, in keeping with our strategy of the last 6-12 months, our activity remained centered on short duration (i.e. less than one year), high credit quality (AAA rated) notes which help support the running yield of both funds without taking any meaningful market or credit risk.

Fund Positioning & Activity

Given our cautious view of the Australian economy and general pessimism about the likelihood of both the US and Europe avoiding recession in the next 12 months, our high-level portfolio strategy has remained consistent for the past 6-9 months and we suspect will continue to do so until late in 2023.

The core of the strategy is to limit market exposure (i.e. the risk that all assets reduce in price due to a broad increase in risk aversion) which can be measured in both portfolios' credit duration (chart 3).

Chart 3



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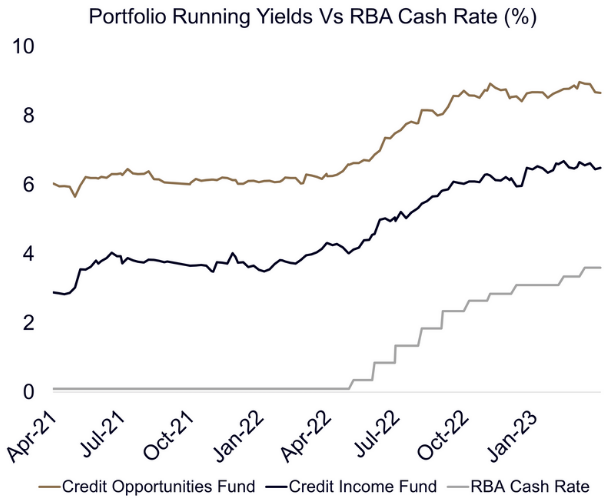
Sector Performance & Fund Positioning

Fund Positioning & Activity

We're able to take this conservative stance without dramatically sacrificing potential returns due to the high credit quality but short duration opportunities available within the private warehouse funding market that help underpin a running yield for both portfolios in line with historic levels (chart 4).

Chart 4



If our fears are unfounded and the domestic economy proves to be more resilient and credit markets rally from here, the running yield on both portfolios still provide a healthy return over cash rates despite potentially sacrificing some upside from capital appreciation.

With credit spread duration in both the Credit Opportunities Fund and Credit Income Fund of around one year, on average the securities across both portfolios mature in 12 months. This means that both portfolios generate a significant amount of cash each month due to the maturity of securities.

This gives us the flexibility to pivot our approach and take advantage of markets that have repriced in times of volatility.

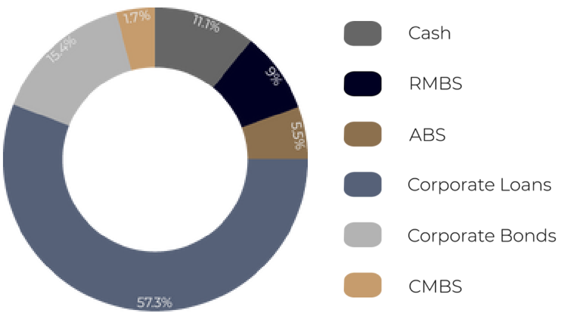
Fund Perfomance

Credit Opportunities Fund

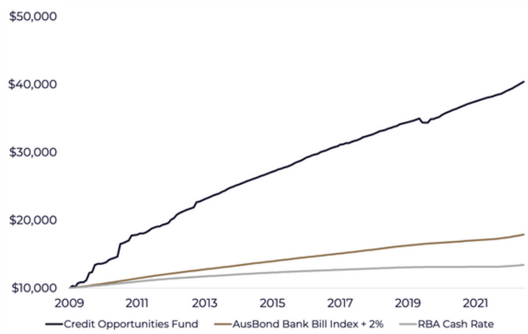
The Alexander Credit Opportunities Fund has a benchmark of the AusBond Bank Bill Index +2% pa. The Fund achieved a net return of 1.76% for the quarter ended 31 March 2023 for an annualised net return over the previous 12 months of 5.86%, and paid a distribution for the quarter of 2.5 cents per unit.

	Fund	Benchmark
1 Month*	0.56%	0.46%
3 Month	1.76%	1.29%
6 Month	3.40%	2.56%
12 Month	5.86%	4.10%
3 Year (pa)	5.50%	2.76%
Since Inception (pa)	10.96%	4.43%

Portfolio˜ as at 31 March 2023



Performance of $10k Invested Since Inceptionˆ

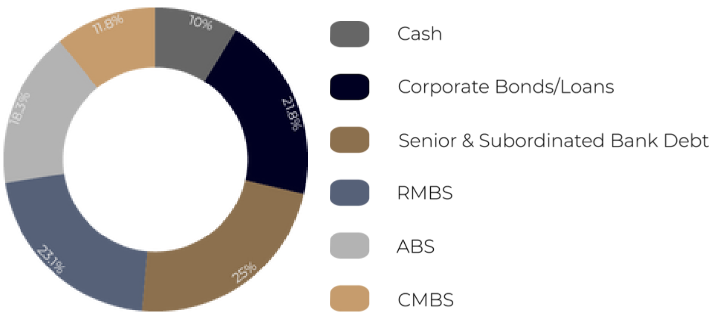


Credit Income Fund

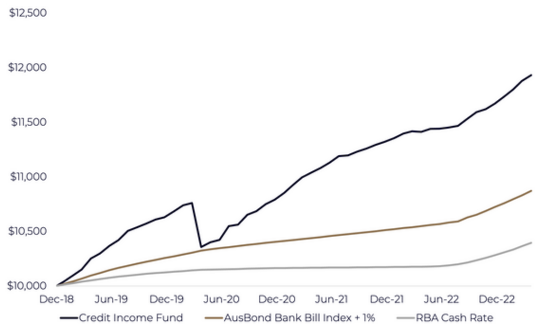
The Alexander Credit Income Fund has a benchmark of the AusBond Bank Bill Index + 1% pa. The Fund achieved a net return of 1.68% for the quarter ended 31 March 2023 for an annualised net return over the previous 12 months of 4.56%, and paid a distribution for the quarter of 1.25 cents per unit.

	Fund	Benchmark
1 Month*	0.46%	0.38%
3 Month	1.68%	1.04%
6 Month	3.00%	2.05%
12 Month	4.56%	3.07%
3 Year (pa)	4.83%	1.74%
Since Inception (pa)	4.16%	1.94%

Portfolio˜ as at 31 March 2023



Performance of $10k Invested Since Inceptionˆ



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Notices & Disclaimers

 * The monthly return is an actual return net of all fees, costs and taxes generated by dividing the redemption unit price by the previous month's redemption unit price. Past performance is not a reliable indicator of future performance. All return figures for periods greater than 12 months are annualised.
~ Portfolio Composition is net of hedges
^ Assumes reinvestment of all distributions

Alexander Funds Management Pty Ltd (ABN 77 136 871 924) (AFSL 476697) ("Alexander Funds") is the Investment Manager of the Alexander Credit Opportunities Fund (ARSN 156 026 514) ("ACOF" or "Fund") and the Alexander Credit Income Fund (ARSN 629 915 199) ("ACIF" or "Fund"). Equity Trustees Limited ('Equity Trustees) (ABN 46 004 031 298) AFSL 240975 is the Responsible Entity for the Fund. Equity Trustees is a subsidiary of EQT Holdings Limited ABN 22 607 797 615, a publicly listed company on the Australian Securities Exchange (ASX: EQT).

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ACIF's PDS and TMD can also be found at
https://www.alexanderfunds.com.au/alexander-credit-income-fund
ACOF's PDS and TMD can also be found at
 https://www.alexanderfunds.com.au/alexander-credit-opportunities-fund

A Target Market Determination is a document which is required to be made available from 5 October 2021. We recommend that you read this document as it describes who this financial product is likely to be appropriate for (i.e. the target market), and any conditions around how the product can be distributed to investors. It also describes the events or circumstances where the Target Market Determination for this financial product may need to be reviewed.

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1300 138 401
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