Daintree
CAPITAL

# DAINTREE HYBRID OPPORTUNITIES FUND (MANAGED FUND) (ASX: DHOF)

## MONTHLY FACTSHEET: 30 September 2021

## Awards & Credentials

The Daintree Hybrid Opportunities Fund (Managed Fund) (ASX: DHOF) is rated as a Superior offering by SQM. Daintree Capital is also a signatory to the United Nations Principles for Responsible Investment.

Signatory of:

## Fund Description

DHOF targets an absolute return over time by investing in a diversified portfolio of hybrid securities which offer the best risk adjusted returns available from a global universe of securities.

We have applied for DHOF to be admitted to Trading Status under the AQUA Rules, with an expected trading date in November 2021.

## Fund Objective

The aim of DHOF is to provide a steady stream of income over the medium term, by investing in a diversified portfolio of Australian and global hybrid securities and cash, and to provide a total return (after fees) that exceeds the Benchmark by 3.5%-4.5% measured throughout a market cycle.

## Monthly Highlights

- Wider credit spreads detracted from performance in September
- Higher bond yields also detracted, although this was mitigated by the low duration stance of the fund. Longer-term, higher rates enhance the profitability and therefore credit quality of the underlying securities in the fund

## Key Statistics

| | |
|---|---|
| Modified Duration (Yrs) | 1.24 |
| Spread Duration (Yrs) | 2.38 |
| Running Yield (%) | 3.90 |
| Average Credit Quality | BBB |
| Portfolio ESG score (MSCI) | A |

Note: Portfolio yield is the expected return over the next year, assuming no changes to either portfolio composition or market yields. Average credit quality excludes overlay positions. Portfolio yield and spread duration reflect the net credit default swap exposures in the portfolio. The Portfolio ESG score is the weighted average portfolio ESG rating based on Daintree Capital's application of MSCI data. Data as of 31 July 2021

## Fund facts

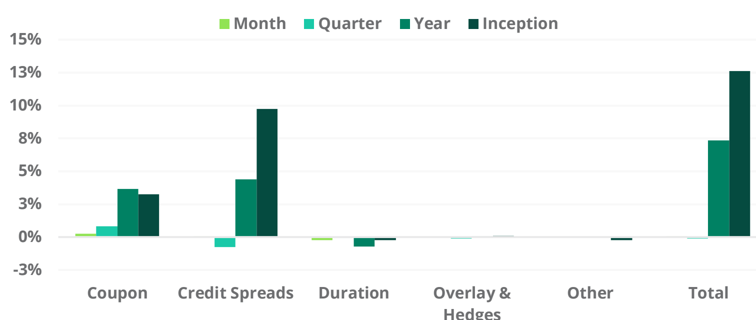
| | |
|---|---|
| Trust name | Daintree Hybrid Opportunities Fund (Managed Fund) (ASX: DHOF) |
| Responsible Entity | Perennial Investment Management Ltd |
| Portfolio managers | Brad Dunn, Mark Mitchell & Justin Tyler |
| Inception date | 1 March 2020 |
| APIR code | WPC2054AU |
| ISIN | AU60WPC20540 |
| Management costs | 0.65% pa + 0.10% pa expense recovery |
| Buy/sell spread | +0.10% / -0.10% for unlisted units; exchange-quoted spread for listed units |
| Entry and exit fees | None for unlisted units; broker fees applicable to listed units |
| Initial investment | $25,000 for unlisted units; no minimum for listed units |
| Distribution frequency | Quarterly |
| Currency | Australian Dollar |

## Performance & Analytics

| | Month (%) | Quarter (%) | 1 Year (%) | Inception (% pa) |
|---|---|---|---|---|
| Fund (gross) | 0.03 | -0.10 | 7.33 | 12.61 |
| Fund (net) | -0.03 | -0.29 | 6.59 | 11.86 |
| Distribution (net) | 0.60 | 0.21 | 1.17 | 1.34 |
| Growth (net) | -0.63 | -0.50 | 5.42 | 10.52 |
| RBA Cash Rate | 0.01 | 0.03 | 0.11 | 0.17 |
| Excess Return | -0.04 | -0.32 | 6.47 | 11.69 |

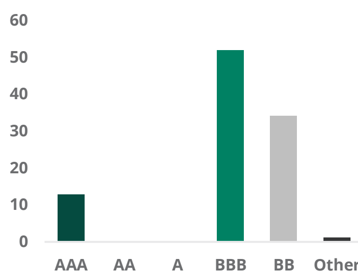
Note: Performance inception is 1 March 2020. Excess return is measured with reference to net performance. Returns for periods longer than one year are annualised. Distribution return is the difference between total return and ex-distribution unit price return. Past performance is not a reliable indicator of future performance.

### Performance Contribution (Pre-Fees)



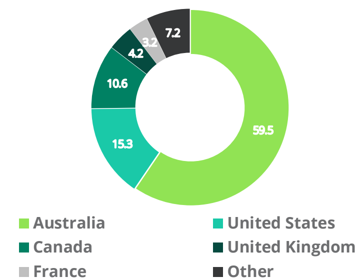

Note: Overlay strategies use derivatives to ensure that the fund exposure to interest rates, credit and other relevant factors is controlled separately to the physical assets in the portfolio

### Rating Exposure (%)



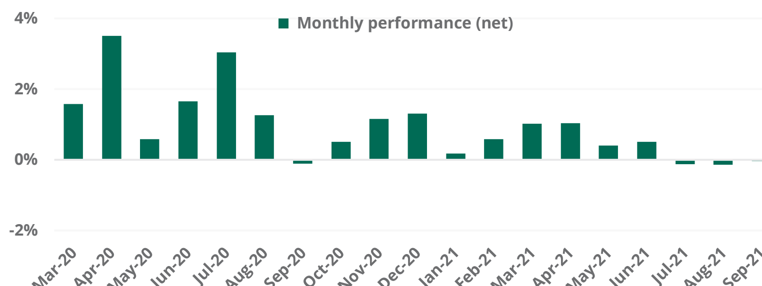

Data as of 31 July 2021

### Country Exposure (%)




Data as of 31 July 2021

### Monthly Performance




### Cash Income

The Fund distributed 0.60 cents per unit in September. The next distribution is expected in December.

## Distribution Partners

## Fund Review

The Fund posted a modest negative result for the month, with credit spreads primarily responsible for the underperformance. Ongoing inflationary fears saw interest rates respond to the upside, especially in September. Hybrid securities have a complicated relationship with movements in nominal rates. Floating rate instruments, representing about half of net assets, have coupons based off short-term interest rates which we expect to remain at or near zero for at least the next two years in Australia. However, judgments on the appropriate spread to trade at are based on different parts of the rates curve and are driven by a wide range of factors, including inflation expectations. When it comes to the offshore portfolio, upward movements in interest rates are most closely associated with the improving profitability of the issuers, despite their higher duration exposure. Performance of the fund over recent months typifies the interplay of these cross-currents.

At a more fundamental level, the portfolio retains a high level of issuer diversity, and a weighted spread duration that allows for flexibility to respond to rapidly changing market conditions. We continue to identify pricing discrepancies that favour offshore issues compared to local offerings. From a short-term income perspective, the yield advantages on offer are more than 100bp compared to Australian yields. Recent primary issuance in Australia suggests there is strong demand, leading to flat spread curves and no new issue concessions. The implementation of new Design and Distribution Obligations from early October may also impact market dynamics in the coming months.

## Outlook

Much airtime is devoted to the September seasonal weakness that is often seen across financial markets. September 2021 once again provided confirmation to those who take views on such things. At its lows on September 29, the benchmark ASX200 index had reverted to levels last seen in June. This weakness in equities was driven by moves in government bond markets that were the most dramatic seen since February this year - government bond prices fell, and their yields re-traced almost two months of moves lower. The Australian benchmark 10-year government bond maturing in November 2031 saw its yield move more than 40 basis points higher from its low of 1.0785 on August 20, ending September at 1.49. Holders of this bond will now need to earn more than 2 and a half years of the 1% coupon return on offer to offset this latest loss of value. Another illustration of the perils of excessive interest rate risk exposure in bond portfolios.

Weakness was not confined to government bonds though, as credit spreads also moved wider. Volatility in credit markets, however, remains much lower than volatility in either government bonds or equities. For example, credit spreads in Australia were between zero and 5 basis points wider on average, a much lesser move than the sorts of moves seen in government bond markets. Offshore credit spreads moved a little more but importantly, we see credit as being supported by low net issuance and a continued hunt for relatively safe income on the part of investors.

As always, the key question for financial markets is how the macroeconomic backdrop will evolve. Will risk markets resume their march higher? Concerns abound: Covid in the northern hemisphere winter; the recurring US debt ceiling saga; falling Chinese growth amid tighter fiscal policy in both China and the US; and policy normalisation on the part of several global central banks as they come to the realization that global inflation may not be as transitory as they first thought. We expect markets to continue pricing a 'living with Covid' status quo which will see the pricing of downside tail risks from this source diminishing over time. We also expect that, once again, the debt ceiling will be lifted in the US and a crisis averted. What really matters though is the distribution of risks around these views. With respect to politics, for example, human nature can and has led to unexpected outcomes throughout history. Covid presents a range of issues to consider too - risks include the potential for break-through infections to accelerate amid falling vaccine efficacy, as well as the potential for long Covid to be revealed as a significant public health issue. We feel that given the elevated pricing of some markets (US equities in particular) the potential impact of the major risk factors is significant now.

When we add central bank policy normalisation to the mix, the clouds darken further. Even though recent central bank speeches have fallen on the dovish side and managed to appease markets, each speech that is successful in this regard heightens the bar for future communications. Eventually, market expectations of central banks will be sufficiently dovish that a disappointment will register, or alternatively the credibility of a consistently dovish stance will be bought into question by the data flow. Inflation is already very elevated, and the yield curve steepening seen in September may mark a new phase for bond markets on this issue. We feel that policy makers are ushering in a period of increased uncertainty in markets, whether they want to or not. Our view on inflation has evolved too, and this informs our view on central banks. Is it sensible, for example, to expect shipping costs to fall? Shipping capacity constraints are already prompting companies to increase precautionary inventories, which will in turn increase these shipping-related cost pressures further. Feedback loops like this turn transitory outcomes into long-lived ones in the absence of a policy response. On the supply side, new capacity in both shipping and ports takes years to develop and environmental regulations will increase the costs of such upgrades. Moving from shipping to the consumer, we wonder what happens if Covid does remain under control and travel picks up just as commodity prices (notably oil) are accelerating? Increased services prices beckon at a time when supply chain pressures remain high.

The balance of risks with respect to inflation seems clear and the required policy response is clear as well. What is unclear is the willingness of central banks to cause the sort of market disruption that an accelerated pace of tightening will cause. The problem is that a market correction will be forthcoming anyway if central banks do not react appropriately to incoming data.

We are positioning our portfolios defensively given the particularly uncertain backdrop. Central bank tapering is well-priced by markets, but we watch real yields in the longer-end of the US curve which have risen sharply from record lows over the last two months. Further increases could hamper risk asset valuations. We see US wage growth as perhaps the single most important variable to focus on in the near-term, because the transient inflation narrative will come under further pressure if wages growth does not slow in the coming months in line with increased US labour supply (given the end to unemployment benefits earlier this month) and a decelerating US fiscal pulse. If wage growth cannot decelerate against this backdrop, we feel that treasury yields will see more upward pressure. The likelihood that both treasuries and equities fall in value together will increase. Investors who have not closely assessed the amount of duration risk they are holding in their defensive asset allocation should now address this as a priority.

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