Alexander Funds

The Alexander Perspective

Quarterly Update
September 2022

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CEO's Update

Welcome to our first quarterly update for the 2023 financial year.

2022 has reminded us that investment markets can move quickly and aggressively. Just look at how much the Australian market has changed in the past 12 months. This time last year, cash rates were at 0.10% compared to the current 2.60%. The ASX200 was around 7500 and is now around 6500. A trip overseas (if you could manage to leave the country) was a lot cheaper, with our dollar buying 75 US cents versus the current exchange rate of 62 US cents. Volatility is back, and it looks like it will be sticking around for a while.

Despite this, I'm happy to report that our funds continue to perform well in this challenging environment, benefitting from our decision to invest in primarily floating rate assets and reduce risk in the portfolio. Both have seen an uplift in their quarterly returns since June, with the Credit Income Fund and Credit Opportunities Fund seeing an increase in their three month performance figures of 0.80% and 0.42% respectively.*

We continue to be recognised for our achievements, with the Credit Opportunities Fund receiving Best Fixed Income and Credit Fund at the Australian Alternative Investment Awards in Sydney last month. The fact that we have received this award six times in the previous nine years demonstrates the effectiveness and resilience of both our investment strategy and dedicated team.

Alexander Funds reached a new milestone in the first quarter of the financial year, with over $500 million under management across our two portfolios. Our investment team's primary focus throughout the period has been to ensure that this growth is supported by investments in high-quality, high-yielding assets that benefit all unitholders, as well as to ensure that any new opportunities meet the requirements of our Responsible Investment Framework.

You will see on the following pages how our investment team is reacting to the current economic environment and structuring our portfolios accordingly. As always, I hope you enjoy reading this quarter's update and look forward to another successful year for our funds.

Warm Regards

Rachel Shirley
CEO

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Market Commentary

Persistent Inflation Drives Market Movements

After a year in which interest rates rose by historical proportions due to persistently rising inflation, it should come as no surprise that the same issue was the primary driver of market movements during the September quarter. The questions that still have no firm answer are;

- how high do rates need to rise to tame the current inflationary outbreak?
- what impact does that have to growth in the economy?

At various points over the last 3 months, the market has swung between an optimistic and pessimistic outcome for these key questions.

Inflation and its trajectory are key factors for the outlook of all asset markets and, outside of commodities, the historical impact of rising inflation is almost universally detrimental to returns. As such, after a multi-decade period of benign inflation, the current change in regime represents the critical factor for investors to consider across all asset classes when constructing a portfolio.

Several factors have contributed to the reversal of the 40-year deflationary trend. These include;

- Broken supply chains from COVID;
- The impact on commodity prices from the Ukraine War;
- Significant fiscal stimulus injected into economies to support them through COVID lock downs; and
- Expansionary monetary policy settings being maintained well beyond what the economy required.

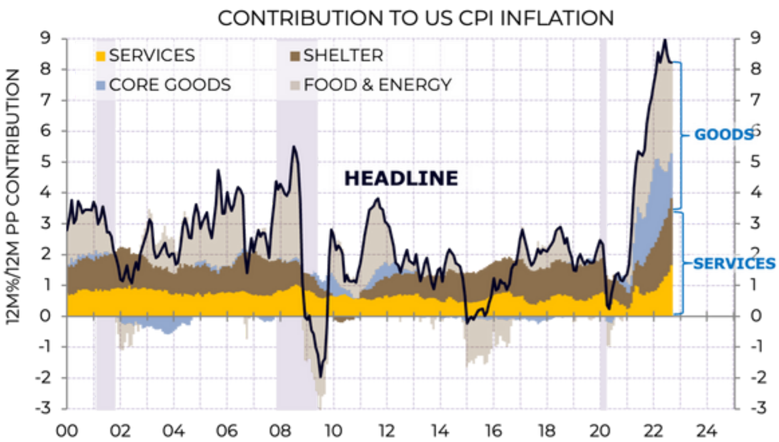
The last point on monetary policy is the factor that draws the most attention from investment markets, as policy makers attempt to shift from being a cause of inflation to being a solution.

United States - Transitory to Permanent

There has been a lot of criticism of the Federal Reserve for being so far behind the times in dealing with the current outbreak of inflation. While there is plenty of justification behind these comments, it's important to recognise the substantial amount of noise created by the impact of COVID lockdowns, particularly on the efficiency of global supply chains.

As seen in the below chart, the initial push higher in inflation was primarily driven by goods inflation. A lack of supply combined with a population quarantined at home, with extra cash from fiscal support programs and idle hands, set their attention to buying goods. In the US, this resulted in the Federal Reserve defining the initial rise in inflation as "transitory" with an expectation that it would return to prior levels once the acute phase of the COVID pandemic passed and supply chains re-opened. With the benefit of hindsight, this was clearly a mistake. Rising inflation was already entrenched in services and wages, so leaving interest rates effectively at zero was pouring additional fuel on a growing fire.

Chart 1 - Contribution to US CPI Inflation



Source: Minack Advisors

Market Commentary

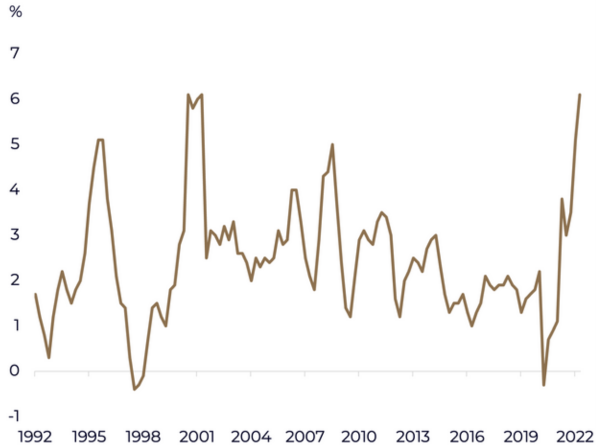
Australia - Similar trend but different degrees

Australia's inflation journey to date has shared many common features with the US, including;

- Large fiscal and monetary stimulus;
- Supply side challenges (particularly in the labor market); and
- A tardy and poorly communicated monetary response (Phil Lowe's February 2022 prediction of no rate rises until 2024 being a highlight)

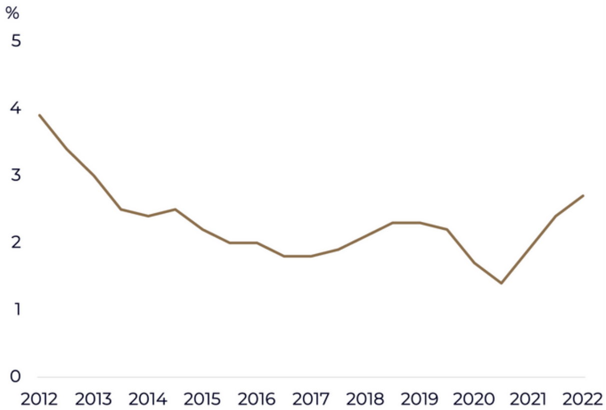
However, it is important to note that the scale of the problem domestically is well below that being experienced in the US and Europe. Whilst CPI and wage growth have increased (Charts 2 and 3), they sit well below the high single digit and low double digit figures seen in the northern hemisphere.

Chart 2 - Australian Consumer Price Index (CPI) Year-ended Change



Source: RBA/ABS

Chart 3 - Australian Wage Price Index



Source: RBA/ABS

Despite inflation being generally more contained than the US, interest rate markets are currently pricing in a similarly aggressive monetary response.

This aggressive future profile for interest rates has been supported by rhetoric from the RBA, which has created expectations of an overnight cash rate well above 3% by early 2023. In our view, the impact to the Australian economy from such a large and rapid move in interest rates makes the domestic economic outlook for calendar year 2023 particularly challenging.

We acknowledge there are factors within the domestic economy that provide some resilience against rate rises, including;

- Interest rates are rising off levels that constitute emergency lows and much of the current change is simply returning to "neutral";
- The Australian consumer has used lower interest rates and lower spending during COVID to generate a higher than normal savings buffer (Chart 4); and
- Many mortgage borrowers took advantage of low fixed rate lending during 2020/21 to fix their mortgage rate so will be immune to the rise in rates until their fixed rate period ends (largely rolling off over 2023).

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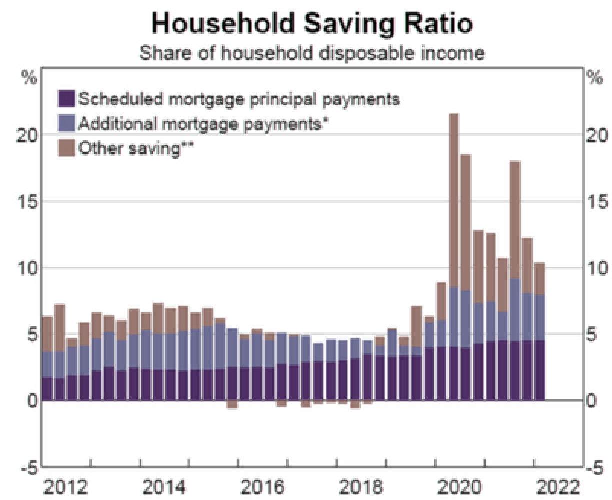
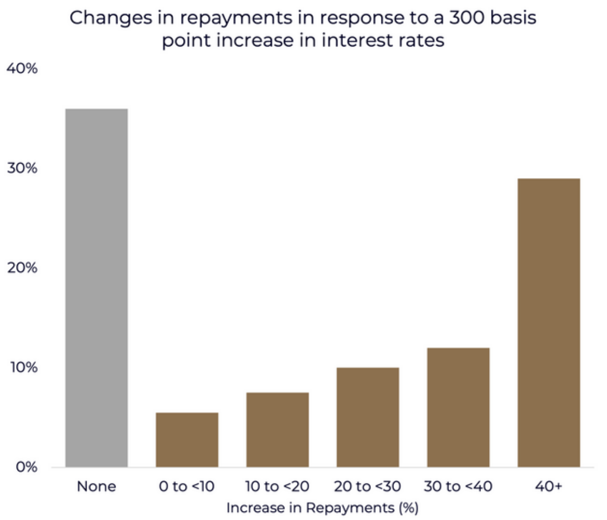
Despite these mitigating factors, the reality is the Australian economy is undergoing a period of the steepest rise in interest rates in well over a generation, at a time when household debt to income levels have never been higher. By the RBA's own estimation, a 300bps rise in interest rates will lead to a 40% increase in mortgage repayments for close to 30% of borrowers (Chart 5).

Chart 4 - Household Saving Ratio



Source: RBA

Chart 5 - Repayment Increases for Variable Rate Loans



Source: RBA

The decrease in consumer spending capacity from rate increases of this magnitude will be material, and while the impact may be reduced through the use of savings, we expect the behavioral impact of a slowing economy will erode a lot of this potential support.

The other balance to this rapid and material change in interest costs is rising wages, but given the magnitude of the change for a large portion of the population, on current evidence it will be insufficient to make any meaningful offset.

Market Commentary

What does this mean for our portfolio and credit markets?

This path forward isn't set in stone. Just because the market is estimating a cash rate in the mid 3% range by early 2023 doesn't mean it will definitely happen, and to this end the RBA has repeatedly stated that the future path of interest rates remains data dependent.

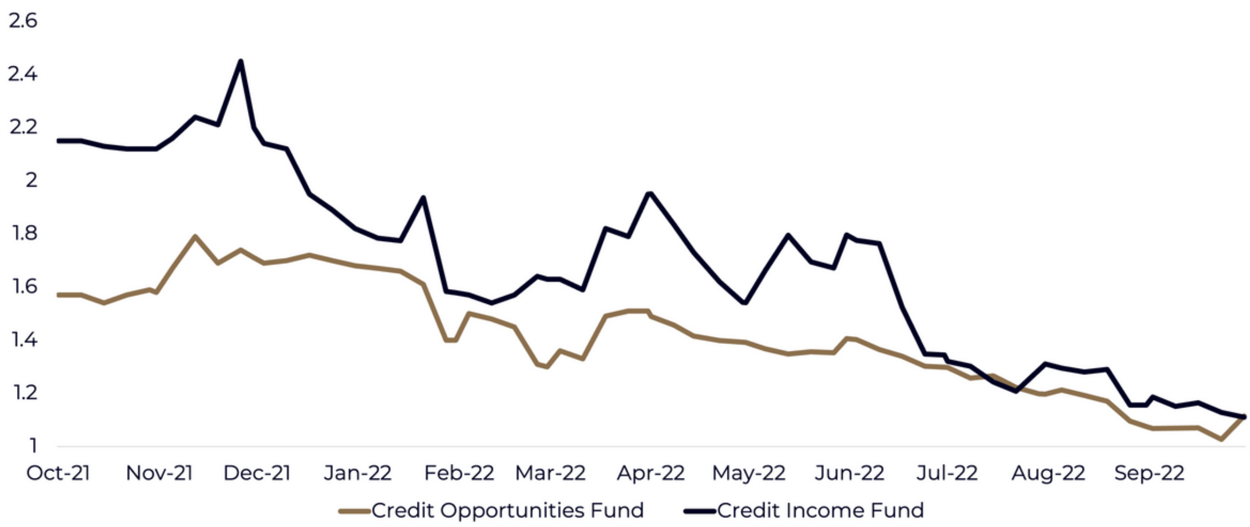
However, Alexander Funds is positioning our portfolios to be resilient under the low growth/recessionary outcome that we expect will result from having the overnight cash rate well over 3% within the first few months of 2023. Importantly, if we're wrong and either the RBA is less aggressive on the cash rate than the current market forecasts, or the Australian economy is more resilient to higher rates than we anticipate, our approach to building our portfolios will still provide our investors with a stable yield.

Minimising Market Risk

Credit markets have already adjusted significantly over the past 12 months, reflecting initially a normalisation in pricing post the removal of significant monetary stimulus and subsequently a deterioration in economic fundamentals over the course of 2022. During this time, Alexander Funds has kept the portfolios' exposure to shifts in the price of risk ("market risk") to a minimum.

A key measure of this risk is credit spread duration, which is a weighted average of the maturity of all securities within the portfolio (i.e. a number of 2 means that on average the portfolio holdings will mature within 2 years). The lower the number, the less market risk within the portfolio. Looking at Chart 6, you can see that as at the end of September, both Funds have a credit spread duration of around 1 year, near all-time lows for both portfolios.

Chart 6 - Historical Credit Duration (Years)



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The Warehouse Market

A core aspect of the portfolio strategy for the last two years has been to access opportunities within private warehouse funding markets. The combination of growth in the non-bank lending sector in Australia driving demand for warehouse funding, and the limited providers of capital in the space, mean that this market represents a chance for the Funds to take advantage of a supply/demand imbalance and earn a superior return relative to risk.

The opportunities within this market have short time frames to maturity, thereby allowing both Funds to still generate a meaningful running yield while still adhering to the preference for keeping the profile of the portfolios short in duration. To achieve similar results with a focus purely on Debt Capital Markets and public RMBS/ABS markets would require buying longer dated securities to benefit from a term premium (while also accepting more market risk), and sacrificing credit quality by buying lower rated securities.

Neither of these are desirable in an environment that we believe will be challenging economically, and by extension within financial markets, over the next 12-18 months.

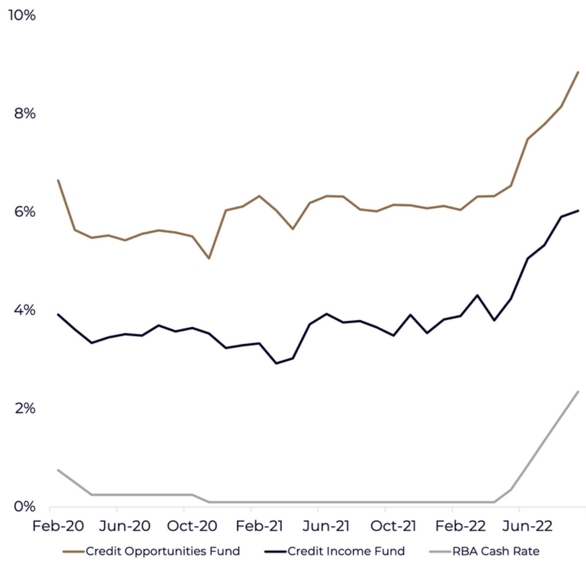
Rising Portfolio Yield

Alexander Funds' portfolios are exclusively positioned to be floating rate exposures. As pure credit managers we will never take active positions on the direction of interest rates by holding (unhedged) fixed rate bonds regardless of the outlook.

Therefore, the impact of rising rates to the yield of our portfolios is positive (with a 1-3 month lag) and as shown in Chart 7, the recent (and any future) rate rises will lift the nominal return of both portfolios (all else being equal).

This is important in considering the prospects of our Funds in the future, but also relevant to assessing historical performance, understanding that results over the last 2.5 years have been in an environment with essentially no contribution from underlying cash rates.

Chart 7 - Historical Running Yield (before fees)



Sector Performance & Fund Positioning

Debt Capital Markets

Over the quarter, debt capital markets reacted positively to a more favourable tone broadly across risk markets in July and most of August.

The change in mood from what had been a relentlessly negative previous 6 months was driven by the market theorising that the current tightening in monetary policy would tame inflation rapidly and potentially allow central banks to begin lowering rates into the drop in growth anticipated to come during 2023.

Chart 8 - Australian iTraxx

Source: Bloomberg

However, as per Chart 8 this rally proved short lived. Persistently rising inflation, combined with an escalation in the hawkish tone from central banks, led the market to the conclusion that higher rates will likely persist beyond 2023.

One segment of the debt capital markets that was able to outperform was major bank Tier 2. Tier 2 was a a clear under-performer in a falling market during the June quarter, mostly due to persistent new issuance on the back of regulatory requirements.

However, the market began to recognise the relative value in the space during July and it has rallied accordingly. During the quarter the Funds participated in new Tier 2 issues as well as buying shorter dated Tier 2 bonds to take advantage of this relative value and subsequent rally.

Structured Credit

The RMBS market struggled to digest new transactions early in the quarter, forcing the credit spread on new issuance up to 100bps wider in the lower rated tranches on proposed deals in the market. However, after adjusting the spreads to meet demand, the market found a level that worked for issuers and investors and new issuance volumes returned to a fairly robust level.

The Funds activity in the space continued to focus on the highest rated (AAA), short average life (~0.5 years) tranches within new transactions, consistent with our conservative view on the outlook for the domestic economy.

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.

We anticipate this trend remaining in place over the medium term with several new transaction in the pipeline stretching into 2023.

Fund Positioning & Activity

The Funds' positioning remains reflective of our cautious view on the outlook for the Australian and global economy over the next 12-18 months.

Credit duration is near its lowest point since inception for both funds and we are deploying maturities into short-dated assets to maintain portfolio yield whilst limiting market risk.

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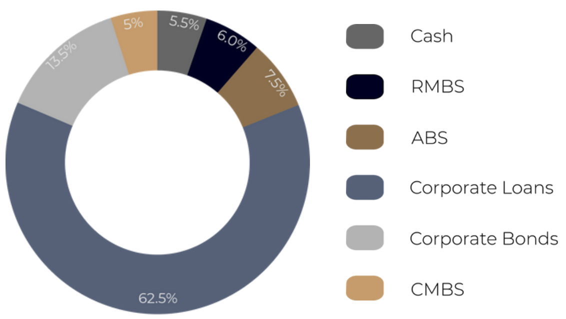
Fund Perfomance

Credit Opportunities Fund

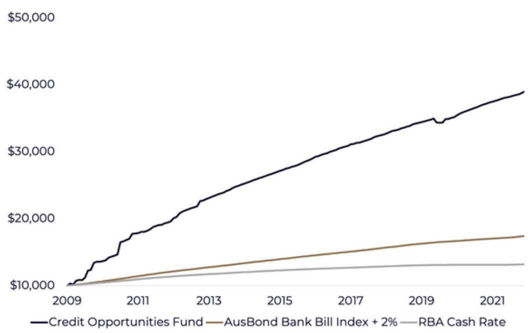
The Alexander Credit Opportunities Fund has a benchmark of the AusBond Bank Bill Index +2% pa. The Fund achieved a net return of 1.39% for the quarter ended 30 September 2022 for an annualised net return over the previous 12 months of 4.49%, and paid a distribution for the quarter of 1 cent per unit.

	Fund	Benchmark
1 Month*	0.54%	0.31%
3 Month	1.39%	0.93%
6 Month	2.38%	1.50%
12 Month	4.49%	2.54%
3 Year (pa)	4.37%	2.41%
Since Inception (pa)	11.12%	4.40%

Portfolio˜ as at 30 September 2022



Performance of $10k Invested Since Inceptionˆ

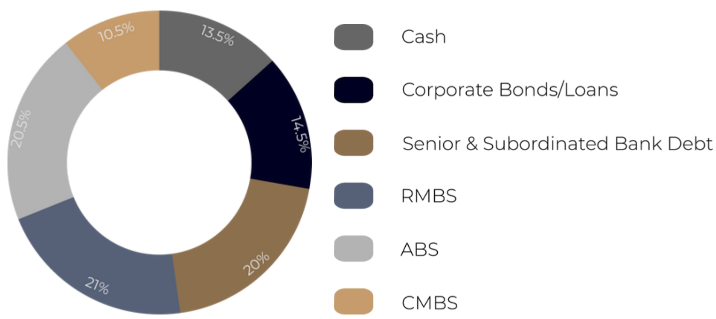


Credit Income Fund

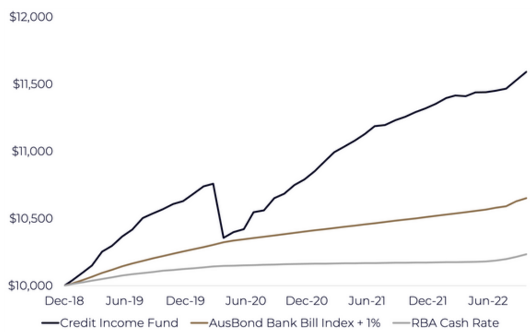
The Alexander Credit Income Fund has a benchmark of the AusBond Bank Bill Index + 1% pa. The Fund achieved a net return of 0.46% for the quarter ended 30 September 2022 for an annualised net return over the previous 12 months of 2.89%, and paid a distribution for the quarter of 1 cent per unit.

	Fund	Benchmark
1 Month*	0.46%	0.23%
3 Month	1.16%	0.68%
6 Month	1.52%	1.00%
12 Month	2.89%	1.52%
3 Year (pa)	3.10%	1.39%
Since Inception (pa)	3.91%	1.74%

Portfolio˜ as at 30 September 2022



Performance of $10k Invested Since Inceptionˆ



Notices & Disclaimers

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* 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.
~ 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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