Challenger IM Credit Income Fund – Class A

ARSN 620 882 055 APIR HOW8013AU

Monthly Report October 2022

Performance[1]

	1 Month (%)	Quarter (%)	6 Months (%)	FYTD (%)	1 Year (%)	3 Years (%) p.a.	5 Years (%) p.a.	Since Inception (%) p.a.[2]
Challenger IM Credit Income Fund – Class A	0.56	0.82	0.96	1.44	1.69	-	-	3.69
Challenger IM Credit Income Fund - Class I[3]	0.56	0.82	0.96	1.44	1.69	2.74	-	-
Bloomberg Bank Bill Index	0.24	0.54	0.75	0.67	0.76	0.43	-	0.38
Active return	0.32	0.28	0.20	0.77	0.93	2.31	-	3.31

Data Source: Fidante Partners Limited, 31 October 2022.

[1] Returns are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures.

[2] The Inception date for Class A is October 1 2020.

[3] As at the date of this report two classes of units are offered: Class I which has been offered since the inception of the Fund on 3 October 2017 and Class A which has been offered since 1 October 2020. For information purposes, and to give a longer term view of the Fund's performance, the returns for the Class I are also provided in the Performance table and shows Class I's performance. The returns quoted for Class I have been adjusted to reflect the fees applicable to the Class A units.

Fund Features

Experienced team - Boasting one of the longest track records In institutional private lending strategies, the team is uniquely positioned to exploit opportunities across both public and private lending markets. The team's breadth of experience allows the Fixed Income team to exploit market inefficiencies across all sectors in the global credit market.

Risk management - The Fund aims to reduce market risk by considering low cross-sectoral correlations and maintaining a relatively short spread duration. The team identifies complexity risks to provide income and what they consider to be attractively priced but hard to access liquidity, allowing the Fund to minimise more volatile currency and interest rate risks.

Diversification - The Fund invests across both public and private credit markets providing the opportunity to allocate to the most attractive sectors over time. The Fund targets a weighted average investment grade rating and the diversified set of asset classes in which the Fund can invest includes secured loans, securitised credit, corporate bonds and real estate debt.

Strong governance - The Fixed Income team's clients benefit from a robust governance framework including an independent credit risk management team within the Challenger Group.

Fund Objective:

The Fund aims to achieve superior absolute returns over the medium to long term whilst offering capital stability and a steady income stream.

Fund Details

Management Fee	0.60% p.a.
Strategy FUM	$500.9 mil
Buy/Sell Spread	+0.18/-0.18%
Distribution Frequency	Quarterly
Redemption Terms	Monthly with 10% Fund level gate

Key Statistics

Number of Issuers	117
Running yield (%) p.a.	5.3
Modified duration (yrs)	0.10
Average Rating	BBB-
Credit Spread Duration (yrs)	2.7
Non-AUD Denominated	30%
Private Credit Allocation	22%

Monthly Commentary

Performance Update: The Fund delivered a positive return in October as markets rebounded from the volatility of late September. The net return for the month was 0.56%, an excess return of 0.32% over the Bank Bill Index. On a trailing 1 year basis, the Fund has returned 1.69%, an excess return of 0.93%, comfortably ahead of the Bloomberg AusBond Credit FRN index which has returned 0.53% over the corresponding period.

Key for us has been the high income generation of the strategy, low allocation to major bank senior bonds which continue to widen plus the neutral duration positioning. In the low interest rate environment that preceded 2022, many managers ran slightly higher duration positions relative to a cash benchmark. Even small overweight positions have been painful with many struggling to deliver a positive outright return, let alone a positive excess return over cash. For the month, tighter credit spreads were slightly offset by the widening in the swap futures basis which we have discussed in previous reports. Income for the month was 0.44%, steadily increasing as the effect of higher interest rates flows through the portfolio.

Over the month there were no individual names which significantly dragged on performance.

Fund Positioning: Throughout 2022, the consistent repricing of risk has necessitated frequent reassessment of our views around fund positioning.

For most of 2022 (and indeed most of 2021), we believed that securitised credit was priced to perfection and consequently reduced our holdings. Currently the risk contribution (i.e., allocation on a spread duration weighted basis) is 6% to securitised credit.

With the repricing that has taken place, there is an attractive entry point into securitised bonds although we strongly believe that caution is warranted. Yes, mezzanine spreads are at June 2020 levels, approximately 200 basis points wider than the tights of 2021 (for single A-rated non-confirming) BUT consumer fundamentals are weak and arrears are inevitably going to rise (although they haven't yet).

In securitised, we are favouring new issues over 2021/2 vintage deals, focussing on call incentives and demanding higher credit enhancement to replace the lack of excess spread in transactions today.

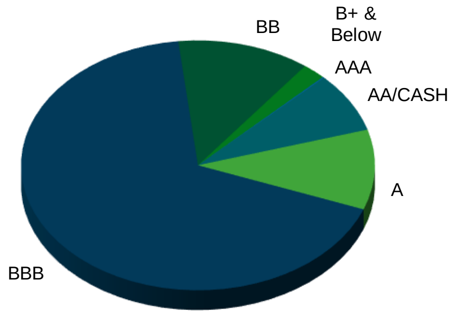
With such a low weighting we have room to moderately increase but plan to average in slowly, reflecting our higher level of caution right now.

Our financials exposure is also relatively low and importantly we have low exposure to low coupon margin Tier 2 debt and no exposure to additional Tier 1 notes (see comments below on APRA's announcement regarding uneconomic calls of capital instruments),

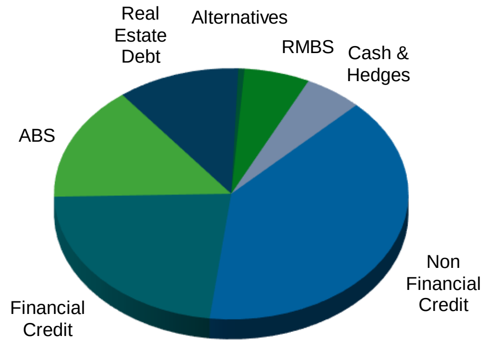
Performance Statistics

Standard Deviation (ann.)	2.4%
% of Down months	9.8%

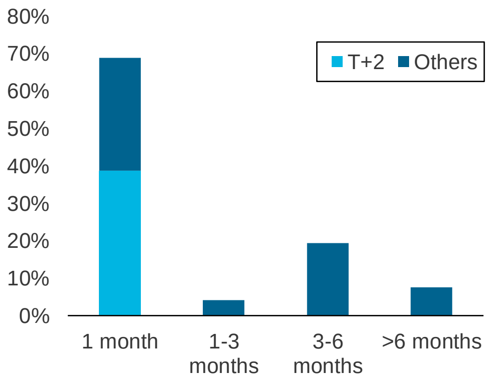
Fund Credit Quality



Fund Asset Allocation



Fund Liquidity Exposure



We retain our low weighting to commercial real estate lending. On the private side, we expect an increase in the opportunity set and have room to add. To remind, our exposure here will only be secured against income producing assets; there is no construction or development risk in the Fund and there will not be.

We are currently overweight in foreign currency bonds with a 29% allocation (noting this is all fully hedged to AUD) reflecting the better relative value in offshore markets. We are currently looking to manage this exposure down slightly in order to free up room in case of volatility in the future. Of course, our ability to do this is somewhat contingent on our ability to source attractive opportunities in Australian dollars. We expect the buy leg to be mainly domestic securitised credit and domestic private credit.

Market conditions: In the Q3 Around the Grounds report, we discussed the LDI (Liability Driven Investor) selling and impact on wider markets, particularly securitisation markets. The selling persisted into early October albeit the panic selling was mostly in September.

As soon as it become clear that the LDI selling had subsided, the market started to rally and global investment grade credit spreads ended the month 10-15 basis points tighter. The fuel for the rally was signs and accompanying rhetoric from central bankers that the peak of inflation was behind us and that the pace of interest rate increases would soon slow. Over the month a full quarter point of hikes was taken out of the US futures market with the peak in rates pushed back until mid-2023.

However, domestically credit spreads were weaker than offshore markets. The move wider was led by financials. Firstly, major bank reporting on Q3 results was a precursor to more major bank senior unsecured issuance with spreads moving wider on the actual $4.6 billion of issuance in October and anticipating further issuance in November (where already $13.4 billion has been issued). This persistent technical (already over $100 billion has been issued year to date) has pushed primary funding spreads towards post-GFC wides.

The second factor at play in financials was APRA's announcement in early November that it would not allow "uneconomic calls" of subordinated capital instruments by banks or insurers. It's still not entirely clear what APRA exactly means by "uneconomic" though they have essentially said that they don't want to see capital replacement of one instrument with a low coupon with a capital instrument of a higher coupon without some rationale as to why it makes sense.

The announcement was not anticipated by the market despite a cryptic comment by outgoing APRA Chair Wayne Byres in the weeks leading up to the announcement. There were two deals due to be called and wholesale markets briefly seized up as investors struggled to interpret the news. Both deals were subsequently called for reasons that were more idiosyncratic in our opinion.

Our take on this news is that the warning from APRA should lead to a healthy and appropriate repricing of risk. We see the most at-risk instruments being those with the longest tails post call. These are Tier 2 bonds issued by insurers where the final maturity can be more than 20 years into the future and additional Tier 1 instruments, both retail and wholesale. We are more sanguine on the traditional 10 non-call 5 year bank tier 2 market and expect only the lowest coupon bonds to be at risk of a non-call due to the rapidly declining capital benefit.

In private markets, we continue to be surprised at the strength of the domestic bid. Despite European and US leveraged loans selling off sharply in the wake of repricing of CLO risk due to LDI selling, Australian private loans continue to garner strong support. To illustrate, BB and B rated US leveraged loans trading down to the low 90s in late September and have rallied back to more like 95 cents in October. This compares to benchmark Term Loan Bs issued by Australian corporates which are trading in the mid to high 90s despite in some cases having even been downgraded.

Pillar 3 reports from the major banks have shown that banks have continued to be very aggressive in growing their non-financial corporate lending books with only isolated signs of stress across their portfolios. This being said, we do think we are close to peak demand as rising funding costs will start to weigh on the competitiveness of bank demand and wider pricing offshore will draw offshore capital back to their home markets (anyone interested in Twitter senior secured debt?)

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