Challenger IM Credit Income Fund – Class A

ARSN 620 882 055 APIR HOW8013AU

Monthly Report February 2023

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	0.79	2.85	4.15	5.15	4.66	-	-	4.73
Challenger IM Credit Income Fund - Class I[3]	0.79	2.85	4.15	5.15	4.66	3.61	3.98	-
Bloomberg Bank Bill Index	0.24	0.76	1.40	1.68	1.76	0.66	1.05	0.75
Active return	0.55	2.09	2.75	3.47	2.90	2.94	2.93	3.98

Data Source: Fidante Partners Limited, 28 February 2023.

[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.

Past Performance is not a reliable indicator of future performance.

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	$526.7 mil
Buy/Sell Spread	+0.18/-0.18%
Distribution Frequency	Quarterly
Redemption Terms	Monthly with 10% Fund level gate

Key Statistics

Number of Issuers	120
Running yield (%) p.a.	5.3
Modified duration (yrs)	0.10
Average Rating	BBB-
Credit Spread Duration (yrs)	2.7
Non-AUD Denominated	28%
Private Credit Allocation	19%

Monthly Commentary

Performance Update: The Fund returned 0.78% in February taking the trailing 12 month return to 4.55%, a 2.79% excess return over the Benchmark. The strong returns continue to be driven by income generation and spread tightening though there are signs that the pace of spread compression may be slowing.

Fund Positioning: We continue to preach the virtues of patience in the current market. The strong rally in the first 2 months of the year has been underpinned by a sharply inverted yield curve which itself implies an increasing likelihood of a recession.

In short, we are not believers in the current rally and anticipate more volatility in the coming months as fundamentals deteriorate.

As was the case last month, we are neutral on the illiquidity premium at the current point in the cycle. We are favouring higher credit quality deals across public and private markets. As evidence, we are in advanced stages of due diligence on a Ba1 rated private loan which will price in the mid-400s. This represents a liquidity premium slightly below our through-the-cycle target of 2% per annum albeit for a very robust credit profile.

Our caution on financials has also been justified with widespread fears of bank runs spreading across the United States following the news of the Silicon Valley Bank and Silvergate Bank failures. Our positioning within this sector has always been to favour the strongest banks in each respective jurisdiction. We have minimal domestic regional bank exposure and no exposure to European laggards Deutsche Bank or Credit Suisse (nor any exposure to Silicon Valley Bank or any US regional banks). Our weighting to banks is 12.4% with a 2.6 year spread duration. Our only exposure to a smaller bank is a 1% exposure to Judo Bank, a domestic neo bank focused on servicing the Australian SME sector. Unlike Silicon Valley Bank, Judo has over 70% of its deposit portfolio funded via retail term deposits making it significantly more resilient to any short-term funding stress.

Our largest weighting continues to be to the corporate sector with our commercial real estate lending exposure at around 11%. And even this may overstate the risk; of the 11% invested in commercial real estate lending markets, 10% is investment grade rated REIT paper with only 1% invested in private markets. We expect more opportunities in commercial real estate loans as interest rates increase and will increase rotate allocations from public markets to performing first lien senior secured real estate investment loans as opportunities emerge.

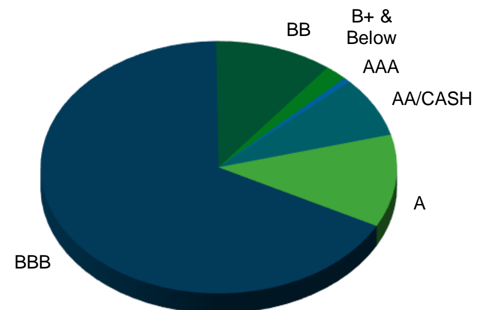
Market conditions: Occasionally, this portfolio manager is forced to ask themselves whether in writing a February monthly report they can only refer to events that occurred in February. This is one of those months!

The month of February saw a continuation of the bid tone of the last 3 months. Investment grade credit spreads tightened around 10 basis points over the month, taking the overall move to almost 40 basis points since the wides of early November. Since the end of February spreads have only retraced by around 15 basis points.

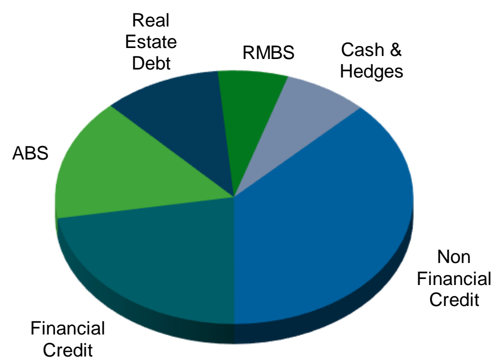
Performance Statistics

Standard Deviation (ann.)	2.4%
% of Down months	9.2%

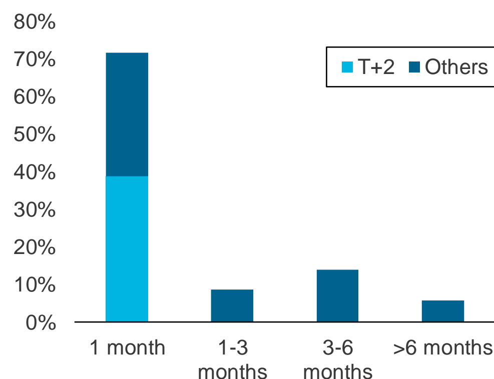
Fund Credit Quality



Fund Asset Allocation



Fund Liquidity Exposure



These moves occurred even as central bankers continued to hike rates. In early March, the RBA hiked for the second time in 2023 taking the cash rate target to 3.6% a full 3.5% higher than it was a short year ago. This is the sharpest rise in history, the implications of which remain as yet unknown. Indeed, the RBA's own economists have stated that they believe only 50% of rate hikes have flowed through to the wider economy.

Given the events of early March, it is hardly surprising that financials were the laggards with A$ tier 2 paper widening by around 45 basis points from February month end. However, with the exception of name specific issues, we remain well inside of the wides for the past year. Recent issuances have only reached a credit spread of around 260 basis points versus ANZ's mid-February primary print of 280 basis points. European financials fared worse with the ICE/BAML Euro Financial Index reaching 145 basis points in March, which is in line with the October 2022 wide print.

As we learned during the GFC, stress in the banking system can rapidly become systemic given the important role banks play as credit providers. Importantly, policymakers seem to understand this as well evidenced by the speed of their responses on both sides of the Atlantic. There is still a risk of further instability within the banks but thus far we have seen a strong commitment to financial stability from central banks.

Corporate paper has held in well during the recent volatility and continues to trade with a scarcity premium. With US interest rates curves heavily inverted (the difference between the 10 year yield and the 2 year yield reached -110 basis points at the lows) and Australian curves flat, short dated credit looks attractive to yield based buyers. Telstra took advantage of this strength and priced a 5 year deal at +93 basis points, slightly inside the clearing level for major bank senior unsecured paper.

Securitised credit woke up from the regular January slumber with almost $4 billion in issuance. Another $3.9 billion is already looking to price in March although this will slow if volatility persists. The strong rally in credit spreads in early 2023 has made its way into securitised markets, albeit not equally distributed with most of the tightening in the investment grade part of the capital structure. The most junior tranches appear to be lagging, with a lack of demand evident where fundamental credit risk is highest. Even after stripping out seasonal effects, arrears are rising and are most pronounced in SME portfolios with large exposure to the construction sector.

On the private side, we have seen a pickup in activity levels from last year. With interest rate increases slowly permeating through the real economy we expect more opportunities to flow from banks to non-banks. To illustrate consider that the move in base rates with have effectively halved interest coverage ratio on a first lien senior commercial real estate loan. A 50% LVR bank loan on a 5% cap rate asset was >3 times interest coverage and sat firmly in bank territory. The move in base rates takes this to <1.5 times forcing the borrower to deliver the loan or go to an alternative lender.

Even as we look forward and expect more stress purely on the basis of interest rate increases, there are relatively few signs of stress outside of construction. Even still it seems impossible that the stress can be limited to the just construction. Even before the Silicon Valley Bank and Credit Suisse problems emerged financial conditions were tightening rapidly. Historically this has led to increases in defaults. We see no reason why this time should be different.

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