Perennial Yield Plus Conservative Trust

Perennial Partners

Monthly Report September 2022

	Month (%)	Quarter (%)	FYTD (%)	1 Year (%)	Since Inception^ (%)
Perennial Yield Plus Conservative Trust (Net)	-0.1	-0.5	-0.5	-3.4	-2.7
RBA Cash Rate Total Return Index	0.2	0.5	0.5	0.6	0.5
Value Added	**-0.3**	**-1.0**	**-1.0**	**-4.0**	**-3.2**

^Since inception: June 2021. Past performance is not a reliable indicator of future performance.

Overview

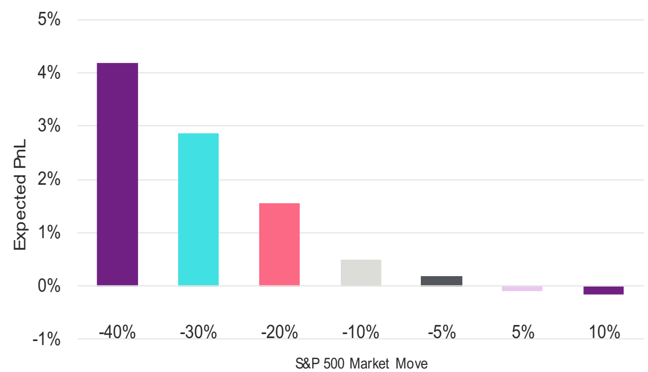
Macro drivers were very much at the fore during the month, with the Fed leaving little doubt as to their hawkish intentions, and the UK government and pension sector conspiring to provide a thrilling ride for gilt investors. Markets finished the month very much in risk-off mode.

The Trust delivered a loss of -0.1% for the month, net of fees, with a modest loss for the Core Income strategy, and a small gain on the Option Strategy.

Core Income performance was impacted by wider credit spreads, with a partial offset coming from overlay positioning. The strategy remains defensively positioned amid volatile market conditions, although we have increased exposure to short-dated assets.

The Put Write strategy showed a fairly flat performance with gains earlier in the month offset by losses in the back half, and the Protection strategy produced a small gain.

Estimated PnL Outcomes by Market Move



The chart provides the total expected portfolio PnL given a high velocity move in the S&P500.

Source: Perennial Value Management. As at 30 September 2022.

The above figures are forecasts only. While due care has been used in the preparation of forecast information, actual outcomes may vary in a materially positive or negative manner.

Fund Characteristics

The Trust aims to generate income by harvesting equity, credit and volatility risk premia; with a conservative risk profile. A portion of this income is invested in an explicit rules-based equity option defensive strategy to offset, or benefit from, market drawdowns.

Portfolio Manager
Michael Pollard

Trust FUM
AUD $18.2 million

Distribution Frequency
Quarterly

Minimum Initial Investment
$50,000

Trust Inception Date
June 2021

Fees
0.6% p.a.

APIR Code
WPC3204AU

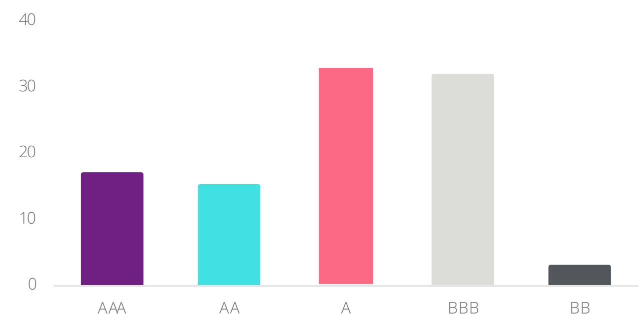
Expense Recovery
Capped at 0.1% p.a.

Portfolio Characteristics	
Modified Duration (Yrs)	-0.01
Spread Duration (Yrs)	2.02
Portfolio Yield (%)	4.73
Average Credit Quality	A

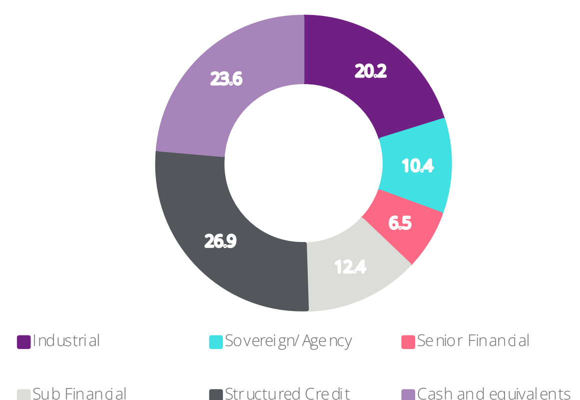
Source: Perennial Value Management. As at 30 September 2022

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.

Rating Exposure



Sector Active Exposure



Trust Review

The Core Income strategy returned -0.22% for the month net of fees. The fund's performance was positively impacted by coupon income, but wider credit spreads detracted. Widening was seen across sectors, particularly in US CLOs, and on average Australian and US investment grade credit spreads were approximately 14 and 17 basis points wider on the month respectively. Our interest rate position at month end was zero.

We continue to run a low exposure to the Put Write strategy. Our view is that the market lows are yet to come, so it is sensible to run the Option Strategy defensively. If we see a capitulation event it will then be an interesting time to look at increasing the Put Write notional (though of course capitulations only look obvious in hindsight).

Trust Activity

Given our defensive positioning and continuing modestly bearish outlook for spreads over the medium term, we largely avoided new issues during the month. We did however participate in a new Think Tank RMBS deal, but otherwise we continue to carry larger than normal cash and short-term securities weightings in the fund.

During the month we unwound one position early for a scratch, and elected not to roll it for the time being. We are currently only running around 5% notional in the Put Write.

Outlook

Despite significant volatility all year, markets ended September at arguably their most tenuous state of the year so far. Almost every asset class registered declines last quarter, with the uncertainty severe enough in some cases to force direct intervention from authorities. We expect systemic fragility and variable liquidity to remain the driving force of market movements in the coming few months.

We suggest that the fulcrum around which this volatility has been emanating is the concerted rally in the US Dollar. The combination of quantitative tightening reducing USD liquidity and availability, and interest rate normalisation attracting global capital into Treasuries has forced both direct and indirect interventions in Asian currencies. For example, Japan spent 2.8tn yen supporting its currency as it depreciated toward 145 per USD. Meanwhile, China took a range of steps which included pointed warnings against taking "one-way bets" even as the yuan has fallen by 11% against the USD this year, its weakest result since 1994.

Outlook

It was not just a rising USD causing market dislocations in September. The newly appointed UK government's tone-deaf mini budget created significant upheaval in UK Treasuries (known as gilts). Market reaction was so severe that the Bank of England was forced to step in and temporarily offer to buy an unlimited number of long-dated gilts after yields jumped by 75 basis points in one session, threatening the solvency and viability of multiple pension funds. A swift about-face from the government has relieved some of the pressure on the GBP and rates markets, but trust issues with the new PM and Chancellor will linger for some time.

Inflation remains elevated, leaving central banks no choice but to continue restraining demand to restore price stability. They have been emboldened in part by resilient employment outcomes to date, but economic strains elsewhere are becoming harder to ignore. A strong USD will create a headwind for corporates with offshore earnings, adding to concerns that poor consumer confidence will constrain growth by more than expected in the US. Recent economic data suggests that the prospects of a "soft landing" are becoming increasingly remote. Financial conditions tightened swiftly during the quarter, but the full impact of actions already taken are yet to be felt across the US economy or more broadly.

Europe remains in the grip of an energy crisis, with the suspected sabotage of the Nord Stream pipelines virtually ensuring a shortage of natural gas this winter, and sharply rising costs for consumers. There is real risk of recession, placing the ECB in a diabolical position, and it remains to be seen how much pain it is willing to inflict in its pursuit of price stability. With the uncertainty caused by the UK front of mind, European lawmakers now know what can happen when jittery markets are presented with poor communication, mixed messaging, and poor execution.

Against this backdrop, risks to credit spreads remain high. While in 2020 it was volatility across the credit complex that catalysed wider market movements, in 2022 it is rates markets in the driving seat while credit has been comparatively well behaved. Strong corporate fundamentals provide a firm foundation and partly explain the resilience across spread products. However, should a period of sustained economic deterioration eventuate, we expect this will inevitably spill over into credit. With rates volatility at multi-decade highs, we believe that despite being credit investors we can add considerable value by having the appropriate duration settings, which for now remain tightly clustered around zero. We expect the coming months to remain challenging.

As always, our aim will be to generate a running yield from credit and fixed income markets, with a conservative risk profile, whilst deploying an options strategy that carries flat to small positive with potential upside in a large equity drawdown. If market conditions make striking a balance between return and protection difficult, we would tend toward prioritising protection.

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Signatory of:

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