MARKET MATTERS
INVEST

MONTHLY REPORT | JULY 2023 | ACTIVE INCOME

PORTFOLIO DETAILS

Portfolio Name	Active Income
Structure	Separately Managed Account
Benchmark	RBA Cash +4%
Management Fee	0.85% incl GST
Platform	Open Wealth | Praemium
Included Assets	Equities, Hybrids, Trusts, ETFs
Portfolio Manager	James Gerrish
Annual Performance	9.40%*

OBJECTIVE

The objective of the Market Matters Active Income Portfolio is to provide a high level of regular tax-effective income with lower volatility than the underlying share market. This is achieved by actively managing a portfolio of high-yielding equities combined with ASX listed income securities that offer diversification benefits to both Australian equities and cash or term deposits.

**Inception Date 05.07.2017*

MARKETS & PERFORMANCE

The Market Matters Active Income Portfolio added +2.79% in July, outperforming its RBA Cash +4% benchmark which increased +0.68%. The portfolio has returned +13.78% for the rolling 12 months (against the benchmark return of +7.17%) and +14.30% per annum for 3 years.

PERIOD	1 MONTH	3 MONTH	6 MONTH	1 YEAR	2 YEAR PA	3 YEAR PA
PORTFOLIO %	2.79	2.81	3.41	13.78	9.62	14.30
BENCHMARK %	0.68	1.99	3.80	7.17	5.65	5.10
RELATIVE %	2.11	0.82	-0.39	6.61	3.97	9.20

Benchmark: RBA Cash Rate +4%

FY24 started on the front foot with solid gains in July underpinned by the local energy sector on the back of rising oil prices. The S&P/ASX 200 Accumulation Index (+2.9%) rose, inline with the MSCI Developed Markets Index (+2.9%), while the S&P 500 gained (+3.2%) in local currency terms.

Australian 10-year bond yields edged marginally lower to 4.05% as the RBA's Jul-23 meeting saw the cash rate stay at 4.10%. US yields on the other hand ticked up 14bps to 3.95%, as the Fed passed through another 0.25% hike to 5.5% in July. Amongst commodities, prices were generally up across the board headlined by Oil which rallied US$10.09 to US$84.99/bbl, on tighter market fundamentals and improved US macroeconomic data. Iron Ore prices rose by US$1.00 to US$114.50/Mt while Gold prices rose despite dollar fluctuations, up by US$42.00 to US$1,954.

There continued to be significant sector divergence locally, with the Energy sector bouncing back from recent weakness, up (+8.8%), while Financials (+4.9%), IT (+4.5%), Utilities (+4.0%), REITS (+3.8%) and Consumer Discretionary (+3.4%) all outperformed.

Most weakness was felt by Healthcare (-1.5%) while Staples (-1.0%) also fell. Materials (+1.4%), Industrials (+2.4%) and Communication Services (+2.7%) were up but trailed the index.

PORTFOLIO STOCKS

The portfolio held 20 positions at the end of July with a forecast yield of 5.35% plus franking. The portfolio is weighted 52% in Equities, 40% in Hybrids/Fixed Income, 7% in property and 1% cash.

One of our core principles at Market Matters is understanding what we're investing in, and having a strong handle on what will drive that investment's performance over time. We recently exited a long-held position from this portfolio despite the underlying fund delivering on its objectives since listing.

Metrics Master Income Trust (MXT) is a listed trust that provides exposure to a diversified portfolio of direct loans to Australian corporates, managed by Metrics, which has around $15bn of funds under management (FUM). They're good operators but we became concerned about the markets they operate in, so we elected to sell the investment for several reasons:

The visibility of their underlying exposures is low. While it is a diversified portfolio with over 300 loans, the composition of its portfolio seems to be changing, adding risk that we are less comfortable with.

The portfolio holds a mix of investment-grade and non-investment-grade exposures. Their investment grade exposure has averaged ~57% since 2017 – currently, this proportion sits at just ~48% – its lowest level since listing. Exposure to Real-Estate by lending to REITs and property developers/managers has averaged ~43%, which has now crept up to ~54%, its highest level of exposure zsince listing.

Sub-investment grade loans have a higher level of default risk associated with them, and we are mindful that defaults generally tend to cluster during periods of prolonged economic distress.

Considering the declining interest rate environment since MXT was listed, and despite the disruption from COVID-19, the credit environment has been a strong one given the huge amounts of liquidity being injected into the market. The trust has not been tested in tougher conditions, and with rates up 4% since their lows, this is clearly a 'testing' environment where defaults, particularly in the Real-Estate sector seem probable to us.

Entering this period, with, from what we can see, the highest level of risk since listing does not sit well with us.

We could draw on the stability of their Net Asset Value (NAV) per security which is currently $2 and has been every month since listing, as a positive anchor point, however, unlike a publicly traded bond, where the value of the asset is determined by its traded price, MXT's portfolio will largely comprise loans where a traded price does not exist. The NAV is based on Manager's internal loan valuations, and while there is external oversight and audit, its NAV is not tested by the market.

PORTFOLIO STOCKS	
NO. OF HOLDINGS	20
ESTIMATED YIELD (%)	5.35
TOP 5 POSITIONS (% OF AUM)	31.37
TOP 10 POSITIONS (% OF AUM)	58.64

STOCK	CONTRIBUTION (%)
NATIONAL AUSTRALIA BANK (NAB)	0.52
AGL ENERGY (AGL)	0.50
NEW HOPE CORP (NHC)	0.35
COMMONWEALTH BANK (CBA)	0.34
DEXUS (DXS)	0.20

STOCK	DETRACTION (%)
MAGELLAN FINANCIAL GROUP (MFG)	-0.07
TELSTRA GROUP (TLS)	-0.05
METCASH (MTS)	-0.01

%	JUL	AUG	SEP	OCT	NOV	DEC	JAN	FEB	MAR	APR	MAY	JUN	YTD
FY24	2.79												**2.79**
FY23	4.22	0.30	-3.64	3.31	4.82	-0.07	3.49	-1.61	0.06	2.16	-2.01	2.07	**13.10**
FY22	0.10	3.04	0.58	-1.58	-1.31	3.01	-2.45	4.05	4.25	-0.09	-1.80	-6.54	**1.26**
FY21	1.16	2.22	-1.21	-0.17	9.29	1.46	0.47	0.96	2.73	2.79	1.91	2.39	**24.00**
FY20	1.54	-0.57	2.90	-4.54	1.16	-0.51	1.78	-3.97	-15.53	7.33	6.24	1.94	**-2.23**
FY19	1.35	0.76	-0.62	-3.09	-0.61	-0.40	2.42	3.92	-0.21	1.17	3.13	1.37	**9.19**
CUMULATIVE													**48.11**

PORTFOLIO STOCKS CONTINUED

We have fielded feedback on this sale from investors, and Metrics themselves, however, ultimately, we are about backing our own convictions and when the weight of evidence skews our outlook on any individual position, we take action, fully understanding that we could be jumping at shadows.

AGL Energy (AGL) has been a top-performing stock in this portfolio since its inception in 2018 with an aggregate gain of over 200% achieved via three separate holding periods. Our current position was established six months ago below $7 and has appreciated over 70%, showing that significant moves can happen in large stocks when market positioning is set one way. Things do change with a company and identifying those inflexion points when a poor performer turns can be very beneficial to performance. However, as individual positions rise more than the portfolio as a whole, the weighting gets bigger and therefore so does its influence on the portfolio. This is different to a position that falls more than the portfolio, as its influence reduces over time. Given this advance, we were active during the month bringing the position back to our targeted ~3% portfolio weight ahead of its FY23 results.

As longer-term investors in this portfolio would appreciate, one of our worst performers has been **Magellan Financial Group (MFG)**, as we completely underestimated the outflows stemming from the implosion of star stock picker, Hamish Douglas. The position was ultimately sold for a disappointing ~50% loss above $12, and we switched to the rival manager, Pendal (PDL). The move was timely as Pendal was bid for by Perpetual (PPT), and we were issued stock in the combined entity.

Perpetual (PPT) had also struggled over the past decade but has not shown the boom and bust characteristics that Magellan has experienced, a result of their more diverse business, with a very stable trust services division, wealth management and of course, funds management. While we think there is more upside to go in Perpetual adding 'alpha' is about relative performance and our analysis pegged Magellan worth north of $12 (+40%) while Perpetual (PPT) in our view is worth ~$30 (+20%).

We recently sold Perpetual for a gain and have bought back into Magellan. We see multiple potential catalysts for value to be recognised, via improved performance that leads to better FUM flows, performance fees, and/or capital management. While this has been an uncomfortable move for some (feedback has been universally negative!), it is always important to look forward and invest accordingly, as difficult as that may be at times.

The banks are typically weighted heavily in income portfolios; however, we remain underweight for now with a preference to buy weakness, not chase current strength, especially while bank hybrid securities are offering ~7% yields with less risk.

The banks collectively have enjoyed rising rates which have helped to improve margins at a time when bad debts have stayed incredibly low. The recent guidance from Credit Corp (CCP) which buys bad debts from financial institutions shows a lack of available inventory, which is a positive sign for the sector. The banks have flagged aggressive competition as a headwind, the much discussed 'mortgage cliff' creating a potential churn event for borrowers looking for a better deal, but as rates have risen, serviceability becomes a more pressing issue, and staying with an existing lender generally helps with that calculation. More recent data points show competition has eased.

We are neutral on the sector overall, only looking for opportunities into weakness. We currently hold positions in Commonwealth Bank (CBA) and National Bank (NAB) in this portfolio, along with a 25% weighting in bank hybrids.

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