Fixed Income Fund

Report | January 2022

SharePrices

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Fund Overview

The Fixed Income fund's point of difference is the variety of return sources it uses to deliver its investment objective. It seeks to protect investors against inflation risk by using specialised techniques, which enable the hedging of inflation. The fund also utilises the skill set of the manager, Fortlake Asset Management, to run overlay, arbitrage and offer short-term credit strategies.

5% p.a
Targeted Distribution of Income to Investors*

0.41%
Income Distribution Each Month Since Inception^

100%
Positive Months Since Fund Inception

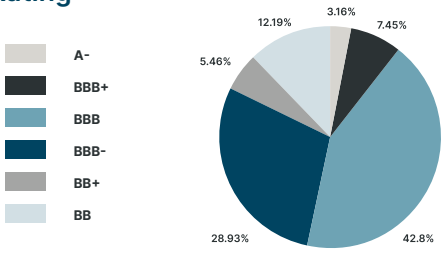
Diversified
Portfolio of Investment Grade Bonds

BBB
Average Credit Rating

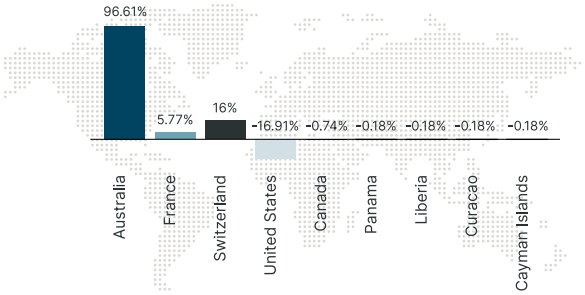
224 - 298
Number of Exposures

Gleneagle Investment Trust | Retail Offer	
Name of Class	Fixed Income Fund
Asset Class	Short Term Fixed Income
Target Returns	Targets a return for investors to receive a consistent distribution of income of 5% p.a*
Investment Manager	Fortlake Asset Management
Responsible Entity	Gleneagle Asset Management Limited
Administrator	Apex Fund Services Pty Ltd
Custodian	J.P.Morgan & Gleneagle Securities (Aust) Pty Ltd
Withdrawals	Monthly applications & withdrawal requests
Distributions	Monthly
Reinvestment	Monthly distribution can be reinvested
Unit Pricing	Monthly
Minimum Investment	$50,000 (no maximum)
Establishment Fee	Nil
Contribution Fee	Nil
Withdrawal Fee	Nil
Termination Fee	Nil
Management Fee and Costs	2.2%
Manager Performance Fee	Nil
Buy / Sell Spread	0.00% / 0.15%
Investments	Bank Deposits & Term Deposits High-Grade & Investment-Grade Bonds Asset Backed Securities
Risk	Refer to PDS
Reporting	Confirmation statement upon account opening, transaction statements, annual distribution, holding and tax statements, online account statements.

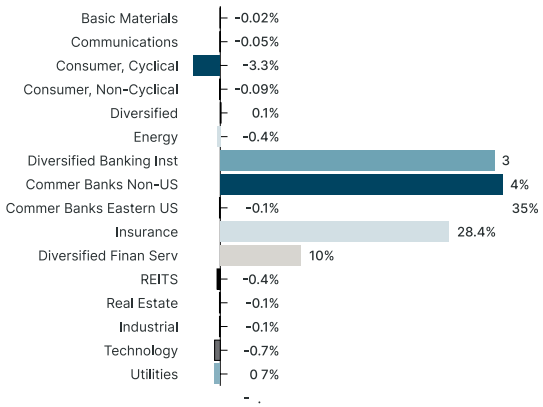
Credit Rating



Market Exposure by Country



Market Exposure by Sector



*^Past performance is not indicative of future performance. *Targeted return provides an indication of what the fund aims to achieve. There is no guarantee this target return will be achieved. Fund inception is 18th May 2021.*

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January 22 Update

Markets – Credit where Equity is due

The month started in a holding pattern awaiting the critical January FOMC meeting. In addition, inflation numbers and other economic data were eagerly anticipated by market participants. Risk markets responded poorly to the persistently high levels of global CPI with equities commencing a steep sell-off as data came out. VIX went to a high of 31.96 per cent from a low of 16.60 per cent, intra month. Across the capital structure in 5-year, we saw High Yield spreads widen by +46bps. On the top side of the capital structure, we saw senior preferred move wider by +10bps. Indices were all wider with US IG out +10bps, Aus ITRX out +11bps, EUR Main out +11bps, and EUR Financials SUB +18bps. At-the-money HY credit volatility was out +10 per cent and interest rate volatility in the 1 and 10 year part of the Australian curve was 73bps normalised (+4bps) and 76bps normalised (-4bps), further inverting. It follows, that Issuance started to slow as capital market volatility resurfaced. We also saw the significant disparity in Credit Tranches with Equity, Junior Mez, Senior Mez and Super Senior illustrating large dispersion across the tranches. Of note, the equity tranche underperformed the S&P500 over the month.

Outflows across credit gathered pace as the month went on with the worst being High Yield, seeing around 3 per cent drawdown at month-end. High Yield has now returned only 0.38 per cent for the year with 4.40 per cent volatility. In US investment-grade we saw similar drawdowns with the US IG (IBOXX) down 3.17 per cent for the month with 5.74 per cent volatility. The majority of central banks outlined outlooks and reductions for asset purchases, which saw further pressure placed on risk markets. Global yields were higher over the month set against the FOMC reaffirming its stance on inflation with the US 10-year finishing the month at 1.77 per cent, up +26bps. Australian yields went higher over the month with the 10-year yield now 1.895 per cent up +22.5bps. Intense pressure was seen in the front part of the Australian curve with the 3-year moving up 40bps in the month to 1.31 per cent adding to short to mid curve implied volatility.

Economy – The Ostrich or the Owl

A philosophical perspective is an important part of any investment process, so unsurprisingly, we are often asked to articulate our views on this particular topic. However, I thought it would be worthwhile delving into this a little more deeply as its relevance and its true effect on actual outcomes depends on a variety of factors. In many ways and across many institutions, the investment philosophy is a constructed process that lacks authenticity. Often left to the marketing department to formulate, its essence and true meaning tend to have little buy-in from the investment personnel. What you tend to see is that philosophies are very idealistic, overarching, long term in their ideal but in many instances get eroded by the day-to-day friction of team dynamics, personality, bureaucracy, or hidden ulterior beliefs. Take, for example, an institution that has not changed its philosophy for 20-30 years. Can we truly believe everyone that goes in and out of that turnstile was a true convert to the philosophy that was thrust upon them…The cornerstone of the business should, in fact, be an authentic philosophy and one that you believe in, perhaps obsessively. In turn, this attracts people who see the merit in that way of thinking and hopefully want to come along for the ride. Importantly, this doesn't come at the exclusion of diversity of thought and more constructive approaches. From our perspective, this should be a

The Mechanics of QT

The Fed has made clear its intentions to slow the pace at which it reinvests principal payments on its maturing or prepaying US Treasury and agency MBS assets. The following describes how this will head to a corresponding decline in reserves held by the commercial banking system.

The simple example is to begin with maturing US Treasury obligations. The two pertinent liability entries on the Fed's balance sheet are deposits of depository institutions, usually called reserves (a Fed obligation to commercial banks) and the Treasury's general account, or TGA (an obligation to the US Treasury). The Fed is the fiscal agent of the Treasury, and the TGA effectively functions as the bank account of the federal government. In normal times, when a person pays taxes to the US Treasury, the Fed will debit the reserves of the taxpayer's bank and credit the TGA (with no change to the sum of the two types of obligations and therefore no change in the overall size of the balance sheet). Similarly, when the federal government pays a vendor the TGA will go down and the reserves of the vendor's bank will increase.

What about when the Fed ceases reinvesting maturing US Treasuries? As a Treasury security comes due, the Treasury is obligated to deliver the par amount of that security to the Fed. Mechanically this

happens through the Fed reducing the balance in the TGA by that amount. Thus, if, say, $1 million of Fed holdings of Treasuries come due on a certain date, the Fed's securities portfolio will be reduced by $1 million and the TGA will also be reduced by $1 million. So far both sides of the balance sheet have been lowered by equal amounts, though there has been no change in the amount of reserves held by commercial banks.

Of course, like any prudent cash manager, the Treasury will seek to maintain a certain amount of funds in its "bank account." It has said that it seeks to maintain funds to cover about a week's worth of outflows, or maybe around $700 billion. In order to replenish the TGA after paying the Fed to satisfy its obligations, the most likely action to rebuild cash balances would be for Treasury to issue debt to the private sector. After auctioning off debt to the private sector, the bank of whoever bought the security will see its reserve account debited because it has bought the treasuries (instead of the Fed). At the same time the TGA will be credited, as the purchase of the bond by the commercial bank equates to cash simply going into the TGA. Thus, after all is said and done, the level of Fed holding of US Treasuries will be $1 million lower, the TGA will be unchanged, and commercial banks reserves will be $1 million lower. (Viewing this reduction in bank reserves as a two-step process is conceptually useful, but often Treasury auctions will settle on the same day that previously-issued securities mature).

The manner in which maturing or prepaying MBS leads to a decline in reserves is very similar to the process for Treasury securities. The two mortgage GSEs (Freddie and Fannie) have the privilege of having their own account at the Federal Reserve (rather than settling payments through commercial banks, as other non-governmental institutions do). Principal payments obligations to the Fed are carried out by the Fed debiting their accounts. As the GSEs replenish their Fed balances, commercial bank reserves will decline.

How does QT affect Financial Conditions?

There are two potential channels through which the investors' balance sheets are affected by QT. First, the Treasury and GSEs will need to find private purchasers to step up and fill in the demand for their securities vacated by the Fed. Second, banks will have fewer reserves. The first effect should exert upward pressure on longer-term interest rates, though the magnitudes are very imprecisely estimated. Whatever the size of this effect, there are three reasons why it should likely be much smaller than the size of the effect when the Fed purchased the assets. First, the purchases were concentrated in a much shorter period of time than the runoff will take place. Second, much of the purchasing was done in a period of intense market stress, when central bank asset purchases are more potent. Third, the signaling channel of asset purchases is mostly turned off when runoff is set on autopilot to be running in the background.

What about the second impact of QT? What will fewer reserves in the banking system do to financial conditions? The short answer is the decline in reserves should have little impact on interest rates, currencies, or other financial conditions. However, risk markets will have reverse displacement now i.e.crowding out of risk-free assets into risk assets will now go back the other way. Textbooks written 15 or more years ago would assign a much more influential role to reserves in determining financial conditions. But there are two crucial institutional changes that have altered the reasoning found in these older treatments of the topic: the payment of interest on reserves, and the dominance of capital requirements as the chief regulatory constraint on banks' balance sheets.

To see the importance of interest on reserves first consider the way inter-bank markets functioned prior to the Fed's ability to pay interest on reserves, which occured before late 2008. In that environment, the Fed's ability to control overnight interest rates was almost entirely a function of its ability to fine-tune the amount of reserves in the banking system. When the Fed would inject reserves into the banking system, their scarcity value went down and the interest rate charged to borrow those reserves declined. A withdrawal of reserves worked in the opposite direction, increasing interest rates.

Now, however, overnight interest rate control is almost completely divorced from the amount of reserves in the banking system. Beyond some amount, the banking system's demand for reserves is likely satiated. After that point, interest rates are now controlled by fiat, through the rate paid on reserves.

Those same textbooks would also describe another channel by which central bank reserve injections or withdrawals would affect credit conditions: by easing or tightening the degree to which reserve requirements are a limiting factor on the overall size of bank balance sheets. Reserve requirements, however, were eliminated in March 2020. And so the old money multiplier view whereby more bank reserves supported more lending no longer makes sense in a regime without reserve requirements.

Ordinarily, the Fed holds enough assets to meet the public's demand for its liabilities. Recent times have been extraordinary, and the Fed has supplied more liabilities than the public demands. To know when Fed balance sheet normalisation ends we have to estimate the public's demand for Fed liabilities. The largest liability, currency, tends to exhibit fairly steady growth, a little above the rate of nominal GDP growth. Another liability is the TGA; as mentioned earlier, the Treasury will demand about $700 billion of Fed liabilities in this account.

Finally, commercial banks demand reserves. The level of this demand is probably the hardest to gauge. As mentioned earlier, banks no longer have reserve requirements. However, they do have a variety of other liquidity requirements. For example, some large banks are subject to liquidity stress-testing. These regulations create a large demand for reserves. Gauging this demand is difficult. In late 2019, money markets suffered from the "repo tantrum." There were likely several causes of this episode, but a scarcity of reserves was very likely a contributing factor. At that time reserves in the banking system were just under $1.5 trillion. There are reasons to believe this threshold should be higher now—the banking system is about 30% larger—or smaller—the Fed's creation of the standing repo facility (SRF) may allow banks to comfortably hold less reserves.

Using this $1.5 trillion number as an initial guess for the demand for bank reserves, and adding in Treasury's TGA demand, gets us to the desired size of the balance sheet of $2.2 trillion-plus currency in the hands of the public. Given the maturity schedule of the Fed's US Treasuries, and assumptions on their MBS principal payments, we estimate QT will end in 2026 or 2027, with a Fed balance sheet that is a little over $5 trillion.

Strategy and Performance

Strategy over the month focused on risk mitigation. Many of the protective features within the funds triggered, and consequently, strategy is now well placed for the next quarter. Importantly, this means risk allocation shifted over the month into more dislocated areas in credit. Risk markets are still absorbing many changes and the environment remains highly uncertain. We are also starting to see more rational pricing across inflation markets allowing for a repositioning across the funds.

Performance across the funds, whilst slightly negative versus the RBA Cash rate, was pleasing given the challenges over the month. Credit related indices in Australia such as the Bloomberg Credit 0+ year Index was down -0.57 per cent while the Bloomberg Credit FRN 0+ Index was +0.01 per cent. Therefore, gross performance of the funds was comparable, with FRIF (-0.13%), FRHIF (-0.38%) and FSOF (-0.52%), under testing conditions.