Portfolio Manager Insights
June 2014

We recently sat down with Darren Harvey and Christopher Joye to engage with them on a more sophisticated level about how they actually go about actively managing Smarter Money Active Cash's portfolio, which has delivered a 5.9% per annum return after fund fees since its inception 2 years ago. We thought you might enjoy this edited transcript of their responses to our questions, which try to get to the heart of how they add-value.

In brief, what's your approach to managing the Smarter Money Active Cash portfolio?

We have a simple "active cash" strategy that is distinctive insofar as our investment mandate is highly restrictive in the risks that are not allowed to be introduced into the portfolio.

We define "active cash" as Australian deposits and Australian-issued (mainly bank) floating-rate notes (ie, not fixed-rate bonds) that are of a highly liquid investment-grade quality with a weighted-average S&P credit rating of around A (the target is between A+ and A-).

We cannot take on leverage in the portfolio, assume currency risk, or invest in foreign bonds, fixed-rate bonds, sub-investment grade bonds, unrated bonds, equity hybrids, or direct mortgages. Through a related entity we are also approved as an Eligible Counterparty with the RBA, which means we can exchange qualifying bonds with the RBA in return for cash if we ever needed emergency liquidity.

The portfolio is built so that it is highly liquid (hence why we offer daily liquidity) and can preserve both capital and liquidity during a major crisis (eg, a repeat of the GFC) given any reasonable holding period. This is also reflected in our very low annual volatility of returns, which has been just 0.66% per annum since inception (ie, less than 1% or a fraction of traditional bond or equities volatility).

Since Smarter Money Active Cash's inception over 2 years ago we have had an average 55% portfolio weight to deposits (with an average maturity of less than 90 days) and a 45% portfolio weight to floating-rate notes with an average A rating from S&P.

Crucially, within our permitted universe of investments we are highly active. We think most folks are too forgiving when they come to their cash and accept sub-par returns. Most people also have highly polarised or bar-belled portfolios: a big cash allocation and then lots of very high risk equities and property with little in between. We see our role as providing a much safer continuum of returns between these two ends of the bar-bell, and helping investors make their cash work much harder for them.

We do this through aggressively seeking out the best possible returns across our deposit portfolio, where we see ourselves as an opportunistic liquidity provider to the Australian banking system. We are also very active in our floating-rate note portfolio, where we combine both bottom-up valuation methods with top-down relative pricing to identifying inefficiencies and mispricings. And we constantly see these mispricings: whether they be a very cheap floating-rate bond relative to peer securities; anomalies that open up between the same bonds traded in, say, the different (but both ASX-owned) Austraclear and exchange markets; a pure arbitrage; or retail brokers and clients making mistakes when trying to buy and sell ASX bonds.

Unlike many traditional fixed-income funds we avoid “interest rate risk”, or so-called “modified duration”, like the plague. The average interest rate risk, or modified duration, in the UBS composite bond index, which is a popular benchmark, is around 4.5 years. This is like investing in 4.5 year term deposits. You’re taking a significant punt on the future course of interest rates.

Having traded interest rate risk for over 20 years, and worked inside the RBA, the one thing we know with confidence is that nobody, including the RBA itself, and certainly not financial markets, can accurately predict interest rate changes beyond 6 months. So why take 4.5 years of interest rate risk in your portfolio?

Across Smarter Money Active Cash’s portfolio we keep our interest rate risk under 3 months. And if we want to add value through exploiting mispricings in interest rate expectations, which we have consistently proven is possible over time-frames of less than 6 months, we do so through our term deposits, not fixed-rate bonds or derivatives. (We’ve never used any derivatives in our portfolio ever.)

While we have been persistently successful in anticipating short-term RBA rate moves and capitalising on this through our term deposits (eg, locking in higher rates before cuts) the key benefit of using TDs is that we do not expose investors to any capital risk or mark-to-market losses in the event that the RBA’s moves do not accord with our expectations.
Coming back to our investment management philosophy, we think there are opportunities to add a lot of value around a narrow band of credit risk within a bank’s capital structure.

Deposits are simply unsecured loans to banks (although they are protected by depositor preference under the Banking Act, which means they are paid out first before other liabilities, except covered bonds).

The last time an Australian depositor lost money was in 1931. With a very strong and active prudential regulator in the form of APRA, Australian bank liabilities are, we believe, relatively low risk (but not riskless) investments. One further reduces the probability of loss through only investing in investment-grade floating-rate notes and thereby avoiding conventional interest rate risk.

We believe one of Smarter Money Active Cash's roles is to provide investors with cost-effective diversification across the Australian banking system (we have 17 deposit-taking institutions represented in the portfolio) and across a bank's capital structure.

So we have held short-term deposits, AAA-rated floating-rate covered bonds, senior and subordinated floating-rate bonds, and, subject to a maximum portfolio limit of 25%, other highly rated secured bonds (eg, AAA-rated and RBA repurchase eligible RMBS). Currently we have about 67% of the portfolio in deposits with 32% in floating-rate notes and 1% in AAA-rated RMBS (the maximum exposure ever to AAA-rated RMBS, which is RBA repurchase eligible, has been circa 15%).

What's the most challenging thing you face running Smarter Money Active Cash's portfolio?

Every day is spent hunting for superior returns across our deposits and bonds. This is our defining challenge while ensuring the portfolio remains highly liquid with very low risk. Before we expand on that, we also believe we have a responsibility to educate investors on what they are getting with our portfolio. People tend to think that deposits are fee-free. They are not: the fee you effectively pay on a deposit is the substantial 2% to 3% per annum "net interest margin" the banks earn when they take deposits in at say 2.5% to 3.5% and lend that money out to households and businesses at say 5% to 7%.

Another task is explaining why no investment is truly risk-free (even government bonds carry credit risks and a government guarantee is not, as a result, risk free). People commonly assume deposits are risk-free, but they are not. They simply sit lower down the scale in the probability of loss ranking. The challenge for investors, therefore, is to get the best possible risk-adjusted returns subject to their own preferences. And we think the low hanging fruit can often be found within a bank's capital structure in sometimes neglected investments, like certain bonds, or when different pieces of the capital structure (eg, covered bonds versus deposits) get misaligned from a pricing perspective.

The flip-side of the risk-free presumption is the errors that get made when pricing the risks of hybrids and convertible preference shares. Many suppose that these are cash substitutes, which they are not. They are equity substitutes. Before investing in a low-ranking hybrid like a convertible preference share, you should ask yourself the question: how do the returns I am getting compare to ordinary bank shares (because the risks are very similar)? Today you will find they are much lower (one day they may not be).

APRA is treating these hybrids as equity, but investors are assuming they are like debt. This is precisely why the banks have rushed to issue so many hybrids: it is extremely cheap money for them. Ipso facto, on current pricing, hybrids are a poor trade for investors in our opinion: you would be better off simply taking the ordinary shares. If you want something between equities and cash, look to bona fide bonds.

A final challenge is cautiously managing the vagaries of the credit and overall financial market cycle. Many traditional fixed-income managers have been hold-to-maturity guys that tend to fire and forget. They are paid low fees and investors get correspondingly passive portfolios that tend to hug benchmarks. We are not interested in buying deposits or bonds simply because they mirror an index. Every asset that is added to our portfolio must play a role in enhancing returns and/or reducing risk.

In this context, our active cash strategy is index agnostic, and much more absolute return in character. We generate consistently stable positive returns after fees that are 1-2% above deposits in the market. Returns vary slightly month-to-month, but that has been the outcome we've delivered over every quarter.

The challenge is to be vigilant in selling assets when overvalued. This is why you will see our mix between deposits and bonds sometimes change quite materially depending on where we see value in the two markets.

How have you been able to produce a 4.3% pa return over the last 6 months when other cash and active cash products are only doing 3.0% to 3.5% pa?

We distill down our risk-adjusted excess returns, or alpha, into a few key categories:

1. **Deposit premiums:** We negotiate superior returns on our deposits through high intensity bilateral discussions with banks and our ability to move quickly to provide liquidity over specific maturities (although never normally beyond 180 days) as and when they require it. We are, for example, currently getting 125 basis points over the RBA cash rate on an "at-call" basis (uncapped) and 140 basis points over the RBA cash rate for TDs of less than 180 days.

2. **RBA arbitrage:** We seeking to exploit mispricings in interest rate expectations as and when they arise through rapidly adjusting our TD exposures. We find that the yield curve as embedded in TDs is especially inefficient. So if we think the RBA will cut rates we will lock in higher TD rates over the short-term before the TD rates also adjust down. If we think the RBA is going to hike and future TD rates will improve we would bring our cash in to much shorter maturities. As discussed, we don't think you can make money by second-guessing interest rates beyond 6-12 months, as the RBA's own research has demonstrated. This is why we think fixed-income guys carrying more than 12 months of duration are on a hiding to nothing.

3. **Bottom up and top down active bond investing:** We actively invest in our floating-rate bonds and seek to generate capital gains through exploiting market inefficiencies. We think the Australian fixed-income asset-class is particularly inefficient because: (1) there has been a paucity of active managers; and (2) there is poor price discovery because of the non-transparent nature of the Austraclear OTC market where, unlike the ASX, transaction prices do not have to be disclosed (we hope this will change on day). Fees have been wafer thin, so managers have not been paid to produce outstanding performance (one of our investors is fond of the saying, you pay peanuts, you get…). We think by having fees that allow managers to earn a reasonable living, and which incentivise them to spend a lot more time extracting alpha (and attracting and retaining top manager talent), investors will ultimately get better experiences. It is like the difference between buying a Hyundai and a BMW. You get what you pay for.

   We believe this shift towards more optimal and sustainable active fee structures is inevitable as the population ages and the demand for lower risk, income producing strategies rises. There is also a growing evidentiary basis for this thesis with more and more fixed-income funds adopting performance fee models that offer a stronger alignment with investor outcomes. Turning back to our active bond philosophy, we look for inefficiencies everywhere. This might be a particular bond that for some reason is poorly priced and/or materially out of line with comparable assets (eg, we see this all the time amongst ASX listed bonds). It might be a class of securities that appear to be mispriced (eg, ASX bonds for years relative to OTC bonds, covered bonds in 2012, or AAA-rated RMBS in 2012/2013). It might be a sector that for some reason is out of favour (eg, investment banks). Or it could be a pure arbitrage, which we occasionally see, where we can buy and sell the same bond simultaneously with two other counterparties for a risk-free profit.

4. **Active asset-allocation:** Our final source of alpha is asset-allocation. We retain the agility to switch between cash and bonds based on our

valuation views of each sector. When credit spreads are wide and the risk-return payoff on bonds is high we have had the portfolio ratio to cash/bonds at 20:80 (eg, in mid-2012). When credit spreads tighten right up we do not hesitate to take profits and crystallise capital gains. So in December 2012 our cash weight hit 80%, as it did in April 2013, and it was pretty high again at the end of May (67%) as the value of our bonds rose strongly on the back of tighter spreads. This relative shift in the portfolio's centre of gravity between cash and bonds will drive some of our modest volatility month-to-month. So in May we delivered a 5.2% annualised return for the month after fund fees whereas in March it was closer to 3.1% over the month (and 4.3% in April). While Smarter Money Active Cash offers daily liquidity, it should really be viewed as a more medium term (say 6 months plus) active cash solution.

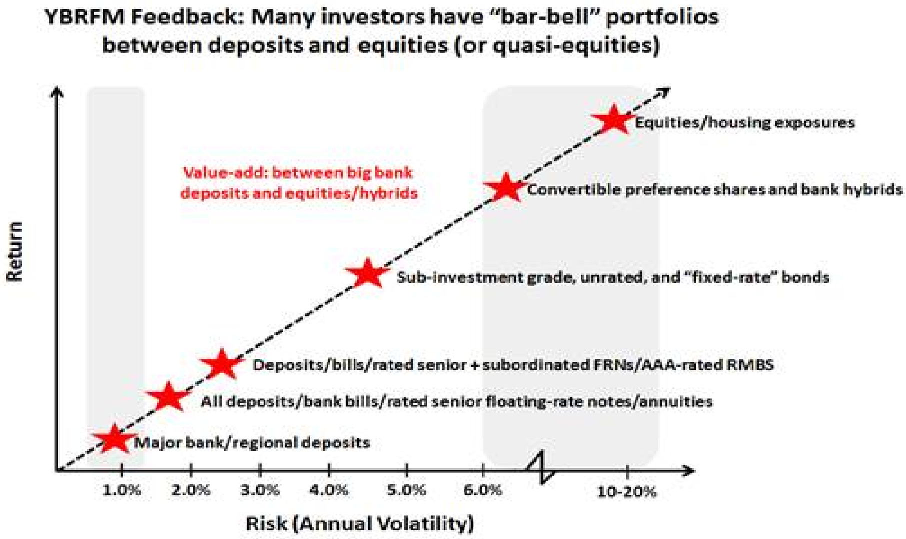
What are your key investment strategies/themes currently?

We've been working the ASX bond market hard for several years now and have become increasingly sophisticated in the way we approach it. Initially we were capitalising on relative value mispricings of ASX bonds compared with identical instruments traded in the wholesale OTC Austraclear market. We've seen effectively the same two bonds from the same bank trade as much as 60-70 basis points wide of one another. In the last year we have also focussed on mispricings within the ASX market. So every day we will be a buyer and seller of the same bond that we hold in our portfolio at very cheap and very expensive prices, respectively. We see retail investors sell at absurdly cheap and buy at irrationally expensive levels all the time, and seek to profit from these behaviours.

What asset-class do you place Smarter Money Active Cash in?

We call Smarter Money Active Cash an "active cash" solution. Others think of us as short-term fixed-interest or short-term credit, which mean similar things. Smarter Money Active Cash is not a bank deposit: it is a professionally managed portfolio of deposits and mainly bank bonds. As noted above, we think there is too much bifurcation in retail portfolios with lots of pure cash and lots of high risk equities with little in between. We produced the following chart for a client recently, which summarises our views on this subject.

Smarter Money Investments feedback: Many investors have "bar-bell" portfolios between deposits and equities (or quasi-equities)



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