Smarter Money Investments™

August 2018

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Fund: **Smarter Money Fund**

Strategy: **Cash Plus/Short-Term Fixed-Interest**

Return (inception Feb. 2012): **4.9% pa gross/4.0% pa net**

Net return volatility (inception Feb. 2012): **0.45% pa**

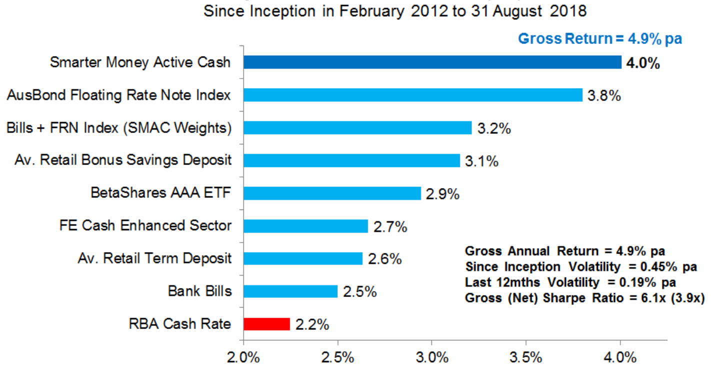
FE/Aust. Ratings/Lonsec/Atchison rating: **5 FE Crowns/Superior/Recommended/Highly Recommended**

Objective: An independently-rated/recommended strategy targeting low-risk cash and fixed-income returns that exceed the RBA's cash rate by 1%-2% pa after fees, over rolling 12 month periods.

Strategy: We actively invest in a diversified portfolio of Australian deposits and investment grade floating-rate notes with a weighted-average "A" credit rating. We do not invest in fixed-rate bonds (unless interest rate risk is swapped out), sub-investment grade bonds, direct loans, equities, capital notes, preference shares (aka 'hybrids'), use leverage, or take currency risk. We add value via active asset-selection using a range of valuation models with the aim of (1) delivering lower portfolio volatility than traditional cash/bond funds and (2) providing superior risk-adjusted returns or alpha without explicitly seeking interest rate risk, credit risk or liquidity risk.

Performance*	Gross Return (Assisted)	Net Return (Assisted)	Net Return (Insto.)	RBA Cash Rate	Gross Excess Return	Assisted Net Excess Return
1 month	**0.39%**	**0.31%**	**0.31%**	**0.13%**	**0.26%**	**0.18%**
3 months	0.87%	0.66%	0.70%	0.38%	0.49%	0.28%
6 months	1.29%	0.89%	0.98%	0.75%	0.54%	0.14%
1 year	2.95%	2.18%	2.29%	1.50%	1.45%	0.68%
2 years pa	3.48%	2.66%	2.73%	1.50%	1.98%	1.16%
3 years pa	3.83%	2.93%	3.00%	1.63%	2.20%	1.30%
4 years pa	3.76%	2.91%	2.99%	1.79%	1.97%	1.12%
5 years pa	3.98%	3.16%	3.23%	1.93%	2.05%	1.23%
Inception pa Feb. 2012	**4.94%**	**4.00%**	**4.06%**	**2.25%**	**2.69%**	**1.75%**

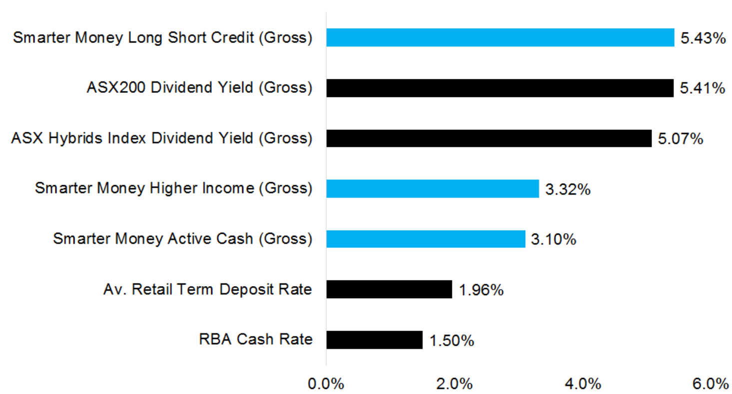
Smarter Money Active Cash Annual Returns (Net) vs Benchmarks:
Since Inception in February 2012 to 31 August 2018



Source: RBA; Bloomberg; Coolabah Capital Investments

Disclaimer: Past performance does not assure future returns. Returns are shown after all trust fees. All investments carry risks, including that the value of investments may vary, future returns may differ from past returns, and that your capital is not guaranteed. To understand Smarter Money Active Cash's risks better, please refer to the detailed Product Disclosure Statement. The graph above shows the net returns since inception (Feb. 2012) after all fees attributable to Smarter Money Active Cash (source: Mainstream) and various benchmarks (source: Reserve Bank of Australia and Bloomberg). A fund is not a bank deposit and your capital is not guaranteed. This information has been prepared by Smarter Money Investments. It is general information only and is not intended to provide you with financial advice.

August 2018 Investment Running Yields (Gross)



Source: RBA, Bloomberg, Solactive Hybrid index, Coolabah Capital Investments

% Monthly Returns > RBA Cash Rate + 0.66%	84.8%	Inception Av. Portfolio Weight to Cash	41.3%
Portfolio Weight to Cash Securities	19.2%	Portfolio Weight to AT1 Hybrids	0.0%
Portfolio Weight to Floating-Rate Securities	80.8%	Portfolio Weight to Sub-BBB- Securities	0.0%
Av. Portfolio Credit Rating	A	Cash-Flow Duration Across Portfolio	1,241 days
No. Cash Securities	11	Portfolio Weight to ABS/RMBS	0.3%
No. Floating-Rate Notes/Bonds	40	Credit Spread Duration	3.1 years
Total Number of ADIs	14	Annual Volatility (since incep.)	0.45% p.a.
Av. Interest Rate (Gross Running Yield)	3.10%	Gross/Net Sharpe Ratio (since incep.)	6.1/3.9 times
Modified Interest Rate Duration	0.12 years	Quant Ratings: 5 FE Crowns (FE); 4 Stars (Morningstar, April 2018). Qual Ratings: Recommended (Lonsec); IG (Mercer); Highly Recommended (Atchison); "Superior" (Aust. Ratings)	

www.smitrust.com.au
www.coolabahcapital.com

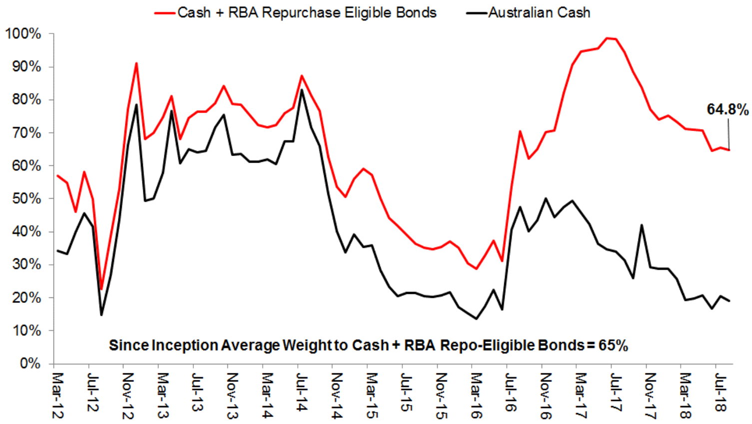
Coolabah Capital
Wholesale fund manager for Smarter Money Investments

FE CROWN FUND RATING

Recommended Lonsec Research

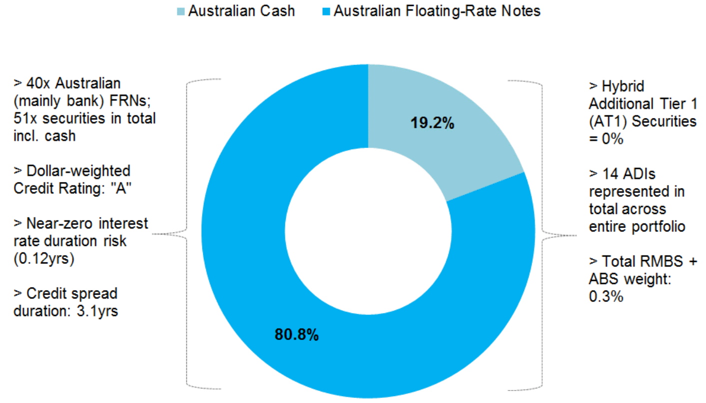
*Past performance does not assure future returns. Please read the PDS to understand risks. See smitrust.com.au for rating disclaimers

SMAC Portfolio Weights: Cash Plus RBA Repurchase Eligible Bonds
(End of Month, August 2018)



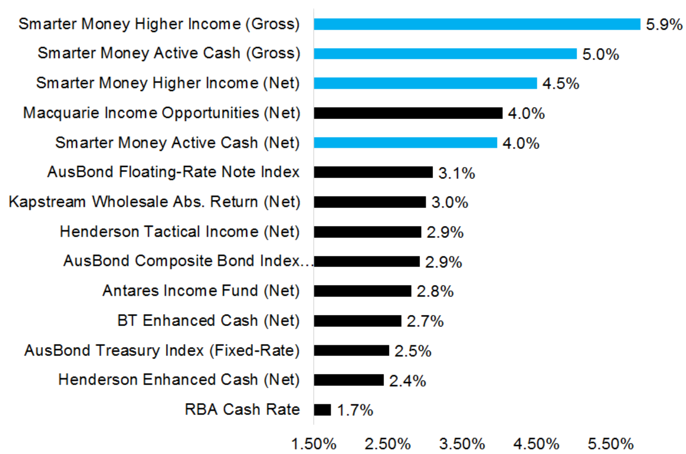
Source: Coolabah Capital Investments

Smarter Money Active Cash Portfolio Composition:
31 August 2018

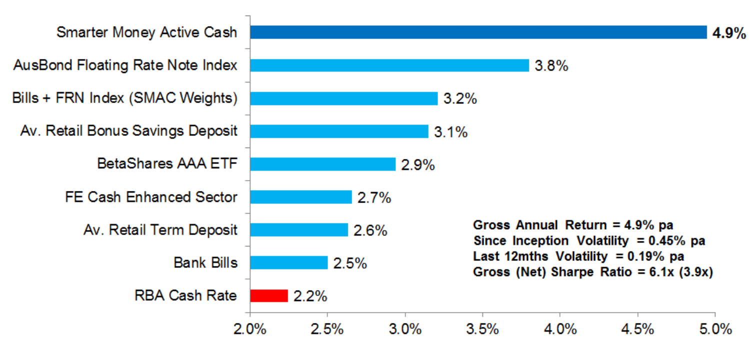


Source: Coolabah Capital Investments

Who Thrives When Duration Dives? Peer Returns Over 2016
Source: Coolabah Capital Investments



Smarter Money Active Cash Annual Returns (Gross) vs Benchmarks:
Since Inception in February 2012 to 31 August 2018



Source: RBA; Bloomberg; Coolabah Capital Investments

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The since inception gross (net) return of 4.9% p.a. (4.0% p.a.) is the total annual return earned by the fund since February 2012, including interest income and movements in the price of the bond portfolio after all fund fees. The net return quoted applies to the Assisted Investor Unit Class, with quarterly distributions reinvested. Each investor's return will vary depending upon their own investment date and any top-ups and withdrawals they make. **The annualised volatility estimate of 0.45% p.a.** is based on the standard deviation of net daily returns since inception, which are then annualised, attributable to the Assisted Unit Class.

Portfolio Managers	Christopher Joye, Darren Harvey, Ashley Kabel, Stephen Parker: Coolabah Capital Investments		
APIR Code (Assisted)	CRE0014AU	Fund Inception	17-Feb-12
mFund Code	SMF01	Distributions	Quarterly
Morningstar Ticker	19382	Unit Pricing	Daily (earnings accrue daily)
Asset-Class	Short-Term Fixed-Interest	Min. Investment	$1,000
Target Return	Net 1-2% over RBA cash rate	Withdrawals	Daily Requests (funds normally in 3 days)
Investment Manager	Smarter Money Investments	Buy/Sell Spread	0.00%/0.05%
Sub-Manager	Coolabah Capital Investments	Mgt. Fee (Assisted)	0.41% p.a.
Responsible Entity	OneVue RE Services Ltd	Admin. Fee	0.25% p.a.
Custodian	BNP Paribas	Perf. Fee	20.5% of returns over RBA cash + 1.66% p.a.

Portfolio commentary: In August the daily liquidity and near-zero interest rate duration Smarter Money Active Cash (SMAC) strategy returned 0.39% gross (0.31% net of fees), which was its best month since January 2017, outperforming the RBA cash rate (0.13%), the AusBond Bank Bill Index (0.17%), the AAA ETF (0.18%) and the average "cash enhanced" peer fund reported by Financial Express (0.16%) despite holding 64.8% of the portfolio in cash and extremely liquid bonds eligible for the RBA's repurchase facilities. SMAC's weighted-average interest rate on its cash and bonds (or running yield) remained robust at 3.10% at the end August, reflecting its elevated holdings of mispriced (i.e. cheap) FRNs with little portfolio exposure (0.3%) to expensive ABS/RMBS, which SMAC largely exited at the start of 2018. The strong returns in August were driven by mean-reversion or normalisation in credit spreads back towards the portfolio managers' modelled fair value targets as a benign technical backdrop allowed fundamentals to reassert their dominance over asset pricing. **Since its inception over 6 years ago in February 2012, SMAC has returned 4.0% annually net (4.9% pa gross) of fund fees compared to the average "cash enhanced" peer fund reported by Financial Express, which has returned 2.7% pa. Over the same period, SMAC delivered 1.8% pa net (2.7% pa gross) above the RBA cash rate and 1.9% pa net (2.8% pa gross) above Australia's core inflation rate. SMAC's since- inception Sharpe Ratio, which measures risk-adjusted returns, has been 6.1 times (3.9 times) gross (net)**. In August, SMAC's weighted-average credit rating was "A"; modified interest rate duration risk was negligible at 0.12 years (the target is sub 3-months); the portfolio weight to high-quality RMBS/ABS was minimal at 0.3%; and the portfolio weights to AT1 hybrids and sub-investment debt were all 0% (SMAC cannot invest in these securities). In February 2018 SMAC was awarded the highest possible, "5 FE Crowns", rating from Financial Express (FE) analytics on the basis of its 5 year risk-adjusted performance in FE's 31 product "cash enhanced" category.

Overall strategy commentary: August was an interesting month in which all asset-classes performed: Australian shares finished up 1.7 per cent; ASX hybrids climbed 1.18% (bringing total hybrid returns to 3.5% over the last 3 months); fixed-rate bonds delivered a strong 0.81% return as long-term interest rate expectations were pared back; and the floating-rate note (FRN) index offered a solid 0.28%. In the absence of any new issuance, or supply, shocks, credit spreads on 5 year major bank hybrids listed on the ASX have compressed sharply from around ~410 basis points (bps) over the 3 month bank bill swap rate (BBSW) to ~325bps over at the end of August, which is now only ~25bps above January's levels. As ASX hybrid risk premia have dropped 85bps, their capital values have appreciated. The fixed-rate Composite Bond Index's performance was powered by a general re-rating downwards of the market's forecasts for 5 year and 10 year risk-free rates, partly as a result of the decision of local banks to lift mortgage rates to recoup higher funding costs (Westpac announced a 14bps hike in mortgage rates at the end of August). If banks raise rates, the RBA has, by definition, less work to do normalising its cash rate, and expectations for future rate increases are correspondingly cut. The portfolio managers had at least one RBA rate hike pencilled in for 2018 at the start of the year, and it looks like lenders will do this job for the central bank. **Lower government bond yields mean investors will need to search for superior total returns through higher spread assets, which should support risk-taking. Combined with a robust global economic growth pulse and currently low investment-grade default rates, spread investments should perform in the short-term subject to the usual caveats around exogeneous shocks and Trump "tape-bombs".** In August the portfolio managers observed offshore investors increasingly rotate out of bail-in-able senior-ranking bank bonds, known as Total Loss Absorbing Capacity (TLAC) securities, into non-bail-in-able senior bonds, which are commonly referred to as "opco" bonds. Asian banks were selling their TLAC holdings, possibly under regulatory pressure, and switching into non-bail-in-able senior bonds offered by Australian and Canadian banks. The portfolio managers believe that opco paper that is eligible for repurchase with central banks (unlike TLAC paper) will attract a growing scarcity premium amongst investors that value its superior liquidity. **The portfolio managers largely exited the RMBS sector in February 2018 by taking profits on existing positions, and in August these assets underperformed, with spreads widening on the back of further supply, rising default rates, reduced prepayment rates, and inferior collateral protection as Australian house prices continue to decline.** Falling house prices pose a big threat to RMBS credit ratings: in some 2018 RMBS deals a 10% drop in house prices would lower the rating on AAA (or AA) tranches to just BBB- (or B+). Our data science team published a quant research paper releasing a new compositionally-adjusted "hedonic" default index for Aussie RMBS, which showed mortgage defaults clearly increasing, contradicting S&P's claim---based on its non-adjusted index---that RMBS default rates have been decreasing (download it here). This is the first hedonic regression-based method that has been applied to the problem of removing compositional biases from mortgage default indices. **While the portfolio managers' central case over the next four months is positive for credit, there are some countervailing headwinds, including a recent spike in bond supply, which is forecast to continue as the northern hemisphere returns from their summer break. The cross-currency-basis is also making AUD supply attractive for foreign issuers, which could induce indigestion. Then we have the ECB tapering its corporate bond buying program, though this is arguably well priced, and the usual suspects like US-China trade relations.** ASX hybrid investors assume CBA will replace its CBAPC security at some point in 2018, though redemptions of ASX listed securities, including the $770m SUNPD in November and the $325m AMPHA in December, combined with the $2bn to be repaid via CBAPC in December, should provide a favourable technical tail-wind into year-end. Hybrid maturities in 2019 are modest with only two major bank deals expected to mature. The portfolio managers believe that the major banks will look to the USD hybrid market in 2019 and consider an over-the-counter deal in AUD, which will further reduce ASX supply. **In August APRA announced it was looking at revising the way in which Aussie banks report capital ratios to make them more globally comparable. CBA, for example, currently reports a 10.7% equity ratio, which would be 15.5% on an internationally harmonised basis.** APRA notes that moving to a globally consistent model would create much greater room between the banks' equity ratios and the 5.125% equity ratio trigger at which point hybrids are automatically converted into shares. The regulator opined that this would give it superior flexibility to respond to bank crisises and put APRA on a level playing-field with offshore regulators that have 5.125% triggers in their bank hybrids measured against artificially higher capital ratios. If APRA does adopt this approach, it should in theory reduce banks' cost of funding given the probability of default on hybrids would be materially reduced and made more comparable with rivals overseas.

Investment Ideas	
• **No: Australian RMBS** (applicable to Smarter Money Active Cash, Smarter Money Higher Income and the Smarter Money Long Short Credit Fund)	• We bought AAA rated and RBA repurchase-eligible RMBS between 2012 and 2015 • Our analysts liked RMBS as a secured, highly-rated and repo-eligible asset-class, which was the beneficiary of active government support post 2008 when the Australian Office of Financial Management (AOFM) invested about $15bn into the sector (one of our portfolio managers originated this idea) • Between 2012 and 2015 spreads were very wide on a risk-adjusted basis, implying valuations were attractive • Issuance of new RMBS supply was very low (around $10bn pa) • House prices were booming (from 2013 to 2017), improving the collateral protecting RMBS • Mortgage rates were falling (from 2012 to 2016), enhancing debt serviceability • Mortgage default rates were falling, reducing losses • Borrower prepayment rates were increasing, lowering the weighted average life (WAL) of RMBS bonds • We sold most of our AAA RMBS in February 2018 because all these variables turned negative o House prices are now falling, as we predicted in April 2017 o Mortgage rates are rising (primarily because of funding costs) o Mortgage arrears/defaults are climbing o RMBS supply has surged to > $40bn pa o RMBS spreads had contracted to at or close to post-GFC tights in February, and are now increasing again o Borrower prepayment repayments have declined to decade lows, which is blowing-out bond maturities (WALs) o And we forecast this welcome housing correction will continue for 1-2 years • Finally, RMBS typically pays an interest margin over the 1 month bank bill swap rate (BBSW), whereas 3 month BBSW has increased much more than its 1 month equivalent, implying that total returns from RMBS are lower than from floating-rate notes (FRNs) that pay margins over 3 months BBSW • We think there will be more attractive entry points for RMBS in the future
• **Yes: Verizon and Challenger Life Aussie dollar floating-rate notes (FRNs) on high probability upgrade** (Smarter Money Active Cash, Smarter Money Higher Income and the Smarter Money Long Short Credit Fund)	• Our analysts have high conviction that both Verizon (BBB+) and Challenger Life (A) will be upgraded by S&P to A- to A+, respectively, potentially reducing their credit spreads by more than 10-15 basis points (and increasing their prices) • Our analysts' forecasts have Verizon on track to meet all S&P's criteria for an upgrade to A- in the next circa 6-12 months, including reduced leverage and superior wireless services revenue growth • S&P already has Challenger on "positive outlook" for an upgrade to A+ and Challenger will benefit immensely from the federal government's decision to mandate that all retirees are offered a lifetime income solution (typically an annuity) on retirement, and the government's recommendation that 15-20% of a retiree's superannuation balance is invested in a lifetime income product • Our analysts estimate that the annuity market in Australia could grow from circa $17bn currently to $150bn to $200bn based on the current size of the superannuation sector (ie, not factoring in future growth) • While new participants are likely to enter the market, Challenger Life currently captures about 90% of new annuity flows and has a much more sophisticated approach to asset-allocation that traditional annuity providers that allows it to produce 18% returns on equity with only around 5x leverage
• **Yes: major bank senior-ranking FRNs** (Smarter Money Active Cash, Smarter Money Higher Income and the Smarter Money Long Short Credit Fund)	• The major banks' 5 year, AA- rated senior FRNs are paying spreads (90-95bps) that are some 9x wider than their 2007 levels despite massive deleveraging of bank balance-sheets and de-risking of business models • They are also paying these 90-95bps spreads over a much higher BBSW rate, which has leapt from 1.8% to as high as 2.1%, which means that total returns are being lifted by an extra ~30bps per annum • Since the GFC government support for banks has increased with the introduction of a government guarantee of deposits and the RBA's globally unique Committed Liquidity Facility to provide emergency liquidity injections during shocks (these arrangements did not exist before 2008). The government also explicitly guaranteed the banks' senior-ranking bonds during the crisis for a fee. And it now charges the big banks a 6bps per annum tax on their wholesale liabilities as a price to pay for their implicitly government guaranteed status

Investment Ideas

• **Continued…**	• Globally banks are replacing their traditional senior bonds, often called "operational company" or "OpCo" bonds, with bail-in-able senior bonds that count as Total Loss Absorbing Capacity (TLAC). The major banks' senior bonds are OpCo senior bonds that are not bail-in-able and do not count as TLAC. In recent shocks like the Italian crisis and trade ructions, non-TLAC OpCo bonds have significantly outperformed TLAC bonds in both price and liquidity terms • Our analysts project that S&P will affirm Australia's sovereign rating as AAA "stable" as the federal budget moves into surplus, which supports the major banks' senior bond ratings. Australia's budget has been in surplus on 2 of the 3 key measures over the first 11 months of FY2018 in what has been a surprise for most analysts and rating agencies • We believe that if APRA introduces a TLAC regime it will either (1) involve a new Tier 3 security that sits between senior and subordinated bonds, reducing the supply of major bank senior and increasing the subordinated capital protecting it, or (2) entail a new bail-in-able senior security like the Canadians have introduced, which will make the majors' existing senior FRNs a super-senior bond that becomes increasingly scarce • The paucity of repo-eligible OpCo senior bonds around the world as more and more TLAC debt is issued will become increasingly apparent, and drive a scarcity premium for investors seeking repo-eligible assets with superior liquidity characteristics • The major banks have radically improved their equity capital ratios by raising over ~$50bn of equity, which now ranks them among the best capitalised banks in the world. They are also derisking their businesses by selling non-core operations such as their overseas holdings, life businesses, and wealth operations • As balance-sheet growth slows due to the current housing correction, major bank issuance of senior bonds will likely slow. There has been speculation that reduced deposit growth will spur more wholesale bond issuance, but since the GFC the major banks have been encouraged to maintain their deposit bases at around 55% to 60% of assets as a financial stability objective. Reduced deposit flows are therefore likely to be countered by higher deposit rates rather than a greater reliance on wholesale funding
• **Yes: bonds that receive upgrades from higher SACPs** (Smarter Money Active Cash (only senior and T2 bonds), Smarter Money Higher Income and the Smarter Money Long Short Credit Fund)	• S&P downgraded Australia's economic risk score from 2 to 3 (higher is worse) in 2017, which resulted in a reduction in banks' Stand Alone Credit Profiles (SACPs). Because of striking improvements in Australia's fiscal profile, economic activity, and the unwinding of housing imbalances, in 2018 S&P have said that they have put the economic risk score on a "positive trend" for an upgrade from 3 to 2 • With the budget likely to head officially into surplus in FY2018/19, our analysts believe that it is probable S&P will lift Australia's economic risk score, which will in turn upgrade the banks' SACPs. This will increase the credit ratings on the major banks' AT1 hybrids from BB+ to BBB- (crucially putting them back into the investment-grade band). It will also improve some banks' senior and subordinated ratings • Our quantitative analysts' valuation models imply that the major banks' AT1 securities are cheap at current levels with spreads above those required by institutional investors in the USD market, some 3.5x to 4x wider than those that prevailed in 2007, and more than 100bps above mid 2014 levels • Accounting for the larger banks' assets, liabilities, leverage and equity volatility, our bottom-up models imply minimum credit risk premia above BBSW of between 150bps and 250bps compared to current levels of 350bps to 400bps • In APRA's recent stress-tests the 13 largest banks performed much better than the last publicly available results from 2014. APRA reported than CET1 ratios fell on average from 10.5% to 6%-7%, notably above the 5.125% level that results in AT1 securities being converted into equity. This is despite APRA's harsh assumptions, including a 35% drop in house prices, an increase in the unemployment rate to 11%, a 4% contraction in GDP growth, and a mis-selling crisis