Positioning for opportunities in credit and fixed income

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Fund has been able to take advantage of a range of opportunities afforded by the recent tightening of financial conditions.

Over the past year, credit and fixed income markets have grappled with a sharp reduction in liquidity and tightening of financial conditions. The reversal of central banks' extraordinarily easy monetary policy regimes has created significant disruption and liquidity risks are set to persist. The quantitative tightening programs that central banks have embarked upon to combat inflation represent the largest withdrawal of liquidity from global financial markets in history. The Federal Reserve (Fed) recently accelerated the pace of quantitative tightening (asset sales) as it seeks to reduce its nearly $8.5 trillion balance sheet. Navigating these conditions has highlighted the strengths of the Diversified Income Fund's active management approach, with management of risk exposures and exploitation of idiosyncratic relative value opportunities being rewarded during 2022.

In mid-2022, the biggest risk I saw in the coming year was tightening financial conditions and with it, the potential for heightened volatility, price gapping and heightened liquidity risk. To prepare for this, the Fund maintained an elevated allocation to highly liquid assets across cash, government and government-adjacent securities. This allocation was maintained between 20-25% from June to October before reducing to 15-18% as the outlook for credit improved in late 2022. This positioning has not only mitigated the impact of credit and swap spread volatility over the past six months, but it also ensured that the Fund had the dry powder required to execute on opportunities presented by disrupted liquidity.

In October, the release of the UK's mini budget (presented by then UK PM Liz Truss) created chaos in UK fixed income markets. UK government bond yields rose dramatically as investors expected further BOE issuance in order to fund the fiscal expansion. As a result of the sharp spike in bond yields, a number of UK pension funds had to meet margin calls on their derivative positions and liquidated assets at discounted valuations to fund them. During this period, UK pension funds sold over $1.3 billion of Australian Residential Mortgage-Backed Securities (RMBS) on the secondary market (amongst other assets they were liquidating such as global equities). Our purchases of RMBS for Perpetual's Income suite of products accounted for nearly 10% of the RMBS sold by these pension funds. The Perpetual Funds were able buy these RMBS at discounts of 25-50bps below market value, thus monetising the liquidity premium for investors in the funds by providing liquidity to these forced sellers of RMBS.

Whilst this was a unique market event, the pattern of event-driven volatility, price gapping and liquidity disruption has been a fertile hunting ground in recent months. The Diversified Income Fund also took advantage of the surprise change in the Bank of Japan's yield curve control policy (loosening the yield on its 10yr government bonds from 0.25% to 0.5%). The surprise

The ability to execute on opportunities such as these is predicated on the Portfolio's conservative positioning and the careful management of liquidity risks.

2023 will see the continuation of the largest withdrawal of liquidity from financial markets in living memory. As a result of the long and variable lags of monetary policy impacts, the risk of policy errors is elevated. The Diversified Income Fund remains well positioned to withstand liquidity stresses while also retaining the capacity to quickly take advantage of relative value opportunities presented by potential market dislocations.