ASX:PCI

Perpetual Credit Income Trust

ARSN 626 053 496

Perpetual

2022 Year in review

Financial year 2022 (FY22) was dominated by several macroeconomic factors, which made for a challenging market landscape; albeit one with many opportunities for our investment team to deliver returns for our investors. We are pleased that in FY22 the Perpetual Credit Income Trust (Trust; PCI) has continued to deliver to its investment objective of providing investors with monthly income by investing in a diversified pool of credit and fixed income assets.

The Trust has paid monthly distributions since inception which have been in line with the target total return of the RBA Cash Rate plus 3.25% p.a. (net of fees) through the economic cycle[1]. For FY22, 4.38 cents per unit[2] has been paid to investors, which equates to an annual distribution return of 3.9%[3].

Market overview

FY22 saw the end of the post COVID-19 rally in financial markets with markets buffeted by a combination of persistent high inflation, monetary policy tapering and then tightening, alongside rising geopolitical risks. This potent combination saw market volatility spike and most assets classes fall over the first half of 2022. Within fixed income markets, fixed rate bonds' valuations fell dramatically, while floating rate securities exhibited resilience.

Higher inflation rates were brought on initially by very strong economic growth arising from, stimulative monetary and fiscal policy combined with supply chain disruptions caused by the COVID-19 pandemic. These factors were further exacerbated by the invasion of Ukraine, which put extreme pressure on energy and soft commodities, fuelling the highest inflation rates seen in decades.

Monetary tapering – the rolling back of extraordinary policy measures such as quantitative easing – dominated the discourse over the first half before giving way to aggressive tightening and a flurry of rate increases over the second half of FY22. The RBA commenced an aggressive tightening cycle with a pair of higher-than-expected rate rises during the June quarter. Nonetheless, inflation rates are yet to respond, and the risk of higher interest rates still remains elevated.

This has had profound implications for bond markets with yields selling off dramatically as markets priced in future rate hikes and the Bloomberg AusBond Composite Bond Index experienced its worst ever fiscal year return of -10.5%. The Bloomberg Global Aggregate Bond Index is also on track for one of its worst years in history for calendar year 2022. These two indices comprise government and semi government bonds in Australia and globally respectively and measure the performance of fixed rate assets.

While not immune to the elevated volatility, floating rate bonds and strategies substantially mitigated the impact of rising yields and significantly outperformed fixed rate assets over the period.

Credit spreads widened throughout FY22. Credit spreads refer to the compensation or return provided for accepting credit risk, which is the risk that a borrower or counterparty does not meet its principal and/or interest payment obligations as they fall due. When credit spreads tighten, this indicates improving market conditions and/or a more positive view on the risk profile of borrowers. We saw this during the COVID-19 recovery rally in 2021 and it resulted in the value of assets in the portfolio increasing.

1 This is a target only and may not be achieved.
2 Rounded to two decimal places.
3 Distribution return has been calculated based on the PCI investment portfolio return less the growth of Net Tangible Assets (NTA). Past performance is not indicative of future performance.

However, it all ended in FY22 and uncertain economic conditions and the perceived creditworthiness of borrowers deteriorated, leading to the widening of credit spreads and the value of assets in the portfolio decreasing.

Towards the end of the financial year, we saw recession risks come to the fore with rising concerns about aggressive monetary tightening potentially leading to a hard landing. Central banks are left with a delicate balancing act needing to curb rampant inflation while minimising the impact on economic growth.

Investment philosophy and process

At Perpetual, we believe the key to investing in credit and fixed income assets is constructing, and actively managing, a well-diversified portfolio of quality assets. Through the Trust's flexible investment strategy diversification can be achieved across asset type, credit quality, maturity, country and issuer. At least 30% of the portfolio must be held in investment grade assets[4] and the Trust has a maximum allocation of 70% to high yield assets (sub-investment grade and unrated assets[5]). We believe this provides the opportunity to generate higher returns for the portfolio while complementing the allocation to investment grade assets.

The team follows a robust, active and risk-aware approach to investing in credit and fixed income assets. This involves top-down market screening of the credit environment and extensive bottom-up fundamental research to develop a list of approved issuers. Our research seeks to identify attractive issuers who we consider have:

- A good balance sheet
- Predictable cash flows
- Hold a competitive market position
- Have a quality, capable management and governance structure
- Have low susceptibility to the potential impact of regulatory changes, political risk, litigation risk and other types of event risk.

For unrated or sub-investment grade assets, we undertake a more extensive due diligence process, which includes meetings with arrangers and borrowers. We mainly focus on high yield assets that have senior loan positions in the capital structure. This includes senior or subordinated debt which means the investment capital should typically be repaid before capital is repaid to investors in hybrids or shares in the event of a company being wound up. We will not invest unless we have high conviction.

While the Trust has the flexibility to invest globally, our preference generally is to focus on Australian issuers which can be listed or unlisted and denominated in AUD or foreign currencies. We believe our local presence and ability to meet borrowers and their management team provide an advantage in assessing opportunities and managing credit risk for the portfolio. As at 30 June 2022, the portfolio consisted of 82.6% of issuers domiciled in Australia, 4.7% of issuers across North America, Europe and Asia combined and 12.8% in cash.

Our investment process aims to find the most attractive segments of the market and to ensure that adequate compensation is provided for investments. We actively manage risk via our thorough investment process and by diversifying the portfolio across industry sectors, maturities and credit rating bands.

Portfolio composition

The Trust maintains floating rate exposure and short credit duration. We believe these characteristics are beneficial in the current environment and seek to provide better protection against inflation than fixed rate assets.

Firstly, the Trust is likely to benefit from rising interest rates as the interest payments received from underlying assets are expected to rise in line with rising interest rates.

Secondly, short credit duration (average life) is a way for us to manage risk and be less sensitive to credit spread movements. Interest rate duration or credit duration measures the sensitivity of the Trust's portfolio to changes in government bond yields. The Trust reduces this risk by investing in floating rate bonds or by hedging fixed rate exposure with short term government bond futures. This is why the Trust's interest rate duration is so close to 0 (i.e. 30 days as at 30 June 2022). For context, the duration of the Bloomberg AusBond Composite Bond Index, which measures the performance of fixed rate assets in Australia, is about 6 years by comparison. Constructing the Trust's portfolio with short duration has been beneficial over the second half of FY22 as the value of the Trust's portfolio (as measured by the Trust's NTA) was resilient in comparison to fixed rate bond indices and funds which posted deeply negative performance.

We assessed the credit outlook throughout the year and took steps to reduce the risk in the portfolio in order to navigate conditions. For example, the weighted average life (a measure of the Trust's sensitivity to credit spread movements) of the portfolio was reduced from 3.9 years to 2.4 years over FY22.

4 Investment grade assets are those where the issuer is in the rating bands BBB to AAA, as rated by an independent agency.
5 A sub-investment grade asset has a rating below BBB-/Baa3 and includes unrated assets.

At the same time, the Trust's cash allocation increased from 3.8% at the end of June 2021 to 13.5% as at 30 June 2022. We believe this active management contributed to the defensive capabilities of the Trust and will also provide dry powder to take advantage of opportunities offered by credit spread widening as we enter the new financial year.

As at 30 June 2022, the Trust's portfolio held 113 assets across 87 issuers[6]. Investments include corporate bonds, floating rate notes, securitised assets and private debt (for example, corporate loans). 48.6% of the portfolio was invested in investment grade assets[7]. During the year, we elected to substantially reduce the allocation to BBB rated securities where we believed the yields on offer were less attractive for the level of risk. The Trust's exposure in these assets was reduced from 40.8% to 26.8% contributing to the overall reduction in credit risk in the portfolio.

As of 30 June 2022, 50.9% of the portfolio was invested in sub-investment grade or unrated assets[8]. We believe that unrated or sub-investment grade assets provide a point of differentiation for the Trust's investment strategy as they typically pay higher coupons when compared to investment grade assets. While inherently riskier, by undertaking in-depth and enhanced due diligence in this asset class, we believe we are able to critically assess the strength of a borrower and their capacity for repayments, seeking to mitigate the potential downside while generating a valuable source of income.

Trust performance

Over the 12 months to 30 June 2022, the Trust's portfolio returned 0.7%[9], which was attributable to income generated from assets held and changes in the value of the Trust's assets.

The Trust continued to provide monthly income throughout FY22. The Trust remains near fully invested and we believe the portfolio is well positioned to continue to offer investors regular, monthly distributions.

During a period of persistent credit spread widening, we considered the income received from investments to be the most substantial and predictable component of return for the Trust. Income return was the key contributor to performance over the last 12 months and more than offset the impact of widening spreads.

The Trust's income was primarily generated by coupon payments and interest income from investments in loans. The Trust's income return was primarily generated from allocation to non-financial corporates. Residential Mortgage-Backed Securities (RMBS), property and domestic bank exposures also contributed to the Trust's income return. Sharply rising yields and widening credit spreads benefitted the Trust's robust running yield via increasing coupons on floating rate securities. The portfolio's running yield increased from 3.8% in July 2021 to 4.7% in June 2022.

The Trust's floating rate structure, robust running income and defensive positioning continued to mitigate the impact of elevated volatility in fixed income markets.

Credit spread widening detracted from investment portfolio performance over FY22 as a result of inflation, monetary policy and economic growth concerns mentioned above. The most significant detractors of the portfolio over the period were assets in the non-financial corporate sector, Real Estate Investment Trusts, and RMBS. It is worth noting that being a listed investment trust, the share price performance has exhibited some equity-like characteristics. In contrast, the underlying investment portfolio has performed solidly evidenced by the resilience of the Trust's NTA.

As of 30 June 2022, our view is that the outlook for credit markets is challenging and negative, indicating sustained pressure on credit spreads. With this mind, we actively manage and construct the portfolio with anticipation of the market outlook. We are comfortable with the level of risk in the portfolio and have proactively reduced credit risk (e.g. shortened duration). We focus on the diversification in the portfolio by number of assets, as well as allocation across various sectors.

We believe the Trust is well positioned to not only weather the challenging conditions presented by macroeconomic factors but also to generate higher running yields as interest rates rise.

Thank you for your continued support and we look forward to providing you with further updates on the Trust's investments over the coming year.

Perpetual Investment Management Limited (the Manager)

6 Number of holdings and number of issuers reports on a full look through basis (excluding derivates).
7 Investment grade assets are those where the issuer is in the rating bands BBB to AAA, as rated by an independent agent.
8 A sub-investment grade asset has a rating below BBB-/Baa3 and includes unrated assets.
9 Investment returns, net of management costs have been calculated on the growth of Net Tangible Assets (NTA) after taking into account all operating expenses (including management costs) and assuming reinvestment of distributions on the ex-date. Past performance is not indicative of future performance.

Investment objective

To provide investors with monthly income by investing in a diversified pool of credit and fixed income assets

Target return

The Trust has a target total return of RBA Cash Rate plus 3.25% per annum (net of fees) through the economic cycle^.

Investment strategy

The Trust will hold a diversified and actively managed portfolio of credit and fixed income assets.

The Trust will typically hold 50 to 100 assets.

Investment grade assets[10]	**30-100%**
Unrated or sub-investment grade assets[11]	**0-70%**
Assets denominated in AUD	**70-100%**
Assets denominated in foreign currencies[12]	**0% - 30%**
Perpetual Loan Fund	**0% - 70%**

The Trust will diversify exposure and has maximum exposure limits to issuers.

Typical investments will include corporate bonds, floating rate notes, securitised assets and private debt (for example, corporate loans). Exposure to corporate loans may be gained indirectly through the Perpetual Loan Fund.

About the manager

The Trust is managed by Perpetual Investment Management Limited. The Manager has one of the most experienced, proven and stable credit and fixed income teams in the Australian fixed income market. The Manager and the Responsible Entity are wholly owned subsidiaries of Perpetual Limited.

Portfolio manager

Michael Korber

Managing Director, Credit & Fixed Income

Portfolio Manager:
Perpetual Credit Income Trust
Perpetual Pure Credit Alpha Fund

Michael has over 39 years' experience, having been involved in credit markets since their development in Australia during the 1990's. Unlike many other fixed income portfolio managers in this market, Michael has a background in lending and banking, understanding credit risk in a fundamental way.

^ This is a target only and may not be achieved.
10 Investment grade assets are those where the issuer is in the rating bands BBB to AAA, as rated by an independent ratings agency.
11 A sub-investment grade asset has a rating below BBB-/Baa3 and includes unrated assets.
12 As at 30 June 2021, all foreign currency exposures were hedged to Australian dollar floating rate.

Contact

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