yieldreport % PrimeValue Building Wealth Together

PRIME VALUE

Share

CASH AND FIXED INCOME MANAGER

August 2017

In our series of fund manager profiles, we speak to Matthew Lemke, Portfolio Manager of the Prime Value Cash Plus Fund. Prime value provides specialist active management in the in the liquid cash plus & short-term fixed interest asset-classes.

Matthew has over 15 years of experience working in portfolio management and over 30 years in global investment markets in London, New York, Singapore Hong Kong and Australia. Matthew has previously worked for JP Morgan and Deutsche Bank. He has a law degree, and his experience working for a law firm in the area of securities, provides insights necessary to understand the legal aspects of securities in the Fund portfolio. Matthew was instrumental in setting the up in 2014. Prime Value Cash Plus Fund.

YR: Welcome Matthew. The Prime Value Cash Plus Fund has an active cash strategy which has returned 6.5% gross and 5.9% after fees for the 12 months to 30 June, yet term deposits have averaged around 2.8% and the RBA cash rates averaging around 1.5%. What's been the mix of income and capital growth in that return?

PV: In the Prime Value Cash Fund the average gross running yield on the cash and bonds we have held over the last year was 3.4%. We generated a further 2.5% in capital gains across the portfolio through active asset-selection.

YR: What was your best performing asset over the 12 months? What were the return metrics for this?

PV: There was no single stand out performer over the year. The performance of the fund has come as a result of a mix of securities which met our criteria for how exposed to a single stock or a single sector we felt comfortable with. These securities also had to meet our liquidity and credit criteria. We aim for diversity and a spread of risk and as a rule we do not like to single out securities as they all play a part in the portfolio.

The main factors influencing the portfolio return is a combination in roughly equal percentage terms of:

- Investing in securities that are clearly under-valued by the market according to our experience and research
- Credit duration
- Credit rating

YR: Take us through the different market phases and your portfolio positioning over the last 12 months.

PV: The credit market, which generally describes the market for debt securities, is basically comprised of two types of securities – fixed rate bonds and floating rate bonds. The fixed rate bond market has seen a lot of volatility and some price falls as interest rates in Australia have risen from their all-time lows of about nine months ago.

Our Fund, on the other hand, is predominately invested in floating rate debt securities, and the prices of these securities have been well supported over the past 12 months due to the outlook for higher rates in Australia and the improvement in credit conditions in the banking and corporate sectors. Recently we strategically moved to protect invested capital and continue to produce a regular return to investors by shortening our credit duration and increasing our cash holding.

We're now positioned for a reasonably stable credit market through the next 6 to 12 months. We are vigilant to market "surprises", and negative economic and financial market events that might impact the credit market. We place high emphasis on ongoing due diligence and credit analysis of the stocks that we've invested in.

YR: Why do you think credit markets will be stable over the next 6-12 months?

PV: We believe credit markets will be stable over the next 6 to 12 months for several reasons:

- the corporate and bank reports over the past few months indicate stability
- economic data in Australia and major western economies indicates stability the US, European and Chinese economies appear stable
- central banks, supranational agencies such as the World Bank, well-informed economists and other market-watchers project stability
- Market indicators such as the gold price and implied volatility measures available real time in equity, bond, credit, commodity and foreign-exchange markets indicate stability.

YR: The funds gross return over the last 3 years has been 4.4% p.a. Have there been any negative quarterly returns during this period?

SM: Pleasingly, we've never had a negative quarter over the last 3 years (since the Prime Value Fund's inception in June 2014.

YR: What was the highest and lowest rolling 12 month return over the period and what impacted those return outcomes (both positive and negative)?

PV: Our best rolling 12 month period returned 6.5% in the April 2016 to March 2017 period. Our lowest one year return was 2.3% during the August 2015 to July 2016 period.

We have learnt from our best-performing securities that taking a position based on a well-researched view and being prepared and patient to wait for the correct entry-price level will ultimately be rewarded. Our main lesson from our worst-performing securities is that being in liquid securities is paramount to be able to exit efficiently when the fund wishes to no longer hold that security.

YR: what type(s) of investors would your fund be suited to?

PV: This fund will suit investors seeking an income stream in excess of what they can achieve in traditional bank accounts, term deposits and cash management trusts, whilst preserving liquidity and security. As the fund maintains a mix of short term investments and cash, it means the fund is “liquid” and can redeem investor capital within 2-3 days of a redemption request, which is unlike a term deposit where investors will typically incur penalties on early withdrawal.

There are no exit fees or penalties for redeeming units in our fund. We truly seek to provide a “cash” type investment with higher returns than traditional cash investments whilst still at all times protecting investor capital, and giving investors quick access to their funds as required. This is our paramount objective and fully governs all our investment strategies and security investments.

YR: Your FUM has grown by over 25% over the last 12 months to more than $50m. What do the profiles of your investors look like?

PV: Direct retail and High Net Worth individuals (including SMSFs) is where most of our fund flows have come from, although we have Not-For-Profits invested too. The fund’s now been operating for three years and given its performance track record and its level of franking benefits we’re beginning to see more interest from institutional type investors and the Not-For-Profit sector. As a cash fund, our track record is important for investors that typically place special priority on capital protection and return on their cash holdings.

Typically, larger (wholesale) investor account balances are around $500,000 to $1.5m, while for retail investors balances are around the $500,000 to $200,000 mark. While these are the typical account sizes, our minimum investment requirements are $500,000 for wholesale investors and only $50,000 for retail investors.

YR: Has the growth and size of the fund impacted your investment universe or the way that you trade or execute your positions?

PV: The growth in our funds under management hasn’t impacted the universe of stocks or the way we invest. We only invest in stocks that are rated or where the parent issuer is rated investment-grade. We place reliance on the external rating of all stocks in the portfolio and have high regard to their franking, return and liquidity characteristics.

We haven’t encountered any liquidity or other issues in the stocks we manage, or the volume of stocks under management. Through our many years of managing funds in the market, we’re fully aware of liquidity issues that can arise in the market, and manage the fund with this in mind in terms of the securities in the portfolio.

YR: Have you made any additions to your investment team as a result of this growth?

PV: The Prime Value Cash Plus Fund is part of a team of 10 analysts and portfolio managers in the cash plus, equities, agricultural and property investment teams where ideas are exchanged on a regular basis. This combination of perspectives and market involvement is powerful and helps us have a full view of the market so we are not blind-sided by cross-over effects that can happen in markets.

YR: In terms of your strategy, can you briefly describe your investment strategy?

PV: The Prime value Cash Fund's strategy is to provide a return at a reasonable margin above the RBA cash rate whilst protecting investor capital. We achieve this by being spread across investment-grade entities in securities that meet our stringent liquidity and return characteristics, and that pass our credit tests on an ongoing basis.

We are a cash fund and therefore place a high emphasis on being able to return investors' money quickly upon an investor redemption request. We have only invested in Australian securities issued by Australian entities thus avoiding complications that can emerge in offshore markets and investments.

A differentiating factor in our portfolio management focus is the ability to earn and distribute franking credits to investors. We have been successful in this regard and our clients have found this strategy beneficial according to their individual circumstances.

YR: Under what conditions would you expect your strategy to not perform/not outperform relative to RBA cash rates? What strategies do you have to mitigate this?

PV: A major credit market meltdown would impact the portfolio. We mitigate this risk by ensuring that we are only invested in Australian domestic investment-grade stocks that exhibit exceptional liquidity characteristics. Our entire portfolio is able to be sold down in a matter of a few days. This is because we are primarily invested in the professional/wholesale market where stocks can be bought or sold in large volume through the professional market.

We can also shorten overall credit duration if we become nervous about the state of the credit or bond market. This is done quite simply by relevant stock switches.

YR: The fund invests in ASX listed hybrids and notes. What is the thinking behind this?

PV: We restrict our hybrid investments to generally between 0-25% of the portfolio. It currently makes up approximately 16% of the portfolio.

Hybrid stocks provide a robust, ongoing return with the benefit of franking credits. We manage hybrid risk by only investing in stocks issued by major banks/financial institutions in Australia. We ensure that the issuer call date is not too far off so that we have an effective redemption date limiting the impact of any market volatility on market price levels.

We also only invest in hybrids where we have thoroughly examined the issuing documentation and have full knowledge of all regulatory requirements that might impact those hybrids in the market. We're vigilant to any changes in regulatory requirements and read all external credit rating reviews and updates of the financial institutions in which we're invested.

If we believe the risk is rising for these types of instruments we can move (if required) to a position of zero weighting with regards our hybrid investments.

YR: Given your exposure to hybrids, how much emphasis do you place on franking levels?

PV: We don't invest in hybrids just to earn the franking credits. However, this is a clear benefit to investors, both offshore and onshore and particularly to investors that have a low or nil tax paying status such as private individuals, SMSF's and charities/foundations.

Approximately 60-70% of the portfolio is invested in floating rate notes which are traded on an over the counter market which is available only to professional investors. Many investors and advisers aren't familiar with this market and in fact are unable to access it themselves.

Given our benchmark is the RBA cash rate, we naturally want to be invested in floating rate securities. Floating rate securities are a large part of the domestic debt market along with fixed-rate bonds. The floating rate market has been in existence in Australia for decades and pricing and trading conventions are well documented and understood, particularly in the professional market in which we predominantly invest. The fund has only a minor exposure to the fixed interest/bond market.

YR: Looking forward over the next 12 months, what's your view on official cash rates, term deposit rates and credit margins on floating rate notes and what will be the key things to look out for?

PV: The main factors that we constantly review in managing the portfolio are credit markets, equity markets, and other markets such as property/ real estate, foreign exchange and commodity markets. As part of our process, we take note of what the RBA, China and other and other central banks in the major developed industrialised economies are saying or doing by way of changes in monetary policy or local credit conditions.

We also invest in bank securities so place a lot of emphasis on what regulators are saying and implementing with regard to bank capital. We carefully review all major economic data in Australia, the United States, China and other major countries.

We do not factor in specific views on the rates as we manage risk based on the fund criteria and appetite, and investment objectives. We don't place "bets" in the market. Having said that, we believe the US may hike 2 or 3 more times over the next 12 months. We do not believe the RBA will alter rates up or down over the next 12 months.

YR: Inflation has been benign for some time. What is your outlook for inflation and how will you/have you positioned the portfolio for this?

PV: We're extremely well-positioned for any move higher in inflation, because we're almost exclusively invested in floating- rate securities. If inflation moves higher, it is quite likely to be associated with interest rate hikes by the RBA, or the market's prediction for this to happen, which would flow directly through into higher returns on the securities in which we have invested.

YR: What are some potential black swan events that fixed income markets may not have factored in over the next 12 months?

PV: The potential major “black swan” event not factored in by the credit market would be a significant melt-down in equity markets. However, whilst the credit market would be surprised by this, we have adopted a portfolio strategy that would mitigate this eventuality, notably:

- being able to liquidate investments very quickly and efficiently
- our credit duration is low which would mitigate any volatility flow through effects
- being only invested in investment-grade securities mitigating any flow-through credit issues

We watch the market extremely closely and can react quickly to events suggesting an equity market meltdown is imminent.