Perpetual Credit Income Trust

ASX:PCI

2023 Year in review

Dear Investors,

During Financial Year 2023 (FY23), the Perpetual Credit Income Trust (Trust; PCI) marked its 4-year anniversary on the ASX and 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. In FY23, investors were paid 6.90 cents per unit[1] and since inception, the Trust has paid out $77.1 million in distributions or 19.26 cents per unit.

Market overview

Fixed income markets continued to face challenging conditions in FY23 as rising interest rates, persistent elevated inflation and rising recession risks manifested in bond yield volatility. Traditional fixed rate bond strategies recovered slightly in 2023 after their worst calendar year on record but continued to exhibit elevated volatility as markets struggled to anticipate the path of central bank monetary policy tightening.

By contrast, floating rate credit strategies (such as PCI) were well insulated from elevated yield volatility and benefitted from rising interest rates which resulted in higher income for our investors from floating rate coupons. Credit spreads provided a healthy yield premium throughout FY23 as spreads remained wide relative to historical levels.

FY23 also was notable for an elevated number of event driven relative value opportunities throughout the year where spiking volatility or dramatic shifts in yields or credit spreads created a happy hunting ground for active managers. These included UK pension funds liquidating assets as bond yields spiked following the disastrous Truss government mini budget in September 2022, APRA clarifying their guidelines on callable bonds in November 2022, and most recently sharp selloffs in credit (most notably bank hybrids) following the collapses of Silicon Valley Bank and Credit Suisse in March 2023. We aim to construct a portfolio with defensive properties that mitigate the downside of tail risks events such as these, while being able to take advantage of the relative value opportunities left in their wake.

Trust performance

Over the 12 months to 30 June 2023, the Trust's portfolio returned 7.1%[2].

Income return was the single most significant contributor to performance over the past 12 months. The most aggressive monetary policy tightening cycle I've seen has provided a strong tailwind for the Trust's running income as a result of its exposure to floating rate assets. The running yield[3] on the Trust's assets increased substantially over the period from 4.7% in June 2022 to 7.6% in June 2023. The Trust's running yield also continues to offer a robust buffer against ongoing volatility in credit and bond markets.

1 Rounded to two decimal places.
2 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.
3 For the Trust, the running yield is based on NTA and represents the anticipated return on the underlying securities if it is held to maturity assuming nothing else changes.

The Trust's income was primarily generated by coupon payments and interest income from investments in loans provided to non-financial corporates. Residential Mortgage-Backed Securities (RMBS), Domestic Banks and Real Estate Investment Trusts also contributed to the Trust's income return.

Credit spread dynamics contributed to return over the year. Credit spreads represent the yield premium paid to bondholders for taking on credit risk and narrowing credit spreads increase the value of the Trust's assets. Credit spreads remained wide of historical levels through FY23, consolidating after a significant selloff observed in FY22. The most significant contributing sectors to spread return were non-financial corporates and domestic banks while RMBS exposure detracted marginally as spreads widened reflecting elevated securitisation volumes. The Trust's US dollar denominated exposures performed well as USD spreads narrowed throughout FY23. Note that while the Trust has a capacity to invest in foreign denominated bonds, exposures are fully hedged back to Australian Dollars.

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.

Our 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 and predictable cash flows
- Hold a competitive market position
- Have a quality, capable management and governance structure; and
- 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. 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.

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 portfolio is predominantly floating rate, with near zero duration (resulting in very low susceptibility to changes in interest rates) and relatively short weighted average life (reducing the sensitivity to movements in credit spreads). These characteristics are crucial in the current environment as they minimise duration risk, benefit from rising and persistently elevated interest rates (through higher coupons) while managing and mitigating credit risks.

Over the year, the Trust portfolio selectively added risk reflecting the improving outlook for credit spreads (while remaining challenging) and the attractive relative value of new issues. The Trust's weighted average life was lengthened, ending FY23 just under 3-years which – while representing an uplift from June 2022 – remains relatively conservative. The Trust's credit rating exposures are also relatively conservative with 44.1% of the portfolio invested in investment grade assets and cash at the end of FY23. The Trust added to BBB and BB rated exposure over the year, taking advantage of relative value on offer at the nexus of investment grade and high yield.

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.

When it comes to positioning, we believe diversification is incredibly important. As at 30 June 2023, the Trust's portfolio held 126 assets across 87 issuers[6]. Investments include corporate bonds, floating rate notes, securitised assets and private debt (for example, corporate loans). Diversification is not simply about having a large number of issuers or different types of credit quality.

We also spread the risk in the portfolio across a variety of sectors, industries, and asset types such as government bonds, RMBS/ABS, and corporate loans.

In terms of what we look for in the portfolio, the borrowers are typically large corporates with a strong market position, strong barriers to entry to protect their market share from new entrants and high recurring revenues that are resilient to economic downturns.

In contrast, we have very little exposure to companies that have exposure to discretionary spending. We also have no exposure to property development, which is more dependent on economic cycles, and we're mindful that many investors are already heavily weighted to the property sector with their own direct investments.

Changes to the Trust in FY23

The Trust may obtain its exposure to corporate loans and securitised assets indirectly by investing in the Perpetual Loan Fund and the Perpetual Securitised Credit Fund.

In November 2022, the Trust announced an amendment to its investment strategy to allow it to invest in the Perpetual Securitised Credit Fund (SCF) to gain indirect exposure to securitised assets. The establishment of SCF creates operational efficiencies in dealing with securitised assets and provides prospect for greater access to deal flow by utilising the purchasing power and expertise of Perpetual's broader credit and fixed income team. The Portfolio Manager of the SCF is Senior Portfolio Manager Thomas Choi who has worked with the Credit and Fixed Income team since 2010, where his focus has been on securitised and structured assets and the management of investment grade and enhanced cash strategies.

In April 2023, Michael Murphy was appointed as Portfolio Manager of the Perpetual Loan Fund. Michael is primarily responsible for sourcing and assessing investments in the high yield space. As at 30 June 2023, the Perpetual Loan Fund comprised 45.7% of PCI.

Outlook

Ongoing uncertainty around the outlook and the path of monetary policy tightening continue to provide a challenging environment for investors. We believe that diversified actively managed credit plays a crucial role in investor portfolios. The Perpetual Credit Income Trust offers a source of regular income offering an attractive running yield by prudently and selectively taking on credit risk while minimising interest rate risk.

The Perpetual Credit and Fixed Income Investment Team has a proprietary credit scoring process that examines valuation, macroeconomic factors, supply and demand alongside technical indicators to quantitatively assess the outlook for credit markets. As of 30 June 2023, our view is that the outlook for credit markets is marginally negative, indicating a challenging environment for credit spreads.

While risks are elevated, there are also a number of promising corollaries to the most aggressive tightening of financial conditions in decades. Most notably for credit focused and floating rate strategies, rising interest rates fuel increases in the coupons paid on floating rate assets, improving the income generated for investors. At the same time, higher rates and tightening financial conditions means quality issuers come to market offering more attractive yields to take on their debt. These are the conditions where prudent active management can set up portfolios for success. We have been selective in what new issues to add to the Trust portfolio, especially in the high yield and private loan space over the last 12-months but expect to be increasingly active in the coming financial year. While we expect to see more attractive opportunities, recession risks, earnings and credit downgrades mean that prudent management of credit, capital structure and sector risks remains crucial.

We believe the Trust is well positioned to continue providing a stable source of regular income while weathering the challenging conditions presented by the macroeconomic outlook.

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.

6 Number of holdings and number of issuers reported on a full look through basis (excluding derivatives).

Investment objective

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

Target return

To target a total return of RBA Cash Rate plus 3.25%p.a. (net of fees) through the economic cycle. This is a target only and may not be achieved.

Investment strategy

The Perpetual Credit Income Trust invests in a diversified and actively managed portfolio of credit and fixed income assets.

The Trust will typically hold 50 to 100 assets.

Investment grade assets	**30-100%**
Unrated or sub-investment grade assets	**0-70%**
Assets denominated in AUD	**70-100%**
Assets denominated in foreign currencies (which are typically hedged back to AUD)	**0% - 30%**
Perpetual Loan Fund	**0% - 70%**
Perpetual Securitised Credit Fund	**< 5%**

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

Typical investments will include corporate bonds, floating rate notes, securitised assets and private debt (for example, corporate loans).

About the manager

The Trust's investment portfolio is managed by Perpetual Investment Management Limited, part of the Perpetual Group, who believes the key to investing in credit and fixed income assets is constructing a well diversified portfolio of quality assets. Its experienced and highly regarded investment team actively manages investments based on fundamental research and analysis of quality, value and risk.

Portfolio managers

Michael Korber

Managing Director,
Credit & Fixed Income

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

Michael has over 41 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.

Michael Murphy

Senior High Yield Analyst

Portfolio manager:
Perpetual Loan Fund

Michael is an experienced credit markets specialist, having prevoiously worked in high yield, private debt and leverage finance roles. As portfolio manager of the Perpetual Loan Fund, Michael has a focus on sourcing and assessing higher yielding income opportunities.

For more information

Investor relations

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