How the Perpetual Credit Income Trust is being managed in current market conditions

By Michael Korber
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The continuous spread of the Coronavirus (COVID-19) has dominated news headlines and caused volatility across markets since February. Despite the market turmoil, the Portfolio

Manager remains confident in the defensive capabilities of the Perpetual Credit Income Trust (PCI) (Trust) portfolio.

The Manager’s key focus in asset selection is on credit quality and capital stability of issuers, low susceptibility to credit risk and relative value of assets. Accordingly, the Manager is confident with the credit risk held in the portfolio. The Manager has deep experience in the Australian fixed income market and a proven and stable team. The team is well resourced and are highly skilled and experienced in actively managing credit, with an average of 22 years’ experience. This has been evidenced by the team’s proven ability to generate income for investors through multiple market cycles and events by remaining true to their conservative and disciplined investment process.

How the risk is being managed

In line with the Manager’s investment process, the potential risks to the portfolio from COVID-19 are being managed as follows:

Market and economic conditions

- Diversified portfolio of credit and fixed income securities across issuers, sectors and asset types.
- Invest in securities from companies with strong balance sheets.
- Investing in higher parts of the capital structure where value is better retained than at the bottom of the capital structure.
- Monitoring exposure to impacted sectors.

Liquidity risk

- Closed end structure of PCI (i.e. no applications or redemptions) means the Manager is not a forced seller.

Credit risk

- The Portfolio weighted average life is ~4.5 years which is short and less sensitive to credit spread movements (e.g. credit spreads continuing to widen) than longer dated securities.
- Portfolio is well diversified across different types of credit securities, sectors and corporates.
- Detailed fundamental credit analysis undertaken for each security held.

Interest rate risk

- Aim to build a portfolio in which overall interest rate exposure is floating and duration is relatively short.
- Interest payments on a floating rate asset will typically move up or down as market interest rates move up or down.

Distribution risk

- Focus on investing in companies who have a good balance sheet, predictable cash flow and quality and capable management.
- Continuing to collect a running yield on the portfolio.

Composition of the portfolio[1]

PCI's portfolio has 86 holdings across 64 issuers. The portfolio is diversified across different types of fixed income and credit assets and is well diversified across issuers, sectors and asset types.

Credit quality

- 58.8% of the portfolio is invested in investment grade assets. This means that the issuer of the security is rated AA and above, A or BBB by an independent ratings agency such as Standard & Poor's or Moody's.
- Sub-investment grade or unrated assets comprise 41.2% of the portfolio.

Capital structure of issuer

- Over 60% of the portfolio is held in senior debt. This means that in the event an issuer or company is wound-up or liquidated, senior debt has first priority and will be repaid first.

Geographic exposure

- The portfolio is predominately Australian domiciled.
- 87.4% of the portfolio is domiciled in Australia, 8.1% in Europe, 2.9% in North America and 1.6% in Asia.

Sector location

- Less than 5% of the portfolio are securities in the education, tourism and energy sectors and the Manager is comfortable with the resilience of each of those Australian assets (with no offshore names in those sectors).
- No ASX-listed bank hybrids

Types of securities

The portfolio typically comprises bonds and floating rate notes which are tradeable and independently priced at the market value.

The Manager focuses on investing in companies who have a good balance sheet, predictable cash flow and quality and capable management. Typically, the maximum allocation to an issuer is approximately 2% of the portfolio.

Issuance of corporation

- Corporations – this includes bonds and floating rate notes issued by investment grade issuers such as Aurizon, Bluescope, Coles, Downer, and Incitec Pivot or non-investment grade issuers such as Barminco, Next DC, Omni Bridgeway and Zenith Pacific.
- Australian banks – PCI's portfolio includes debt securities issued by Australian banks such as National Australia Bank, Westpac, Bendigo and Adelaide Bank, and Bank of Queensland. The portfolio has no exposure to ASX listed bank hybrid securities.
- Financial corporations and global banks such as IAG, Suncorp and Barclays
- Property trusts such as Vicinity Centres and GPT.
- Investment grade infrastructure groups and utilities such as Port of Melbourne and DBNGP.

Private debt assets and loans

- Approximately 17% of the portfolio which are typically senior secured loans given to well established businesses such as MYOB, Leap/Infotrack and Arnotts to fund acquisitions and capital expenditure.
- These loans typically rank higher on the capital structure than shares and hybrid securities, in the event a company is wound up.
- The Manager's key focus is on high coupons, credit quality and capital stability of issuers and low susceptibility to credit risk.

ABS, CMBS and RMBS

- Approximately 13% of the portfolio in Asset backed securities (ABS), commercial mortgage backed securities (CMBS) and residential mortgage backed securities (RMBS)
- ABS, RMBS and CMBS are priced daily at the readily observable market price
- These securities are collateralized with real assets such as motor vehicles and equipment, commercial real estate and residential property.

Distributions

PCI's income is primarily generated by coupon payments. Investments in loans also provide interest income to the portfolio as the issuing company repays the loan with principal plus interest.

PCI continues to collect a strong running yield with income return predominately by non-financial corporates, prime RMBS, domestic banks and non-bank financials. This has assisted in offsetting widening credit spreads in challenging conditions.

The Reserve Bank of Australia (RBA) announced two interest rate cuts during March, bringing the official cash rate down to 0.25%. The Trust's distributions were reduced in March to reflect the lower official cash rate. Despite this, the Trust's target total return of the RBA Cash Rate plus 3.25% (p.a.) net of fees over the economic cycle remains unchanged[2].

1. As at 13 March 2020.

2. This is a target only and may not be achieved.