GCI State of Play

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Overview

If there is one word RRM would use to describe GCI's performance over its now 3-year track record, it is consistency and consistently exceeding its benchmark return target of RBA Cash Rate + 3.5%. Over the last 12-month period, GCI has delivered a distribution yield of 4.68% and currently has a running yield of 4.46%.

On the back of this successful performance, GCI raised additional capital, the first being $62.1m to sophisticated investors in this September and second being a Unit Purchase Plan raise to existing investors, raising a total of $12.3m and which was completed on 31 October 2021.

As previously expressed, RRM viewed the size of these raises as prudent and aligned with unitholder interests (the sophisticated investor offer was over-subscribed. By this we mean that the raise amounts were calibrated with the expectation by the Manager that the additional funds raised could be invested in a timely manner.

In doing so, the intention was 1) minimising potential cash drag risk (which would ultimately adversely effect monthly distribution levels for a period of time) and, 2) minimising market timing risk with respect to new issuance RMBS pricing at the time (and new issuance RMBS has had strong demand recently).

With respect to the first point noted above, it was the Manager's expectation, and it has indeed been the case, that the additional capital that was raised was invested over the immediate subsequent monthly periods. The consequence is the expectation that there would be no diminution to the monthly distribution amounts relative to preceding monthly levels.

We have recently seen the market pricing GCI at a small premium to NTA. While debt LITs are not generally about capital growth (it is all about income, income, income) RRM does not view this as irrational market behaviour nor implying GCI has become a less attractive investment.

Rather, RRM views it as a rational possible response to a combination of potential factors, specifically:

- As noted above with respect to the sophisticated investor raise being over-subscribed (materially so), potential latent excess demand;
- A now three-year track-record and one of never having missed a beat. That is, the potential diminution of what may of have been any perceptions of performance risk. Or, to put it another way, strong investor confidence;
- Potentially a growing understanding of the RMBS and ABS asset classes (the asset classes had not previously been widely understood). More specifically, the key safeguards with respect to both capital and income that exist in the Australian RMBS market (discussed in greater detail below);
- All RMBS and ABS securities GCI invests in are floating rate notes, providing protection against a rising inflation / interest rate environment (in contrast to fixed rates investment grade bonds, for e.g.).
- And of course, the general search for yield in an environment in which TDs and Investment Grade bonds have been offering negative real yield returns.

Investor Suitability

Performance wise, GCI has not missed a beat. We view GCI as the lowest risk of all the public and private debt ASX-listed LIT vehicles, a view that we view as relatively uncontroversial: Australian RMBS is truly loss remote.

We remind investors that there has never been a default in the Australian market since its advent over 30 years ago. While the distribution profile does not have the higher octane 'sex appeal' of some public and private debt vehicles, nor does it have the higher risk profile. While RMBS has been a mainstay of the Australian fixed income landscape for several decades, many investors (and quite a few analysts outside the ratings agencies) may not have a thorough appreciation of the key structural protections (borrowers' equity, Lenders' Mortgage Insurance (LMI), excess interest, and bond subordination) that make the Australian RMBS truly loss-remote.

In the continuation of a near zero term deposit environment, and given the risk profile of the asset class and expertise of the Manager to maximise return bang for risk buck, we view the Trust as a very strong option for investors seeking stability of income, exceptional downside capital protection, with the comfort the money is managed by a proven manager (comfortably sleep at night factor).

Why RRM remains Favourably Predisposed to GCI

Gryphon - a RMBS Specialist among Generalists - Many participants in the Australian RMBS market are generalist fixed income managers, or certainly not specialising solely in RMBS (or ABS). As a specialist RMBS manager, the Manager has a detailed internal data set to enable it to understand which investments are likely to provide best relative risk-adjusted returns (i.e. relative value plays) where generalist RMBS investors are generally reliant upon the independent ratings agencies and are likely to have a crisis of confidence during crisis periods.

Through Market Cycle Experience Matters - The ability for the Manager to perceive the market opportunity and have the conviction to act, where others were in retreat, stems from two key factors in our view: 1) the Gryphon team has significant experience in working through a number of crises, starting with Russia defaulting in 1998, the Asian crisis, the GFC and the European debt crisis. GCI's portfolio positioning as it sits now and for the bulk of 2020 was shaped by the events of the Covid market dislocation in March and April of 2020. When the extent of the pandemic became evident in March 2020, many generalist RMBS investors pulled back from the RMBS market.

Proof is in the (Performance) Pudding - The retreat of many generalist investors in the April - May 2020 period led to what the Manager identified as repriced opportunities. Over the March to May 2020 period, the Manager was able to transact and reinvest around 40% of the total portfolio. In doing so, not only did the Manager reduce the risk in the portfolio but, on account of the dislocation event, garnered a higher portfolio running yield and, by extending the portfolio credit duration, to lock in these higher returns for longer. This impact is evident in the uptick in distributions from June 2020 onwards. Solid performance in up markets is clearly valued, but solid performance in down markets is even more appreciated by investors.

Gryphon Capitalises on the Advantage of Captive Capital - The portfolio repositioning above is a perfect illustration of the primary advantage of a close-ended investment vehicle - the ability to capitalise on market dislocation events. The Manager siezed on this opportunity during the Covid sell-off. Open-ended unit trusts, in contrast, run the risk of outflows and being forced sellers at precisely the worst time. A common lament this analyst has is many LIC managers do not actually capitalise on this key advantage (and one that can offset the additional risk of share price to NTA movements).

Australian RMBS Outlook Remains Stable - This stable outlook, as S&P states "is underpinned by the robustness of transaction structures, credit support build up, and the relatively strong collateral quality of most asset pools." "The transition away from mortgage-relief arrangements is continuing in an orderly fashion" and "we expect around 1.0%-1.5% of loans in the Australian prime RMBS sector to transition to formal hardship arrangements at the end of mortgage relief periods." S&P also expects rising arrears to be tempered by relatively modest LVR profiles and rising house prices.

The Four Key Protections in Australian RMBS - RMBS deals' liquidity and bondholder protections in the form of excess spread and note subordination lessen any credit negative effects of a potential downturn in the Australian property market. For any investor that wishes to gain a full understanding of these protections, the RBA produced an excellent document entitled 'Structural Features of Australian Residential Mortgage-backed' in 2015.

Inflation Risk Protection – Jerone Powell, the US Federal Reserve chairman, this week may have gone some way to resolving the single largest question that has been occupying markets over the last 12-months – is inflation a transitory risk or a more permanent one? And he just moved beyond the 'transitory' characterisation. All the RMBS and ABS securities GCI invests in are floating rate notes. As the Manager notes, the notes are structured so that their interest resets monthly to the current level of interest rates. If the RBA increases rates, the interest rate on GCI's investments will also increase at the same time. I.e., distributions to investors would increase. In contrast, it is investment grade bond investment vehicles that are most at risk in such an environment (hence the recent sell-off (capital loss risk) in this market).

RMBS Market Developments & Outlook

The Australian RMBS market has experienced a strong 2021 period, and it is probably fair to say that it has performed better than what the ratings agencies were predicting at the beginning of the year.

At that point, the outlook was in itself relatively rosey, or specifically 'Stable'. For example, Fitch had a Stable Outlook on all RMBS ratings in Australia. Fitch had said it expected mortgage arrears to increase to 2.0% in 2021 and losses to increase after the expiry of payment holidays and government stimulus measures were tapered. Nevertheless, its outlook remained Stable as it believed transactions had sufficient credit enhancement, excess spread and adequate liquidity to absorb any higher losses. While it had expected excess spread to reduce in 2Q21, as more borrowers fell into arrears, it noted that the recent recovery in property prices over the 2H20 period would have prevented rising losses if borrowers defaulted.

What we have actually seen is not only an extremely orderly transition away from mortgage relief arrangements (which was expected) but a significantly lesser degree of loans in the Australian prime RMBS sector transitioning to formal hardship arrangements at the end of mortgage relief periods. The level of hardship assistance that now exists (compared to 2020) is miniscule compared to the 2020 period.

What has driven this? Well it has transpired essentially due to the fact that the need is simply not there; unemployment is low, household savings have increased over the lock-down periods, in some cases household members are still receiving some sort of fiscal assistance and Australian mortgage interest rates are historically low, which is positive for borrowers' capacity to repay loans. In this context, there has been a very low level of delinquencies. Australia's 30+ days mortgage arrears fell by 13bp to 1.02% qoq in 3Q21.

The outlook remains stable based on a continuation of the factors noted above as well as the RMBS market being underpinned by the robustness of transaction structures, credit support build up, and the relatively strong collateral quality of most asset pools. On the topic of collateral quality (homeowner equity largely), all investors would be well aware of the exceptional growth in both the metropolitan and regional property markets over the last 12-months. The exceptional growth in house prices over the past year raises the likelihood that borrowers in financial difficulty will be able to sell properties at high enough prices to repay mortgages and avoid a delinquency or default.

Not surprisingly, while home prices continued to rise in 3Q21, with Australia's eight capital cities recording a quarterly increase of 4.7%, the pace is slowing. And the expectation is this slowing trend will continue into 2022 due to increasing affordability constraints. To our knowledge, CBA has issued the most 'aggressive' expectation of a decline in the housing market, predicting a 10% decline in 2023. But, as the Manager notes in its October 2021 monthly update, Australian RMBS has multiple layers of protection (borrowers' equity, Lenders' Mortgage Insurance (LMI), excess interest, and bond subordination), protecting RMBS investors in even a prolonged downturn.

As a 2020 RBA research paper concluded, for a home loan borrower in Australia to default requires both an inability to repay the loan, and (importantly) the home loan to also be in negative equity. The RBA has made clear that it will not be raising rates until full employment is achieved. And it may also be worth noting that job vacancy adds are currently 30% higher than pre Covid 19 levels. The GCI portfolio has a very small number of loans in negative equity and without mortgage insurance.

Meanwhile in the Australian RMBS market itself, there has been very strong institutional demand for new issuance right across the capital stack from Prime RMBS (AAA, AA) to the Mezzanine level (A, BBB). This demand has been reflected in contracting spreads, which has been most pronounced in the Prime segment in the market and to historically tight levels. This has ultimately fed into a slight upward revaluation in the GCI NTA.

However, spreads have contracted in the Prime RMBS segment to such a degree that many large international buyers in Prime RMBS segment have stepped away from the market, seeing better relative opportunities elsewhere. The Prime RMBS section of the capital stack of a new issue has been the hardest part to sell, with demand remaining solid for the Mezzanine stack.

It is the Manager's view that spreads will need to widen moving forward to attract sufficient demand. Should it transpire, then one could expect a small degree of downward pressure on the NTA of GCI. However, it is the Manager's expectation that any downward pressure would be minor. For example, a $2.03 NAV/unit to a $2.00 NAV/unit move.

Would this have an impact on income distribution levels? Well, the answer to that is an emphatic absolutely no. And as we noted previously, when it comes to a debt LIT such as GCI it is all about income, income, income.

Portfolio Positioning

Clearly the broad market outlook is important but, of course, the Manager's portfolio positioning is equally important to perceived risk and return moving forward. In this regard, we would remind investors that the over-riding principals of the Manager's approach to portfolio construction and management is firstly to preserve capital (which it has an excellent track record in delivering upon) and, secondly, in this context seeking out the most attractive relative value offerings to maximise return within a given risk constraint.

There is a number of points to focus on in relation to the GCI portfolio in general, as per the November Monthly report.

Diversification - First, the mortgage loans portfolio is diversified by number of bond holdings, numbering 103, secured on 105,022 loans as at 30 November 2021, and diversification by maturity bucket. Both serve to insulate the portfolio from market volatility. The relatively tight maturity window of slightly over two years comprises many bond holdings that mature over the next 12-months, which facilitates market confidence in getting their investment back rather than a more extended time frame.'

+90 Days Arrears - In terms of changes, the most important metric is the +90 days arrears figure. The 90 days arrears figures teases out how many borrowers are in distress. At 0.40% as at 30 November 2021, this level is broadly consistent with its pre-Covid levels. This illustrates, that despite the Covid turbulence GCI has not recorded a material increase in loans with +90 days arrears. To put the 0.40% figure in perspective, the major banks typically have +90 days delinquency rates at around the 80-90 bps level, i.e. GCI is approximately almost one-third that level. The 0.40% figure also compares very favourably to the market wide level noted above, specifically 0.70% as at June 2021.

Weighted Average LVR - With a weighted average indexed LVR of 66% and a weighted average loan size of $566K, the average borrower has approximately $290K equity in their home – this equity in the home is the first (of four) protections against loss for bondholders. The percentage of the book representing an LVR greater than 80% sat at 0.1%.

Moving Forward - In terms of looking forward, the operative words for any portfolio shifts is that any such changes "will be at the margin". GCI has a core portfolio of RMBS securities such that any changes are expected to occur around the edges - the Manager must remain true to label. Furthermore, the market and asset class is not one set-up for rapid wholesale changes in portfolio holdings. A 4-5% shift in the portfolio is considered a large move. And to provide some context, this was the degree of the move the Manager made during peak Covid in 2020 when it de-risked the portfolio by increasing its relative weight into Prime RMBS.

With regards to portfolio changes, it is a case of 'steady as it goes', which is exactly what an investor would expect in an income product with the risk-return objectives of GCI. Specifically, consistency of income, a focus on capital preservation, minimal fluctuations in NTA, and no surprises.

Performance Analytics

Detailed performance analytics are contained overleaf based on RRM's standardised template for Debt LITs. The historic performance of GCI since inception is now in excess of three years, a time period that is considered a key threshold for many investment research houses. We would also note this time period covers a market disruption event during the Covid period (not that the Manager had not been tested in prior market disruption events).

We would note the following:

Distributions - Since construction of the target portfolio was completed in September 2018 (as outlined in the IPO PDS), there has not been a single monthly period in which the Manager has missed its target rate of return and the distribution profile (vs the RBA Cash Rate) has been particularly consistent, which we would expect from an adept RMBS investment manager;

Capital Preservation - It is often said that investors value solid performance in up markets but value it more in down markets. GCI delivered well during the ructions of 2020 – income levels actually increased and the Manager successfully preserved capital.

Share Price to NTA Performance - Share price to NTA performance has, excluding the ructions post March 2020, been relatively stable. Whatever weekly variations there are around this, we would view as simply supply and demand issues.

Distributions Moving Forward - Where income goes in 2022 will largely in our view be determined by the direction of global bond markets and the market consensus now is they are likely to go only one way - up. Bear in mind that all instruments GCI invests in are floating rate notes; if the RBA increases the cash rate (and the market is pricing in four 25 basis point increases), then the GCI distribution will increase. As an aside, in such an environment, probably the last place an investor would want to be in is investment grade bonds (high yield bonds are a little more complicated in such an environment).

GRYPHON CAPITAL INCOME TRUST (GCI)

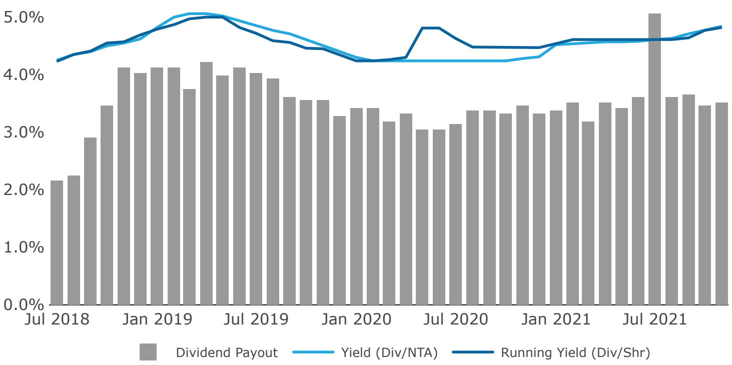
Fund Facts

Manager	Steve Fleming / Ashley Burtenshaw
Listing Date	18-May-2018
Share ($) / PreTaxNTA ($)	$2.03 / $2.02
Premium/(Discount)	0.50%
Market Capitalisation ($M)	$493.62M
Management Fee	0.72%
Performance Fee	None
Peer Index	Fixed Income LIC Index
Trailing Yield	4.57%
Target Distribution	RBA Cash Rate + 3.5%

Fund Features

GCI is a specialist Australian Residential Mortgage Backed Secuities (RMBS) and Asset Backed Securities (ABS) investment vehicle and is managed by Gryphon Capital Investments. GCI is the only focused RMBS / ABS (structured finance) ASX-listed LIT in the market. The predominant portfolio positioning is to RMBS (84% at April 2021) rather than ABS (15%). The RMBS portfolio has to date, and is expected to remain materially invested in Prime RMBS versus Non-Conforming RMBS, i.e. at the lower end of the RMBS risk spectrum. That said, the manager is market opportunistic, seeking to rotate the portfolio based on perceived attractive risk-adjusted relative value plays. Gryphon Capital Investments was formed in 2014 and has exhibited an impressive track-record with respect GCI since its IPO date in May 2018. The Trust is underpinned by a highly experienced investment team and one that is an RMBS specialist in a sector dominated by fixed income generalist investment managers (read: information advantage). As a specialist RMBS manager, the Manager has a detailed internal data set to enable it to understand which investments are likely to provide best relative risk-adjusted returns (i.e. relative value plays) where generalist RMBS investors are generally reliant upon the independent ratings agencies and are likely to have a crisis of confidence during crisis periods. This was evident in the manager's early and confident repositioning of the portfolio post peak Covid, in addition to being a perfect illustration of the primary advantage of a close-ended investment vehicle - the ability to capitalise on market dislocation events. The Trust has a target return of RBA Cash Rate + 3.50% p.a., of which it has never missed since September 2018 when the manager had achieved its target portfolio construction as per the IPO PDS. RRM reminds investors that there has never been a default in the Australian RMBS market – it is truly a loss remote asset class. GCI recently finalised a placement to wholesale and sophisticated investors up to a maximum of 15% of total issued capital (over-subscribed) and a UPP to existing investors.

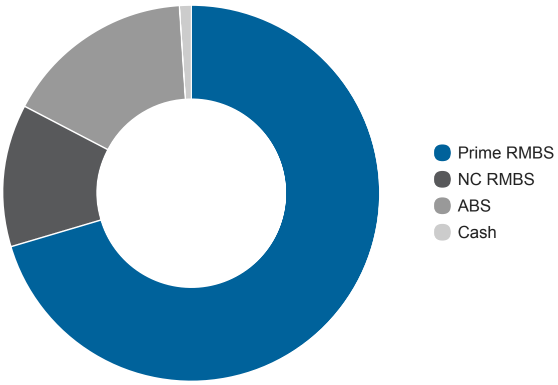
Yield & Running Yield



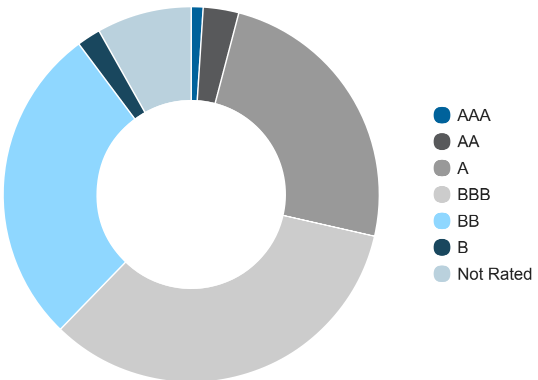
Portfolio Statistics

Running Yield	4.46%
Distributions (12m)	4.68%
Interest Rate Duration (yrs)	0.04 yrs
No. of Bond Holdings	103
No. of Underlying Mortgage Loans	105,022
Prime RMBS	61%
NC RMBS	17%
ABS	19%
Cash	1%

Collateral Allocation



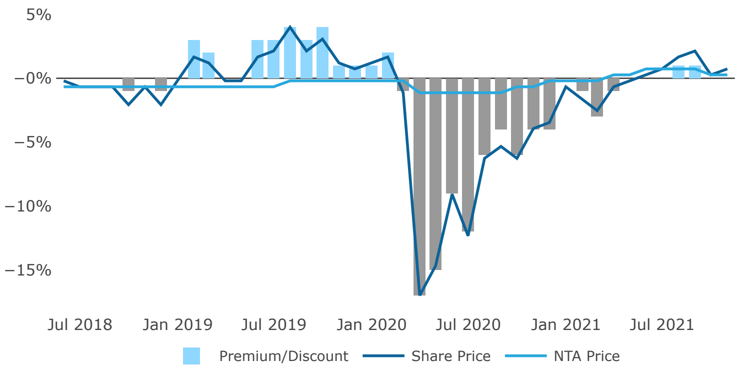
Rating Diversification



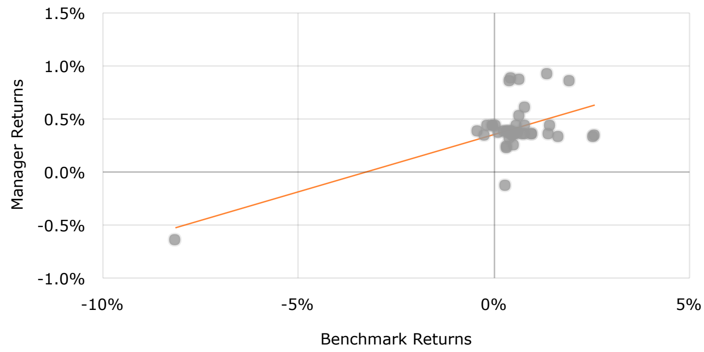
Index Excess

	GCI NTA	Peer Index	Excess
3 Months	0.62%	0.84%	-0.22%
6 Months	2.43%	2.27%	0.16%
1 Year	5.70%	7.54%	-1.84%
2 Years (PA)	4.73%	5.44%	-0.71%
3 Years (PA)	5.04%	5.54%	-0.49%
5 Years (PA)	-	-	-
Inception (PA)	4.90%	5.29%	-0.39%

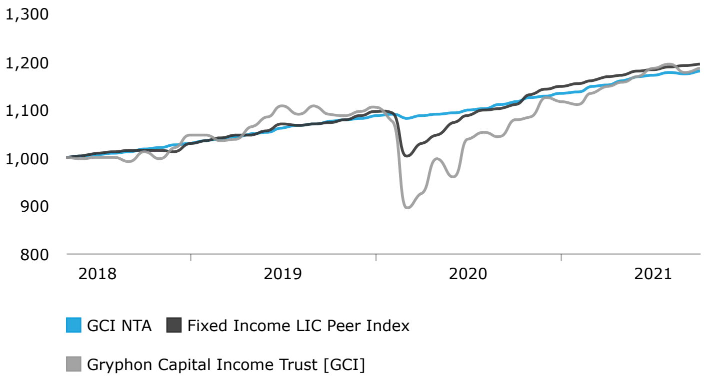
Premium / Discount to NTA



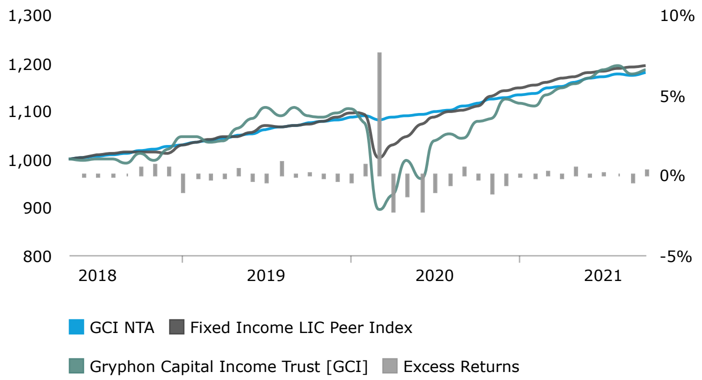
Manager Consistency



Cumulative Total Returns



Excess Returns

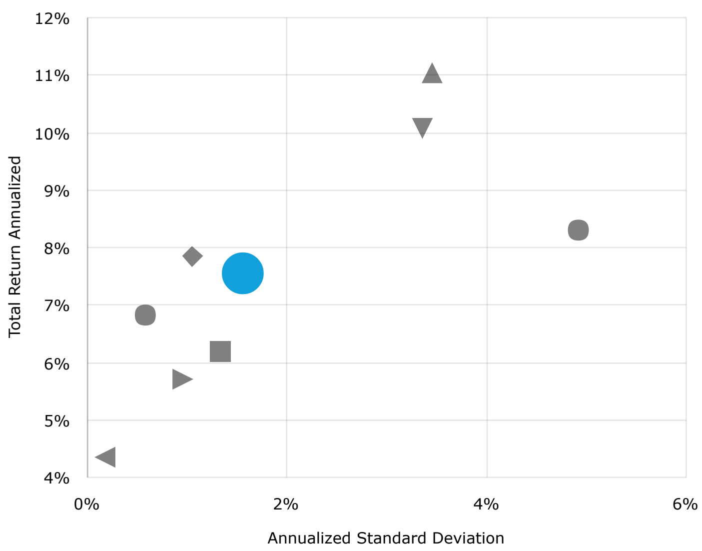


Click for Performance Analysis

Risk & Efficiency

	1 Year	2 Years	3 Years	5 Years	Inception
Ann. Standard Deviation	0.96%	1.07%	0.93%	-	0.89%
Ann. Downside Dev.	0.13%	0.46%	0.38%	-	0.35%
Sharpe Ratio	5.82	4.35	5.28	-	5.41
Sortino Ratio	42.73	10.04	13.07	-	13.57
Beta	0.30	0.11	0.11	-	0.11
Tracking Error	1.53%	6.16%	5.09%	-	4.77%

Peer Index Comparison (Trailing 12month)



Click for Peer Index Comparison

Capital Preservation Measures

	1 Year	2 Years	3 Years	5 Years	Inception
Outperform consistency	66.7%	66.7%	63.9%	61.7%	57.0%
Up Market Capture	249.3%	190.7%	191.9%	183.1%	191.1%
Down Market Capture	96.5%	157.9%	161.1%	123.9%	126.9%
Drawdown	-3.5%	-26.9%	-26.9%	-26.9%	-26.9%

THE ETF AND LMI SPECIALISTS

About Risk Return Metrics

Risk Return Metrics Pty Ltd (ABN 98 642 969 819, AFSR no. 001286457) was established by the company's principal Rodney Lay in June 2020 with the express intention to provide institutional grade absolute and relative performance analysis and ratings for retail and wholesale investors, IFAs and investment managers. The primary focus is on the managed investment sectors, both LICs/LITs and Active and Passive ETFs listed on the Australian market. A secondary focus is on the provision of select quantitative based profiles on select Australian domiciled unlisted managed funds. In total, RRM is expected to provide monthly updates on approximately 550 Australian domiciled investment strategies across the full asset class spectrum.

The investment product reports produced by RRM contain a number of differentiating factors to which have and are currently available in the Australian market, with the most notable being 1) HTML-based sub-reports for each strategy and 2) the emphasis on peer group benchmarking for comparative analysis as opposed to the industry standard of utilising industry benchmarks.

The former function enables the provision of detailed metrics regarding returns, risk/capital preservation, performance path, and efficiency, but does so by way of the sub-report feature without comprising the conciseness and readability of the primary report. Less is More, and More is More. The latter is viewed as a superior comparative basis in terms of facilitating investor choice regarding competing investment strategies in a particular (sub-)asset class.

In March 2021, RRM successfully obtained both a retail and wholesale research rating license (Risk Return Metrics Pty Ltd is an authorised representative of Alpha Securities Pty Ltd (ACN: 124 327 064, AFSL: 330757). The retail license is essential to enabling the broad distribution of rated research reports, and is deemed essential for both the LIC/LIT and, in particular, the fast growing ETF segment in Australia, from the perspective of maximising value of ratings research dollar spent by investment managers.

Rodney Lay has 25 years' experience in investment analysis, first starting as an equities analyst at BZW / ABN Amro. Subsequently, he specialised in structured products in the lead up to the GFC and then moved to a dedicated focus on listed and unlisted managed investments. Rodney has had a long involvement in the listed space of the market, both LICs/LITs and ETFs.

Asset class experience is broad, including equities (long-only, long/short, market neutral, enhanced income), global listed infrastructure and property, alternative strategies (hedge funds, global macro, quantitative strategies), retirement solution products, private assets, and public and private debt. Public and private debt strategies have been a particular focus over the last three years, reflecting growing retail and wholesale client demand.

Rodney has a strong understanding of the nuances of different investment structures, including LICs/LITs, Active ETFs, SMAs/ IMAs and the recently launched dual listed/unlisted structure. Rodney has undertaken investment analysis on behalf of some of the most recognised global and domestic fund managers in both the listed and unlisted investment strategy sectors.

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