AUSTRALIAN

RESEARCH

INDEPENDENT INVESTMENT RESEARCH

Gryphon Capital Income Trust

(ASX: GCI)

March 2021

INDEPENDENT
INVESTMENT RESEARCH

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4) Our research process for valuation is usually more conservative than what is adopted in Broking firms in general sense. Our firm has a conservative bias on assumptions provided by management as compared to Broking firms.
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6) All staff are not allowed to trade in any stock or accept stock options before, during and after (for a period of 6 weeks) the research process.

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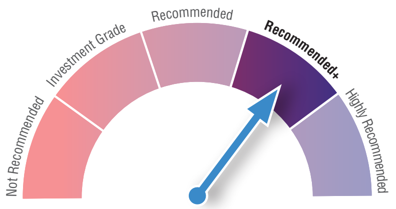
Note: This report is based on information provided by Gryphon Capital Investments Pty Ltd as at March 2021.

Rating



Key Investment Information	
ASX Code:	GCI
Unit Price at 29 March 2021	$1.985
NAV per unit at 28 Febraury 2021	$2.01
Listing Date	May 2018
Distribution Frequency	Monthly
Structure	Listed Investment Trust
Investment Classification	Fixed Income
Responsible Entity	One Managed Investments Funds Limited
Investment Manager	Gryphon Capital Investments Pty Ltd
Fees (net of GST & RITC):	
Management Fee (p.a)	0.72% (incl. GST)
RE & Custody Fee (p.a)	0.054%-0.056%
Expenses (p.a)	Expected range 0.12%-0.14%
Performance Fee	na

Fee Commentary

The management fee is at the low-end compared to LIC/LIT fixed income peers with a peer group average management fee of 0.93%.

OVERVIEW

Gryphon Capital Income Trust (GCI or the "Trust") is designed to provide investors with regular monthly income through an actively managed portfolio of Residential Mortgage Backed Securities (RMBS) and Asset Backed Securities (ABS). The Trust is managed by Gryphon Capital Investments Pty Ltd (the Manager), a specialist fixed income manager and is the only fixed income LIC/LIT with exposure primarily to RMBS and ABS. The portfolio is typically positioned predominantly to RMBS with the portfolio weighted largely to Prime RMBS versus Non-Conforming RMBS. As at 28 February 2021, 85% of the portfolio was invested in RMBS, with 78% of the RMBS exposure being to Prime RMBS and 7% to Non-Conforming RMBS. The portfolio has been weighted to the lower risk Prime RMBS since its inception in May 2018 and this is expected to continue. With that said, the Manager is market opportunistic and will rotate the portfolio to identified attractive risk-adjusted value plays. Since becoming fully invested post listing, the Trust has performed well with the Trust meeting or exceeding its return target of the RBA cash rate + 3.5%p.a, net of fees and expenses. The performance is underpinned by an experienced investment team that specialises in RMBS and ABS.

INVESTOR SUITABILITY

The Trust is designed to provide unitholders with a monthly income stream and as such is suitable for those seeking a regular income stream. On average, the Trust has generated an annualised distribution yield of 4.52% based on the distribution as a percentage of NTA, since listing. We view GCI at the lower-end of the risk spectrum for ASX-listed public and private debt vehicles, given Australian RMBS has been loss remote. There has never been a default in the Australian Prime RMBS market since its advent over 30 years ago. RMBS has been a mainstay of the Australian fixed income landscape for several decades and there are key structural protections (borrowers' equity, Lenders Mortgage Insurance (LMI), excess interest and bond subordination) that make the Australian RMBS loss remote. Given the continued low rate 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 an investment option for investors seeking an enhanced return on cash with stability of income and downside capital protection.

RECOMMENDATION

Independent Investment Research (IIR) has assigned the Gryphon Capital Income Trust (ASX: GCI) a **Recommended Plus** rating. The Manager offers a fixed income investment with a difference when compared to other listed fixed income managed investments, providing exposure primarily to the Australian RMBS market. The Trust has been "true to name" since listing in May 2018, with the Manager delivering on target returns and portfolio exposures. Investors get access to a specialist RMBS manager with market cycle experience and investment team stability with the Manager having little turnover in the investment team since it's establishment seven years ago. The Trust has met its monthly distribution mandate and the teams experience was highlighted during the COVID-19 market sell off, which saw the Manager able to capitalise on market conditions to deliver an improved performance. Unitholders were delivered a stable monthly income while the market experienced its turbulence providing a good insight into the diversification benefits that fixed income can deliver to an investors portfolio.

SWOT

Strengths

- The LIT structure is close-ended and provides the Manager with a fixed pool of capital. As such the Manager does not have to manage the threat of redemptions from the Trust. This has proven particularly important in the retail market where investors are still learning about the mechanics of the RMBS market, an asset class that has historically only been available to institutional and wholesale investors.
- The Manager is a specialist RMBS and ABS manager with the Manager having detailed internal data to enable them to understand which investments are likely to provide the best relative risk-adjusted returns. The Manager's knowledge of the asset class was evident in 2020, which saw the Manager able to take advantage of the market dislocation and deliver an improved outcome for unitholders through higher distributions and reduced risk in the portfolio.
- The Manager has delivered on target returns, monthly distributions and portfolio exposures since GCI listed in May 2018.
- There are a number of structural protections in RMBS (borrowers' equity, Lenders Mortgage Insurance (LMI), excess interest and bond subordination) that reduce the risk of capital impairment. These structural protections in combination with Australia's low delinquency rates have resulted in Australian Prime RMBS being loss remote.
- The Trust has raised additional capital since listing. The swift deployment of capital by the Manager resulted in no apparent yield dilution for unitholders. The additional capital also enhanced the diversification of the portfolio and reduced costs per unit.
- The Manager provides a high degree of transparency for this type of portfolio, which provides unitholders with a better understanding of the Trust's investments and the level of risk in the portfolio at any given time.

Weaknesses

- While the Trust has performed well, we note that the Trust has less than three years performance history. While the Trust is young we note the investment team is highly experienced in RMBS and ABS and have experience through a number of market cycles and disruption events.

Opportunities

- The Trust is unique with the Trust being the only listed fixed income vehicle that provides exposure to predominantly RMBS. This can provide an element of diversification to an investors portfolio.
- The Trust provides a fixed income alternative to generate an enhanced return on cash in a Trust that is viewed at the lower end of the risk spectrum.

Threats

- While there has historically been no defaults in Australian Prime RMBS, we note that the asset class is not immune to risk. While there are a number of structural protections in place that reduce the risk associated with these investments, a significant and prolonged economic and/or property downturn would have the potential to result in capital loss.
- Being a listed vehicle, the Trust may trade at a discount or premium to the NTA, a fact that was made evident during the COVID sell off. While discounts provide an entry opportunity for investors, existing unitholders may not be able to sell their investment at a price equivalent to NTA. We note that with the exception of the COVID market sell off in 2020, the Trust has traded in a tight band around the NTA.
- Further capital raisings may result in dilution to unitholder distributions. We note that while this is a risk with regard to any capital raisings for managed investments, the Manager has shown they will only raise capital in the event the funds can be deployed in a timely manner to avoid distribution dilution for unitholders.

TRUST OVERVIEW

Gryphon Capital Income Trust (ASX:GCI) is a fixed income Listed Investment Trust (LIT), designed to provide investors with regular monthly income through an actively managed portfolio of Residential Mortgage Backed Securities (RMBS) and Asset Backed Securities (ABS). The Trust is managed by Gryphon Capital Investments Pty Ltd (the Manager), a specialist fixed income manager that was founded in 2014 by Steven Fleming and Ashley Burtenshaw.

The Trust invests in a portfolio of RMBS and ABS with a minimum of 70% of the portfolio expected to be invested in RMBS. The RMBS investments are expected to be predominantly in the lower-risk Prime RMBS as opposed to Non-Conforming RMBS. At 28 February 2021, the portfolio had a weighting of 78% to Prime RMBS and a 7% weighting to Non-Conforming RMBS.

Portfolio Allocation (as at 28 February 2021)	
Investment	**Portfolio Weighting**
Prime RMBS	78%
Non-Conforming RMBS	7%
ABS	12%
Cash	1%

The portfolio will only invest in securities that are fully secured by collateral domiciled in Australia and is expected to primarily invest in securities that are rated AA and below, however, the Manager can invest in AAA rated securities. At least 50% of the portfolio is expected to be invested in investment grade securities (BBB- and above).

Ratings Breakdown (as at 28 February 2021)	
Rating	**Portfolio Weighting***
AAA	1%
AA	4%
A	23%
BBB	36%
BB	22%
B	3%
NR	9%

*Excluding the Manager loan.

The Trust will seek to pay a monthly distribution that is expected to match the net income generated by the Trust. The Manager has met the monthly distribution payments since listing.

The Trust has a target return of RBA cash rate + 3.5%p.a, net of fees and expenses. As detailed below, the Trust has met or exceeded the target rate since becoming fully invested in September 2018.

The Manager receives a management fee of 0.72% p.a. (net of GST & RITC) of the NAV of the Trust. No performance fees apply to the Trust. The management fees are at the low-end when compared to other fixed income LIC/LITs.

RMBS OUTLOOK 2021

RMBS performance in 2H'CY20 remained strong, with RMBS transactions continuing to experience extremely low levels of realised collateral losses. Excess spread was sufficient to cover these losses on all transactions in 2H'CY20.

The critical foreseeable development for the Australian RMBS market in 2021 is the end of the mortgage-relief arrangements in March. However, we note that the ratings agencies have stable outlooks on the Australian RMBS sector with, for example, S&P stating it expects "COVID-19 related rating actions in the major asset classes of RMBS and ABS to be limited, if any, to the lower-rated tranches of some non-conforming transactions and small-ticket CMBS transactions, given their higher exposures to self-employed borrowers" (Australian Structured Finance Outlook for 2021 - dated 26 January 2021).

This stable outlook, as S&P goes on to say "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.

Fitch has Stable Outlooks on all RMBS ratings in Australia. Fitch has said it expects mortgage arrears to increase to 2.0% in 2021 and losses to increase after the expiry of payment holidays and as government stimulus measures are tapered. However, outlooks remain Stable "as we believe transactions will have sufficient credit enhancement, excess spread and adequate liquidity to absorb higher losses." While it is expects excess spread to reduce in 2Q'CY21, as more borrowers fall into arrears, the recent recovery in property prices should prevent rising losses if borrowers default, it recently stated.

Gryphon themselves points out that "despite the turmoil of 2020, we have seen the Australian consumer respond in the most encouraging ways, largely using mortgage payment holidays to pay off more expensive debt before returning to making regular mortgage repayments." Additionally, we note that the Household Saving Ratio increased materially throughout the year (to 19.8% from 6.0%), and major population hubs (metro and regional) are now back to property price peaks (lowering LVRs).

The comments from the rating agencies above echoes the Manager's 'mantra' regarding the four key protections in Australian RMBS, namely borrowers' equity, LMI, excess interest, and bond subordination. In short, based on these four protections and the expected dynamics discussed in the above paragraphs, Australian RMBS is expected to remain loss-remote.

Where is the RMBS Sector Risk Greatest?

The comments above relate to the Australian RMBS sector as a whole. Of course, given the pandemic has thrown the country into its first recession in 30 years, the impact is expected to vary by geography and RMBS sub-sector. In the more immediate period post March-April last year the three sub-sectors noted below were identified as having the greatest risks. While this may continue to be the case, we note that the performance subsequently of certain sub-sectors has surprised to the upside, particularly SME loans.

- **SME Loans** - risks were expected to be greatest for deals exposed to SMEs, impacting RMBS portfolios with a larger proportion of self-employed borrowers or borrowers employed by SMEs. However, repayment deferrals to SME borrowers, which peaked at 18.0% in May (vs 11.3% for housing loans) declined to 1.9% as at 31 December (vs 2.4% for housing loans). It remains to be seen whether the cessation of Government support (JobKeeper) will adversely impact performance over 2021.
- **Investment Loans** - declines in rental income, which are more pronounced in particular areas, may translate to debt serviceability pressures, particularly for more leveraged borrowers. The clear view is that declines in rental income are likely to be more pronounced in inner city areas where rental income is being impacted by rising vacancies due to falling international arrivals, Airbnb declines and higher job losses in cafes and restaurants in these locations (sectors where employees typically rent).
- **Non-conforming RMBS** - Non-conforming RMBS portfolios include loans to borrowers with adverse credit histories, as well as typically high shares of loans to self-employed borrowers. Repayment deferrals for non-conforming RMBS peaked at 20.6% in May 2020 (vs. 6.5% for Prime) and sat at 5.0% at November 2020 (latest available data and vs 3.9% for Prime). This is not a significant margin relative to Prime and presumably the 5.0% rate has continued to decline. The upshot being the sub-sector, similar to the SME borrower sub-segment has performed better than earlier expectations.

INVESTMENT MANAGER

Gryphon Capital Investments Pty Ltd is the Manager of the Trust's portfolio. The Manager was founded by Steven Fleming and Ashley Burtenshaw in 2014. The Manager specialises in fixed income with in excess of $2.3 billion in AUM.

The investment team comprises six members, most of whom have significant market experience with a collective average of 21 years' experience. The time in market and the specialisation on structured finance, and mainly RMBS, has enabled the Manager to develop proprietary in-house systems. The investment team has been stable with little turnover in the team since the establishment of the Manager 2014.

Steven Fleming and Ashley Burtenshaw hold ultimate responsibility for the implementation of the Trust's strategy and make-up the Investment Committee for the Trust's investments. We have detailed their experience below.

- **Steven Fleming - Chief Executive Officer:** Steven is a founding partner of GCI. As CEO, he is responsible for the firms business strategy, risk management, operational oversight and is a member of GCI's Investment Committee. Steven has more than 27 years' experience across a broad range of areas, including debt capital markets, securitisation, funds management and structured finance. Before co-founding GCI, Steven spent five years at Threadneedle Investments as the Australian co-head responsible for managing the firm's global ABS portfolios. Prior to this Steven held several key roles specialising in structured finance and securitisation which included, co-head of the Babcock and Brown Capital Markets Group, Director commercial property financing in Nomura's New York office and Associate Director in Nomura's Principal Finance Group based in London. Steven began his career with Price Waterhouse in Sydney.
- **Ashley Burtenshaw - Chief Investment Officer:** Ashley is a founding partner of GCI where he acts as the Chief Investment Officer (CIO). As CIO, Ashley is responsible for the firms investments, portfolio management and is a member of GCI's Investment Committee. Ashley has over 26 years' experience in financial markets that spans across a broad range of areas, including securitisation in debt capital markets, fixed income trading and funds management. Before co-founding GCI, Ashley spent five years at Threadneedle Investments as the Australian co-head responsible for managing the firms Global ABS portfolio's. Prior to this he worked as a director, fixed income at Credit Suisse First Boston and as a senior ABS portfolio manager at Babcock and Brown. Ashley began his career as fixed income trader with Nomura in the London and Tokyo offices.

Investment Team

Name	Position	Years' with Manager	Industry Experience
Steven Fleming	CEO	7	27
Ashley Burtenshaw	CIO	7	26
Shane Stanton	Portfolio Analyst	7	15
Sergey Podzorov	Portfolio Analyst	7	27
Piers de Putron	Portfolio Analyst	1	24
Vijay Singh	Portfolio Analyst	2	8

INVESTMENT PROCESS

The Manager has a long-only, research driven, macro-aware investment process that incorporates both top-down and bottom-up analysis to construct the portfolio. The Manager conducts its bottom-up research analysis on every investment with a hold to maturity mindset, however, will sell the investment if the manager believes the capital could be deployed more effectively elsewhere. Capital preservation is paramount for the Manager, particularly through periods of economic turbulence.

The Manager has a robust investment process which can be broken down into four key steps:

1) Idea Generation

The Manager has an extensive database that incorporates data on each bond and the underlying collateral, including the loan data on each individual loan at the origination of the securitisation. The information is sourced from the Originator of the security and a security can only be invested in if this information is provided by the Originator. The database is updated regularly during the term of investments. As at March 2021, the Manager's database included details on in excess of 480,000 residential loans and over 1,600 Australian RMBS securities.

The data collected is overlaid with analysis of the macroeconomic environment, with the output driving the IC to set down the "guardrails" for the investments. The guardrails are sized taking into account a range of factors, such as current versus historical pricing of RMBS and ABS investments, pricing of comparable asset classes, portfolio concentration (e.g. for RMBS the geographic concentration or concentration of interest only loans versus principal and interest loans), changes in the regulatory landscape, supply and demand equation, and composition of the existing Portfolio to identify themes and associated investment opportunities.

The Investment committee (IC) meets as required and recently the frequency is closer to bi-weekly to evaluate the portfolio. At worst, the IC will meet once a week. Discussion at the IC relates to name a few - analysing the structure of the portfolio and its exposure to market risks, credit rating profile and collateral securing the portfolio investments using the proprietary database.

2) Security Selection & Research

After identifying investment opportunities, the IC engages the research team to conduct a thorough credit analysis of the opportunities. This involves the research team obtaining the data file from the Originator, which contains a summary term sheet for the collateral of the security and loan data.

The credit analysis includes:

- Credit Report - this report evaluates the individual loans which make up the security, the parties to the transaction and identifies the risks of the securities.
- Deal Modelling - a detailed model is constructed which includes an analysis of the investment protections, such as excess spread and level of mortgage insurance, and provides an analysis of the likelihood of a possible rating downgrade/upgrade of the securities.
- Security Analysis - this analysis involves a detailed analysis of the collateral underlying the security to determine the risk of the collateral pool.

Once the credit analysis is complete, the research team stress test the security given the occurrence of certain events. For example, the security will be tested against a significant decline in national house prices to project a worst case loss scenario. In order for the IC to proceed to the execution phase of the investment process, the strength and size of the protections must satisfy a multiple of 'worst case' loss scenarios.

For any investment (including non-rated investments) to be included in the portfolio it must pass the team's stress testing procedure. Non-rated investments typically benefit from all of the protections afforded to rated investments except for bond subordination (that is, non-rated investments are lower ranking than more senior securities) and therefore a potential non-rated investment would typically only pass the stress test if it exhibited stressed collateral losses that were very low by comparison to other potential investment opportunities, which in turn requires it to have much stronger collateral.

3) Portfolio Construction

The portfolio will primarily invest in Australian RMBS with a focus on Prime RMBS. The IC will consider the following with respect to construction of the portfolio:

- Diversification across the portfolio.
- Relative value between existing holdings and those available in the investable universe which may lead to rebalancing the portfolio by selling investments the team considers overvalued and acquiring what are to be perceived as better value investments.
- Analysis of credit quality of any counterparty to a securitisation.
- Drivers of mortgage performance, such as an analysis of historical trends in the speed of borrower repayments which can create an early buy or sell signal for the team.

Portfolio Allocation Limitations

Authorised Investment	Allocation Expectations
RMBS	70%-100%
ABS	0%-30%
Cash	0%-10%

4) Portfolio Management

The Manager will monitor the portfolio and regularly review the loans in the collateral pool for a security. This provides dynamic reporting for each loan in a security. The Manager tracks the performance of delinquent loans over time which allows the Manager to determine if the collateral pool is deteriorating or if borrowers are improving the position.

The monitoring involves in-depth risk reporting on securities in the portfolio and provides a projection for the likelihood of any rating downgrade or upgrade. The Manager also regularly reports on the excess spread to determine the safety margin that exists before bondholders will incur a loss.

PORTFOLIO POSITIONING

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 1H'CY20. When the extent of the pandemic became evident in March 2020, many RMBS investors pulled back from the market, becoming nervous about the impact of loan deferments on RMBS performance. This retreat led to what the Manager identified as repriced opportunities.

This investor reaction coupled by the Australian Office of Financial Management (AOFM) decision to support the market enabled the Manager to reduce the risk in the portfolio. GCI both co-invested with, and made secondary sales to the AOFM, both of which were important in de-risking the portfolio from the perspective of potential COVID ramifications. With respect to secondary sales, GCI also sold early, enabling it to not only reduce risk early but take advantage of more distressed secondary purchases to improve the overall risk-return profile of the portfolio. In short, the Manager moved the portfolio away from non-conforming RMBS and SME borrowers into Prime RMBS, with Prime securities being predominantly backed by borrowers with lower risk scores.

Over this 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, locked in these higher returns for longer. This impact is evident in the uptick in distributions from June onwards.

The ability for the Manager to perceive the market opportunity and have the conviction to act stems from two key factors in our view: (1) the investment 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; and (2) 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).

The repositioning is evident in the table below. Of particular note in our view is the relative lack of changes over the second half of 2020 (bar the reinforcement of the early move to an increasing re-weighting to Prime RMBS). That is, the Manager made the right decisions in relation to portfolio re-positioning in March and April 2020.

GCI Portfolio Allocation

Metric	July 2019	March 2020	July 2020	December 2020
Prime RMBS	70%	72%	74%	79%
Non-Conforming RMBS	13%	8%	7%	7%
ABS	14%	16%	15%	12%
No. Mortgage Loans	78,407	113,567	114,870	107,743
Weighted Average LVR	64%	65%	65%	66%
Weighted Average Seasoning	26 months	29 months	30 months	29 months
Weighted Average Interest Rate	4.84%	3.96%	3.67%	3.51%
Owner Occupied	58%	65%	65%	65%
Interest Only	27%	25%	24%	22%
90+ Days in Arrears (% of loans)	0.38%	0.32%	0.41%	0.25%
% Loans >$1.5m balance	0.64%	1.09%	0.89%	1.14%

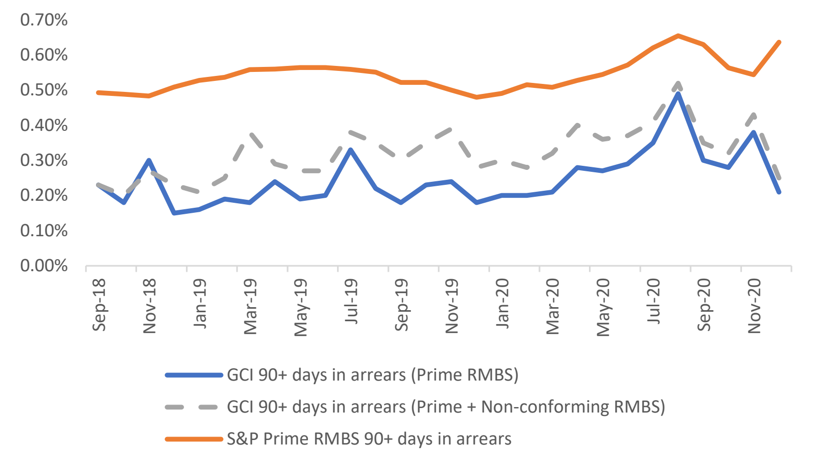
Source: GCI Monthly Investor Updates

There is a number of points to focus on in relation to the GCI portfolio in general and in terms of changes over the last 18-months.

- **Diversification** - First, the portfolio is diversified by number of bond holdings (98), secured on 107,743 mortgage loans as at 31 December 2020, 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 in Arrears** - In terms of changes, the most important metric is the 90+ days in arrears figure. The 90+ days arrears figures teases out how many borrowers are in distress. At 0.25% as at 31 December 2020, this compares to 0.38% 18-months prior.

This illustrates, that despite the COVID turbulence, GCI has not recorded (to date) an increase in 90+ days in arrears. After a slight uptick in July and August, 90+ days in arrears actually decreased in 2H'CY20. To put the 0.25% figure in perspective, the major banks typically have 90+ days delinquency rates at around the 80-90 bps level, i.e. GCI is approximately one-third that level.

Prime RMBS 90+ Days Arrears Timeline



Source: Gryphon Capital

- **Prime RMBS** - Allocations to Prime RMBS increased to 79% as at 31 December 2020 and Non-Conforming RMBS declined by almost one-half to 7%.
- **COVID-19 Hardship** - During 2020, the percentage of mortgage borrowers that were granted COVID hardship was 6.2% compared to over 10% for the major banks. The Manager conducts granular analysis into the likely loss for any borrowers who may default. For the COVID hardship borrowers in the GCI portfolio, the average loan balance was ~$570K with a weighted average indexed LVR of 65% meaning on average the borrower has greater than $300K equity in their home – this equity in the home is the first (of four) protections against loss for bondholders. More broadly in Australia, the percentage of borrowers taking COVID-19 hardship peaked at 8%, but around 84% of these borrowers "cured" themselves by the end of 2020. This significant improvement is partially explained by the fact that many borrowers originally deferred payments "just in case".
- **High Risk Loans -** The Manager isolates high risk loans using this loan level data stratifying borrowers by attributes including, LVR, arrears, if the loan has LMI, size of loan, self-employed, interest only, dwelling type (ie house or unit), geographic region (ie. non metro, inner city), among others. Rather than work in averages and top down, this granular bottom up stress testing enables the Manager to accurately forecast the most high-risk loans where future losses may arise. As an example of the "higher risk loans" bucket for loans that were experiencing "COVID hardship" throughout 2020, less than 1% was exposed to an LVR > 80% with no LMI. That said, there are additional protections against loss if any of these loans roll into default including excess spread in the transactions and bond subordination (see Appendix A below).
- **Determinants of Mortgage Defaults** - As a recent RBA research paper concludes 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 Manager has adopted these conclusions as another stress test to all of its exposures. The GCI portfolio has a very small number of loans in negative equity and without LMI (approximately 0.1%). None are in arrears and of the COVID impacted loans 2/3rd have the benefit of mortgage insurance.
- **Liquidity stress** - As discussed in Appendix A, Australian RMBS is supported by various in-built liquidity mechanisms to protect bond holders should the interest received on loans in any given RMBS deal be insufficient to pay bondholders. The Manager has stress tested its holding to test downside liquidity. The results being that deals typically have 7-10x liquidity over and above the level of hardship currently reflected in each deal. A consistent problem for the market is the under researched nature of Australian RMBS. GCI has an information advantage due to extensive research and a proprietary database analytics platform leading to better identification of opportunities. Following the advent of COVID, GCI was able to identify inefficient pricing opportunities.

PERFORMANCE ANALYTICS

GCI is nearing its three-year anniversary since listing in May 2018. To date, the Trust has been "true to name" and delivered on target returns and monthly distributions. Some key points to note:

- Since becoming fully invested post the IPO, the Trust has met or exceeded its target return of RBA cash rate + 3.50% p.a. and met its objective of providing a regular monthly income to unitholders.
- It is often said that investors value solid performance in up markets but value it more in down markets. GCI continued to deliver on its strategy throughout the uncertainty of 2020.
- With the exception of the dislocation experienced during the COVID sell off, the share price has traded largely in line with the NTA, which has ranged from $1.99 to $2.01. RMBS remains a relatively new asset exposure for retail investors and as such a closed-ended vehicle has provided captured capital for the Manager to allow it to deliver on its strategy.
- The Trust has operated in a declining interest rate environment since its inception. While the RBA Governor has pointed out that he anticipates the low interest rate environment will remain for some time, at some point there will come a time when interest rates begin to rise. During such a period, we expect the Manager to deliver an increasing return. Given the Manager's experience, investment process and systems in place, we expect the Manager to be able to assess and manage any changes to the risk profile of the mortgage pool in a changing environment and continue to deliver on its objective, in a similar manner to which they did during the market uncertainty in 2020.
- In 2019, the Trust raised $225.7m through two Entitlement and Shortfall Offers. The capital was deployed swiftly by the Manager with no apparent dilution impact on unitholders.

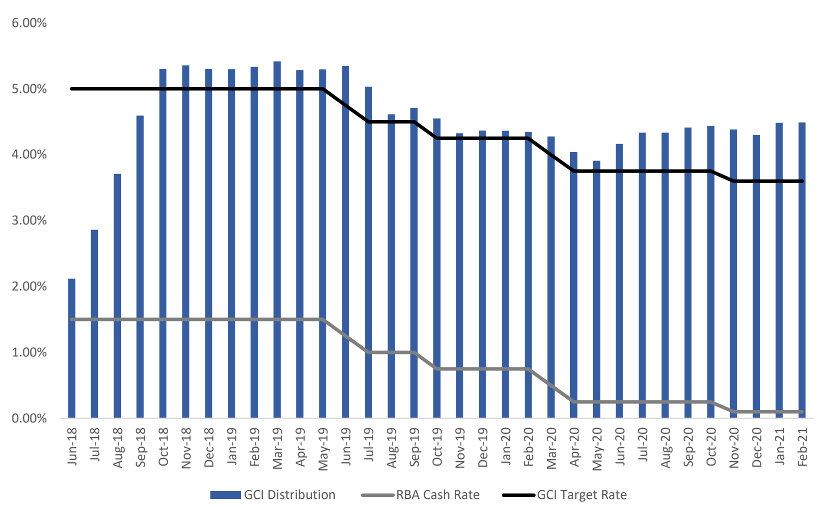
GCI Performance (as at 28 February 2021)

	1 month	3 month	6 month	1 year	Since Inception (p.a)*
Net Return	0.57%	1.28%	3.19%	4.61%	4.86%
RBA Cash Rate	0.01%	0.02%	0.08%	0.22%	0.88%
Net Excess Returns	0.56%	1.25%	3.11%	4.38%	3.94%
Distribution	0.34%	1.07%	2.17%	4.30%	4.49%
Distribution (cents per unit)	0.68	2.15	4.31	8.43	8.82

*Inception date of 21 May 2018

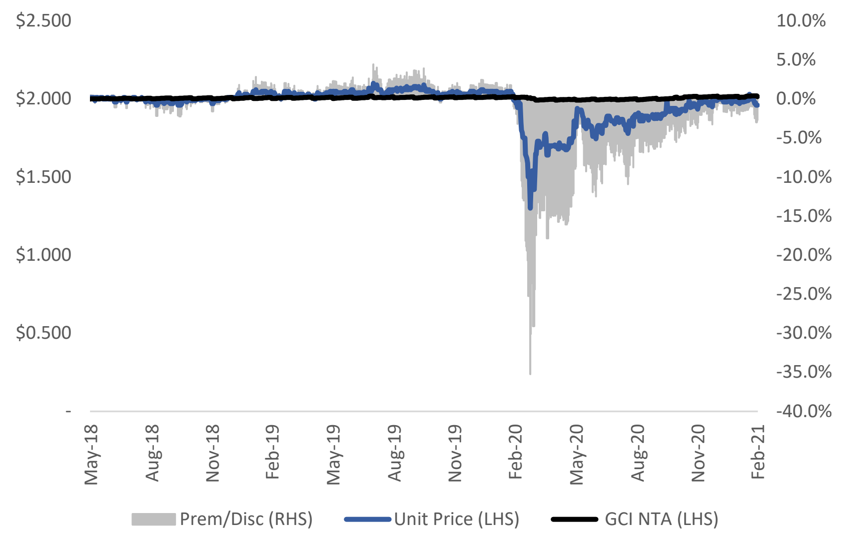
The Trust has largely exceeded the target return since becoming fully invested in September 2018, as highlighted in the below graphic. Target returns are based on the distributions as a percentage of the NTA. We note that during the second half of 2020, the Manager was able to deliver an increase in distributions with the Manager taking advantage of the dislocation in the market and locking in improved pricing for the portfolio.

Monthly Distributions (annualised)



There was a significant dislocation in the share price and the NTA during the COVID sell off with the Trust trading at a discount to NTA of 35.3% at the height of the sell off. The important thing to note is the performance of the NTA as the markets were experiencing the volatility. The NTA remained relatively steady with minimal impacts being experienced during the downturn.

Unit Price & NTA Performance



APPENDIX A: RMBS PROTECTIONS

While discussions of RMBS often focus on the mortgage collateral pool, as all payments to investors are made from the cash flows generated from this pool, the structural features of RMBS play an equally important part in determining the risks facing the holders of these securities. The 'structure' of an RMBS refers to the number and size of the interrelated bonds of the RMBS, the rules that determine how payments are made on these bonds and various facilities that support these payments.

The structure of RMBS is invariably important, but with the economic and labour market downturn triggered by COVID-19 having increased loan delinquency, payment deferral and default risks for Australian RMBS (which is credit negative), understanding these structural supports is particularly important. In short, RMBS deals' liquidity and bondholder protections, in the form of excess spread and note subordination, lessen the credit negative effects of these coronavirus disruptions. The section below summarises the key structural supports.

1) Liquidity Reserves Reduce Payment Deferral Risks

A key consideration in the structuring of Australian RMBS is to ensure the timely and full payments of the required payments in the income waterfall. When the risk of missing required payments arises from temporary factors, it is a form of liquidity risk rather than credit risk. Australian RMBS have liquidity reserves or facilities and principal-to-pay-interest mechanisms, which materially reduces the risk that deals will miss interest payments because of COVID-19 related loan payment deferrals.

There are two main sources of this liquidity risk. The first is that Australian RMBS typically have a longer accrual period on the first interest payment due on the notes relative to the length of the first collection period. The other is that delinquent borrowers make no interest payments, thus reducing the interest paid on the mortgage pool. Although the Manager points out that Australian RMBS structures typically require less than 2/3rds of mortgage pool borrowers to make interest payments each month.

Australian RMBS use a number of facilities (or reserves) and internal structural features to provide temporary support to manage the risk of having insufficient available income to meet required payments.

The first mitigant is an interaction between the principal and income waterfalls through the 'principal draw', which redirects some of the principal collections away from the principal waterfall towards making the required payments in the income waterfall. Principal draws, which are effectively a borrowing from the principal waterfall, must be reimbursed eventually from the excess income in the income waterfall in subsequent periods.

The second mitigant, which is typically used only when the principal draw is insufficient, is a dedicated 'liquidity facility' or a 'liquidity reserve'. A liquidity facility is a line of credit provided to the RMBS trust for a fee. A liquidity reserve, which serves the same role as a liquidity facility, is an account held by the RMBS trust. A liquidity reserve can either be: (1) funded upfront by the sponsor; (2) funded by the issuance of notes with a size equal to the difference between the notes and the mortgage pool; or (3) gradually built up through an accumulation of excess income. After being drawn, liquidity facilities and reserves are eventually repaid or topped up through excess income in future periods.

The final mitigant, and the one that provides the strongest protection against liquidity risk, is the 'threshold rate mechanism'. This is an agreement between the RMBS trust and the mortgage servicer that requires the mortgage servicer to set at each point in time, the interest rate charged on the variable rate mortgages in the mortgage pool to a level that is sufficient to generate enough available income to meet the required payments. According to the RBA, Australian RMBS typically have liquidity support arrangements that can meet required monthly payments equivalent to around 4% of the size of the outstanding notes before there is a need to invoke the threshold rate mechanism. As such, the use of threshold rate mechanism is unlikely in an environment of low delinquency rates on securitised mortgages.

With respect to the COVID environment, loan payment deferrals, while easing the financial strain on borrowers amid the disruptions, reduce RMBS deals' loan repayment collections. Lower loan collections increase the risk that RMBS deals will not have sufficient funds to make note interest payments on time. However, Moody's notes that the prime and non-conforming Australian RMBS it rates have sufficient liquidity to continue making noteholder interest payments for 10 and 11 months respectively on average, even if they do not receive any loan collections.

As previously noted in this report, the potential risk from payment deferrals to Australian RMBS has declined materially over the back half of 2020 as many borrowers that had taken up the option to do so have now 'cured' themselves.

2) Bondholder Protections will Absorb Losses

In the event that delinquent loans do ultimately move into default, the following four protections built into Australian RMBS provide protection against losses on any individual defaulting loan: (1) Homeowners deposit or equity; (2) Lenders Mortgage Insurance (LMI); (3) Excess Interest (or spread); and (4) Subordination.

As mentioned earlier, if we look at the COVID hardship loans in the GCI portfolio in 2020, the average loan balance is ~$570k, with a weighted average LVR of 65%. This means that on average the borrower equity in these loans is over $300k. In other words, house prices would need to fall by 35% before this first bondholder protection would not be enough to cover the losses in event of an actual default.

The next protection then is the **lenders mortgage insurance (LMI)** which pays out in the event that a defaulted loan actually suffers a loss. Mortgage insurers are regulated by APRA and required to hold substantial capital against potential claims. LMI is a type of insurance policy that covers the losses from a default on a (residential) mortgage that remain after the sale of the property. After credit tranching, LMI on the mortgage pool is the main type of credit enhancement used in Australian RMBS. However, the credit enhancement provided by LMI is different from that of credit tranching, as it relies on the LMI provider's willingness and ability to pay under the terms of the policy, and is limited by the financial strength of the LMI provider. The credit ratings agencies take into account the losses on the mortgage pool that are expected to be covered by LMI when determining the minimum credit enhancement required for a note to achieve a particular rating. In this way, more extensive LMI coverage of the mortgage pool results in a lower required minimum credit enhancement.

If the previous two protections are not enough to cover the loss on a loan, then **excess spread** is used to cover losses. For an RMBS to be economically viable, the available income expected to be received from the mortgage pool must be no lower than the interest expected to be paid to the notes and the RMBS expenses. In the income waterfall, available income remaining after the required payments have been made represents excess income, which is used to support some of the key structural features of the RMBS. Uses of excess income include: (1) support to the liquidity facilities by reimbursing previous draws on the facilities, including principal draws; (2) the build-up of internal RMBS reserves that can provide additional credit and liquidity enhancements to the RMBS notes; (3) the reimbursement of charge-offs on the notes, thus reducing losses from mortgage defaults; and (4) the acceleration of the repayment of principal on the notes.

For RMBS that have closed during the period of COVID disruption, the excess spread is slightly lower than in outstanding RMBS, because margins have increased (partially offset by a decreasing RBA cash rate/BBSW basis). Nevertheless, a level of excess spread will remain, which will mitigate the credit negative effect on RMBS deals if losses rise because of COVID disruptions.

The fourth protection, **note subordination (tranching)**, also protects against losses. In an RMBS, principal payments and losses generated from the mortgage pool are tranched across credit and time dimensions to determine how these two risks are borne by the various notes in the RMBS. Tranching establishes the relative order in which the RMBS notes receive principal payments and are allocated losses, by designating each note to be either junior or senior to another note in the principal and charge-off waterfalls. Groups of notes within the same RMBS can also have equal seniority, in which case they are allocated principal and/or charge-offs in proportion of their outstanding amounts.

Through credit tranching, losses that arise from the underlying pool are distributed first to the most 'junior' note outstanding until its principal is fully charged off, then to the next most junior note outstanding until its principal is fully charged off, and so on until losses are fully allocated to the RMBS notes. In this way, a senior note is protected from taking any losses until all of its junior notes are fully charged off; the junior note is said to provide 'credit enhancement' to the senior note through the junior note's credit subordination. The size of the credit enhancement to an RMBS note is measured by the size of the outstanding balance of its subordinated notes as a percentage of the aggregate outstanding balance of all notes.

As a result of credit tranching, RMBS can be structured to have senior notes with much lower credit risk than the credit risk of the underlying mortgage pool by concentrating the credit risk in the junior notes. The reduction in credit risk achieved by the senior note depends on the size of its subordinated junior notes (and any external forms of credit support).

In addition to the prior three protections, the note subordination in Australian RMBS will protect notes against losses if loan defaults increase. For seasoned Australian RMBS, note subordination has built up during the sequential repayment period. Australian RMBS typically have a minimum period when principal repayments occur sequentially starting with the senior notes. Moody's notes that, on average, the note subordination in senior AAA-rated RMBS notes is 3.9x the loss expected in a severe recession. Subordination is much lower for junior and mezzanine notes.

APPENDIX B: GCI NTA CALCULATION

GCI's portfolio is valued daily by an independent third-party provider of fixed income valuation services, ICE Data Services. Valuation methodologies with respect to RMBS can have nuanced differences, but below we outline the fundamental basis of valuing RMBS and, in turn, the derivation of the GCI NTA.

As with any fixed income security, the fair value of an RMBS is the discounted value of its expected cash flows. However, valuing RMBS is more challenging than valuing bullet fixed income securities because most (Australian) RMBS are structured as pass-through securities. As a result, the timing of RMBS cash flows are not known with certainty, even in the case when there are no defaults and losses on the underlying collateral pool, because the security's cash flows depend on the rate at which the underlying mortgages are repaid.

A common approach used by market participants to value pass-through RMBS is to estimate an appropriate measure of the security's effective life (or tenor) and value it as a bullet fixed income security with the same tenor by applying an appropriate discount rate. The weighted average life (WAL), which measures the average time until the principal of the security is repaid, is used as the typical measure of the RMBS tenor in this case.

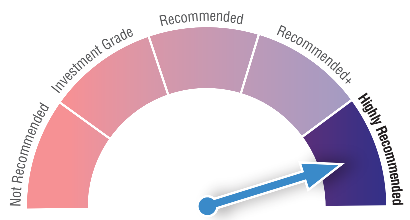
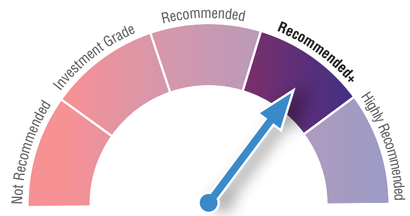
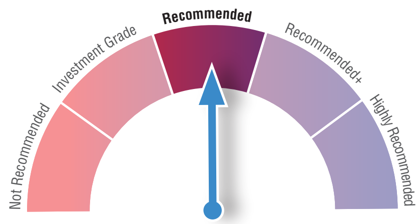
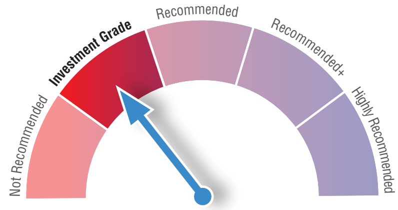
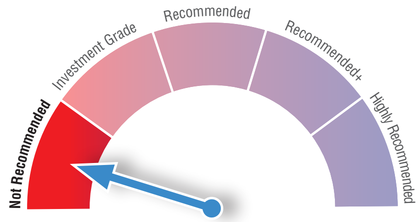
To provide a little more detail, we thought it instructive to look at how the Reserve Bank of Australia (RBA) values RMBS. The RBA's model for valuing self-securitised RMBS is similar to the above and involves two steps. In the first step, the model estimates the security's WAL. The future cash flows from the collateral pool of the RMBS transaction are modelled to estimate the future cash flows of all the notes in the RMBS transaction and, in turn, estimate the weighted average lives of each of these notes. Estimates of the principal repayments on the mortgages in the collateral pool are used to project the future principal payments to the notes in the RMBS transaction by taking into account the relevant structural features of the RMBS in allocating the principal payments across the structure of the transaction. The projections are made under the assumptions that: (1) the collateral pool is closed on the valuation date, as the self-securitised RMBS will be assigned a value when the counterparty to the repurchase agreement is in default and can no longer replenish the collateral pool; and (2) the prepayment rate on the mortgages is constant and the same as the observed prepayment rate on mortgages in similar marketed RMBS. Assumptions about the relevant structural triggers in the RMBS that may alter the security's payment priorities are made consistent with the observed determinants of these triggers at the valuation date. For example, the state of the serial paydown trigger often depends on arrears rates and in the valuation model it is based on the observed level of the relevant arrears rates on the valuation date.

In the second step, the model estimates the appropriate discount rate for the security, which in the case of RMBS is expressed as a trading margin – the difference between the yield on the RMBS and the Australian dollar swap rate for the tenor corresponding to the WAL of the RMBS. The estimated trading margin is consistent with observed trading margins in the market for marketed RMBS with similar characteristics to the self-securitised RMBS. On each valuation date, the RBA estimates the relationship between observed trading margins and the following characteristics of marketed RMBS: WAL, credit rating, seniority in the RMBS transaction, originator type and certain information about the collateral pool, such as the share of low-documentation loans. This observed relationship, together with the estimate of the WAL of the self-securitised RMBS from the first step, provide a fair value estimate of the trading margin for the self-securitised RMBS that could be obtained in the market. The estimated WAL and trading margin for each security, together with information on relevant interest rates, are used in a standard Floating Rate Note (FRN) formula to calculate the self-securitised RMBS fair value.

APPENDIX C – RATINGS PROCESS

INDEPENDENT INVESTMENT RESEARCH PTY LTD "IIR" RATING SYSTEM.

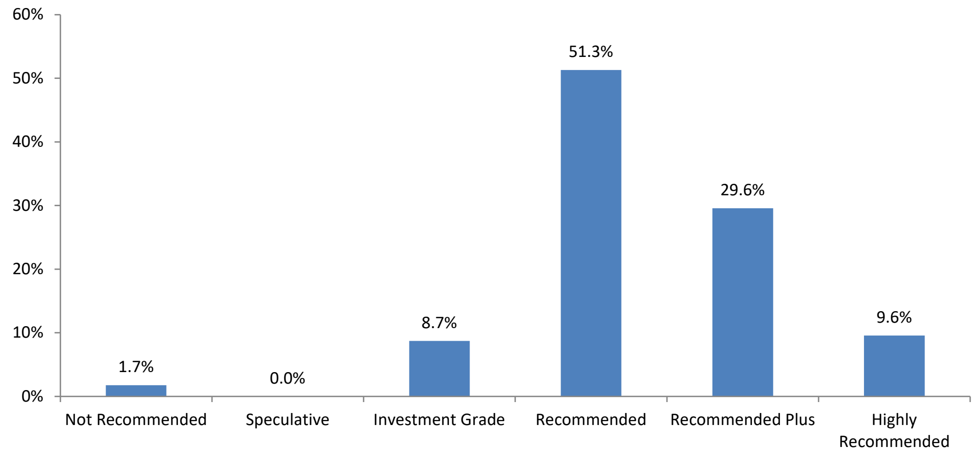
IIR has developed a framework for rating investment product offerings in Australia. Our review process gives consideration to a broad number of qualitative and quantitative factors. Essentially, the evaluation process includes the following key factors: product management and underlying portfolio construction; investment management, product structure, risk management, experience and performance; fees, risks and likely outcomes.

LMI Ratings	SCORE
Highly Recommended	**83 and above**
	This is the highest rating provided by IIR, indicating this is a best of breed product that has exceeded the requirements of our review process across a number of key evaluation parameters and achieved exceptionally high scores in a number of categories. The product provides a highly attractive risk/return trade-off. The Fund is likely effectively to apply industry best practice to manage endogenous risk factors, and, to the extent that it can, exogenous risk factors.
Recommended +	**79–83**
	This rating indicates that IIR believes this is a superior grade product that has exceeded the requirements of our review process across a number of key evaluation parameters and achieved high scores in a number of categories. In addition, the product rates highly on one or two attributes in our key criteria. It has an above-average risk/return trade-off and should be able consistently to generate above average risk-adjusted returns in line with stated investment objectives. The Fund should be in a position effectively to manage endogenous risk factors, and, to the extent that it can, exogenous risk factors. This should result in returns that reflect the expected level of risk.
Recommended	**70–79**
	This rating indicates that IIR believes this is an above-average grade product that has exceeded the minimum requirements of our review process across a number of key evaluation parameters. It has an above-average risk/return trade-off and should be able to consistently generate above-average risk adjusted returns in line with stated investment objectives.
Investment Grade	**60-70**
	This rating indicates that IIR believes this is an average grade product that has exceeded the minimum requirements of our review process across a number of key evaluation parameters. It has an average risk/return trade-off and should be able to consistently generate average risk adjusted returns in line with stated investment objectives.
Not Recommended	**<60**
	This rating indicates that IIR believes that despite the product's merits and attributes, it has failed to meet the minimum aggregate requirements of our review process across a number of key evaluation parameters. While this is a product below the minimum rating to be considered Investment Grade, this does not mean the product is without merit. Funds in this category are considered to be susceptible to high risks that are not reflected by the projected return. Performance volatility, particularly on the down-side, is likely.

APPENDIX D – MANAGED INVESTMENTS COVERAGE

The below graphic details the spread of ratings for managed investments rated by Independent Investment Research (IIR). The managed investments represented below include listed and unlisted managed funds, fund of funds, exchange traded funds and model portfolios.

Spread of Managed Investment Ratings



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