BondAdviser

Research Report

Report Created on 7 March 2018

Issuer Name

One Managed Investment Funds Limited

Security Name

Gryphon Capital Income Trust

Security Recommendation

Subscribe

Security Risk

Upper Medium

Issuer Outlook

Improving	**Stable**	Deteriorating

Key Characteristics

Product Type	Listed Investment Trust	**Asset Class**	Fixed Income
Issue Size*	[$300,000,000.00]	**Sub-Asset Class**	Credit
Net Asset Value**	$2.00	**Investment Manager**	Gryphon Capital Investments Pty
Fixed/Floating	Floating	**Responsible Entity**	One Managed Investment Funds
Payment Frequency	Monthly	**Custodian**	One Managed Investment Funds
Target Return***	RBA cash rate plus 3.50% p.a.	**Administrator / Unit Registrar**	Mainstream Fund Services Pty
First Coupon***	RBA cash rate plus 3.50% p.a.	**Offer Opens**	20 March 2018
Franking Credits Incl.	No	**Offer Closes**	2 May 2018
ASX Listed	Yes (ASX Code: GCI)	**Allotment Date**	12 May 2018
Convertible	No	**Commences Trading on ASX**	18 May 2018
GICS Sector	Investment Companies	**First Payment Date**	30 June 2018

*Issue size subject to change. ** Pro-Forma Net Asset Value (NAV) per unit, subject to change. ***First and ongoing distributions are targeted at RBA cash rate plus 3.50% (after fees) but GCI have outlined it may take 3-6 months to become fully invested. As a result, absolute returns over this period may be below the target return.

Summary

The Gryphon Capital Income Trust (GCIT) is a listed income trust designed to provide investors with exposure to the Australian Securitisation market (Prospective ASX Code: GCI). This asset-class is a pillar of the Australian fixed income market and primarily consists of Residential Mortgage-Backed Securities (RMBS), representing the majority of the GCIT portfolio.

The domestic RMBS and broader securitisation market has historically been restricted to institutional investors but GCIT presents investors with a key opportunity to diversify further across the fixed income spectrum. Unlike traditional fixed income instruments such as bonds, securitised assets offer bespoke investments with a number of structured risk mitigants. Principally for this reason, GCIT offers a unique investment opportunity and exposure to a credit market typically not generally accessible by retail investors.

Due to the specialist nature of investing in RMBS, proven expertise is almost a requisite, accordingly, Gryphon Capital Investments (the manager) will leverage its existing successful strategies for the GCIT. With an anticipated equal allocation between two core strategies, the investment objective of the trust is to provide stable income with a target return of 5.00% p.a. (after fees), payable monthly within target risk parameters.

The trust is expected to list and commence trading on the 18th of May 2018 at an indicative Net Asset Value (NAV) of $2.00 (issue price of $2.00 per unit). One Managed Investment Funds Limited will serve as the Responsible Entity and Custodian.

Figure 1: 10Y Risk and Return

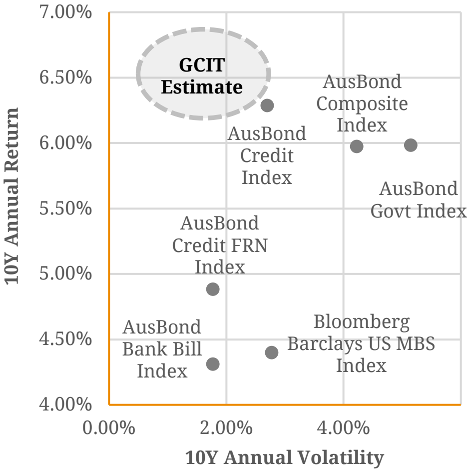
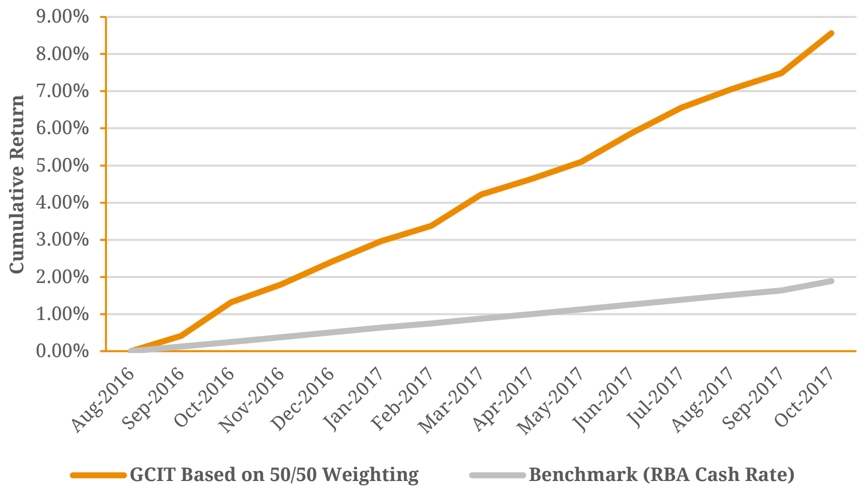


Figure 2: GCIT Theoretical Performance based on 50/50 Weighting



Source: BondAdviser Estimates, Bloomberg, Gryphon Capital Investments

Security Recommendation - Subscribe *as at 7 March 2018*

This product is best recommended for investors looking for diversified exposure to the RMBS asset class with returns that are not typically correlated to equity markets. Our basis for recommendation on the GCIT is a blend of both subjective and objective analysis of the underlying portfolio and the managers' background, experience, analytical capability and proven track record. Based on our research, we believe this product offers investors a stable source of income with the margin being offered over the RBA cash rate considered fair and commensurate with its risk.

A Listed Investment Trust (LIT) structure derives unit holder returns from two sources: distributions and capital returns from the underlying portfolio and share price movements which drive the prevailing premium/discount to Net Asset Value (NAV). The latter is a function of market and manager sentiment but also reflects liquidity and structural features of the trust. The manager has established multiple mechanisms to bolster NAV stability which should minimise trading price variability. Price movements away from NAV would, in our opinion, be more speculative and not a function of asset fundamentals or financial risk management. The former is of course subject to risks and the investment manager's successful implementation of its portfolio strategy and risk framework.

The asymmetric return profile of credit fund managers means that success of the LIT will be achieved chiefly through active risk management at a portfolio level (i.e. diversification) and at an asset level (i.e. loan structuring, covenants). Asset managers who can consistently produce alpha and/or can contribute meaningfully to risk adjusted returns can only do so by either having a superior investment strategy, access to specialist products and/or have a competitive advantage. Although GCI has a relatively short history of fund performance for the two strategies (2015 and 2016) which form the basis of GCIT, the management and analyst team have proven themselves for at least eight years in managing significant Australian Fixed Income investments and for even longer overseas. They comprise a highly effective and specialised team and possess all key traits of a successful asset manager. We believe this is unlikely to materially change through time due to the ownership structure, shared history and unique investment management opportunity that GCIT represents.

For the above reasons, we recommend investors **Subscribe** to the Gryphon Capital Investment Trust.

Positive / Negative Risk Factors

What factors would change the Recommendation UP

- RMBS offerings are variable and typically tailored to fit end-investor needs and requirements. As a result, securitisation vehicles typically have a number of additional structural risk mitigants to ensure recovery rates remain high including excess interest pools, lenders mortgage insurance (LMI) and moderate loan-to-value ratios (LVRs). These features help maintain a sizable equity buffer on capital.
- Unlike traditional forms of credit, prepayment mechanisms allow principle to be returned to RMBS investors prior to maturity, reducing the overall credit risk of specific investments.
- Due to regulatory pressure, capital-relief securitisation has become increasingly utilised as a funding source for Australian banks and non-bank lenders. This will result in a larger RMBS market and new investment opportunities for portfolio diversification for GCIT.
- Specialist expertise is required to operate in this market, which has been well achieved in GCIT's seasoned investment team.
- A rising interest rate environment might result in broad mortgage stress for residential borrowers with possible detrimental effects on GCIT. However, this is risk is mitigated by GCIT's high allocation to prime loans and overarching investment analytics.
- Losses in the Australian RMBS market have historically been very low and has been attributed to a strong prudential framework administered by APRA together with strong asset quality metrics and credit recourse to the borrower.
- If interest rates increase, GCIT, with a floating rate asset base (minimal interest rate duration), will deliver higher unitholder income returns.

What factors would change the Recommendation DOWN

- A significant deterioration in household balance sheets and essentially a 'hard landing' for Australian residential property. This may result in significant mark-to-market losses in the GCIT portfolio. We note that this may not actually result in any realised losses.
- Although the High Grade fund began in January 2010, the underlying investment strategies have operated mostly through fairly benign economic conditions and may experience price volatility in times of economic stress.
- Due to a limited number of participants and transactions, the RMBS market exhibits lower liquidity to other domestic asset classes reiterating the importance of sound investment analysis and risk management throughout diversification and beneficial structural features.
- Given the unit price of the LIT is determined in a public market (ASX), the value of the product will be somewhat sensitive to news flow and other announcements, particularly in relation to the Australian property market.
- A lower interest rate environment due to additional rate cuts by the RBA would dampen borrowing rates and hence the target net return of 5.00% p.a. We note this is a remote possibility currently.

- The prevalence of LMI in Australian RMBS transactions has declined in recent years as lenders increasingly self-insure and investors are sensitive about the RMBS market's over-reliance on LMI providers, given the concentration toward QBE and Genworth Australia. As LMI usage has decreased, the use of other risk mitigants, such as hard credit enhancements have increased. Should this trend reverse in the future or credit enhancements reduce in effectiveness, we may view this negatively.

Issuer Outlook - Stable *as at 7 March 2018*

Performance

The structured nature of securitisation results in some important distinctions when compared to traditional forms of credit. In a similar vein other debt instruments, the overall performance of securitised instruments (RMBS, CMBS, ABS etcs) depends on both income contributions and capital performance. In terms of the latter, principal is typically returned to investors over the life of the asset pool which will naturally result in an equivalent decrease in par value and market price of the security (albeit this rate will be subject to prepayment conditions embedded in the terms of the instrument). In the GCIT structure, returned principal forms capital for new investments. Excluding investments in secondary (existing) issues, where the managers believe there could be capital appreciation, the primary driver of the return profile is therefore expected to be income. This is accordingly determined by the yield offered by the investment class. Prepayment mechanisms could potentially reduce the amount of income-producing assets over the term, but, as mentioned earlier, offers capital for redeployment opportunities.

In securitisation, the yield is determined by the instrument's position in the capital structure of the asset pool and is typically priced at an interest rate spread above a floating rate reference rate (BBSW in Australia). The securitised asset pool will consist of a series of notes ranked by seniority, known as 'tranches'. This ranking will determine the order for payment priority and loss absorption (inversely related) for investors. Credit risks and hence, yields increase in descending order from higher payment priority tranches to lower payment priority tranches (see Appendix 2 for more information). While this will be a main determinant of the investment yield, factors such as covenants, size, term, purpose and market conditions also influence the risk premium. Due to the highly structured nature of securitisation and uniqueness of each issue, the risk / return profile of each transaction can differ markedly from others whilst appearing superficially similar.

The GCIT strategy is designed to broadly replicate GCI's two existing investment mandates, namely 'Investment Grade' (IG) and 'Secured Opportunities Fund' (SOF), while also allowing for a relatively small allocation to non-rated ABS (limited to 5%). Based on these investment guidelines, the initial GCIT target portfolio approximates to an equal allocation of each the IG and SOF strategies.

The IG strategy represents the manager's core, lower-risk approach and invests in the entire spectrum of securitisation products (RMBS, CMBS and ABS) but focused on investment-grade rated tranches. In comparison, the SOF strategy invests solely in RMBS and the investment universe includes non-rated tranches (with a 27% current allocation). While we note both strategies have a limited track record in fairly benign economic conditions, GCI has recorded only three months of negative performance in its history, which unsurprisingly, originated from the relatively higher risk SOF portfolio.

GCI has consistently outperformed its chosen benchmark (Bloomberg AusBond Index). However, it is arguable this does not serve as an appropriate benchmark in the traditional sense but rather provides investors a very clear indication of excess return over a proxy of the risk-free rate. Additionally, there is no broad performance index for Australian RMBS which also makes traditional benchmarking a challenging process. On a monthly annualised basis, this excess return has tracked at 5.03% above its benchmark (net of fees) and supports the GCIT's projected yield target of at least 3.50% p.a. above the RBA cash rate.

Risk Framework

Unlike bonds and equities, capital price appreciation for securitised assets is rare, which emphasises the natural skew in credit investing (i.e. limited upside). It also makes risk management (minimising price downside events) more important. While each securitised asset has its own unique risk profile, scale and diversification is required to minimise and manage credit risks at a portfolio level. At a security level, extensive due diligence at all stages of the mortgage / asset backed security lending cycle is required and expertise in structuring (i.e. covenants, seniority, collateral) helps to ensure that loan-level risk is managed adequately. Similarly to the Major Banks (the dominant originators in the market), Gryphon Capital Investments (GCI) employs a rigorous risk framework to ensure portfolio quality is maintained and expected income is received in a timely manner.

As mentioned previously, GCIT will employ a blend of the strategies utilised by the established Investment Grade and Secured Opportunities Funds. Its main objective is to deliver a stable and predictable income stream by investing in a diversified portfolio of fixed income bonds. It is targeting a net return (after all fees and costs) of 5% per annum.

The GCIT target portfolio will be around to 70% in Prime RMBS, 20% in Non-Conforming RMBS, 10% in Asset Backed Securities with a 0% allocation to cash. GCIT will have an approximate rating distribution of 0% AAA, 10% AA, 25% A, 30% BBB and 35% Non-Investment Grade. Additional to this, its guidelines are that a minimum 50% must be investment grade (rated BBB- or higher) with a maximum of 10% in any one security and the maximum portfolio Weighted Average Life (WAL) be less than 5.5 years. Positively, the maximum non-investment grade exposure for the higher yielding Asset Backed Securities portion of the portfolio is capped at 5%, with all remaining holdings required to have a credit rating.

For a more detailed discussion on Gryphon's investment processes and capabilities, please see the dedicated section towards the end of this research note.

Management

The GCI management team has a long and successful track record of analysing and investing in RMBS and ABS securities in both Australia and Europe. The existing portfolio managers have worked together since 2005 and currently manage around $1.8 billion of client funds and are engaged on specialist mandates for multiple institutional investors.

When GCI was spun out of Columbia Threadneedle, it was agreed that GCI retain the management of all ABS funds that were previously maintained under employment agreements. We view this very positively as it demonstrates great faith from a significant investor in GCIs abilities and history.

The management and analyst team of GCI has extensive experience within structured credit on a global basis. Importantly, the team navigated the 2009 (and onwards) credit crisis together and have remained so since. We feel that this positions GCI very well for any significant downturn which may be experienced in the Australian RMBS market, although this is not our base case.

Market Outlook

The current state of the Australian housing market is mixed. House prices are high and household indebtedness is at record levels however arrears rates and actual defaults are at record low levels.

Although the RBA is expected to eventually begin raising rates, it will do so with a very clear focus to the impact on house prices given that these are central to the 'wealth effect' and which can have a significant flow-on effect to the wider economy.

There are pockets of higher-risk geographies related to the mining sector slowdown and also with an oversupply of apartments, particularly so in inner city Brisbane, Melbourne and to a lesser extent, Sydney. We do note that regulators and originators have both been increasing standards for all involved parties in the mortgage markets in recent years and this should bear some success in keeping risks minimised in the future.

Although we can't predict the future paths for Australian house prices, a status-quo or soft-landing outcome suits GCT well as it is investing lower down the capital structure. An adverse scenario may well present mark to market losses in GCT's portfolio but we would remind investors that because of all the credit support features built into the asset class, actual incurred losses to date are extremely low (if any). Indeed, as we discuss elsewhere, any retracement in prices (higher yields) offers GCT additional investment opportunities provided their cashflow forecasts and analysis identify them. Although not our base case, we would view any additional significant increases in house prices over the near-term negatively.

From a fundamental standpoint, we view minimal stresses over the bulk of the RMBS spectrum in the medium term and expect the GCIT to avoid overdue concentration risk to particular originators, geographies, loan-purpose types (investment), repayment type (interest-only) or title (strata) across its portfolio.

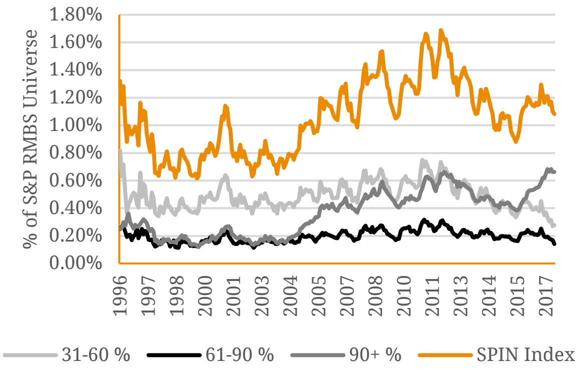
Risk / Return Analysis

There is no broad public market performance index for the Australia RMBS market (which forms ~90% of the securitisation asset class domestically), which makes it difficult to objectively analyse the sub-asset class on a risk/return basis. The most useful observable gauge of market characteristics are the loan books of the four major Australian banks and the Standard and Poor's Arrears Index ("SPIN"), which covers the universe of Australian RMBS rated by S&P. Given the former is still somewhat opaque to outside investors, we will utilise the latter's statistics as the best reflection of the Australian RMBS market.

Australian RMBS has two broad risk classifications, namely 'Prime' and 'Non-Conforming'. Although slightly subjective, the main criteria for Prime loans typically include a clean trailing credit history, relevant documentation and generally would be insurable by a LMI provider. As the name suggests, non-conforming loans do not meet these criteria and usually do not carry lenders mortgage insurance. In terms of the S&P SPIN universe, the bulk of the RMBS market consists of prime loans (~99%). S&P further segregates Prime loans into Full-Documentation and Low-Documentation categories dependent on the quality of documentation utilised for income verification. We note ~98% of the Prime loan universe comprises loans within the 'Full Doc' bracket. As a result, the vast majority of the Australian domestic RMBS market comprises prime, Full Doc loans, traditionally viewed as relatively low-risk.

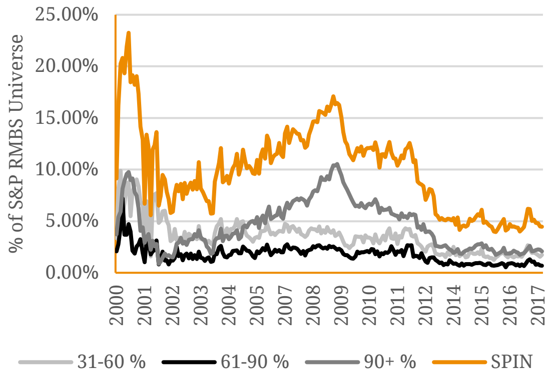
This asset quality of this segment is captured by S&P's Prime SPIN Index which tracks RMBS arrears rates across 30+ Days, 60+ Days and 90+ Days. Since inception in 1996, this index has averaged an arrears rate of 1.05% of the S&P universe total loan balance. Although shorter (beginning in 2000), S&P's Non-Conforming SPIN Index has averaged an arrears rate of 9.88% of the S&P universe total loan balance, highlighting the increase in perceived risks (~10x) between the two loan types.

Figure 3. Prime SPIN Indices



Source: S&P, BondAdviser

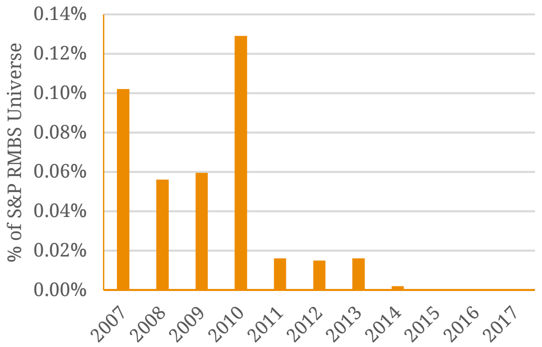
Figure 4. Non-Conforming SPIN Indices



Source: S&P, BondAdviser

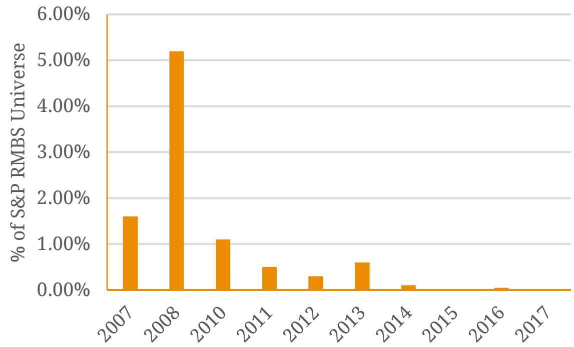
S&P also provides data one-step further along the default timeline after arrears - mortgage defaults. Based on RMBS transactions outstanding, there has been ~$237 million of losses collectively. However, these 'losses' have been recovered entirely from structural mechanisms embedded with RMBS including Lenders Mortgage Insurance (LMI) (~83%), excess interest pools (~15%) or losses directly covered by the seller (~2%). According to S&P, and in our view, a very important point to reiterate - all gross losses to date across both prime and non-conforming Australian RMBS transactions have been covered by recovery mechanisms with no principle loss experienced by investors.

Figure 5. Prime Gross Losses by Year of Issuance before LMI Claim



Source: S&P, BondAdviser

Figure 6. Non-Conforming Net Gross Losses by Year of Issuance before LMI Claim



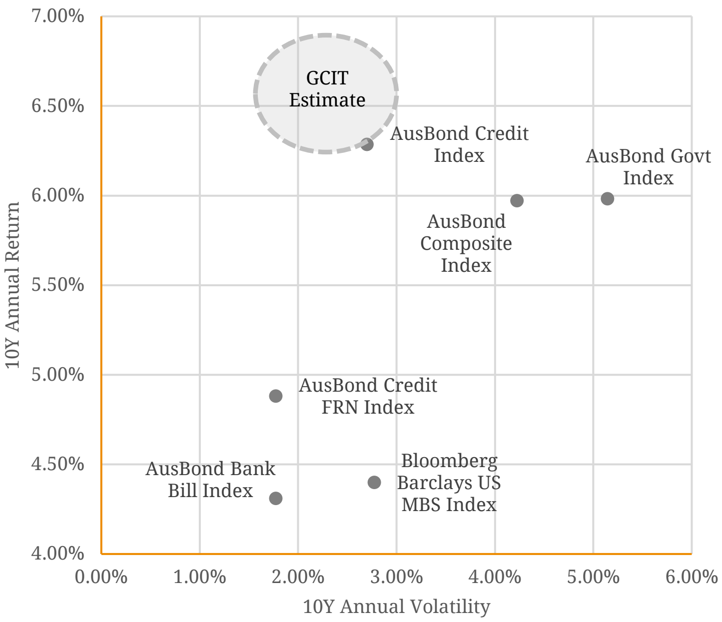
Source: S&P, BondAdviser

Internationally, the longest serving index for RMBS is the Bloomberg-Barclays U.S. Mortgage-Backed Security Index. However, the structure of the U.S. market is distinctly different to Australia in that securities are classified as 'agency' or 'non-agency'. Agency securities are those issued by government-sponsored enterprises such as Ginnie Mae, Fannie Mae or Freddie Mac. These securities are generally guaranteed by these entities and their performance is tracked by the Bloomberg-Barclays U.S. Mortgage-Backed Security Index. On the other hand, non-agency securities are issued by banks and other financial institutions prevalent in the Australian market. The Markit iBoxx US Non-Agency RMBS Index tracks performance for this segment in the U.S. but is a relatively new market gauge, being launched only in 2013. As a result, data relating to the long-term risk / return profiles of non-agency RMBS internationally is limited. Additionally, there are clear differences between the U.S. and Australian mortgage markets which makes any comparison challenging and less valid.

Given their predominantly floating-rate nature, we expect RMBS yields to broadly follow global interest rate markets and reflect country lending rates. At present, the growing economic consensus is for a rising interest rate environment to be established over the coming years with the U.S currently leading the way. As a result, we expect yields to revert closer to the long-term averages over time. Considering the GCIT's target yield of the RBA Cash Rate plus 3.50% p.a. (net of all costs and fees) and the RBA's estimate of the long-term cash rate of 3.50% (an implied yield of ~7.00%), we believe observable historical yields of Australian prime RMBS is a reasonable estimate of expected returns. We note the GCIT's yield at any given point in time will be higher than levels for prime RMBS due to its allocation to non-conforming loans and ABS (target of ~20% and ~10% respectively).

We recognise that publicly available data for the RMBS market encapsulates relatively accommodative economic conditions domestically and does not readily (except for some rating agency data) capture Australia's last recessionary period in the early 1990s where a number of Australian financial institutions collapsed including the government-owned State Bank of South Australia and Pyramid Building Society. However, from a fundamental perspective, we consider the domestic mortgage market has undergone significant reforms and is notably lower risk from a structural viewpoint than its U.S. counterpart. For comparative purposes below, we assume returns will exhibit a similar level of volatility as the Bloomberg-Barclays U.S. Mortgage-Backed Security Index despite the better structural features. Accordingly, and as Figure 7 shows, we believe the GCIT offers a unique risk / return profile over the long investment horizon. However, it is important to acknowledge that in periods of economic distress, portfolio correlations will increase and any mark-to-market losses could be significant, despite historically high Australian RMBS recovery rates and moderate LVRs (equity buffer).

Figure 7. 10Y Return and Volatility of Comparable Indices with Expected GCIT Estimate



Sharpe Ratios[1]	
AusBond Bank Bill Index	0.29
AusBond Credit FRN Index	0.60
AusBond Credit Index	0.92
AusBond Govt Index	0.42
AusBond Composite Index	0.51
Bloomberg Barclays US MBS Index	0.22
GCIT Estimate	**~0.8-1.4**

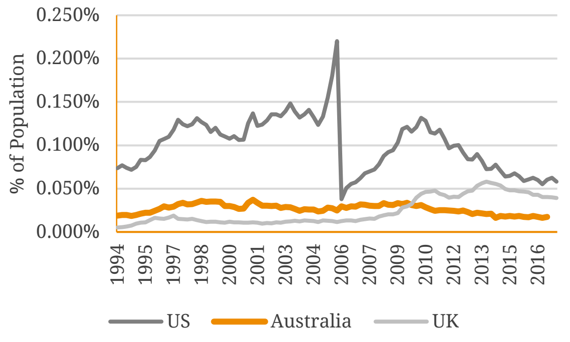
[1] Sharpe Ratios calculated using an 10Y average of the RBA cash rate as risk-free rate proxy.
Source: BondAdviser Estimates, Bloomberg

Asset Class Background: Australian RMBS

Despite only ~6% of the $1.56 trillion Australian home loan market being securitised, the domestic RMBS asset class has been a key pillar of the Australian fixed income market for a number of decades and has been historically limited to institutional investors. As part of the broader ABS classification of securities, securitisation represents ~21% of all debt securities outstanding domestically and is an essential funding source for Australian banks as well as non-bank lenders.

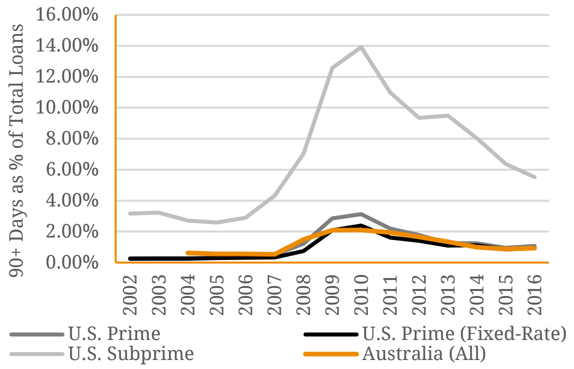
Due to the nature of RMBS, performance is closely linked to the credit health of mortgage borrowers and the broader Australian economy. For these reasons, asset quality metrics are a key indicator for the credit profile of Australian RMBS when accompanied by top-down economic data such as unemployment, economic growth and consumer confidence. This relationship was demonstrated in the US where there is a widespread perception that the securitisation market indirectly contributed to the Global Financial Crisis (GFC), creating somewhat of a stigma around the RMBS asset class. However, it is important to acknowledge the significantly different structure of the Australian market, which predominantly comprises prime recourse loans (~95%), is underpinned by a highly regulated residential lending market (especially so in the current environment). APRA's sound regulation has, in part, contributed to historically lower personal bankruptcy and mortgage delinquency rates and higher pre-payment rates (~10% higher) than seen offshore. In appendix 3, we outline the principle differences between Australian RMBS and US Sub Prime loans.

Figure 8. Personal Bankruptcy Rates by Country



Source: US Bankruptcy Court, Australian Financial Security Authority, UK Department of Business Innovation & Skills.

Figure 9. Mortgage Arrears Rates (US v Australia)

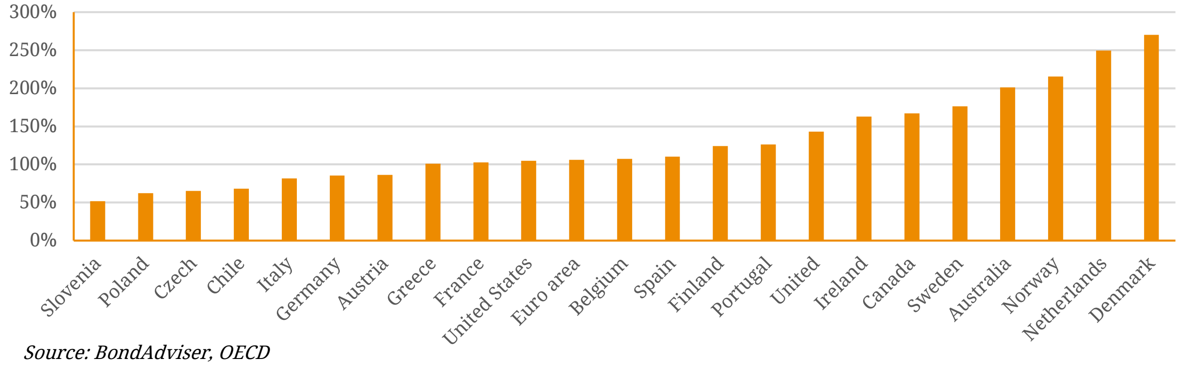


Source: APRA, US Mortgage Bankers Association

That said, Australia was mostly insulated from the full impact of the GFC, which marked the end of the last credit cycle. We are probably nearing the end of another credit cycle with recent lending restrictions imposed by regulators having their intended effect of reining in loan growth, but we note that private sector debt continues to sit at all-time highs. For this reason, there has been a persistent divergence between the stable performance delivered by residential mortgages and the underlying fragility of the economic environment in which they exist as encapsulated by household leverage ratios. A rising interest rate environment will be a landmark test for the Australian economy and given the RBA revealed a third of mortgage customers had no buffer on repayments in its latest Financial Stability Review, we expect any monetary tightening to be conducted with due caution.

It is also important to note the strength of prime versus sub-prime (non-conforming) loans when faced with a major economic deterioration as seen in the US. For this reason, the mix and diversity of RMBS assets within a given portfolio is a major contributor to inherent credit risk. This highlights the importance of the GCIT targeting a ~70% allocation to prime mortgages which have historically remained strong throughout the cycle. Together with a strong risk management framework and structural risk mitigants at an asset level (LVRs, LMI etc.), we believe the GCIT is positioned well for any tail-risks present in the Australian mortgage market.

Figure 10. 2016 Household Debt as a Percentage of Net Disposable Income



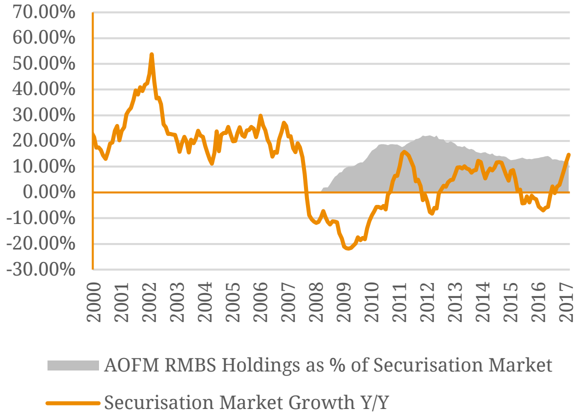
Source: BondAdviser, OECD

Further supporting the Australian RMBS market are a number of key reforms that have been developed and implemented over the past decade from the AOFM, the RBA and APRA. This has reshaped the dynamics of the RMBS market with the ultimate objective to reducing systemic risk in the asset class.

AOFM: RMBS Purchases

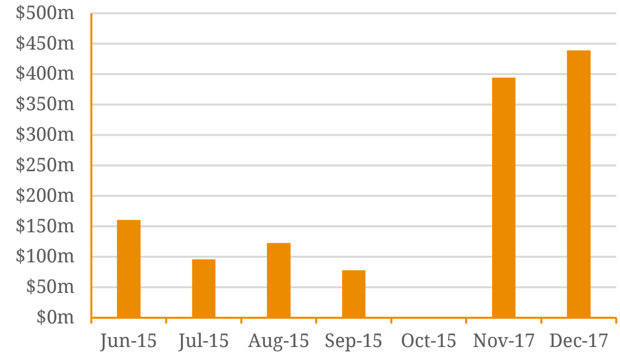
During the GFC in 2008, the Australian Office of Financial Management (AOFM) set up a program to invest in up to $8 billion of new prime RMBS issuance in an effort to support competition in the domestic market. This directive was later increased to $20 billion and primarily targeted issuance from smaller lenders to facilitate transactions at economical funding rates. This past action does demonstrate the importance of RMBS in Australian financial markets in eyes of the Federal Government.

Figure 11. Australian Securitisation Market Growth



Source: RBA, AOFM

Figure 12. AOFM RMBS Auction Results



Source: AOFM

With the market returning to a state of stability, the program ended in April 2013. Since then, the AOFM has held a series of sporadic auctions of its accumulated holdings. In the past these auctions have proven challenging and sales were suspended in February 2016. However, auctions recommenced in November 2017 and 35% of amortised face value was cleared highlighting renewed investor interest and activity in the market.

RBA: Repo Eligibility

To improve liquidity in the Australian securitisation market, particularly during periods of credit distress, the Reserve Bank of Australia (RBA) adjusted its liquidity criteria for repo-eligible securities in 2008. Under the revised framework, the RBA expanded the range of securities for its repurchase operations to include 'AAA' rated (by S&P, Moody's or Fitch) prime RMBS. Additionally, in 2015, the RBA required issuers of eligible RMBS to meet stringent monthly data requirements.

APRA: APS 120

The Australian Prudential Regulatory Authority's (APRA) regulation for securitisation exposure for Australian Authorised Deposit-Taking Institutions (ADIs) is encompassed in Australian Prudential Standard 120 (APS120). The development of the framework spanned over many years, concluded in November 2016 and will come into effect in January 2018.

Unlike US and European jurisdictions, APRA does not require a minimum risk retention for issuers (i.e. retain a portion of the transaction) and rather manages exposures through regulatory capital mechanisms. Specifically, in order for an ADI to be granted full capital relief in regards to a securitisation transaction, it must meet a series of risk-limiting criteria.

Contingent on rating of the tranche, securities held are then either risk-weighted accordingly (highest-rated tranches) or deducted directly from Common Equity Tier 1 (CET1) capital (lower-rated tranches). Under the standard, risk-weighting will increase substantially and will also depend on term. As a result, securitisation exposures for ADIs will become less economical going forward due to the increased regulatory burden and will reduce bank investor and depositor exposures to off-balance sheet special purpose vehicles (SPVs). For the RMBS market, this should improve supply conditions and result in greater investment opportunities in institutional markets.

Gryphon Capital Investment Processes & Capabilities

In the course of our research, we have been impressed with the capability and expertise of Gryphon Capital as applied to all areas of the investment process. We believe it is worthwhile examining in more detail the steps that are taken by Gryphon and adding our own comments where relevant.

As outlined in the offering documentation, the investment process is an iterative evolution of linked elements. Investment strategies are created from initial idea generation followed by tailored research, extensive modelling, portfolio construction and then the actual execution.

Platform

At the core of Gryphon Capital's operations sits its bespoke SQL-based platform, developed and refined over many years.

This stores details of over 2,000 ABS (including RMBS) deals which contain over 8,000 individual securities (the aforementioned tranching of a deal) and the mechanics of individual bond structures. This information can be referred to as static data.

On top of the static data is overlaid a record of dynamic data which includes daily market prices (by instrument), loan-level tape data (see below), research reports and a host of macro-related factors such as house prices, interest rate levels, inflation expectations etc.

The RBA has in place repo reporting requirements which includes monthly loan templates for RMBS and ABS issuers (37 in total) in a set format. In Gryphon's experience, this is generally inadequate for its purposes and it is in constant dialogue with each issuer to obtain loan-level data that satisfies its rigorous (higher) requirements and managed to reconcile over 97% of the available Australian market.

One key feature of proprietary databases is that their intrinsic value increases though time as a more and more data is added to it. We believe that Gryphon's platform has built up a more than sufficient data set for its core purposes and the efficiency and efficacy of this will only improve in the future. We do note that this data set has not experienced a large and widespread macroeconomic shock.

The data provided on the loan-level tapes provided to Gryphon is very detailed and includes information such as current loan balance, original loan balance, written LVR, current LVR, indexed current LVR, current interest rate, principal or interest only, full documentation, LMI, arrears >30days, >60days, >90days, postcode, security type (residential standard, luxury or strata), investment type (residential / investment), loan purpose (purchase, refinance, shares, travel etc), borrower occupation and employment status.

What the platform is then best at is the aggregation and stratification of this loan-level data by whatever metric(s) Gryphon chooses and which can be performed almost as quickly as the SQL query can be written. This stratification is used extensively in underwriting and surveillance packs specific for deals and also for holistic portfolio management and reporting, which are discussed in more detail below.

Top Down

The Top Down part of Gryphon's investment process relates to the analysis of the current macro environment in Australia and the rest of the world with a view to identifying trends which could affect portfolios and/or aid future investment decisions.

Many drivers of mortgage (RMBS) performance are evaluated including employment levels and data, house prices, sales and auction clearance rates, mortgage rates, prepayment data, delinquencies, LMI claims and affordability calculations.

Gryphon maintain data on almost 20 different asset sectors and each of these are continually analysed by credit rating / WAL (weighted average life). These sectors can be further bucketed by risk categories and ranked.

Of the many possible outputs of the Top Down process, at the very least is validation that the overarching macro strategies and approaches are correct. An additional benefit is that the continual monitoring of asset sector risk weightings and bucketing makes emergent trends easier to spot. This can then be utilised by Gryphon through updates to portfolio construction and even allows for new investments into previously unattractive issues or instruments before competitors.

Bottom Up

Gryphon's Bottom Up analysis is in our view the most important element of its processes and extensive work is undertaken both before and after any investment decisions are committed to.

Originator reviews form the core of class and issuer selections and involve ongoing on- and off-site due diligence by Gryphon into the origination practices of issuers. As can be readily understood, poor credit assessment and lending practices by ADIs can have severe negative implications for many ABS issues/series. Gryphon examine management experience, issuer financial capacity, viability and technological sophistication amongst other factors. A focus on exceptions to underwriting standards, i.e. where the issuer consciously does not follow its own guidelines is important. Originator performance history, ie prepayments, delinquency rates and losses can also influence the assessment.

Servicers are entities (sometimes the same as the originator) which manage the administration of loans once transferred to an RMBS and a similar evaluation on the capacity and skills is undertaken by Gryphon. At the other end of the lending process – arrears management is also where investment performance can be improved or diminished. A servicer with good processes will tend to have lower delinquency rates and lower impaired loans and probably lower actual incurred losses also.

Detailed Collateral Analysis is performed on loan-level data and forms the detail of a loan stratification report for Gryphon. This can identify any tail risks in the mortgage population which may affect future performance. Such tail risks can also include the extent of high-risk loans prevalent such as postcodes in high-risk areas or a large number of strata investment properties. A thorough collateral analysis grants Gryphon the ability to accurately predict future payment rates, defaults and loss rates (if any). It is worth noting that loan substitutions can and are made at the request of investors (including Gryphon) as a result of their due diligence processes. This is often the case where an originator has offered a loan for securitisation that does not actually qualify under its own stated criteria.

Lastly, individual Bond Structures (tranches) are queried, which builds on all due diligence conducted and will reasonably predict default and loss timings. A bespoke cash flow model is built and generates multiple possible scenarios. These are then stress tested and scenario analysis performed to assess market and structure risks for individual debt tranches. This type of research is generally referred to by practitioners as 'break the bond'…i.e. exactly what combination of factors will be required to cause expected returns to not be achieved.

Investment Selection

The chief output of all of the above investment processes is a balanced assessment of an issue condensed into an 'Underwriting Report' and used by Gryphon for investment decisions.

After careful analysis of collateral stratifications (risk concentrations), Gryphon will invest in one or more tranches of a particular issue (or none if it no tranches are attractive). It can often be the case that the lower (less than AAA rated) and non-rated tranches contain sufficient credit enhancement features to be the most valued and the investment managers will allocate capital there. This is particularly so in the case of the major banks, whose AAA tranches are highly sought after and often 'overbid' by investors – i.e. the price becomes too high (yield/returns too low) for the expected risk.

Investment Monitoring

The aforementioned Underwriting Report becomes the mainstay for investment monitoring purposes also and as a deal progresses in its life, the loan characteristics and performance is continually updated. This also validates Gryphon's initial cashflow expectations and can serve to increase future modelling accuracy.

Gryphon conduct multiple risk management processes on daily, weekly and monthly timeframes across both the current market and their own portfolios. Such activity is very sound practice and serves to alert the Investment Committee to adverse trends which may affect performance such that early remedial action can be effected.

As also mentioned earlier, such monitoring can indicate when individual bonds, previously considered unattractive, become permissible investment options for Gryphon. This can be the case where arrears rates for certain vintages have increased such that secondary market prices have decreased enough to make the yield large enough for a position to be bought.

Another benefit of all of Gryphon's systems and experience is that there are certain times when increasing arrears rates becomes very beneficial for certain (generally senior) tranches as this (re)asserts payment priority, meaning all cashflows will be directed to this class. Once again, having performed the requisite due diligence on almost all deals affords Gryphon the opportunity to capitalise on investments as and when they arise.

Appendix 1: About Gryphon Capital Investments

Gryphon Capital Investments (GCI) is an independent asset management group specialising in structured finance as well as less liquid credit markets in both Europe and Australia. The firm manages ~$1.8 billion of funds and the investment team has operated together since 2005.

Investment Committee

Steven Fleming – Steven is a founding partner of GCI where he acts as the Chief Executive Officer. As CEO, he is responsible for the firm's business strategy, risk management, operational oversight and is a member of GCI's Investment Committee.

Steven has more than 24 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 portfolio's. 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, senior CMBS trader in Nomura's New York office and Associate Director in Nomura's Principal Finance Group. Steven began his career with Price Waterhouse in Sydney.

Steven holds a Masters of Economics from Macquarie University and a Bachelor of Commerce from the University of Queensland.

Ashley Burtenshaw– Ashley is a founding partner of GCI where he acts as the Chief Investment Officer, as CIO, he is responsible for the firm's investments, portfolio management and is a member of GCI's Investment Committee.

Ashley has over 23 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 firm's 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.

Ashley holds a Bachelor of Science from Queensland University of Technology.

Shane Stanton– Shane joined GCI in 2014 as a Portfolio Analyst. As an experienced Analyst, he is responsible for developing GCI's portfolio and risk management tools. Shane provides day to day portfolio support to the Investment Committee.

Shane has more than 13 years' experience in credit markets, including securitisation, derivatives, funds management and structured finance. Before joining GCI, Shane spent 4 years at Threadneedle Investments as a Quantitative Analyst in the firms ABS team. Prior to this Shane held several key positions specialising in structured products which included, Associate in the Barclays structured products distribution team and Associate Director in the Aviation Division of the Allco Finance Group. Shane began his career by winning a cadetship to the Australian Bureau of Statistics in 2004.

Shane holds a Masters in Applied Finance from Macquarie University, and a 1st Class Honours degree in Science from Sydney University.

Sergey Podzorov – Sergey joined GCI in 2014 as a Portfolio Analyst. As an experienced programmer and developer, he is responsible for building and maintaining the firm's portfolio applications which assist the team with market pricing, compliance, risk and portfolio management.

Sergey has over 24 years' experience in financial markets, in areas including securitisation, structured finance and funds management. Before joining GCI, Sergey spent 5 years at Threadneedle Investments as a Database Programmer in the firms ABS team. Prior to this Sergey held several key system development positions at Babcock and Brown, CBA and Credit Suisse First Boston. Sergey began his career working in a scientific research role for an academic institution in Moscow.

Appendix 2: Basics of RMBS

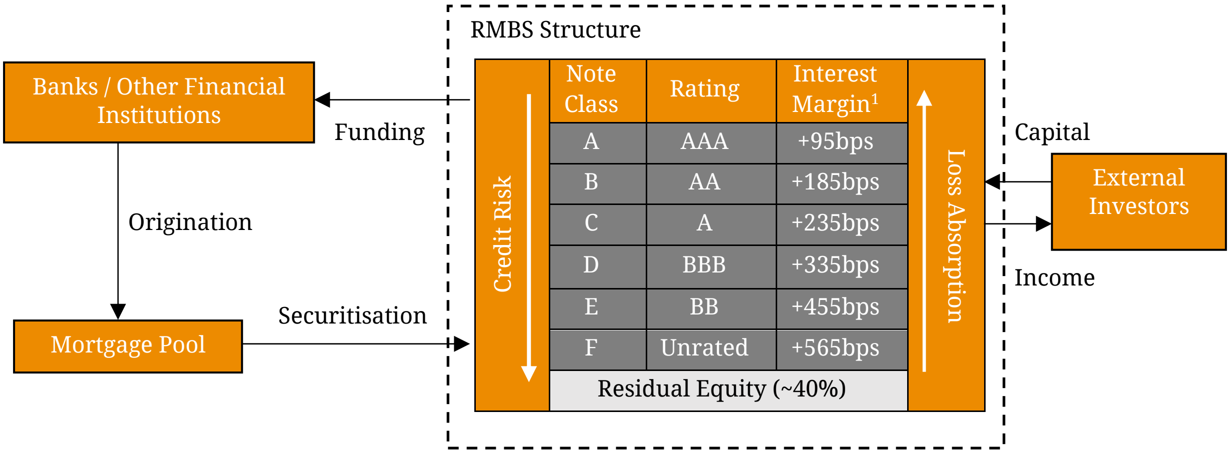
Residential Mortgage Backed Securities (RMBS) are a form of securitisation where a pool of mortgage loans created by banks and other financial institutions are bundled together and sold to external investors. In the Australian market, these mortgages are typically secured against the underlying residential properties and give investors first ranking to all obligated interest payments and collateral in the event of liquidation.

However, within each RMBS transaction, this ranking is segregated into a series of notes, known as a 'tranches' which vary in terms of payment priority and loss absorption features. As a result, credit risk and hence, yield, will increase in descending order from higher payment priority tranches to lower payment priority tranches. These tranches are typically ranked in letter order and will be rated separately by credit rating agencies.

In Figure 13 below, we illustrate a general RMBS transaction. Assuming an average loan-to-value ratio (LVR) of 60%, this implies the funding profile of the typical residential real estate asset comprises 40% equity and 60% secured debt in the form of the mortgage. This debt pool will then be securitised into a series of tranches which essentially act as progressive layers of loss absorption and show a relationship between credit risk and yield.

The residual equity will represent the first line of loss absorption should the underlying value of the property fall, with the 'F' tranche being the secondary line of defence and so on. Similarly, in the event of a shortfall in interest payments (i.e. mortgage delinquencies / default), investors in the most senior tranche ('A' class) will first receive accrued distributions before the next most senior tranche ('B' class) and so on representing a 'waterfall' payment structure. Conversely, loss absorption occurs in a reverse order to payment priority and reflects the credit risk profile of the securitisation vehicle.

Figure 13. General RMBS Transaction Overview



[1] Indicative Interest Margins over BBSW provided by GCI.
Source: BondAdviser, GCI

In the scenario where the underlying borrowers default on their mortgages, there are multiple options that can be sought by RMBS holders.

- **Underlying Asset Sale** - Depending on the LVR ratio of the asset and the value of the asset at point of default, the underlying property can be sold to recoup principal. Should the sale price exceed the market value of the debt (i.e. any decline in value has only impacted the equity buffer), RMBS investors (all tranches) will receive a recovery rate of 100%.
- **Lenders Mortgage Insurance (LMI)** - Australia has a robust LMI market and this is usually a prerequisite for any moderately higher-risk mortgages. As a result, lenders can make a claim on LMI in the event asset divestments does not recover all capital.
- **Excess Interest Buffer** - RMBS structures typically generate excess interest above the set margins on tranches. This is utilised as a safety pool and can be drawn upon if asset divestments and LMI claims are insufficient in recovering losses.

As a result, the above support mechanisms must be collectively inadequate for RMBS investors to experience capital losses. The extent and effectiveness of related variables (i.e. average LVR, LMI coverage, payment structure) should be identified within the structure to evaluate the ultimate backstop should the asset pool deteriorate over the investment horizon.

Appendix 3: Australian RMBS & US Sub Prime Differences

Below, we briefly discuss the four main areas where Australian RMBS differ US Sub Prime:

- **Higher Lending Standards** - The lending standards for loans secured by Australian residential property are generally higher than their US counterparts as borrowers are required to hold significant equity in the property and demonstrate proof of income before loans are granted. Unlike in the US (prior to the GFC), there is no true "sub-prime" market in Australia.
- **Lender Recourse** - The US mortgage market is a non-recourse market, so the release of any residual equity value within the property is the only way of mitigating a loss in a default scenario. This effectively means that borrowers in default can simply hand the keys for a property back to the bank with no threat of further action to enforce repayment. In the Australian mortgage markets after a default, the lender can continue to pursue borrowers for recovery of amounts lent for a multi-year period. This has a material impact on the post-default life of the borrower, creating a more powerful incentive to repay.
- **Alignment of Interests** - In the majority of deals in the Australian RMBS market, the first loss piece is retained by the issuer of the RMBS. Historically, in most US RMBS all the risk was fully transferred from issuer to the bondholder, encouraging the issuer to focus on increasing volume to earn more origination fees rather than maintaining portfolio and underwriting quality. The risk retention by the issuer helps to align its interests with the bondholders.
- **Historical Performance** - Unlike US Subprime, S&P has never lowered the rating to "D" (Default) on any RMBS transaction in Australia.

Table 1. Summary of Main Differences between Australian RMBS and US Sub Prime

Feature	Australian RMBS	US Sub Prime
Majority of RMBS originated by regulated banks	Yes	No
General lending standards	Higher	Lower
Historical use of affordability tests for borrowers	Yes	No
Recourse lending	Yes	No
Personal stigma of insolvency	Yes	No
Originator generally services the RMBS	Yes	No
Originator typically retain first loss piece of securitisation	Yes	No

Appendix 4: GCI Secured Opportunities (SOF) Portfolio Statistics*

Portfolio Composition	
Holdings Detail	
Number of Holdings	52
Fund Market Value	$253,085,475
Maximum Holding	4.47%
Minimum Holding	0.30%
Underlying Loan Size	
No. of Underlying Loans	80,834
Average Underlying Loan Balance	$214,840
Maximum Underlying Loan Balance	$2,422,905
Underlying Loan Metrics	
Loan to Value Ratio (LVR)	
Weighted Average LVR	60.4%
Median LVR	54.0%
Credit Quality	
30+ Days in Arrears as % of Loans	0.65%
12M Average Prepayment Rate	21.45%
Seasoning	
Weighted Average (Months)	50.2
Maximum (Months)	294.2
Loan Composition	
Loan Classification	
Owner-Occupier	75.7%
Investment	24.3%
Loan Type	
Fixed	17.2%
Variable	82.8%
Repayment Method	
Interest Only	16.8%
Principal & Interest	83.2%

Figure 14. Loan Size Distribution by value

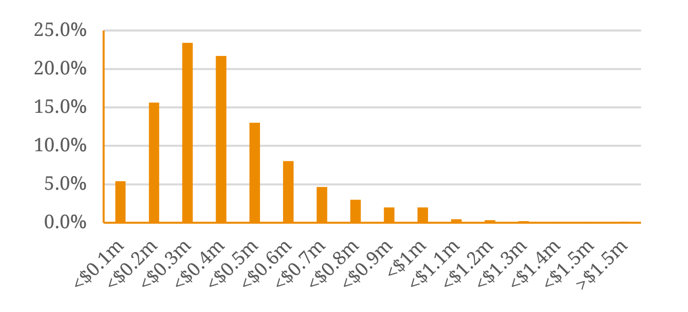


Figure 15. LVR Distribution by value

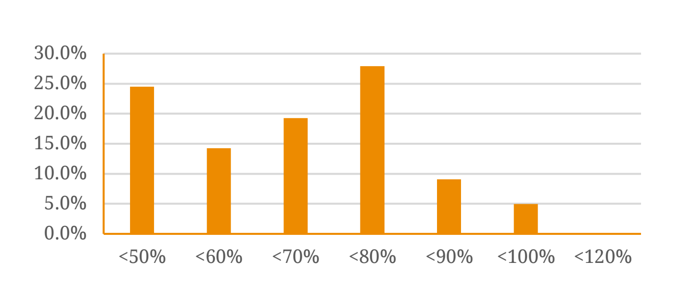
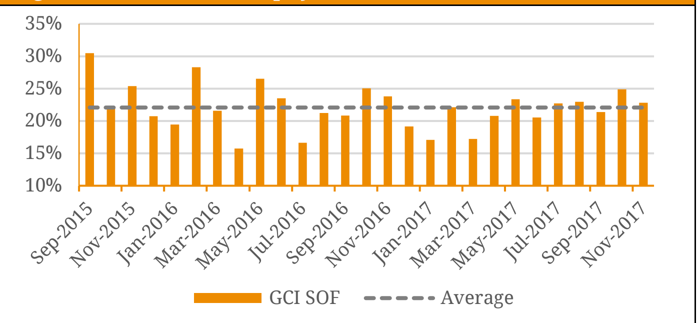


Figure 16. Historical Prepayment Rates



Portfolio Diversification

Figure 17. State Diversification

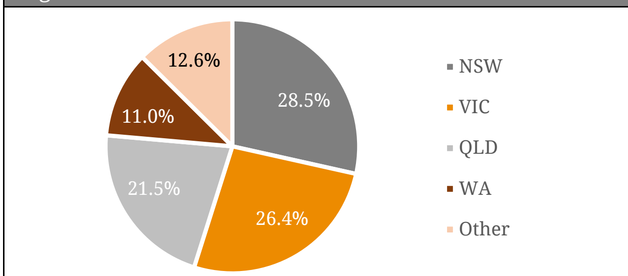
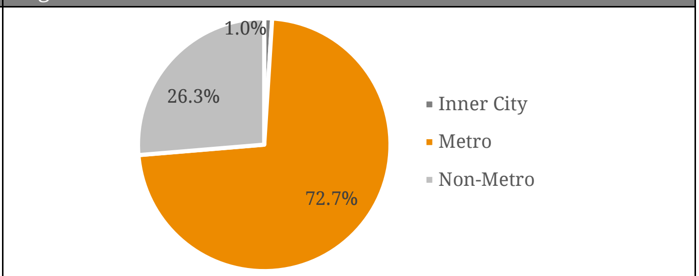
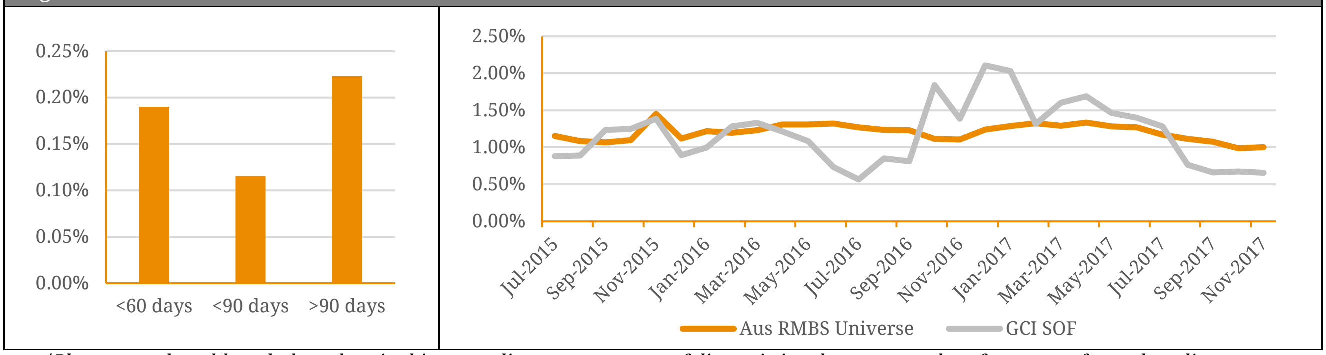


Figure 18. Urban Area Diversification



Asset Quality

Figure 19. Current and Historical Arrears as % of Total SOF Portfolio



**Please note that although the values in this appendix are accurate portfolio statistics, the return and performance of actual credit instruments invested in are assessed individually.*

Source: BondAdviser, Gryphon Capital Partners

Appendix 5: GCI Investment Grade (IG) Portfolio Statistics*

Portfolio Composition	
Holdings Detail	
Number of Holdings	22
Fund Market Value	$97,386,533
Maximum Holding	7.77%
Minimum Holding	2.56%
Underlying Loan Size	
No. of Underlying Loans	38,391
Average Underlying Loan Balance	$233,191
Maximum Underlying Loan Balance	$2,390,784
Underlying Loan Credit Metrics	
Loan to Value Ratio (LVR)	
Weighted Average LVR	60.9%
Median LVR	56.8%
Credit Quality	
30+ Days in Arrears as % of Loans	1.53%
12M Average Prepayment Rate	21.73%
Loan Seasoning	
Weighted Average (Months)	46.3
Maximum (Months)	272.1
Underlying Loan Composition	
Loan Classification	
Owner-Occupier	75.5%
Investment	24.5%
Loan Type	
Fixed	14.7%
Variable	24.5%
Repayment Method	
Interest Only	17.3%
Principal & Interest	82.7%

Figure 20. Loan Size Distribution by value

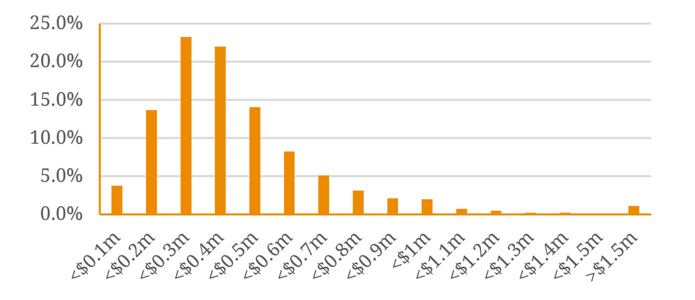


Figure 21. LVR Distribution by value

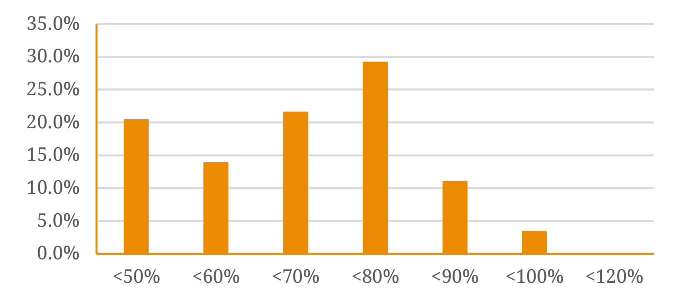
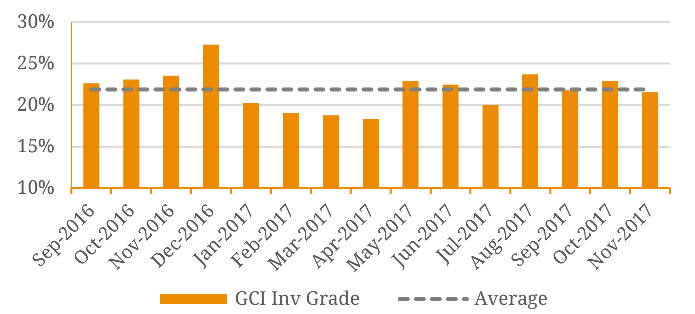


Figure 22. Historical Prepayment Rates



Portfolio Diversification

Figure 23. State Diversification

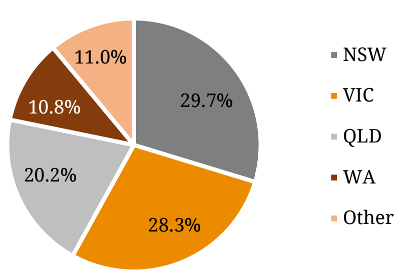
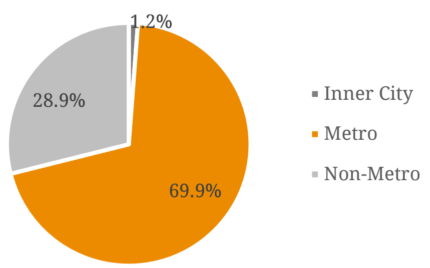
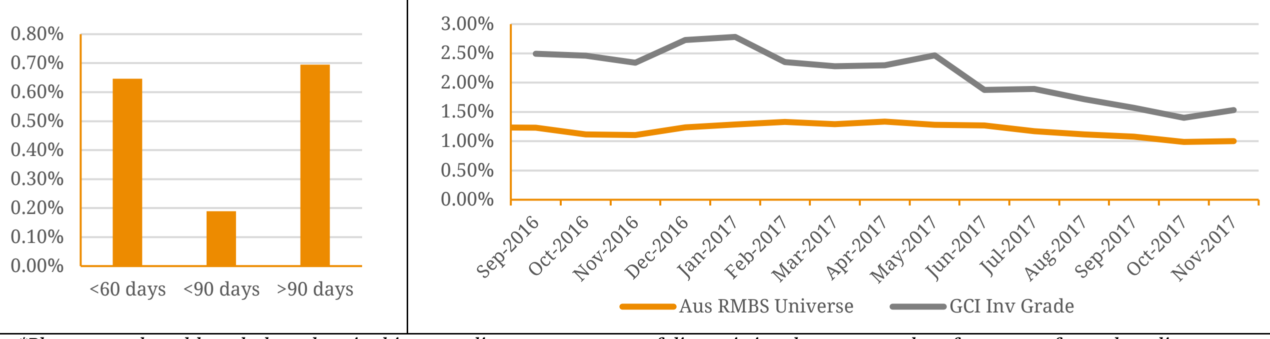


Figure 24. Area Diversification



Asset Quality

Figure 25. Current and Historical Arrears as % of Total IG Portfolio



**Please note that although the values in this appendix are accurate portfolio statistics, the return and performance of actual credit instruments invested in are assessed individually.*

Source: BondAdviser, Gryphon Capital Partners

Research Methodology

Every research report prepared by BondAdviser includes a clear recommendation - **Buy**, **Hold** or **Sell** - on the security. This recommendation framework is designed to help investors navigate different investment opportunities by identifying the market price, yield, term to maturity, liquidity, volatility and risk.

The guide below may help you understand our research opinions. For further information on our research approach, you can refer to our RG79 statement by **clicking here**.

Research Opinions key

- **Buy** - Over the next 12 months, the analyst expects the security to outperform the current yield due to credit spread tightening or favourable movements in the underlying yield curve.
- **Hold** - Over the next 12 months, the analyst expects the security to provide stable returns broadly inline with the current yield but with little credit spread tightening.
- **Sell** - Over the next 12 months, the analyst expects the security to underperform the current yield due to credit spread widening or adverse movements in the underlying yield curve.
- **Suspended** - The recommendation has been suspended temporarily due to the disclosure of new information or market events that may have a significant impact on our recommendation. This also includes situations where we have been given non-public information and we need to temporarily suspend our coverage in order to comply with applicable regulations and/or internal policies.
- **Not Rated** - A security that has not been assigned a formal recommendation.

Analyst

Simon Fletcher
Credit Research
simon.fletcher@bondadviser.com.au

About BondAdviser

BondAdviser is an independent research company that specialises in bonds and fixed income securities. We provide investors, advisers, brokers and institutions with research, data, education and tools to help them invest intelligently. Our service is delivered online via an easy-to-use portal.

BondAdviser has the broadest coverage of retail-accessible ASX-listed and over-the-counter securities, including primary and secondary issues. Our expert credit team draws on its extensive experience and robust research process to deliver unbiased insight backed by detailed analysis.

At BondAdviser, our goal is to lift the lid on the fixed income market so that more investors have the opportunity to invest in the asset class directly.

Learn more

To learn more about the fixed income market visit our website **www.bondadviser.com.au**

Important Information