

Investor Education

Gryphon Capital Income Trust - Diversification

- The Gryphon Capital Income Trust (ASX: GCI) (Trust) seeks to provide investors with monthly income and capital preservation by investing in a portfolio of Australian Residential Mortgage Backed Securities (RMBS) and Asset Backed Securities (ABS).
- This segment of the fixed income market is dominated by institutional investors and until now has been difficult for retail investors to access and therefore build a diversified portfolio.
- The Manager seeks to deliver the Target Return (RBA Cash + 3.50% per annum - currently 5% per annum) while preserving capital.

The investment strategy, implemented by Gryphon Capital Investments (Manager or Gryphon), reflects the key tenets of the Manager's investment philosophy of capital preservation and superior investment returns, given the associated risk. The investment selection processes, policies and risk protocols employed by the Manager in the construction of the Portfolio on behalf of the Trust are the same as those it employs on behalf of its institutional clients.

Are the diversification benefits of investing in RMBS real?

In addition to an attractive (risk adjusted) return profile, the Trust should also offer significant diversification benefits. To understand whether this is in fact the case, we can test this proposition by reviewing the behaviour (correlation) of both the asset class itself, as well as the Manager's institutional strategies, against other asset classes. Correlation is a statistical technique used to measure the strength of the relationship between two specific data sets, for example the performance of two different investment asset classes. In this circumstance, a positive correlation indicates the extent to which the performance of each asset class increases or decreases in parallel; a measure of "1" means there is strong correlation. A negative correlation indicates the extent to which one asset class increases as the other decreases; a measure of "-1" means there is a strong negative correlation.

Morgans has reviewed data supplied by Gryphon which highlights the significant diversification benefits to be derived from investing in RMBS. Specifically, it can be observed in Table 1 that for the period January 2010 – May 2018, the asset class as measured by Australian 2yr Senior AAA RMBS data has exhibited a very low correlation with all major asset classes, except Bank Bills which was relatively high at 0.63. Intuitively, this high correlation makes sense because RMBS interest payments are floating rate i.e. they move up and down in line with changes in the bank bill rate. This is in direct contrast to the -0.01 correlation with global equities; which can be interpreted as meaning there is effectively no correlation between global equities performance and that of AAA rated RMBS. Other asset class correlations sit somewhere in between at 0.04 - 0.16, but all support the story of very low correlation i.e. high diversification.

We can also see that Gryphon's *High Grade* institutional strategy which holds AAA and AA rated Australian ABS (largely RMBS), has provided strong diversification benefits over this time frame. This is demonstrated by the very low correlations evident against other asset classes (far right column).

Table 1. GCI Investment Grade Fund

Asset Class	Aust Bank Bills	Aust Fixed Int	Aus Gov Bonds	Global Gov Bonds	Australian Equities	Global Equities	Aust 2yr Senior AAA RMBS	GCI - High Grade RMBS
Aust Bank Bills	1.00	0.31	0.28	0.32	(0.06)	(0.06)	0.63	0.49
Aust Fixed Int	0.31	1.00	0.99	0.69	(0.25)	(0.41)	0.15	0.01
Aus Gov Bonds	0.28	0.99	1.00	0.67	(0.28)	(0.44)	0.12	(0.02)
Global Gov Bonds	0.32	0.69	0.67	1.00	0.02	(0.12)	0.16	0.14
Australian Equities	(0.06)	(0.25)	(0.28)	0.02	1.00	0.74	0.04	0.13
Global Equities	(0.06)	(0.41)	(0.44)	(0.12)	0.74	1.00	(0.01)	0.12
Aust 2yr Senior AAA RMBS	0.63	0.15	0.12	0.16	0.04	(0.01)	1.00	0.51
GCI - High Grade RMBS	0.49	0.01	(0.02)	0.14	0.13	0.12	0.51	1.00

However, to understand the Trust's potential portfolio diversification attributes, we must look to Gryphon's *Secured Opportunity Fund* (SOF) strategy with which the Trust's investment mandate is closely aligned (see Table 2).

Table 2. GCI Trust Investment Mandate

	Secured Opportunities	Investment Grade Securitized	Trust
Authorised Investments			
RMBS	Yes	Yes	Yes
ABS	No	Yes	Yes
Investment Mandate			
(a) Credit Rating Restrictions			
Minimum Credit Rating	N/A	BBB-	N/A
At least 50% of Portfolio to be Investment Grade	N/A	Yes	Yes
(b) Portfolio Concentration			
Maximum holding in one security the time of investment	10%	10%	10%
Maximum single Originator exposure	25%	N/A	25%
(c) Portfolio Weighted Average Life			
Maximum Portfolio Weighted Average Life ¹	5.5 years	N/A	5.5 years

Source: GCIT PDS

Table 3 below shows all recalculated correlations for the period since April 2015 when the SOF Strategy commenced. Encouragingly, GCI's SOF Strategy (far right column) has delivered as expected. It has exhibited effectively no correlation with any other asset classes including Australian corporate and Government bonds. Similar outcomes have also been delivered by the AAA data set and High Grade Strategy.

Table 3. GCI Secured Opportunity Fund

Asset Class	Aust Bank Bills	Aust Fixed Int	Aus Gov Bonds	Global Gov Bonds	Australian Equities	Global Equities	Aust 2yr Senior AAA RMBS	GCI - High Grade RMBS	GCI -SOF RMBS
Aust Bank Bills	1.00	0.17	0.17	0.15	(0.05)	(0.10)	(0.33)	(0.29)	(0.12)
Aust Fixed Int	0.17	1.00	1.00	0.76	(0.00)	(0.12)	0.04	(0.08)	(0.14)
Aus Gov Bonds	0.17	1.00	1.00	0.77	(0.00)	(0.13)	0.04	(0.09)	(0.14)
Global Gov Bonds	0.15	0.76	0.77	1.00	0.12	0.06	(0.06)	(0.12)	(0.15)
Australian Equities	(0.05)	(0.00)	(0.00)	0.12	1.00	0.76	(0.04)	0.07	(0.15)
Global Equities	(0.10)	(0.12)	(0.13)	0.06	0.76	1.00	(0.02)	(0.02)	(0.14)
Aust 2yr Senior AAA RMBS	(0.33)	0.04	0.04	(0.06)	(0.04)	(0.02)	1.00	0.49	0.34
GCI - High Grade RMBS	(0.29)	(0.08)	(0.09)	(0.12)	0.07	(0.02)	0.49	1.00	0.67
GCI -SOF RMBS	(0.12)	(0.14)	(0.14)	(0.15)	(0.15)	(0.14)	0.34	0.67	1.00

Conclusion

Naturally, we must preface any conclusion with the disclaimer that past performance cannot be taken as an absolute indicator of the future and the fact that we have referenced historical Gryphon strategy data for the purposes of this analysis¹. Notwithstanding, given the similarities between SOF and the Trust, we believe this analysis is highly supportive of the thesis that GCI's investment performance² can be expected to deliver significant portfolio diversification benefits to investors while targeting an attractive cash yield.

For the first time, retail investors can incorporate a dedicated RMBS investment strategy into their portfolio by investing in the ASX listed Gryphon Capital Income Trust.

Appendix

Data referenced in this publication has been sourced as outlined below.

Aust. Bank Bills	Bloomberg Ausbond Bank Bill Index
Aust. Fixed Interest	Bloomberg Ausbond Composite Bond Index
Aust. Govt. Bonds	Bloomberg Ausbond Govt. 0+Yr Index
Global Govt. Bonds	Bloomberg Barclays Global Agg. Government-Related TR Index Value Hedged AUD
Australian Equities	S&P ASX300 Accumulation Index
Global Equities	MSCI World Ex Australia Hedged AUD Net Total Return Index
Aust. 2yr Senior AAA RMBS	Macquarie's 2yr Senior AAA RMBS Trading Margins, converted by GCI to time series of returns
GCI - High Grade RMBS	GCI High Grade RMBS: actual historic time series of net returns
GCI - SOF RMBS	GCISOF RMBS: actual historic time series of net returns

¹ GCIT commenced trading on 25 May 2018 and therefore has limited price history.

² As measured by the Net Tangible Asset Backing (NTA) published on ASX.

Queensland

Brisbane	+61 7 3334 4888
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Brisbane: Tynan	+61 7 3152 0600
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South Yarra	+61 3 8762 1400
Southbank	+61 3 9037 9444
Traralgon	+61 3 5176 6055
Warrnambool	+61 3 5559 1500

Western Australia

West Perth	+61 8 6160 8700
<small>Stockbroking, Corporate Advice, Wealth Management</small>	
Perth	+61 8 6462 1999

South Australia

Adelaide	+61 8 8464 5000
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Canberra	+61 2 6232 4999
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Darwin	+61 8 8981 9555
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