December 2017 Review – Listed Hybrid Sector

Performance

The Elstree Enhanced Income Fund's total investment return for December 2017 was 1.21%. This compares with the Elstree Hybrid Index return 0.97%. In other markets the All Ordinaries Accumulation Index returned 2.03% while the All Maturities Bond Index returned (0.52%).

Basle 3.5 or 4 or whatever

4 years after its debut, the final Basel regulations were announced this month. The good thing is that it appears the formal regulations are now here for the next 10 years or so. Not that it matters what the formal regulations are: they're a bit like Italian road rules; they're optional. Each national regulator decides which parts they want to use. The best description we have heard of banking regulation over the past 25 years since Basel 1 was that Basel 1 encouraged banks to lend to risky assets, Basel 2 (and part of Basel 3) resulted in bank's lending much larger amounts on low risk assets such as housing and Basel 3.5/4 is an attempt to average the 2. Good thing it has only taken 25 years to transition. The big changes in the latest announcement are an attempt to limit a bank's ability to measure risk themselves (and that will increase the capital they hold on "low risk" assets that many banks, including Australian banks, have been gorging on). The best example is loans to housing. Basel 1 imposed a risk weighting of 50% (ie) they were half as risky as loans to corporate entities which were weighted at 100%. Basel 2 allowed the banks to estimate the risk and Australian banks got their risk weighting on housing loans down to a meagre 18% (because they had data showing 25 years of 5%+ p.a. house price increases, low unemployment and no recession; ergo no losses, and what's more the model says there will never be losses). However, if you thought Australian banks were 'taking the piss', it was even worse in Northern Europe where the same recipe of strong house prices had allowed banks to run their "risk" down even further. ABN AMRO (a Dutch bank) used risk weightings of 10% and large swathes of Scandinavian banks were similar. So these Northern European banks had around \$0.60 - \$0.90 capital backing a \$100 housing loan.

Regulators thought this was a little "light".

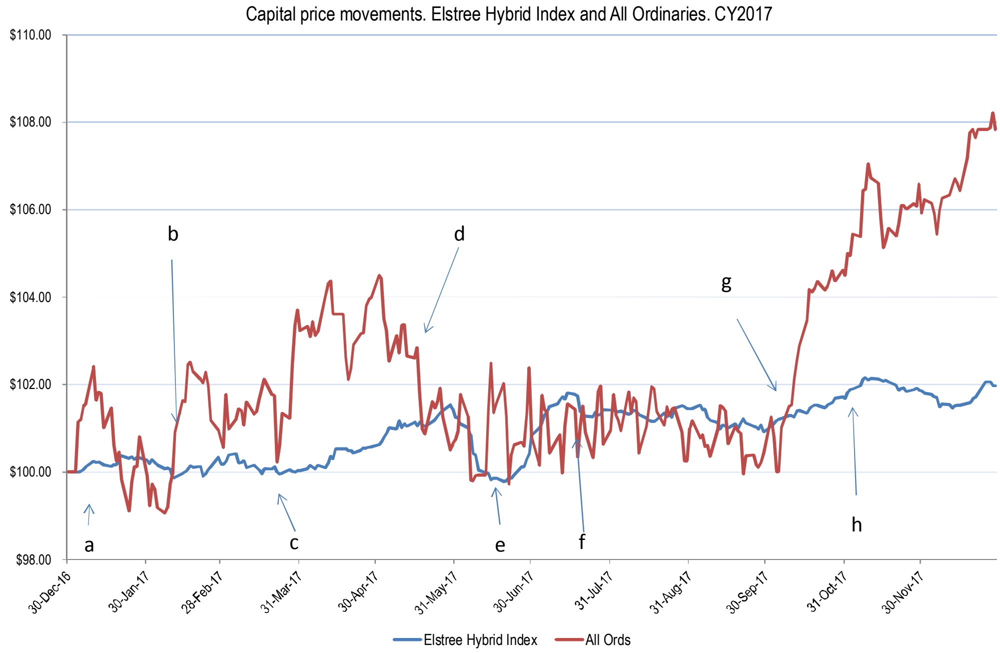
Not surprisingly, some regulators considered this a little light, even if the models were foolproof, so the latest regulations place a floor under the amount of capital required. APRA has been there for a while when it imposed a 25% limit on the risk weight applied to housing loans pushing the amount of capital backing housing loans up to \$2.50 / \$100 housing loan. The net effect is that, apparently, a few of the Northern European banks are going to take a very big hit on their published capital ratios. Australian banks have already been down this road with APRA taking a big stick to the banks internal risk models and being more conservative than many other regulators on what constitutes capital. We think that current capital levels are the line in the sand for at least the next 5 years and with limited asset growth, the capital raising cycle for Australian banks has ended.

That was the year that was

This time last year we showed the path of hybrid capital prices over the year and events of the year. It was far more popular than we thought (showing that we might be better at markets than understanding what readers want), so we thought we'd do it again. Unfortunately this year was a bit of nothing, and readers may never see a less volatile year than 2017. We've seen the current level of equity market volatility in only 2 years over the last 60; 2004 and 1957. It's always been much higher in other periods. This is also true for hybrids where volatility is at all time (since 1999 anyway) lows.
The hybrid capital prices data we show (from the Elstree Hybrid index) is also affected by some

Elstree Investment Management Limited (ABN: 20 079 036 810)
Level 10, 30 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348
Email: info@eiml.com.au

seasonality in coupons, so the fall you see in June was partly due to lots of coupons being paid. The total return index is a lot smoother. However, it does show the really interesting correlation between hybrids and equities. This year they are somewhat correlated in small movements (because sentiment is important), uncorrelated in large movements (because they have different fundamental factors) and are probably more highly correlated in catastrophes/positive catastrophes (and we haven't had one of those for the last 10 years, unless you count the last quarter's equity market 'melt up').



Points of interest

a) Bloomberg headline that Deutsche and Unicredit CoCo coupons at risk. Reflects some panic about hybrids/CoCo's.
b) Strong earnings results season for Australian Equities. Leads to strong month for equities
c) Deutsche Bank hybrid reach $100 after bottoming at $75 in 2016 and $85 at end of 2016. In hindsight this is the end of the European banking crisis. They are not going broke, ending every journo's and hedge fund tenacious and lazy short of the past 4 years.
d) Australian banks sink on news that the government will levy a new tax on their borrowings. It also indicates that the banks are on the nose, so investors take an extra big stick to bank share prices. Hybrids largely unaffected, indicating that the bank share price fall is largely a PE compression rather than a fundamental indicator of bank solvency.
e) Banco Popular, a zombie-ish Spanish bank, is put to death by the regulators with hybrid capital instrument holders getting nothing. A very short sell off follows but very little long term effect on bank capital markets at a global or Australian level.
f) CBA issues a 30 year issue in US markets at 3.9%. Really cheap borrowing but also a very low margin (historically) over bond. An important indication of the lack of investment market concern about banks (or the world in general).

Elstree Investment Management Limited (ABN: 20 079 036 810)
Level 10, 30 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348
Email: info@eiml.com.au

g) Equity markets take off. Small effect on hybrid market prices.
h) ASIC accounces that it will review the distribution of hybrid securities. Although it may increase post 2018 & 2019, there is a some chance there will be no new issues of major bank hybrids in 2018 and not much in 2019.

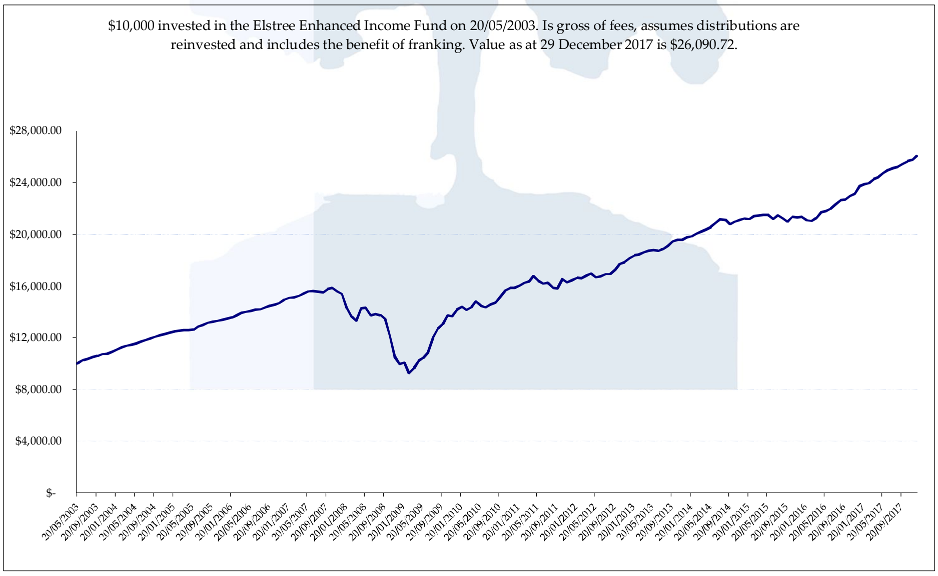
Fund characteristics as at 29 December 2017

Yield to Maturity	
Cash yield to maturity + franking (income yield)	4.8%
Investment grade issuer	93%
Fund average term (years)	4.8
Bank Tier 1 exposure	54%
Property exposure	2%

Performance Table	1 month*	3 months	12 months	3 years p.a.	5 Years p.a.
Elstree Enhanced Income Fund	1.21%	2.46%	9.80%	7.10%	7.49%
UBS Australia Bank Bill Index	0.14%	0.42%	1.75%	2.05%	2.34%

*Returns are gross of fees and include the benefit of franking credits. Past performance is not necessarily a guide to future performance.

Value of $10,000 Invested on 20/05/2003



Disclaimer
The information and opinions contained in this report have been obtained from sources of Elstree Investment Management Limited (ABN 20 079 036 810) believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate or complete and it should not be relied upon as such. Information and opinions contained in the report are published for the assistance of recipients, but are not relied upon as authoritative and may be subject to change without notice. Except to the extent that liability cannot be excluded, Elstree Investment Management Limited does not accept liability for any direct or consequential loss arising from any use of material contained in this report.

Elstree Investment Management Limited (ABN: 20 079 036 810)
Level 10, 30 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348
Email: info@eiml.com.au