July 2017 Review – Listed Hybrid Sector

Performance

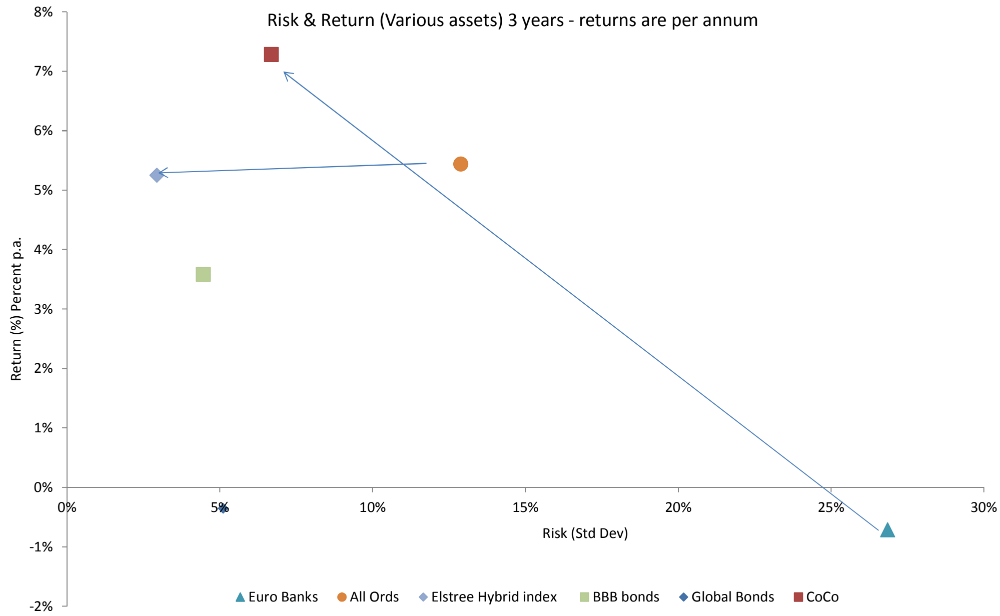
The Elstree Enhanced Income Fund's total investment return for July 2017 was 0.60%. This compares with the Elstree Hybrid Index return 0.46%. In other markets the All Ordinaries Accumulation Index returned 0.18% while the All Maturities Bond Index returned 0.25%.

Events

APRA finally released their guide to "unquestionably strong" capital and guided to a common equity tier 1 ratio of 10.5%. While that wasn't surprising to us, the markets had been a bit more pessimistic and anticipating equity capital raisings, so there was a rally in bank share prices. It looks like there will still be tweaks around how banks quantify the risk of their risk weighted assets (RWA), but we seem to be reaching a plateau in terms of the quantum of capital that banks need. However, for us the most interesting event this month was ANZ announcing they are considering undertaking a buyback (rather than redemption) of the ANZPC security and that they were considering the issue of a new security. There hasn't been a lot of commentary about this which suggests to us that there is some confusion surrounding the detail. However, it confirms something we have felt for a while and that is it's not intuitively obvious that ANZ needs AT1 capital and the pending sale of the wealth management business ANZ's capital requirements and structures may change materially.

How has bank capital performed

For those of you who don't monitor non AUD bank equity and bank capital instruments it's been a rip roaring year. The European bank equity index returned 62% last financial year while the CoCo (Euro based AT1) gained 18% surpassing the unrepeatably high 11% return from Australian hybrids. But it's more interesting if you look at it over a longer term. The chart below shows the risk and return of various asset classes over the last 3 years. The arrows show the relationship between the local and Euro AT1 and the parent equity index.



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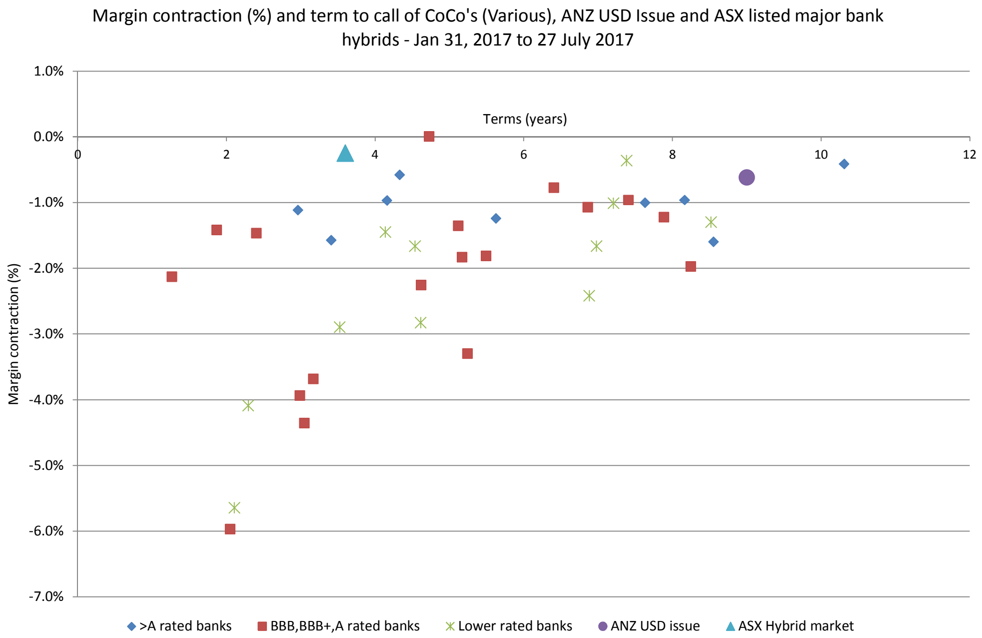
Good times for bank capital

On an ex post (after the event) basis, bank capital instruments were the place to be. AUD hybrids and CoCo's killed equities in either/both a return and risk sense. The drivers of this were the high income yield and valuations that were either too cheap (i.e) CoCo's or not obviously expensive (i.e) hybrids. Markets were too pessimistic and cheapness wins over the long run. More interestingly, it shows that equities and hybrid capital instruments are not necessarily highly correlated.

So what has happened to the Euro Coco market?

Investors changed their mind about the European banking system this year. At the start of the year many bank shares were trading at Price/Book averages of way less than 1 which indicates that investors think the book value is garbage (i.e) they haven't written down bad debts enough, or they didn't earn enough, or they didn't have enough capital, or that there was going to be enormous systemic problems. Now after the c60% return, there are only 1 or 2 of the cohort of large Euro banks trading at a discount to book. This flowed through to the CoCo market. The chart below shows margin movements of the 40 largest CoCo issues by term to maturity/call. We've further split them up by credit rating and also shown the same data for the AT1 that ANZ issued offshore last year and the generic AUD major bank hybrid.



Short junkier CoCo's outperformed

In general, shorter and lower credit CoCo's showed the greatest movement. This is what you would expect in a general re-rating of the sector. The rising tide narrows the risk premiums. It also explains the relative underperformance of the ANZ CoCo (as it was the best credit quality bank in the CoCo market) and the ASX AT1 market (hybrids).

Implications for Australia

We think this ties in nicely with the ANZ announcement in 2 significant ways. ANZ will let investors stay in the ANZPC hybrid which pays a 3.1% margin while the ANZ CoCo trades at a c2.9% margin. The latest ANZPG issue is trading at a 3.8% margin. Given that ANZ doesn't need a lot of capital, we think that ANZ will either not issue, will issue at close to the 3.1% coupon of the ANZPC or will be tempted to issue offshore. Whatever the outcome, we see margins migrating down to the c3% level.

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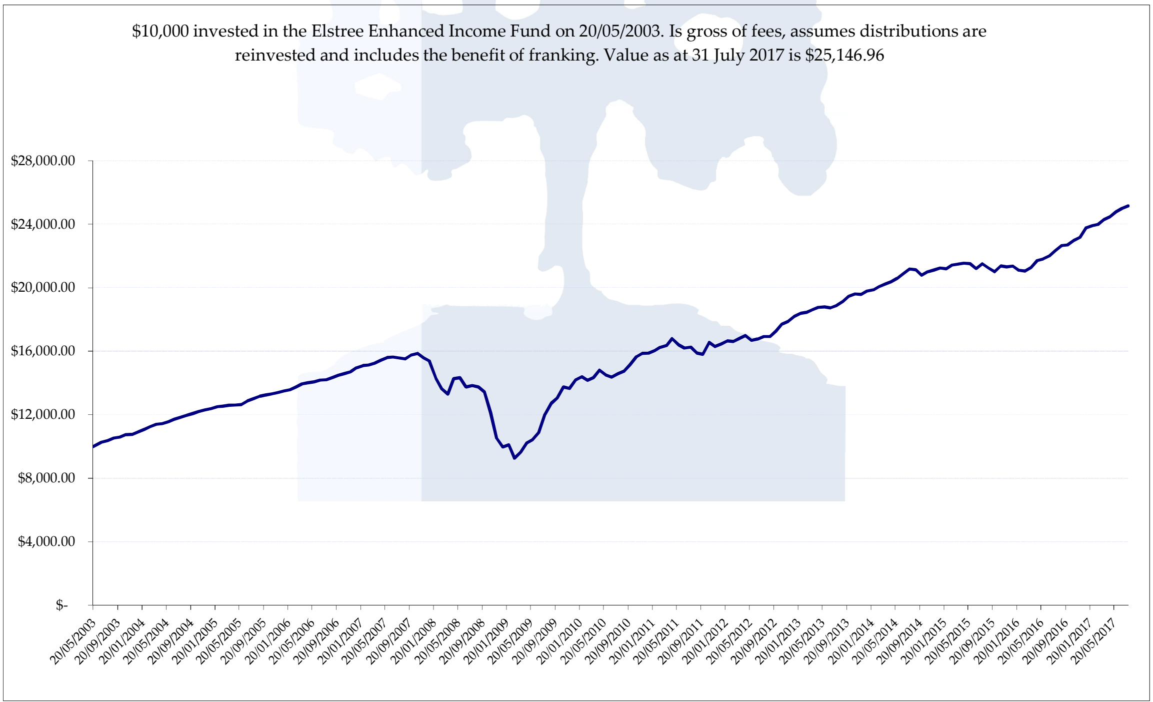
Fund characteristics as at 30 June 2017

Yield to Maturity	5.0%
Cash yield to maturity + franking (income yield)	5.2%
Investment grade issuer	93%
Fund average term (years)	4.5
Bank Tier 1 exposure	52%
Property exposure	5%

Performance Table	1 month*	3 months	12 months	3 years p.a.	5 Years p.a.
Elstree Enhanced Income Fund	0.60%	2.80%	12.62%	5.87%	8.25%
UBS Australia Bank Bill Index	0.15%	0.44%	1.79%	2.19%	2.49%

*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



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