Elstree

September 2017 Review – Listed Hybrid Sector

Performance

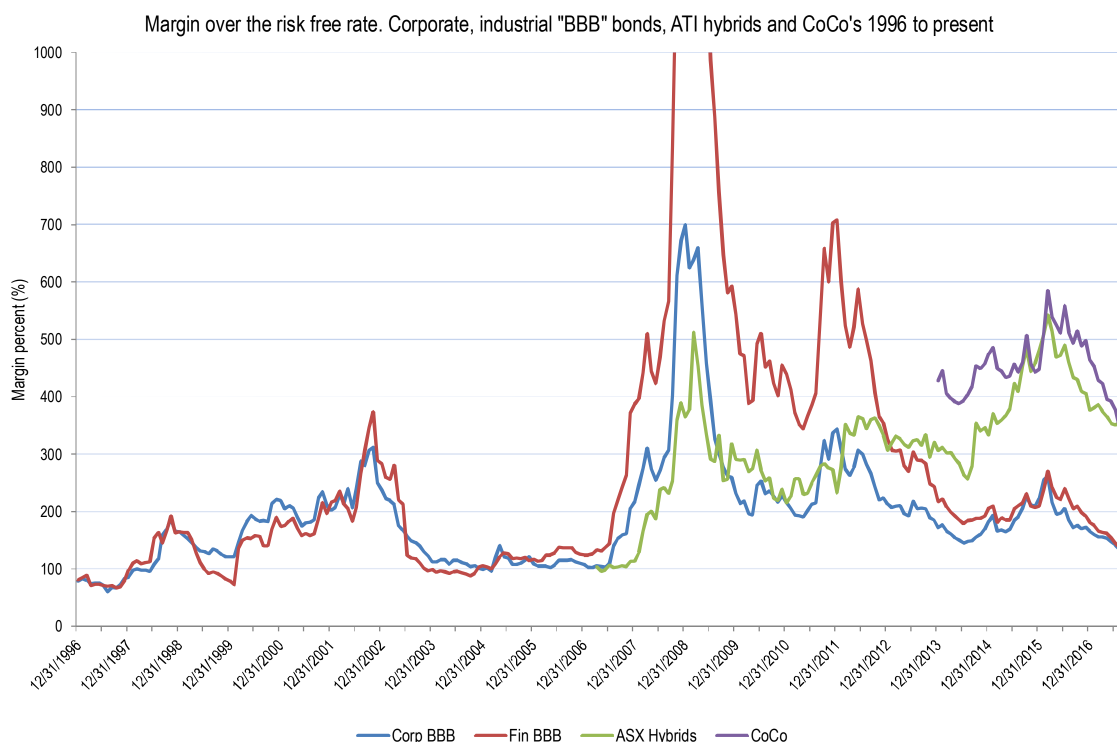
The Elstree Enhanced Income Fund's total investment return for September 2017 was 0.81%. This compares with the Elstree Hybrid Index return 0.75%. In other markets the All Ordinaries Accumulation Index returned 0.05% while the All Maturities Bond Index returned (0.31%).

Events

Westpac issued a 10 year AT1 (hybrid) in the Euro market. At the end of the month it was trading at a spread margin of 2.6% over bond which is expensive compared to the c3.2% margin that ASX Listed AT1's currently trade over bond. Clearly there is a strong pricing incentive for other banks to issue into Euro markets, rather than issue into the domestic retail market.

Bank capital securities: laggards

One of the best uses of a credit rating is to provide an estimation of credit losses. For example, 5 year "BBB" rated securities have an average default loss of around 0.18% p.a. This means if, as an investor, you continually own a portfolio of 5 year "BBB" rated securities, over a long period of time you can expect default costs of c0.18% per annum. In some periods the loss rates will be higher than 0.18% and in some periods they will be lower. At current margins of c1.4% over bond or the risk free rate, you generate a 1.2% higher return than buying risk free bonds. So provided the credit rating is accurate, all "BBB" rated securities should trade at similar margins over bond. The chart below shows the margins of global "BBB" Industrial securities and global "BBB" Financials since 1996. We've also included the ASX AT1/hybrid margins and the Euro AT1/CoCo margins since data on these markets became available.



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There's a few stories in that!

If we go back 20 years, "BBB" industrial and "BBB" financial (bank) issued debt traded at roughly the same spread margins. Financial margins spiked higher around recessions and event shocks, but there were also long periods when they traded at slightly tighter margins than industrial issues. This all changed around the GFC when margins on financial debt went sky high. Markets clearly anticipated that the ratings wouldn't accurately describe the default loss rates and expected that bank defaults would be much higher than industrials. Industrial margins retreated towards "average" levels by late 2009. Financials stayed in the investor dog house for another 4 years and came under further stress in late 2011 when the Euro looked like disintegrating. However, for the past 2 years there has been no material difference between margins on "BBB" financial and industrial debt, which indicates that markets now think that the default experiences are going to be similar (i.e) there is now no additional yield premium added to the debt of financial company issuers. Furthermore, the level of spread margins are back to the early 2000's levels, so the market is telling investors that it expects default loss rates to be on the lower side of average.

Not so on bank capital instruments

The margin movements on bank capital instruments however tell quite a different story. ASX AT1/Hybrids are still at post GFC average spread margin levels, even after the large contraction in spread margins experienced since early 2016. Euro CoCo's spread margins are about 1% lower than their average levels. Margins of AT1 securities indicate that the market thinks there is still an abundant amount of risk embedded in these securities. This is in contrast to the spread margins on senior debt which are implying very low levels of risk and where there is no additional premium *vis-à-vis* industrials. Bank equity prices are saying much the same thing: there is not a lot of embedded risk. The Price/Book (PB) ratio is a strong indicator of bank solvency and profitability. If the market thinks there are undisclosed debts or the bank will earn sub economic rates of interest, the PB will be less than 1. Contrastingly at one stage CBA traded at a PB of nearly 3 as the market expected the returns on equity of c20% justified a strong share price. Currently the PB of global banks is 1.2 which indicates that there are no asset issues and banks will generate high returns.

Why does this occur and does it last forever?

We understand that there should be an uncertainty risk premium built into bank capital securities. Basel 3 changed the landscape for bank capital securities and many investors were worried about how the "non-viability" and compulsory conversion clauses were going to operate. And it was reasonable to assume that banks still had a chunk of fat tail risk. This led to banks having to pay high excess margins on bank capital instruments to sceptical investors. But some of those factors aren't as important as they were before. A lot of the "fat tail risk" has been dissipated by higher capital levels and increased conservatism on funding and by the regulators successful attempts to kill off investment banking. And there has been some experience of how conversion regimes work. Going forward, the only way this premium can be justified is if there are enough events relating to "non-viability" that the premium investors receive from investing in bank capital is eroded. This may happen, but if this is the case, margins on bank debt need to be higher and/or valuations on bank equity need to be lower as a 'non-viability" event is going to affect one of these. This is why we think that part of the current margin is an uncertainty premium which will disappear over time. We have no idea when this occurs, but in a low yield environment, there's a big incentive for it to happen sooner rather than later (or we get a recession, which pushes all spread margins wider as actual defaults and loss rate expectations increase).

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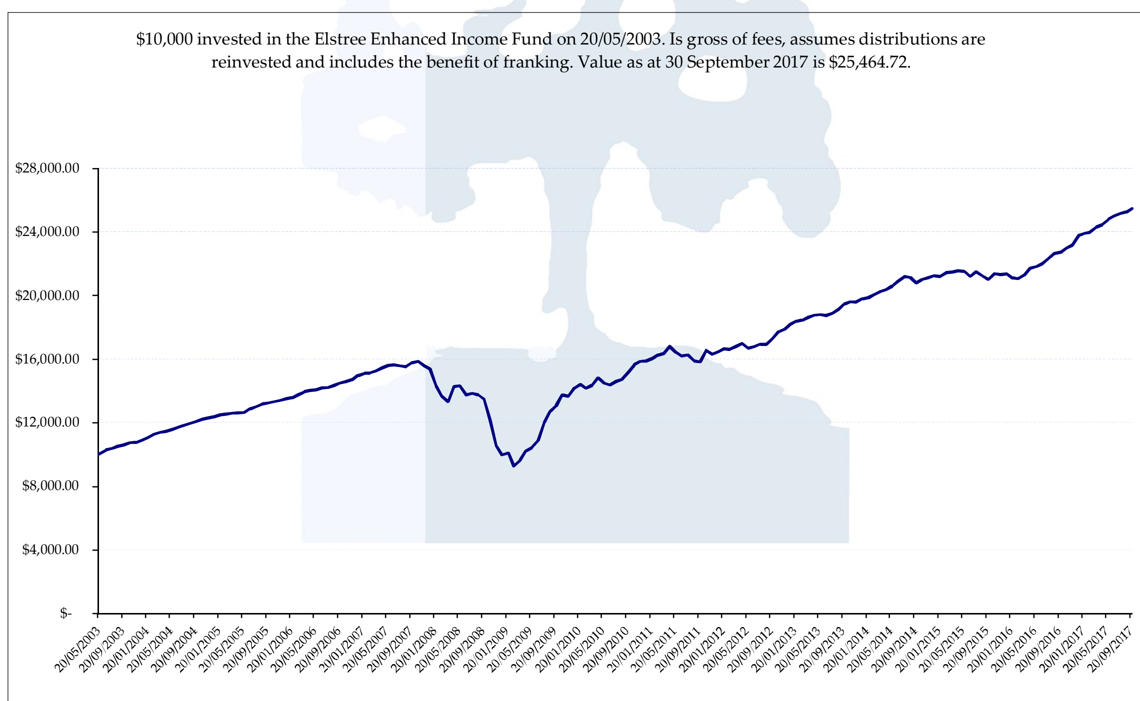
Fund characteristics as at 30 September 2017

Yield to Maturity	4.9%
Cash yield to maturity + franking (income yield)	5.1%
Investment grade issuer	93%
Fund average term (years)	4.4 yrs
Bank Tier 1 exposure	51%
Property exposure	2%

Performance Table	1 month*	3 months	12 months	3 years p.a.	5 Years p.a.
Elstree Enhanced Income Fund	0.81%	1.87%	12.17%	7.01%	8.07%
UBS Australia Bank Bill Index	0.14%	0.43%	1.76%	2.14%	2.43%

*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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