Elstree

April 2022 Review – Listed Hybrid Sector

Fund and market performance

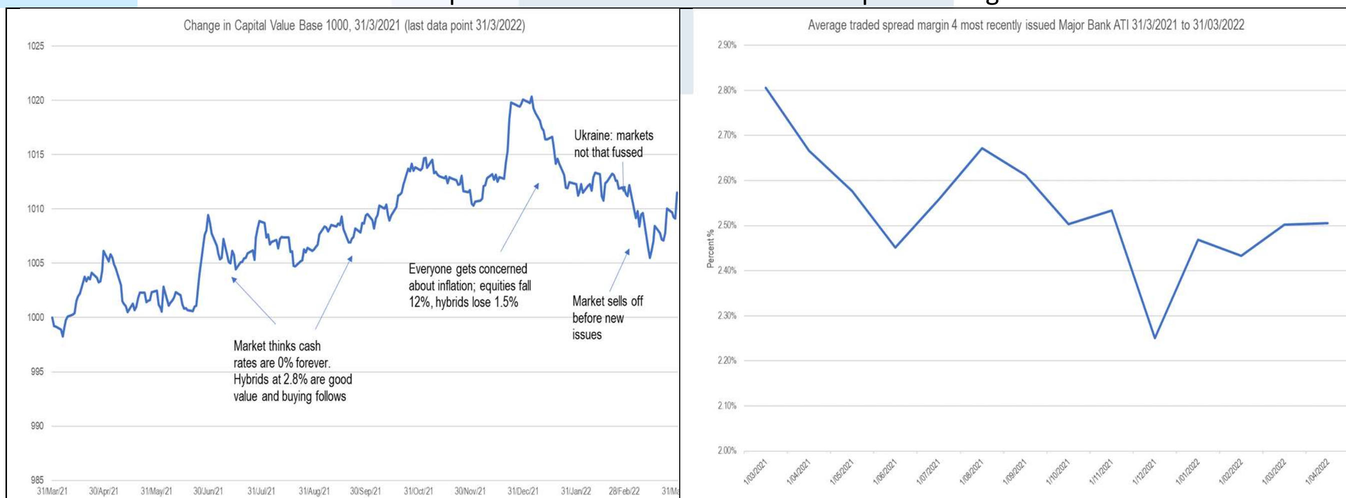
The Elstree Enhanced Income Fund's total investment return for the month of April was 0.38%. This compares with the Elstree Hybrid Index return of 0.43%. In other markets the All Ordinaries Accumulation Index returned (0.81%) while the All Maturities Bond Index returned (1.49%).

The total return outcome is a function of 2 factors - movements in traded spread margins and coupon interest.

Total investment returns of hybrids are fundamentally influenced by 2 key factors. These factors are (i) movements, either positive or negative in the traded spread margin and (ii) the amount of interest income received which is a function of (a) the fixed coupon margin and the level of franking applied at issuance and (b) the level of cash and floating benchmark reference rates over which the fixed coupons are paid. Simply, when traded spread margins contract, prices rise (and vice versa) and when floating benchmark reference rates rise, interest income rises (and vice versa). While spread margin movements are determined by the demand for and supply of securities, floating benchmark reference rates correlate highly with cash rates which are determined by central bankers as they manage their employment, economic and price stability objectives.

Hybrids were true to label over the last 12months. Modest return outcomes combined by low return volatility.

Hybrids form an important part of an investment portfolio. They not only display a low correlation to risk assets such as bonds and equities, but their generally modest return outcomes are typically accompanied by low return volatility. Over the last 12months hybrids were very much true to label. The hybrid market as determined by the Elstree Hybrid Index (Franked Series) returned over the 12months ending 31/3/2022 (including the value of franking) a respectable 4.13%. The market's monthly annualised volatility of 1.5% was accompanied by only 2 negative return months (we typically expect 1.5 per year). Total returns outcomes comprised a combination of mostly income (including the value of franking) with some capital appreciation. The driver of the capital appreciation over the year was a contraction in traded spread margins from a March 2021 high of 281bps to a low of 231bps in December 2021 before widening slightly to around 251bps over the March quarter of 2022. The chart on the lefthand side displays the change in capital value over the course of the 12 months ending 31/3/2022 while the chart on the righthand side displays the traded spread margin contraction of the 4 most recently issued Major Bank alternative tier 1 (AT1) securities over the same period. The contraction in traded spread margins is clear to see.



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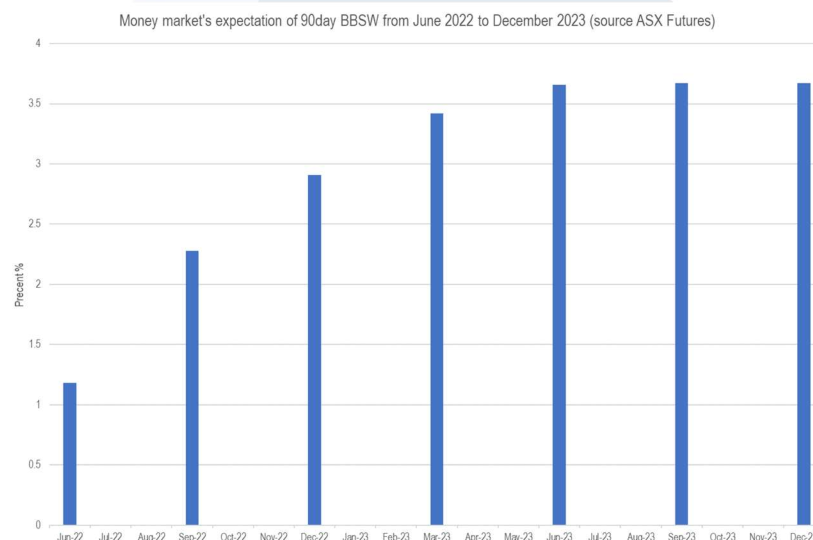
Funds we manage have benefited from traded spread margin contraction. 6months ago the outlook was not looking all that good, inflation has changed that.

As a manager of securities where traded spread margins have steadily contracted the funds we manage, and our investors have been major beneficiaries. In almost every instance our funds out-performed the broader market due to a combination of individual security selection and strategic sector rotation. However, with spread margins approaching our estimation of 'fair value' it became increasingly evident to us at the end of CY2021 that without the tail winds of traded spread margin contraction, return outcomes were destined to decline becoming more closely aligned with the income generated from coupon interest. While this is not a bad thing, in fact it is a good thing, it is just that with 90day BBSW seemingly anchored at the time below 0.10% we were looking only 6months ago at the very real prospect of a 2.75% total return outcome for the broader market. Since then, the landscape has changed materially. With inflation seemingly more entrenched globally than previously thought central banks have embarked on, or are now in the process of, raising interest rates. As an investor in assets that pay a fixed coupon margin over a cash and floating benchmark rate reference rates such as 90day BBSW this is music to our ears.

The futures market is predicting that 90day BBSW will be c3% in 8 months' time and 3.67% in 18 months' time.

While we have shown a similar chart (below) before it bears repeating. The data, which is sourced from the ASX, details the futures markets' prediction of 90day BBSW out of the months detailed on the horizontal axis (the data is from 2 May). By December 2022 the futures market is forecasting that 90day BBSW will be just under 3% and by December 2023 the market is forecasting it will be 3.67%. While we understand that the market is not always right in its collective thinking, and it does get 'ahead' of itself from time to time, we can be certain of one thing, and that is, interest rates are going up. How far they go up most likely depends on the sensitivity of economic activity to interest rate rises – at the end of the day the RBA won't want to be responsible for engineering a recession. Let's assume however, that the market is correct and BBSW does go to the levels predicted. This means, that including the annual coupon margin of the broader market, which currently presents at around 2.75% (including the value of franking), the coupons received will approximate to 5.66% annual rate in 8 months' time (i.e 90day BBSW of 2.91% + 2.75%) and 6.42% annual rate in 18 months' time (i.e 90day BBSW of 3.67% + 2.75%). This is a material increase from c2.75% we were envisaging only 6months ago. We note that 90day BBSW set at 0.96% on 2 May which means coupons are already approaching 3.75% annual rate.



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Traded spread margin compression to be replaced by higher coupon interest as a return driver

Just as we were resigned to the possibility that the tail wind of traded spread margin contraction was losing momentum lessening its contribution to total return outcome it is now almost certain to be replaced as a return driver by higher coupon interest generated directly from rising floating benchmark reference rates. So, if we assume that traded spread margins remain stable at around current levels, which is not unrealistic proposition in the absence of a credit driven event effecting bank and insurer balance sheets, and 90day BBSW rises as the market predicts, we reasonably expect the broader market to return, on an annual basis in 18months' time, something in excess of 6% - more than double what we were projecting only 6 short months ago.

The greater the income component the more compelling the investment thesis becomes

It's important to recognise, that as the broader market's total return outcome aligns more closely with the income return, the more compelling the investment thesis becomes for investors seeking capital stable income investments. An event shock notwithstanding, the hybrid market is characterised by low return volatility which is a function of the total return outcome typically comprising mostly interest income accompanied by small changes, either positive or negative, in the underlying capital value. We note, by way of example, that annual income of c6% provides a healthy capital buffer and in the absence of an event shock of the magnitude of the pandemic or GFC, would not be at risk in any 'normal' return period. To put an annual coupon rate of 6% in perspective, over a one-year return period traded spread margins would have to widen from just over 250bps over 90day BBSW today to 400bps at the end of the period – a position they briefly occupied only 3 times since 1999 – before a negative return outcome would be recorded.

Margin expansion unlikely as capital risks are as remote as they have ever been. IPO supply is expected to be modest.

We view a widening of traded spread margins of this magnitude extremely unlikely but highlight it to simply point out the capital protection afforded by higher rates of coupon interest. Traded spread margins are sensitive to supply shocks which are typically driven by an event such as the pandemic or the GFC and new and largely unexpected issuance (i.e IPO's). At this point we don't see a high probability of either. In support, we note that the majority issuers (i.e the banks and insurers) are as well capitalised, and as securely funded as they have ever been in their history. It follows then that default and forced equity conversion, arguably the 2 biggest capital risks, are as remote as they have ever been. While bank lending growth is accelerating it is expected to slow as interest rates rise and while some new hybrid security issuance is expected it won't surprise the market and is likely to be absorbed by investors seeking out high yielding capital stable investments. In support of this claim the 2 most recent major bank hybrid issues from ANZ and CBA were oversubscribed.

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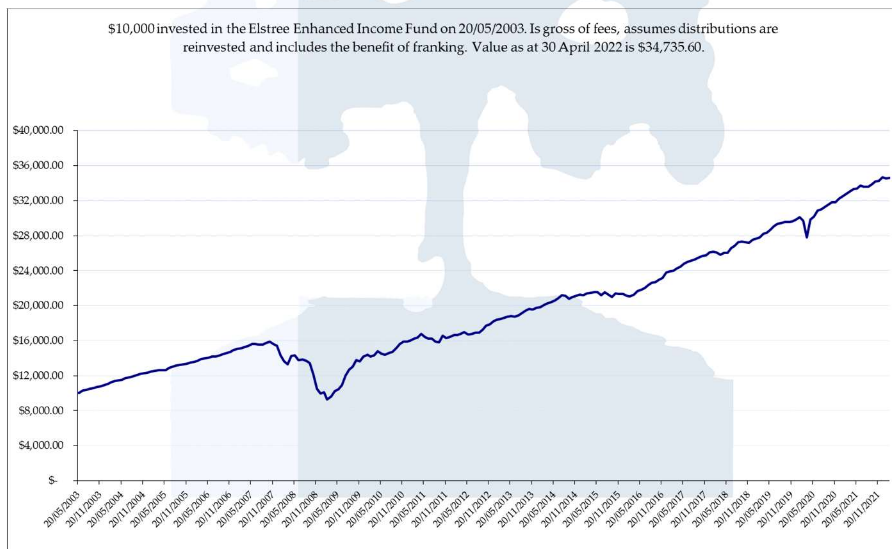
Elstree Enhanced Income Fund portfolio metrics as at (close of business) 29 April 2022

Metric	Value
Yield to Maturity	2.80%
Cash yield to maturity	2.40%
Interest rate duration (years)	0.21
Credit term duration (average years)	3.71
Investment grade issuer (% holding)	89.9%
Bank tier 1 exposure (% holding)	28.0%
Value at Risk (VaR)	3.12%

Performance Table	1 month	3 months	1 year	3 years p.a.	5 Years p.a.
Elstree Enhanced Income Fund *	0.38%	0.62%	4.33%	6.98%	7.26%
Elstree Enhanced income Fund (Basis NAV)	0.29%	0.27%	2.91%	5.50%	5.60%
UBS Australia Bank Bill Index	(0.002%)	(0.01%)	0.02%	0.40%	0.99%
Betashares Hybrid Fund (HBRD)#	0.41%	0.43%	1.95%	3.53%	n/a

Past performance is not necessarily a guide to future performance. *Is the total investment return. "NAV" is net of all fees and does not include the value of franking. "()" denotes negative return outcome. # Source: Betashares. Return is net of fees and does not include the value of franking credits.

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



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