

## December 2020 Review – Listed Hybrid Sector

### Fund and market performance

The Elstree Enhanced Income Fund's total investment return for the month of December was 1.44%. This compares with the Elstree Hybrid Index return of 1.34%. In other markets the All Ordinaries Accumulation Index returned 1.75% while the All Maturities Bond Index returned (0.27%).

### Events of December 2020

There was a raft of new issuance in December. Four new long dated (i.e 6 - 7 year term) bank hybrids commenced trading along with a perpetual capital note issued by Australian Unity (first traded on 4 January 2021). The bank hybrids included "BENPH" (issued by Bendigo and Adelaide Bank), "BOQPF" (issued by Bank of Queensland), "WBCPJ" (issued by Westpac) and "NABPH" (issued by the National Australia Bank). All performed strongly upon listing once the sell down to fund the new issues abated. Returns since listing ranged from +1.2% to +2.6% with the NAB deal leading the way. We note that the \$120million Australian Unity note ("AYUPA"), which began trading on 4 January 2021 did so at a healthy 4.9% premium (subsequently it has traded at a 6% premium). The post listing pricing of these new issues simply serves to highlight the underlying strength of the market in the face of declining cash and term deposit rates and very little expected net new issuance (there will be rollovers) over the next 18 months as bank issuers contend with a combination of weak loan demand and adjust to recent changes introduced by APRA designed to reduce the risk weightings applied to certain loans while increasing the risk weighting applied to others (refer our explanatory note of 10 December 2020). Finally, in other news it is now seems highly likely (after shareholder approval at the AGM on 18 December) that the NAB will redeem the perennial market darling, the \$2billion "NABHA" early in 2021.

### Reflecting on the year that was.

### Drawdowns tell an interesting tale

While there is a lot to like about the market at present before we touch on what it is that we like we thought it might be timely to quickly reflect on the year that was. The chart below details the drawdowns of the Elstree All Bank Hybrid and the All Ordinaries Accumulation Indices over 2020 to December 15. The key takeaway is that the Covid19 induced drawdown of the All Bank Hybrid Bank Index (blue line) while sharp, was approximately 40% of All Ordinaries Accumulation Index drawdown (orange line) and it was not as prolonged, recovering to establish a new high as early as 6 July only 104 days from its nadir recorded on 24 March. As at the time of writing the All Ordinaries Accumulation Index was yet to record a new post Covid high but it is close to doing so.



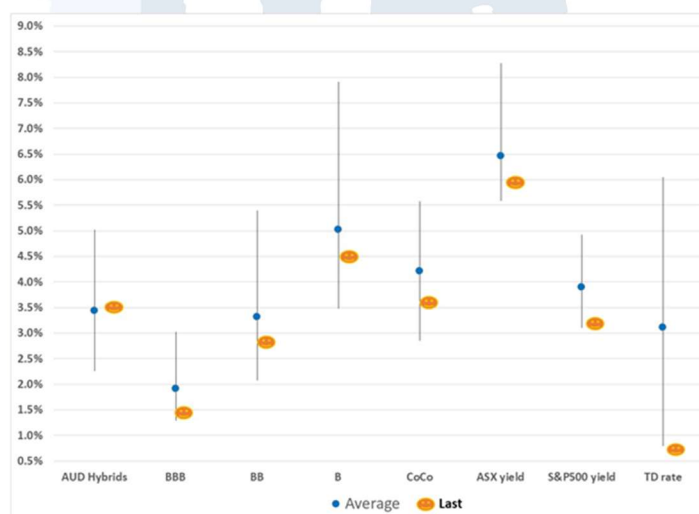
***“One off” events peculiar to the hybrid market perpetuated the drawdown in March***

***The listed hybrid market looks better than fair value when compared to its peers***

***Senior debt margins – a harbinger of narrower hybrid margins***

With only the GFC as a template the drawdowns detailed in the chart depict the behaviour of bank hybrids and the broader equity market as we have come to reasonably expect. There is a high correlation when the equity market draws down sufficiently far enough (where there is typically a lagged hybrid market response) with the hybrid market recovering relatively quickly thereafter. We know now of course, that the hybrid market drawdown of March, particularly March 24 when the market declined 6.4%, was initiated by a confluence of “one-off” events that triggered a surge in transacted volumes of panicked investors. As we commented in the April 2020 review a market that in aggregate turns over about \$150m per week was suddenly confronted with volumes of at least twice that with one day (March 13) recording transacted volumes in excess of \$120m. We know that when weekly transacted volumes exceed \$150m price pressures emerge. While we weren’t surprised by the drawdown of March we were a little surprised by its depth in view of the fact that the market is now 95% populated by investment grade quality issuers.

What is it that like about the market? The chart below details the spread margins (from high to low) over the risk free rate of various credit assets over the last decade with the ASX and S&P500 equity indices being represented by the inverse of the price earnings (PE) ratio. Term deposit rates are also detailed. Both the decade average (blue dot) and ‘last’ (orange) are detailed. With the exception of hybrid spread margins all other assets are expensive *vis-à-vis* their decade average. Clearly, there are wider spread margins (i.e “B” rated bonds and equities), but with those wider spread margins comes increased risk. As a postscript we understand the impact that long term zero risk free rates have on risk premia and the discount rate applied to risk assets and what that means for the pricing of those assets – and while there is justification at present for this pricing it cannot continue in perpetuity because, as we know all too well, eventually ‘the piper has to get paid’.

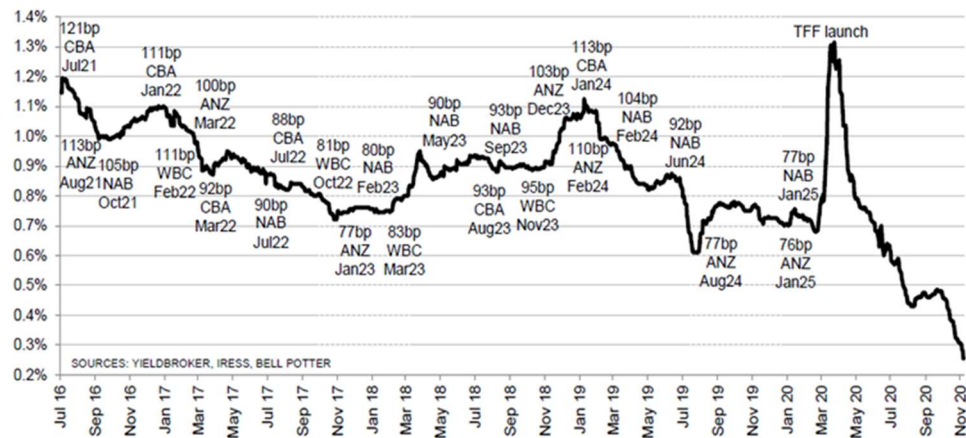


The chart below and overleaf is sourced from Bell Potter. It details the 5 year, Major Australian Bank wholesale senior debt funding margins from July 2016 to the present. Presenting at just below 30 basis points or 0.3% spread margins are all time record low levels. Clearly, the catalyst for the sharp reduction in spread margin - following the steep Covid induced rise in March - coincided with the emergence of the RBA’s term funding facility (TFF). The TFF has allowed the banks to refinance their maturing senior debt very cheaply, all but alleviating the need for them to issue in the wholesale

debt market. Additional term funding providing by the RBA in CY 2021 will see a continuation of this process in the foreseeable future. Not only does this provide the banks with 'term' funding surety at very cheap rates but it has implications for debt securities subordinate to senior debt. First and foremost is opens the door for lower spread margins and higher prices on these instruments including of course, hybrid securities. Everthing being equal we reasonably expect the spread margins of bank hybrid securities to track their senior brethren narrower over time.

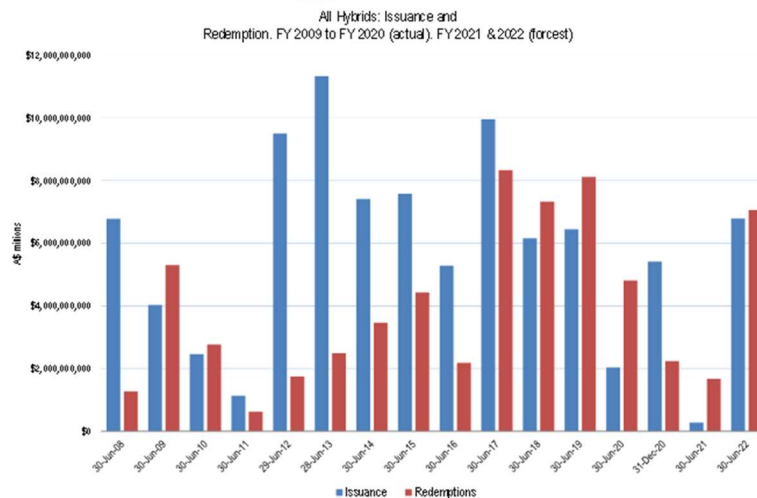
Source: Bell Potter.

Figure 2: 5 Year Major Bank Wholesale Senior Debt Trading Margin



Almost zero new primary market supply

Finally, we are well aware of the implications of supply on hybrid security pricing. In terms of primary market supply (i.e new security issuance) we see very little net new issuance over the next 18 months. While there will be new issuance it will be 'neutralised' by redemptions. The chart below details the redemption (red) and issuance (blue) since the GFC. FY2021 and FY 2022 are forecasts.



A positive backdrop

With a backdrop of near zero percent (0%) cash and term deposit rates and a dearth of primary market supply over the next 18 months it is not unrealistic to expect hybrid security prices to continue to slowly appreciate. Certainly, the influence of the RBA with the TFF and what that means for the pricing of senior debt and APRA with its tweaks to risk weighted asset calculations can only but be supportive of the market over the next 18 months.

## Fund characteristics as at (close of business) 31 December 2020

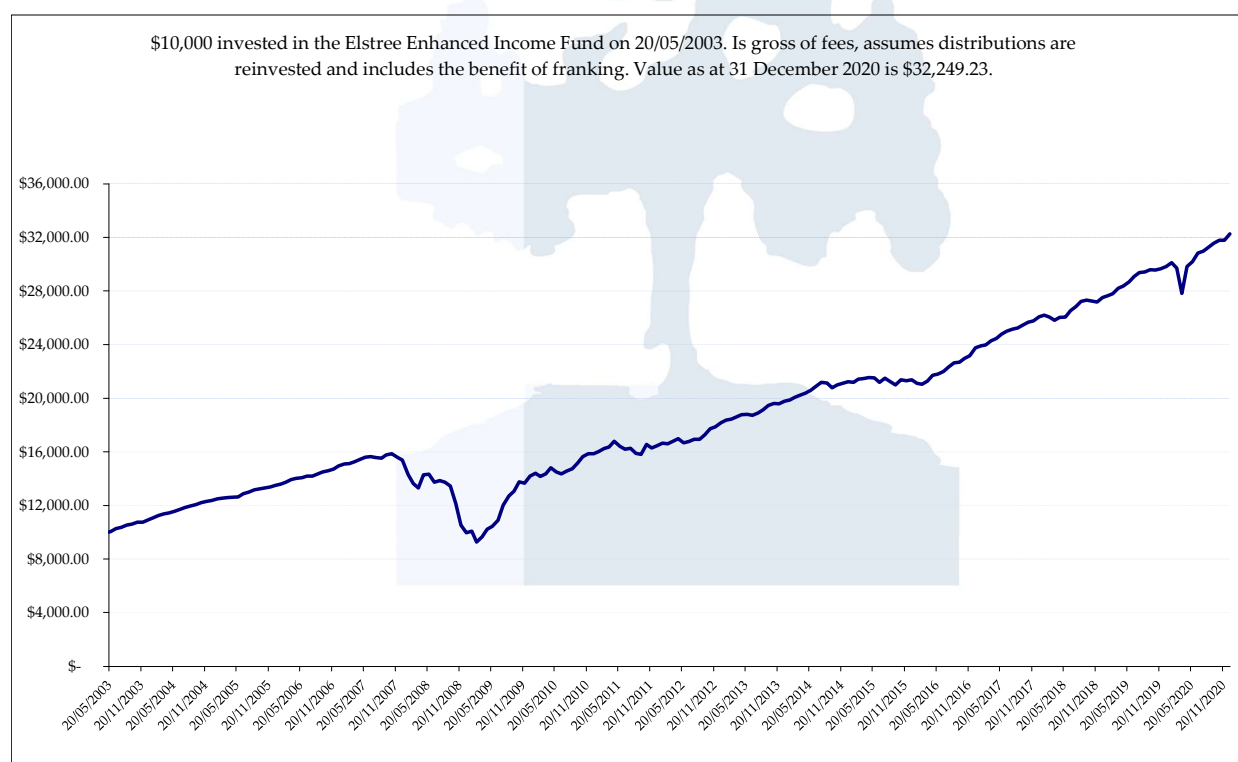
Yield to Maturity	4.30%
Cash yield to maturity	2.20%
Interest rate duration (years)	0.08
Credit term duration (years)	4.07
Investment grade issuer (% holding)	90.01%
Bank tier 1 exposure (% holding)	58.5%
Value at Risk (VaR)	3.45%

Performance Table	1 month	3 months	12 months	2 years p.a.	5 Years p.a.
Elstree Enhanced Income Fund *	1.44%	2.14%	8.06%	8.23%	8.59%
UBS Australia Bank Bill Index	0.003%	0.02%	0.37%	0.93%	1.52%
Betashares Hybrid Fund (HBRD)#	Refer Betashares	1.66% (est)	3.97% (est)	5.35% (est)	n/a

\*Returns are gross of fees and include the benefit of franking credits. Past performance is not necessarily a guide to future performance. “( )” denotes negative return outcome.

# Source: Betashares. Return is net of fees and includes the value of franking credits. “est” – estimated.

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



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