

January 2021 Review – Listed Hybrid Sector

Fund and market performance

The Elstree Enhanced Income Fund's total investment return for the month of January was 0.79%. This compares with the Elstree Hybrid Index return of 0.70%. In other markets the All Ordinaries Accumulation Index returned 0.30% while the All Maturities Bond Index returned (0.42%).

Reflecting on 2020

At this time the year investors typically take time out to review their investment strategy where they reflect upon the year just gone and weigh up the options for the year ahead. After talking to a number of our investors we thought it might be interesting to look back at what happened in the market place in 2020 and dissect what worked and what didn't work for us as a manager.

The events of Q1 2020 provided a window to our process and risk management protocols

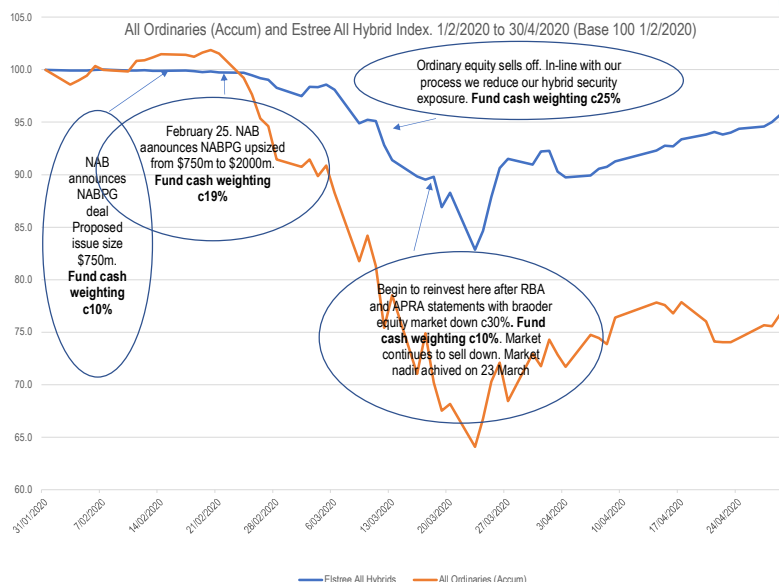
The events of Q1 2020 highlighted a number of idiosyncratic characteristics of the listed hybrid market. It also provided a 'window' as to how we structure a portfolio of hybrid securities and how we manage risk. We have been managing portfolios of hybrid securities for a long time and have an extensive data base that we use to identify when the broader market or the individual securities in which we invest, are either unreasonably cheap or expensive. We use the experience gained over a number of years (including the GFC period) and the data base, which extends back as far as December 1999, to construct portfolios of securities. Ideally, our security selection process results in our funds having an appropriate diverse exposure to the market. We know from our database that two important drivers of market return outcomes are (i) new issue effects and (ii) equity market movements. Both of these return drivers occurred in the space of 6 weeks in Q1 2020. During this period there was a lot of market volatility and a lot of things as a manager to consider.

New issue influence

The dominance of retail investors in the listed hybrid market results in new issues having an outsized effect on short term return outcomes. We'll adjust our portfolio based on our analysis of the volume of new issues and the size of those issues. In late 2020 for example, there were a number of new issues (i.e BEN, BOQ, CGF, WBC). When NAB launched a new issue in February 2020 there was potential for 'indigestion' because we thought the issue might be significantly larger than the market was expecting. In anticipation of a larger than expected issue we adjusted our portfolio cash weighting accordingly.

Equity market influence

The Covid 19 induced equity market drawdown was the largest equity market drawdown since the GFC. There have been 7 > 10% broader equity market drawdowns since the GFC and a raft of individual company equity market downturns that exceeded 20%. While we had some background as to what happens in hybrid markets in those periods the data on large drawdowns, such as occurred in March 2020, was thin. At the same time we had a view that some investor behaviour is transferable in larger downturns. The chart below details the performance of the Elstree Hybrid and All Ordinaries indices over the February - April period. We've also indicated the change in our cash weighting over the period. The way the hybrid market behaved in March was not too far removed from what we expected.



Performance lessons

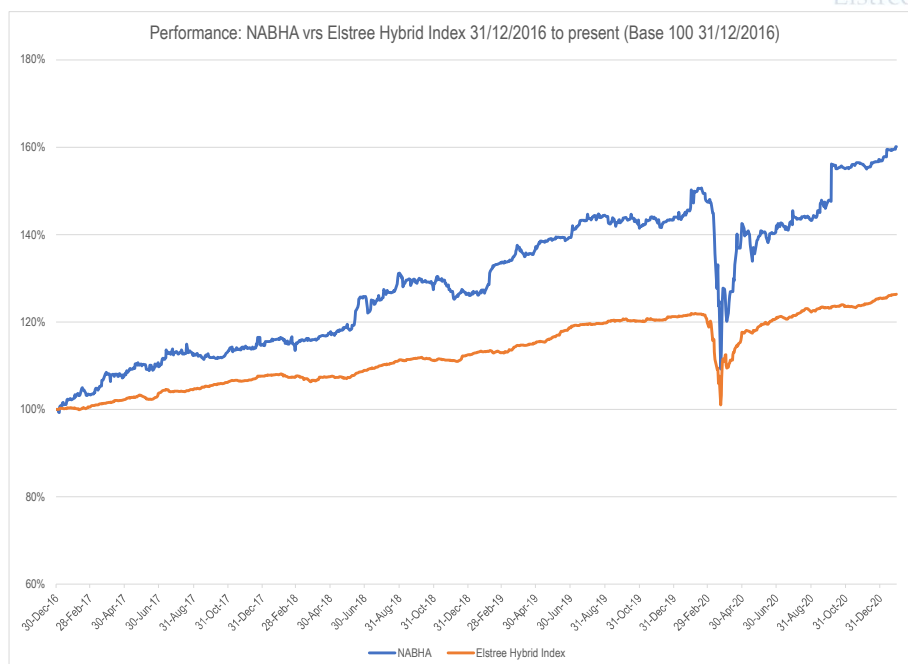
In the 3 months to end April 2020 the Fund outperformed the broader market by more than 2.5%. The outperformance in February was due simply to the Fund's high cash weighting. Interestingly, despite having a high cash weighting we underperformed in March which was a very weak month. We bought some securities in the middle of March which we thought had bottomed. Turns out our timing was wrong as the securities became cheaper still. This detracted from performance. April saw the Fund outperform due to a combination of reduced cash levels and some of the previously over sold securities producing excellent return outcomes. It really was an extraordinary period for some securities. The BOQPE hybrid returned -20% in March followed by 5% and 13% in April and May. Even major bank hybrids were affected with the CBAPD price falling \$21 over the worst of the crisis before recovering \$15 over the next 3 months.

Fund size is important

Hybrid market liquidity is interesting. For small to medium sized transactions liquidity is not an issue and much much better than other fixed income markets. However, once the transactions become sufficiently large, liquidity becomes more problematic. Once a Fund becomes too large, it becomes increasingly difficult to change the fund's structure without impacting the market. Part of our process models the liquidity cost of changing the portfolio's structure. For our Fund, liquidity during the Covid drawdown period was not affected. This was in part due to (i) being the right size to do the things we wanted to do and (ii) market turnover during the period was higher than normal. In what was a period of high turnover for the Fund we noticed we had little or no market impact.

NABHA : end of an era

One of our larger holdings and best performing securities was the NABHA, which, we note, will finally be redeemed later this month. There's been conjecture for years on if, and when, NAB might redeem the NABHA. We took the view a number of years ago that it was more likely to be redeemed than not. We have maintained a large position in the security since. Eventually the price moved closer to its PAR value of \$100 with consequent effect on return outcomes. The chart below is of the NABHA security and its performance *vis-à-vis* the Elstree Hybrid Index since December 2016.



Fund characteristics as at (close of business) 29 January 2021

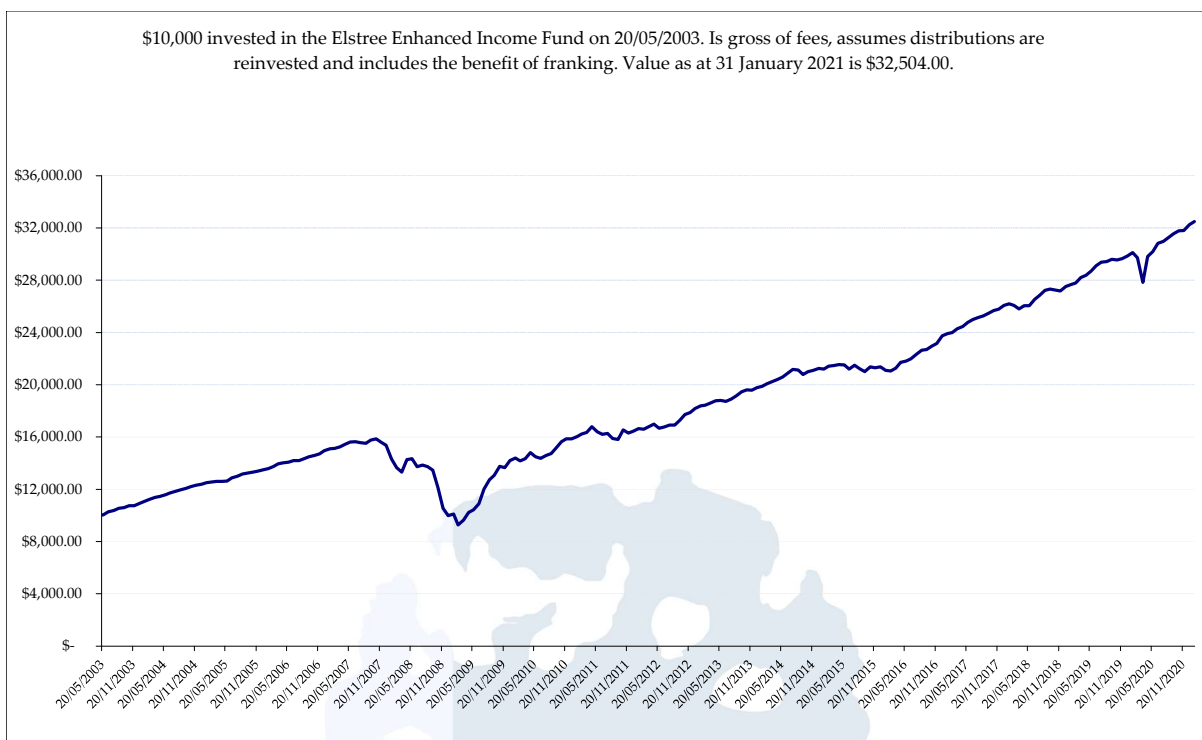
Yield to Maturity	3.4%
Cash yield to maturity	2.2%
Interest rate duration (years)	0.08
Credit term duration (years)	3.89
Investment grade issuer (% holding)	89.7%
Bank tier 1 exposure (% holding)	54.1%
Value at Risk (VaR)	3.13%

Performance Table	1 month	3 months	12 months	2 years p.a.	5 Years p.a.
Elstree Enhanced Income Fund *	0.79%	2.27%	7.92%	8.39%	9.03%
UBS Australia Bank Bill Index	0.001%	0.01%	0.29%	0.84%	1.48%
Betashares Hybrid Fund (HBRD)#	Refer Betashares	2.05% (est)	4.27% (est)	5.33% (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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