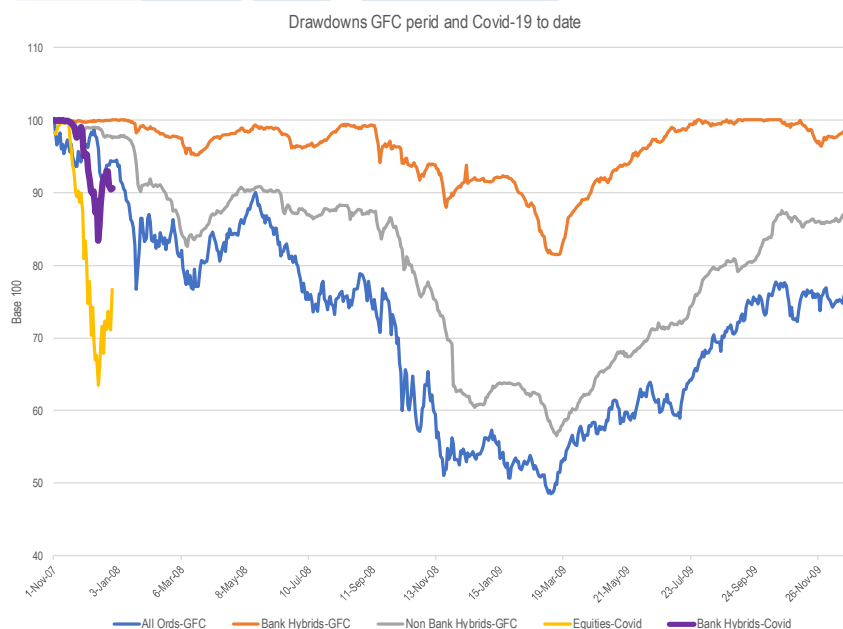


ASX listed hybrids; What's been going on?

- Covid-19 is not nearly as nasty as the GFC for ASX listed hybrids.
- Our funds have performed reasonably well and are well positioned for further outperformance going forward.
- Its actually a great time to increase exposure; prospective returns outcomes (as represented by the spread margin over the risk-free rate) are the highest we have ever seen.

So, what has happened?

Many investors shiver when they recall their hybrid experience in the GFC. Even though equities are putting in another GFC type performance, the hybrid market is far less affected this time around. As at the time of writing, hybrids have fallen around 10% from their mid-February levels and except for 2 capitulation days, have never lost more than 12%, compared to equity markets which were down more than 30% for much of March. The chart below shows the drawdowns for bank and non-bank hybrids and for the All Ordinaries Accumulation Index from November 2007 to end 2009 and the path so far for the All Ordinaries Accumulation Index and bank hybrids. The bank hybrid line (purple) is in the upper left corner. Clearly, it's steeper, but at this stage, its nowhere near as painful.

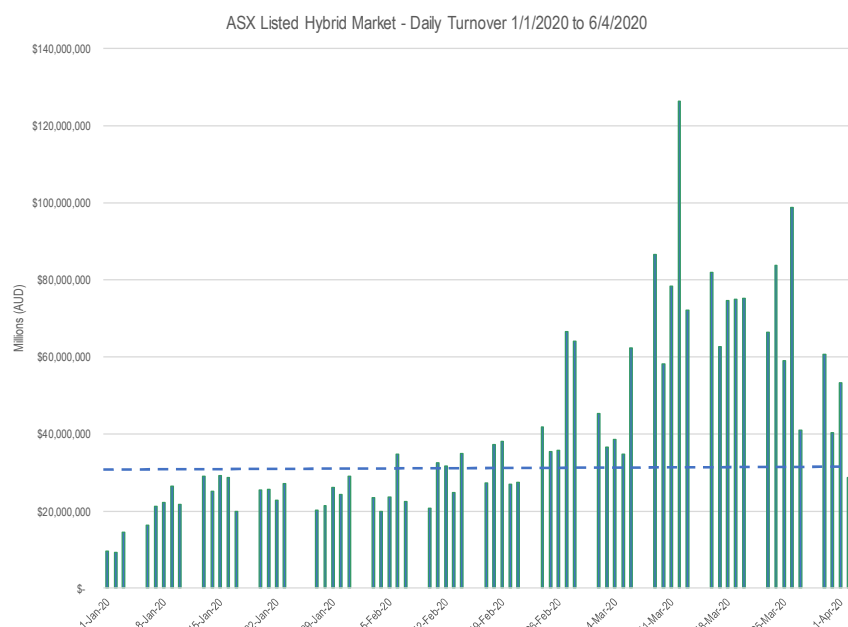


It's trading as well

One of the characteristics of the GFC was that the over the counter (OTC) corporate bond market ceased trading for 6 months to a year. There was no liquidity in the wholesale credit market whatsoever, while the hybrid market kept functioning, albeit at subdued levels. The

**ASX listed
hybrid
turnover
2/1/2020
to
6/4/2020
Source:
Iress and
Elstree**

wholesale bond market is now frozen again with buy sell spreads on investment grade credit funds widening to 1% (from zero). Hybrids have, once again, been liquid. The chart below shows daily ASX listed hybrid market turnover since December 2019. The dotted blue line is the average daily turnover of the hybrid market during the GFC (around \$25m per day). Because of our fund size and expertise in secondary market trading, we have no issues whatsoever entering and exiting positions (and we have been active at times). But size matters. If we were 5 times the size, we couldn't have done anywhere near as much.



Performance

The table below shows investment performance (return includes franking, but is gross of fees) for February, March and from 1 April to April 6.

	Fund	Elstree Hybrid Index	Difference
February	(1.33%)	(1.74%)	0.38%
March	(6.33%)	(6.15%)	(0.18%)
April 1 - April 6	(1.24%)	(2.51%)	1.26%
	(8.7%)	(10.1%)	1.4%

**What
happened**

Outperformance in a bear market is atypical for us. We generally buy when we see compelling value. Often, this is before the market bottoms and then we make much larger returns as the market reverts to "fair" value. This time we were on the right side of the bear market. Some of the drivers behind the return outcomes were,

- We expected NAB to announce a hybrid issue in February and we thought that NAB needed to do a much larger issue than (perhaps) the market anticipated. We entered

February with a 10% cash weighting and increased that to 20% when the issue was upsized from \$750 to c\$2b. This added value.

- We followed our investment process and reduced our exposure to individual securities when there was sufficient equity market weakness. This added value.
- We have operated with cash holdings of between 10% and 25% since mid-February. This added value in a weaker market.
- Our biggest driver in return volatility was our holdings of major bank/non major bank securities. In early March, we thought the non major bank sector was looking very cheap and we increased our weighting to that sector. Given we were running a large cash position at the same time, it meant we were under-weight the major banks.
- During mid to late March, the non major banks got even cheaper (underperformed). Our overweight position detracted value, as can be seen by our sub benchmark performance in March (given we had quite high cash positions during the month).
- April saw non-major banks and insurers outperform the majors. This is reflected in the April performance to date.

We think the non-major bank and insurer issuers are still very cheap and we expect to add material value due to our exposure to this sector at some stage. The 2 charts below (Figure 1 and Figure 2) detail the performances of the major and non-major bank insurer issued hybrids for the period 7 February to 24 March and from 24 March to April 6.

Figure 1.
Security
returns
7/2/20 to
24/3/20

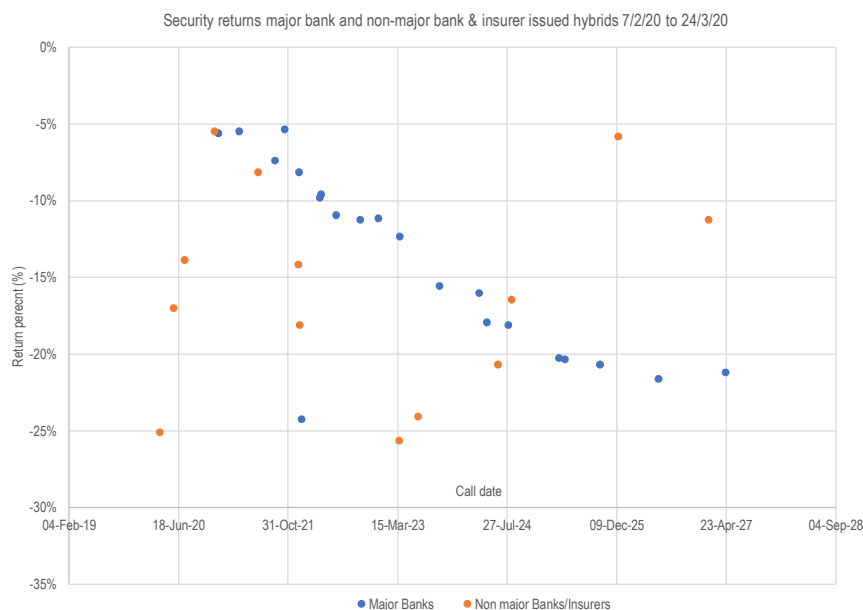
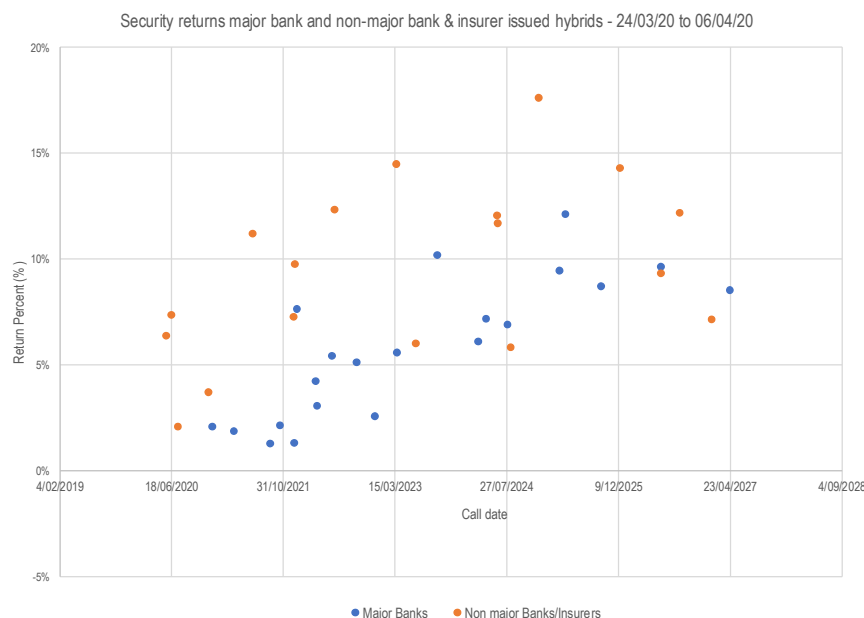
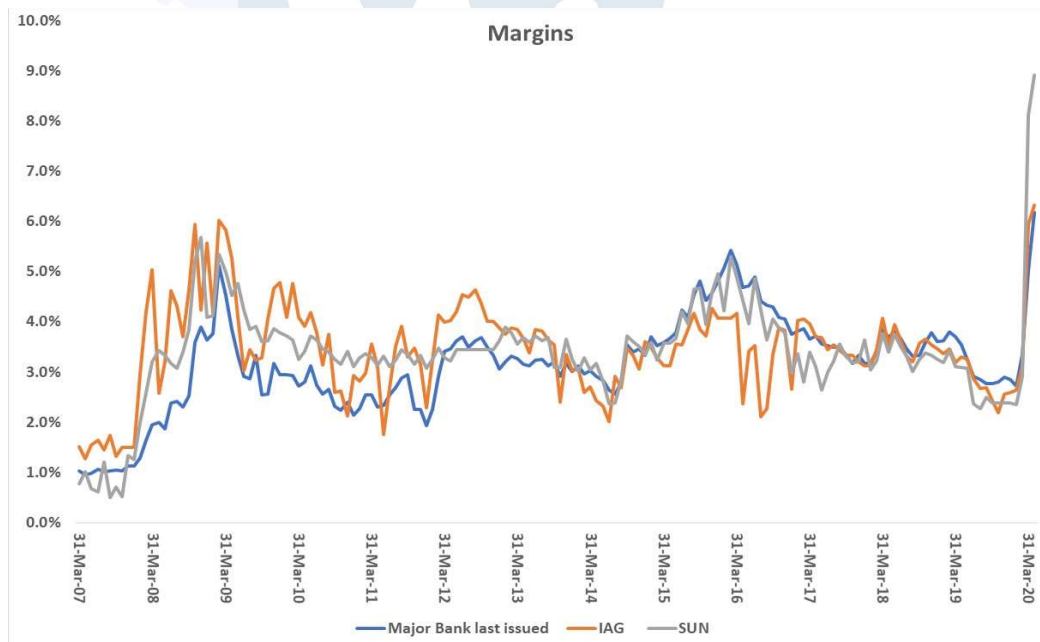


Figure 2.
Security
returns
24/3/20 to
6/4/20



Value?

We've never seen spread margins on hybrids issued by investment grade issuers at this level before. The chart below shows margins for the average of the most recently issued major bank hybrids and for the longest maturity SUN and IAG hybrids since 2007.



Favourable
comparison

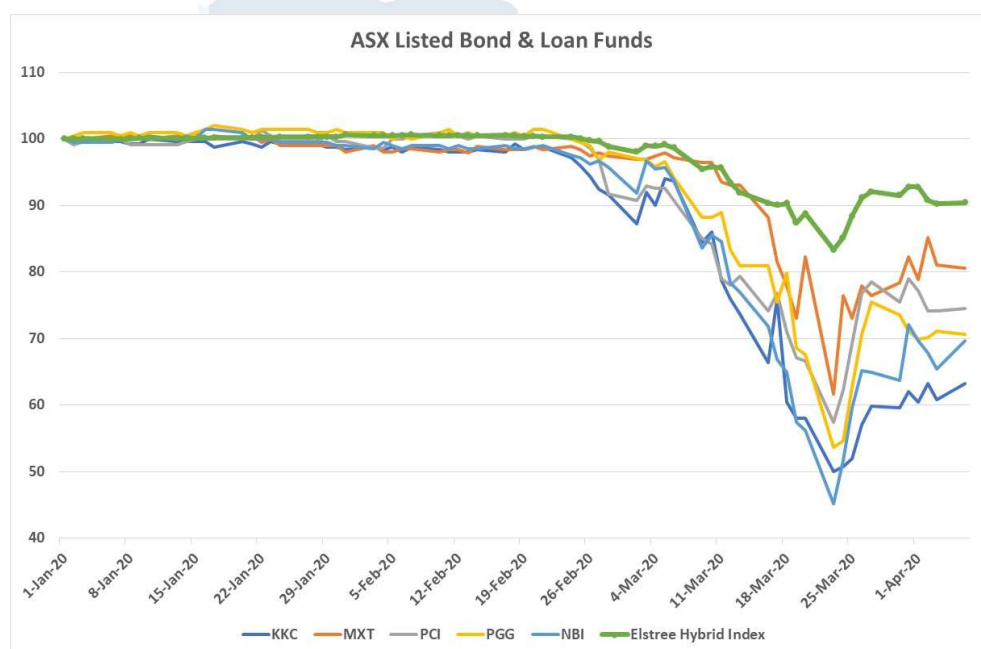
Our Fund (excluding cash) has a yield of around 8% (at today's levels), which represents a 7% or 700 basis point (bps) margin over risk free rates. Since 1999, the All Ordinaries has earned

*to equities
is
compelling
enough
reason to
invest*

*The other
listed stuff*

around 7% on an annual basis which approximates to 2.5% (250 bps) better than risk free rates over that period. Getting a return outcome that is higher than historic equity returns and more than twice the historic equity risk premium is a pretty good outcome. The only caveat to buying now is what happens if the banks or issuers extend issues or get closer to a non viability situation. We think extension risk is remote and the second, right now, is more remote. However, situations will change and with bank and insurer profitability expected to change over the next few years we will watch with interest and adjust portfolios accordingly.

Last year there was a deluge of bond and loan funds listed on the ASX. The chart below shows the price performance of the various funds since 31 December 2019. For comparison we have also included the Elstree Hybrid index. We've rebased them all to \$100 and the Elstree Hybrid Index includes coupon income (so it's not quite a like for like comparison).



*Any
lessons?*

We've always said that the only way for most investors to survive a period of really low cash rates is to take a bit more risk, but it is important do it in a diversified way. In this scenario, investing in better quality credit risk assets is OK and even desirable. However, it was clear then that there were major risks that some investors weren't pricing correctly when they bought billions of dollars of these funds last year.

The risks were (and still remain);

Different risks

- The underlying assets (in almost all cases) are illiquid and unpriceable. The NAVs of all the funds are still well above market prices, but who knows what the real prices of the underlying assets are. Wholesale bond markets just aren't trading and loans rarely trade.
- There's more default risk. The underlying issuers of the ASX hybrid market are almost all investment grade. They are extremely remote from default issues. The underlying assets of the fund are primarily sub investment grade (although some of the Funds will tell you otherwise: see point above though). They will suffer real losses over a default period (although some of the Funds will tell you otherwise) and it looks like we'll see default activity over the next few years. However, you won't know for a few years, which is why they should trade at some discount to current NAV.
- Even we were surprised at how illiquid the units were. In some of the \$1b funds, there was turnover of \$2m a day. This will continue. This is another reason why the share price should trade at below NAV.

The ASX Listed hybrid market has none of the risks mentioned above. It does, however, have different risks, which is why it is an important diversifier from the loan/bond fund point of view.

Disclaimer

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