Elstree
HYBRID FUND (EHF1)

INVESTMENT UPDATE **May 2022**

Welcome to the latest Elstree Hybrid Fund (EHF1) Newsletter.

Returns

Elstree Hybrid Fund (Cboe code: "EHF1') produced a return of -1.27% in May, 0.06% lower than the market return of -1.21%. Since the fund was first quoted on March 31, 2021, it has returned 3.6% p.a. (after fees, including franking) which is above the benchmark return of 3.0% p.a.

For hybrid markets and the Fund this was a large negative month. Prior to Covid, we have to go back to 2014 to find a larger negative return. The drivers this month were expectations of a new hybrid issue (and speculation about a second issue in the near future), some selling from one broker that indicates an investor/allocator moving out of the sector and negative equity markets. Many overseas debt markets were stronger this month which indicates to us that we will see the usual mean reversion over time.

Returns of the Fund, the Elstree Hybrid Index and Bank Bill/Term Deposit returns are summarised in the performance table below.

Performance figures as of 31 May 2022:

Performance as of 31 May 2022	1 MONTH	3 MONTHS	1 YEAR (p.a)	3 YEARS (p.a)
ELSTREE HYBRID FUND NAV + FRANKING (EHF1) *	-1.3%	-1.0	2.2%	n/a
Distribution (cpu) (% franked)	0.6c	3.4c	15.4c	n/a
ELSTREE HYBRID INDEX (P.A.) **	-1.2%	-0.6%	2.6%	4.1%
BANK BILLS	0.0%	0.0%	0.0%	0.4%

* Elstree Hybrid Fund (EHF1) Investment Performance is return after all fees and after the value of franking credits.
** Elstree Hybrid Index includes the value of franking credits.

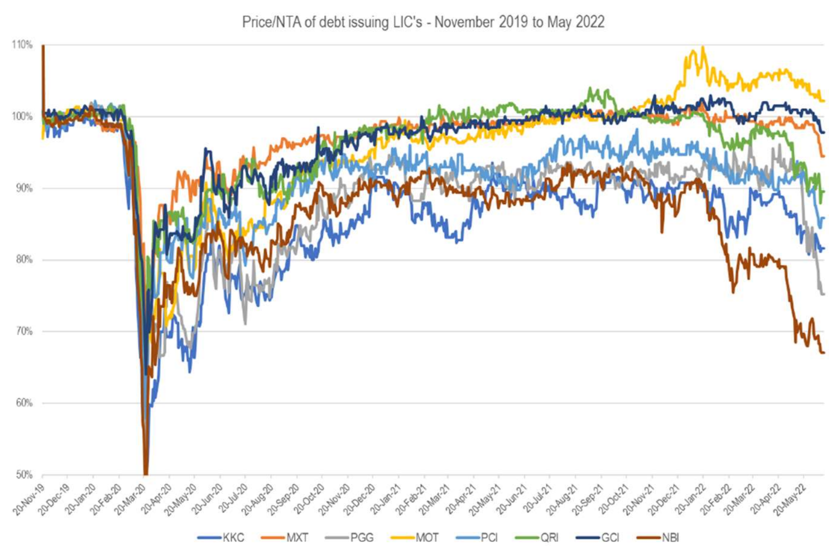
Top Holdings & contributors to returns:

Security	Return contribution	Security	Return contribution
CWNHB	0.01%	**NCCGA**	0.00%
CBAPD	0.01%	**WBCPH**	0.00%
RHCPA	0.00%	**ANZPF**	(0.18%)

Market Commentary

It's been 2 months of chunky (for hybrid markets anyway) negative returns. We've really only seen that during Covid, 2016 and the GFC, so it does need some analysis. Unlike those periods, we have not seen significant share price falls for the equity parents of the hybrid. In the previous periods we mentioned, bank share prices had fallen by more than 25% (over 40% during Covid). By end May, banks were less than than 5% off their highs (this had changed by mid June). Although there is some stress due to the war in the Ukraine and a big hike in interest rates and inflationary expectations, its doesn't have the same consequences for bank hybrids that the end of the global banking system (i.e the GFC) or edge of the cliff (i.e Covid) might have had.

There are some other factors which have affected hybrids including new issues, which always result in flat prices or some weakness, and it looks like there may have been a portfolio sale of hybrids. The other factor we have noted is that there is a fair amount of risk aversion emerging amongst some income investors. Income investors sometimes sell first and ask questions later and this leads to short term price weakness. The chart below shows the price/NTA of the 8 debt issuing LICs that listed on the ASX in 2018 &2019. Because these funds are closed end funds with no market maker, prices reflect the flow of buying and selling and they don't have to trade near NTA. From the chart its easy to see when investors get scared and less scared. During Covid, prices fell c40% before recovering and then sentiment became so bouyant that some of the LIC's were trading over NTA. Taking advantage of the panic and exuberance was profitable. Of more interest is the recent sell off which brings discounts to levels that arent far away from Covid levels. Some of the LICs are property based, which is always a worry, but we think it's an retail investor sentiment is an important driver of short term market returns. Of course, EHF1 operates with a market maker and that ensures the the Fund price remains close to NAV.



BBSW will make you happy: distributions to rise soon

The RBA's interest rate policy over the past 6 months has been like a 4 year old overdosing on cordial; we have never seen a central bank throw a tantrum and change its mind so quickly. Late last year, Governor Lowe was still talking about zero interest rates out to 2024 and now they have done a 180 degree turn and are raising rates more quickly than markets have anticipated.

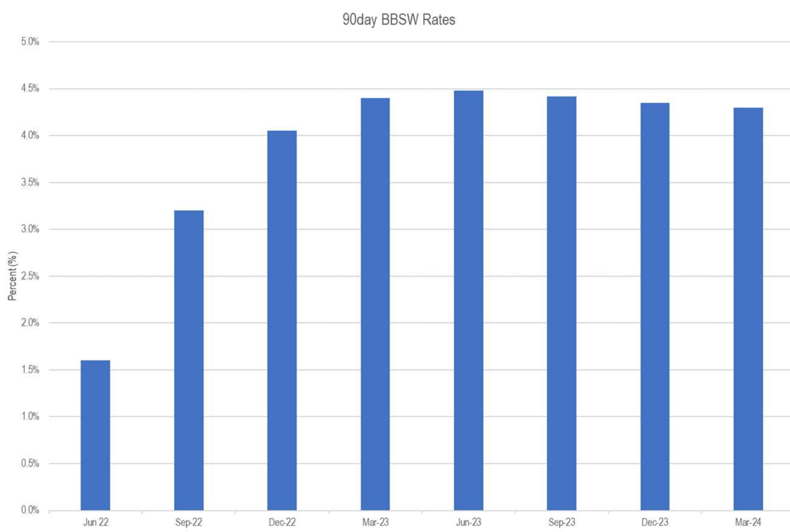
This takes a few months to flow through to actual hybrid distribution payments, but if the future's market is correct in its thinking (more below) hybrids will be paying a c7% annual coupon rate by the end of the calendar year.

Most hybrids pay a coupon that is the sum of;

- The margin which is set at the issue date and
- The 90 day BBSW rate on the date of the coupon payment.

BBSW emerged in the 1980s as a way of quantifiying funding costs for banks, but its big now; it is used as a reference rate for $17trillion of derivative contracts and about $700billion of debt securities (including around $45b of hybrids). BBSW is effectively the markets expectation of average cash rates over the next 3 months.

The chart below shows how markets think BBSW will rise for the next 2 years.



Market change all the time, but at current pricing BBSW is expected to be 4.2% by the end of the year, which when added to the coupon margins of each hybrid, means a coupon payment in excess of 7% annualised rate. The distribution payments of the Elstree Hybrid Fund (EHF1) will gradually increase until they reach that level. For example, lots of hybrids have distributions payable on 15 June, September etc. The September payment will be a combination of June BBSW (c1.6%) and the coupon margin (say 2.75% for the recent CBAPK), leading to an annualised payment of c4.3% p.a. This will increase by around 1.5% p.a. for the December payment. These will automatically flow through to EHF1 distributions.

So even though investors wont see distributions increasing by much for the next few months, its pretty much locked in for the end of the year.

News & Media

Elstree Hybrid Fund (EFH1) has been mentioned in the following articles throughout the last six months, many of which are educational in nature.

livewire

- How Hybrids fit into 2021 Income Portfolios – Campbell Dawson I Elstree Hybrid Fund
- The Hitchhiker's Guide to Hybrids (Part 1) – Bella Kidman I Livewire Markets
- This is the secret to a diversified portfolio (Part 2) – Bella Kidman I Livewire Markets
- The forgotten asset class presenting exciting opportunities – Bella Kidman I Livewire Markets

Firstlinks a Morningstar company

- https://www.firstlinks.com.au/hey-boomer-first-home-buyers-fuss
- https://www.firstlinks.com.au/bank-hybrids-equity-market-weakness
- https://www.firstlinks.com.au/ddo-change-hybrids-bank-treasurers-nightmare
- Fascinating Hybrid Journey Last Year – Campbell Dawson I Elstree Hybrid Fund

FINANCIAL STANDARD

- New Hybrid ETF on Chi-X – Staff Reporter I Financial Standard

MONEY|MANAGEMENT

- Support for Elstree Hybrid Fund – Staff Reporter I Money Management

ADVISERVOICE Education and information for financial advisers

- Hybrids remain attractive alternative for income generation – Evergreen Ratings

More about Elstree Hybrid Fund (EHF1)

Elstree Hybrid Fund (Chi-X: EHF1) is an Exchange Traded Product or ETP. The fund is designed to allow retail investors to access the same successful and long-term investment strategy as our actively managed unlisted wholesale fund, the Elstree Enhanced Income Fund.

The Elstree Hybrid Fund is an ideal investment for investors seeking a cash or bank term deposit alternative investment that displays an acceptable and appropriate risk adjusted return outcome.

The Elstree Hybrid Fund has 'on market' liquidity provided by a market maker (Nine Mile). The iNAV which is estimate of the live NAV, is updated every 20 seconds.

Additional details can be found on the Elstree Hybrid Fund website or email Norman Derham or Michelle Morgan for further information.

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