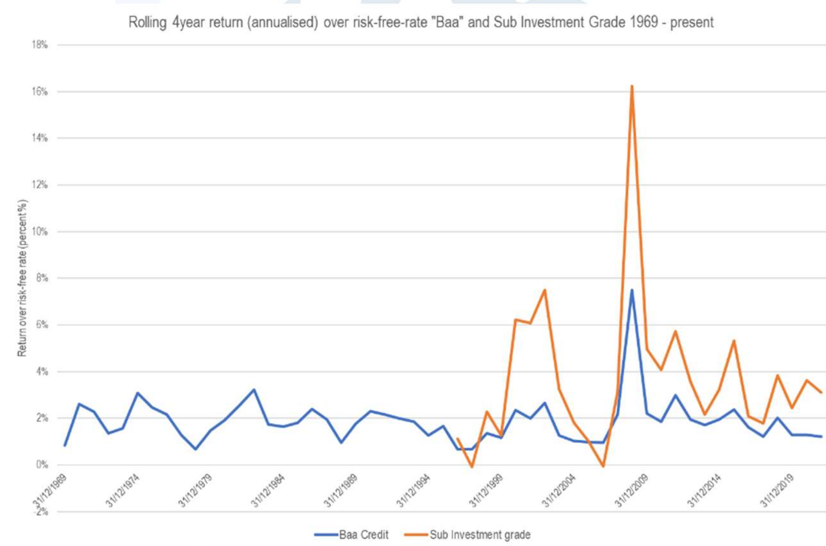
Some perspectives on a weak-ish market

- **Back to 2015?**
- **In any case, just enjoy the income until capital values revert**

There's never a bad time to buy investment grade credit: its either a good or great time

Investment grade ("IG") credit securities provide excellent returns over medium and longer periods and unlike sub investment grade securities it doesn't matter when you buy them - you always outperform the risk-free rate. The chart below shows the annualised rolling 4year return of "Baa" (IG credit - the S&P equivalent is "BBB") and sub (below) investment grade (*aka* High Yield, Junk) over the risk-free rate. The way we have presented it is assuming you buy a 4year "Baa" or sub investment grade bond at the start of the year at the margin at that time and you then hold it for 4 years. Your return over the risk-free rate is equal to the initial margin less the actual defaults over the period - we express that as a % per annum figure. For example, buying 4year "Baa" bonds in January 2007 and holding them to January 2011 produced a positive return of 1% p.a. which is made up of a margin of 1.2% p.a. and total default losses of 1% over the 4 years or 0.22% p.a. Only 1.7% of companies that were "Baa" in 2007 had defaulted by 2011



Data: Moodys, US Fed to 12/1996. BAML/ICE after 12/1996

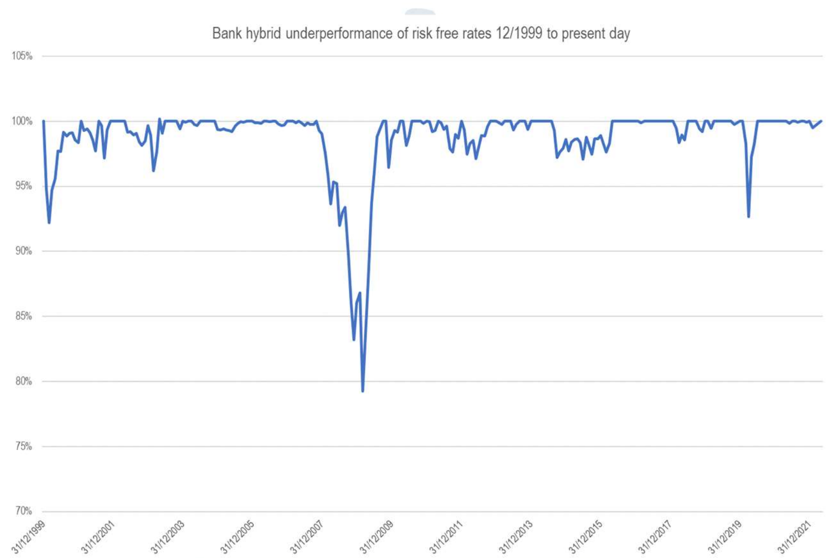
So what?

Since 1970, you have always earned better than risk free rates of return by buying "Baa" bonds. There would have been 'mark to market' movements within each 4 year period, but on average, you received 1.8% more than risk the free-rate and there are no periods where you underperformed the risk-free rate. Its not quite the same for sub investment grade. If you buy sub investment grade bonds just before a recession you would likely underperform (ie) 1999 and 2008. The defaults you suffer in a recession wipe out the additional margin. And, clearly, 'mark to market' losses would be much greater during those periods. In any case, you can buy investment grade credit and come back 4years later and have always received a return above the risk-free rate regardless of whether there were recessions or wars or equity market volatility.

Elstree Investment Management Limited (ABN: 20 079 036 810)
Level Nine, 100 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348 or mobile 0425 749 215
Email: info@eiml.com.au

Does this apply to bank hybrids?

We only have data for the ASX listed hybrid market back to 2000, but the story is the same. Currently, the market is dominated by major banks and insurers who have credit ratings that range between “A” and “AA-“ which is up to 5 rating levels above the “Baa” example mentioned above. Actual default levels after 4 years are about 1/3 less than “Baa” credits (i.e) its extremely rare for a “Aa” rated company to default within 5years of it being rated “Aa” – it is a 1 in 1000 event. Clearly, bank hybrids have other risks than default and you need to get compensated for those risks. Data sourced from the Elstree Hybrid Index shows that the longest period of time that Bank Hybrids underperformed risk free rates was during the GFC where it took 30 months for Bank Hybrids to catch up to risk free rates. Post GFC there is a period of 7 months in 2012, 12 months in 2016 and 2 months in 2020 when investors experienced cumulative underperformance. The chart below shows the periods when Bank Hybrids underperformed risk free rates. If you use a 2% underperformance cutoff, since the GFC, hybrids have underperformed cash rates around 6% of the time (i.e) if you look at your portfolio once every 12 months, there would have been only one time since the GFC that hybrids had underperformed cash.



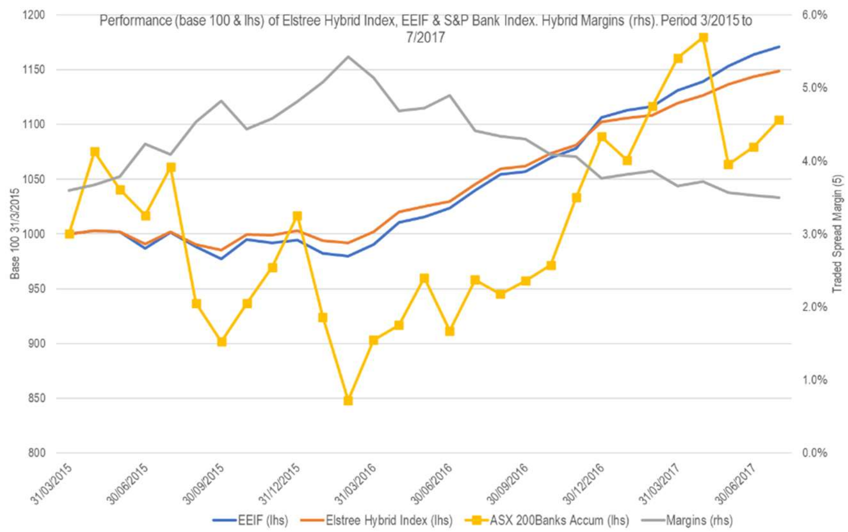
“Time in the market” not “timing the market”

We often see the example of staying invested in equity markets. Doyen equity fund manager Geoff Wilson cites an example of the S&P 500 return between 1997 and 2017 being 7.2% per annum. If you missed the best performing 20 days that return falls materially to 1.1% per annum. The result for hybrids is a vastly different. The return for hybrids since December 2009 is 9.7% p.a. If you missed the worst 3months it increases to 10.5% p.a. and if you missed the best 3 months it falls to 9.3% p.a. We’re not sure why you would try to time your entry into a market when there is so little to be gained or lost by being able to accurately time the market. To capture the attractive returns, investors should simply stay invested. There’s even a paralell to current market conditions. Hybrid returns from January 2022 are c-1% compared to risk free returns of 0%. You would be marginally better off if you predicted all the stuff that has happened this year (Ukraine war, inflation, central banks changing their minds etc). If you became cautious early and sold on 30 November 2021, hybrids have returned 0.4%, so being right (i.e invested in risk free cash) would have been unprofitable. Bonds on the other hand have fallen by around 6%, so if you think you are good at predicting return outcomes you should apply it to other asset classes.

Elstree Investment Management Limited (ABN: 20 079 036 810)
Level Nine, 100 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348 or mobile 0425 749 215
Email: info@eiml.com.au

Are we going back to 2015?

The last intruiging period of hybrid weakness was in 2015/2016. The world was a pretty nasty place then. The Chinese economy was slowing down, oil prices collapsed from over $100 to around $25 barrel, the Greek Debt crisis had worsened - it almost defaulted and Draghis' "Whatever it takes" speech was delivered. It was a nasty and volatile period and most asset classes dislike volatile periods. The chart below details the peformance, base 100 (lhs) of the Elstree Hybrid Index (Franked Series), the Elstree Enhanced Income Fund ("EEIF") and the ASX200 Banks Index. Traded hybrid spread margins and also detailed (rhs). The data is from 31 March 2015 through to 31 July 2017.



What does that show? The aftermath is more important than the crisis

Traded spread margins got cheaper for a year and reached 5% (grey line rhs). The Elstree Hybrid Index had a maximum 2% drawdown and was flat for a year (which is bad for hybrids but not bad compared to bank equity prices which felll 15%). The Elstree Enhnaced Income Fund ("EEIF") underperformed the Index but recovered soon after (we thought the market was cheap and simply bought too early). More interestingly, the world didn't fall to pieces and hybrids and EEIF outperformed materially in the immediate post crisis period. This is logical given that hybrids are ultimately dependent on the underlying credit quality of the issuer and that did not deteriorate. Equities and bank share prices are driven by a raft of other things such as EPS growth, sentiment etc that aren't necessarily tied to the bank's credit quality, and they can still lag when the crisis ends.

What's causing the current weakness?

We've always said that equity market weakness often results in a softer hybrid market. If we knew in advance what the equity market would have done this year, we would have pencilled in a hybrid market drawdown of between 0.25% and 0.5%. The drawdown to date has been higher at c1.2%. We make the following points:

- We almost always expect some price weakness in the month before a new hybrid security issue. We note that the NAB has telegraphed a new issue next month.
- There is also the ebb and flow of buying and selling and if there is a big seller, it takes time for the selling to be absorbed by the market.
- The banks are in good health and a long way away from an event that will result in them not paying distributions or not being able to refinancing existing hybrids when they mature (ie) investors will continue to get their distributions and $100 value at reset dates).
- We expect it recovers to fair value at some stage.

Elstree Investment Management Limited (ABN: 20 079 036 810)
Level Nine, 100 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348 or mobile 0425 749 215
Email: info@eiml.com.au

So, what is fair value for hybrids?

We saw some research recently suggesting that hybrids are now expensive because they normally trade at a 3times multiple of AUD investment grade credit spreads. Investment grade credit spreads have widened by around 0.5% this year and because hybrid spreads have increased by 0.7%, they are not keeping up with the multiple and are therefore expensive. We think there are a couple of issues with this argument. We think those issues are:

1. Hybrids have generated the best risk adjusted return of all the major asset class in Australia over the past 12years (its unambiguous: contact us if you would like to discuss and we will provide the proof). The last decade's outperformance would suggest to us that the yields/spread margins were too high over that decade. Maybe the 3times multiple is too high? Current margins are not that far from the post GFC average, so we think it's probable that you get at least another 5 years of historically good returns. We think that commentators who demand a 3times multiple of investment grade margins should revisit their theory.
2. Clearly, we agree that hybrids should trade at higher spread margins than investment grade credit: they have more and different risks. We have never seen a good argument, why the additional margin should be a multiple, rather than an "addition". If you think the margin should be an addition (rather than multiple), maybe the increase in hybrid margins of 0.7% this year is comparable to the increase of 0.5% in Investment grade margins over the same period?

Elstree Investment Management Limited (ABN: 20 079 036 810)
Level Nine, 100 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348 or mobile 0425 749 215
Email: info@eiml.com.au