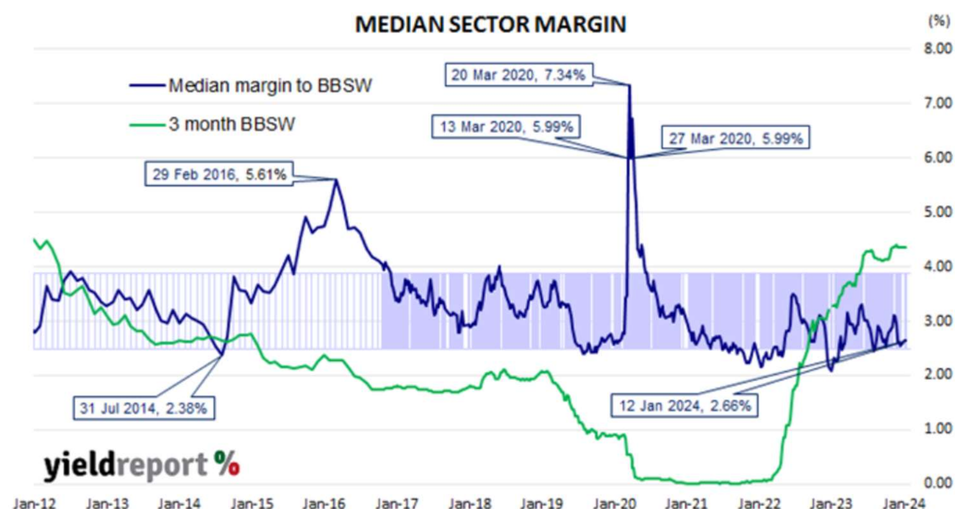
January 2024 Review – Listed Hybrid Sector

Fund and market performance

The Elstree Enhanced Income Fund's total investment return for the month of January 2024 was 0.47%. This compares with the Elstree Hybrid Index return of 0.37%. In other markets the All Ordinaries Accumulation Index returned 1.07% while the All Maturities Bond Index returned 0.21%.

Is it a good time to invest? There are a number of things to consider including the traded spread margin and the expected annual cash flows. Paying a premium price is not unreasonable in view of the cashflows

We are often asked by investors is it a good time to invest? Obviously, as a professional money manager in a nuanced asset class, such as floating rate hybrid capital we have a concept of what represents a fair value investment and what doesn't. In arriving at a conclusion, we would consider, for example, the current average weighted traded spread margin (traded spread margins move in the opposite direction to price). We might then compare the current margin with the margin over time. The chart below is extracted from the Yield Report on 16 January 2024. It shows that the median margin (blue line) over 90day BBSW. On 12 January the margin was at the bottom of the range (blue shaded area) at 266 basis points over 90day BBSW. From the traded spread margin perspective, it would be easy to mount a case to say that the market only just represents fair value. But then we would also have to consider the absolute level of 90day BBSW over which the fixed coupon margins are added to calculate the periodic cash flows. 90day BBSW is represented by the green line. On 12 January it set at 4.36% approximating a 10year high. Coupon cash flows too, are approaching 10year highs. With the sum of traded spread margins and 90day BBSW being priced at a discount to the sum of the fixed coupon margin and 90day BBSW, it is clear that investors are prepared to pay a premium price (i.e more than PAR value) for the cash flows – not an unreasonable thing to do when not only are the immediate cash flows at 10year highs, but the expectation is that they will remain high in the foreseeable future. We know this because 90day BBSW is forecast to set between 3.5% and 4% for the next 4years.



Cashflows provide not only inflation

But is it good time to invest? The fact that the market in aggregate is prepared to pay a premium price for the cash flows would suggest the market most likely thinks it is. As we articulated in previous commentaries investors are disadvantaged by not being invested in the higher yielding

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protection but downside capital protection as well

asset. As we know the average weighted price of hybrids can fall over a 1year period by as much as $3.40 from c$102 now to equal the return of a term deposit based on the RBA's all terms average special rate of 3.6%. Over a longer-term investment time horizon such as 3years, the hybrid price can fall by as much as $10.20 (i.e $3.40 X 3) to equal the return of the RBA's all terms average special rate of 3.6%. Once again this serves to not only highlight investor willingness to pay a premium for the cash flows to combat inflation, but it also highlights the capital protection afforded by the cash flows.

This table tells a tale about portfolio construction and our risk appetite

As the custodian of investors' monies, we are cognisant of where traded spread margins are relative to their long-term average and median levels just as we are cognisant of where the annual cash flows price relative to their long-term average and median levels. The observant among you may have noticed the table below in our monthly performance review and market commentaries with the more observant noting (even) the changes in the metrics from month to month and over time. We refer to it as our "Ready Reckoner". It provides an insight into not only the construction of the portfolio, but it details the riskiness of the portfolio as well. The table below is extracted from the December 2023 and January 2024 review and commentaries.

Month ending	31/12/2023	31/1/2024
Yield to Maturity (YTM)	6.7%	6.5%
Cash yield to maturity (excludes franking)	4.3%	4.0%
Credit term duration (average years)	3.37	3.17
Default cost (per annum)	0.09%	0.09%
Investment grade issuer (% holding)	89.9%	89.1%
Bank tier 1 exposure (% holding)	56.3%	56.3%
Value at Risk (VaR)	3.16%	3.08%

While there are a number of ways to reduce portfolio risk our default method is to reduce the credit term

Despite the table representing the portfolio at a particular point in time it does tell you a lot about our thinking and our risk appetite particularly if you compare it to previous periods. While all the factors have something to say about composition of the portfolio and our risk appetite the telltale factors are the credit term, the underlying credit quality and yield to maturity (YTM). While we can adjust the risk of portfolio in a number of ways our default method is to change the credit term. We can shorten the credit term of the portfolio by simply raising cash (cash has no term and is risk free so both credit term and default risk are reduced). Conversely, should we wish to increase portfolio risk we could do so by extending the credit term by deploying cash. Depending on the shape of the swap curve the yield to maturity and cash yields will be impacted by changing the credit term. Presently, a reduction in credit term will result in a reduction in the cash yield and yield to maturity just as an extension of term will result in an increase in the cash yield and yield to maturity.

Undoubted credit quality of the underlying issuers.

As an investor in AT1 securities issued by a major Australian bank or insurer there can be no denying the credit quality of the issuer across the breadth of the market. While not all the securities we have in the portfolio are rated the most senior instruments issued by the underlying issuers are. Typically, the issuing entity will be investment grade. Currently, 90% of the securities in which we invest are issued by investment grade rated issuers. The annual default cost of the issuer's most senior instruments is detailed in the table. It is calculated by using Moodys historical default cost data and expressed as percent per annum for the term of the portfolio. The expected annual default cost for

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Other risks to consider

the most senior securities of the underlying issuer, where the term is calculated to be 3.37years is approximately 0.09%. While that is a risk worth taking every day of the week it simply serves to highlight that there are other risks, other than issuer default risk, to consider when investing in AT1 hybrid capital securities.

Value at risk

Value at risk or VaR as it is known, is a method designed to quantify the expected loss of a portfolio of securities or assets within a particular confidence interval over a specified time period. We use VaR not only as a standalone measure of risk we also use it to compare our portfolio with the market at large (i.e are we running more or less risk than the market). Without going into detail about the assumptions we make or the methods we employ, the lower the VaR percentage is, the less risk the portfolio is deemed to be undertaking. While VaR does have its limitations it provides, at the very least, a good snapshot of the level of overall portfolio risk.

The key takeaway is that we have reduced portfolio risk

The key takeaway from the table are that over the month of January 2024 we have reduced the risk of the portfolio. We have done this by selling securities and raising cash. This is reflected in a shortening of the credit term from 3.37years to 3.17years and a coincident decline in the cash and yield to maturity to 4.0% and 6.5% from 4.3% and 6.7% respectively. VaR has also declined. We have proactively reduced portfolio risk because we are of the view that there is some new issuance in the offing which is likely to place downward pressure on the market's pricing structure in the short term.

It's always a good time to invest. Allow us to worry for you

Getting back to the original question is it a good time to invest? As an investor in a managed fund such as the Elstree Enhanced Income Fund it is nearly always a good time to invest! Allow us to worry about the ebbs and flows of the market's pricing structure and associated risks. We will proactively adjust the portfolio's composition and risk profile (as indeed we are doing now) to optimise the return outcomes for investors.

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Elstree Enhanced Income Fund portfolio metrics as at (close of business) 31 January 2024

Performance Table	1 month	3 months	1 year	3years p.a.	5years p.a.
Elstree Enhanced Income Fund *	0.47%	2.61%	7.33%	6.44%	7.21%
Elstree Enhanced income Fund (Basis NAV)	0.37%	1.98%	4.83%	4.54%	5.45%
UBS Australia Bank Bill Index	0.37%	1.09%	4.00%	1.83%	1.44%
Betashares Hybrid Fund (HBRD)#	0.38%	1.72%	4.31%	3.17%	3.64%

Past performance is not necessarily a guide to future performance. *Is the total investment return. "NAV" is net of all fees and does not include the value of franking. **"()"** denotes negative return outcome. # Source: Betashares. Return is net of fees and does not include the value of franking credits.

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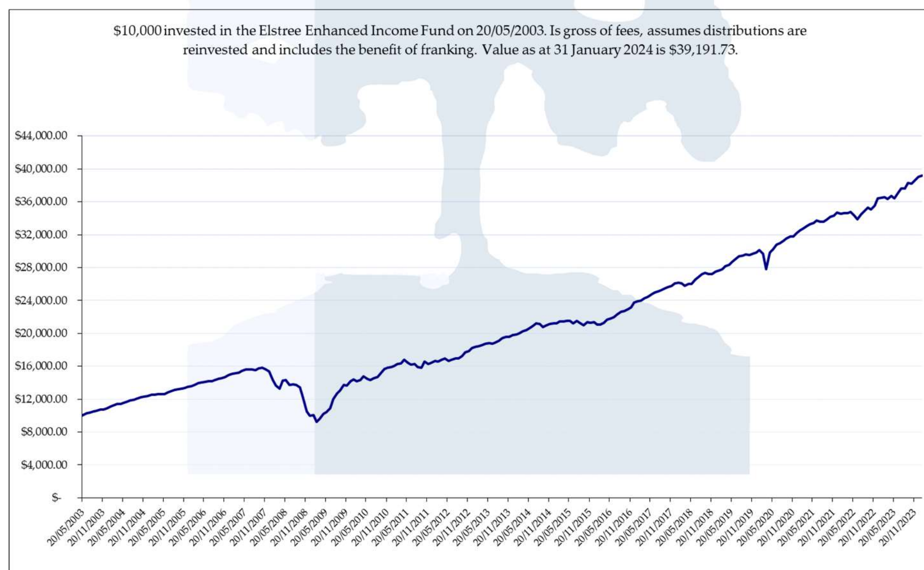
Value of $10,000 Invested on 20/05/2003



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