# April 2024 Review – Listed Hybrid Sector

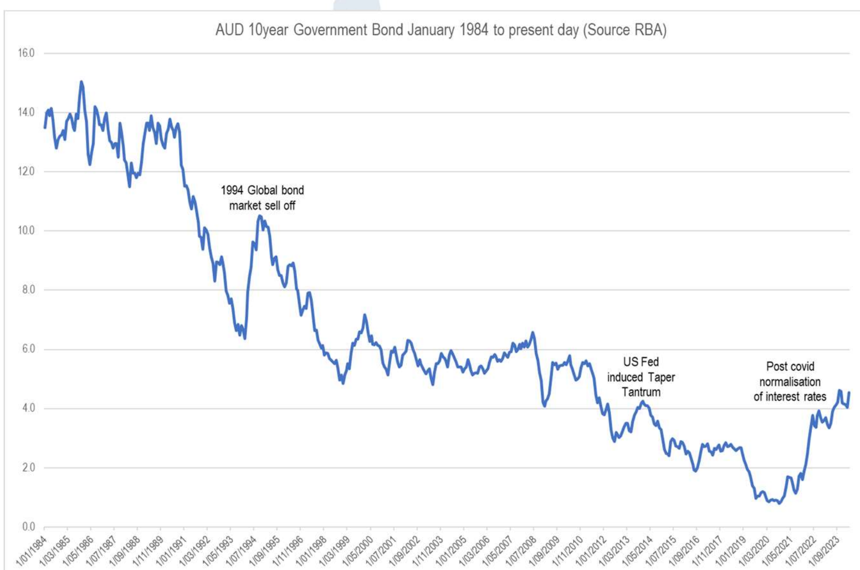
***Fund and market performance***

The Elstree Enhanced Income Fund's total investment return for the month of April 2024 was 1.13%. This compares with the Elstree Hybrid Index return of 1.24%. In other markets the All Ordinaries Accumulation Index returned (2.7%)# while the All Maturities Bond Index returned (1.98%).

# "()" Denotes negative return outcome.

***A brief history of Australian government bond yields through the eyes of the author. Apart from a few isolated incidents, bond yields have fallen since the early 1980's. The path is a little less certain from here as normalisation takes hold***

As a collective the executive directors of Elstree have over 50 combined investment years' experience in investing in government bond markets and another 60 combined years' experience investing in listed floating rate credit markets. As professional investment managers we have seen a thing or two over the journey including 15%+ bond yields in the 1980's, the 1987 stock market crash, Paul Keating's "the recession we had to have", the bond market sell-off of 1994, the Asian crisis in the late 1990's, the "dot com boom", the CFC of late 2007 and 2008 and more recently the covid event shock, accompanied by of course, government bond yields of less than 1%. There is not much we haven't experienced. If there was a thematic over the journey it would without doubt be declining bond yields, the 1994 sell off, the taper tantrum of 2013 and the recent normalisation of interest rates notwithstanding (refer chart below). The writer remembers vividly lodging, by hand, at the RBA in Collins Street Melbourne, on his vfirst day of employment an application form for the benchmark 10year government bond at the time. The bond was a September 1993. The coupon rate was 14%. The immediate covid period saw 10year bond yields fall below 1% as the RBA (in concert with other central banks) cut interest rates to near zero percent and set about providing liquidity (virtually "free" money) to the banking system through the implementation of initiatives such as the term funding facility and by buying 3year government bonds at a yield of just 0.10%. All the while the government of the day embarked on a program of unprecedented fiscal expenditure to shore up embattled households and businesses. The end result, of this interest rate, monetary and fiscal policy collaboration, was of course inflation which is the scourge of bond investors. And so, interest rates have moved higher accompanied too by bond yields.

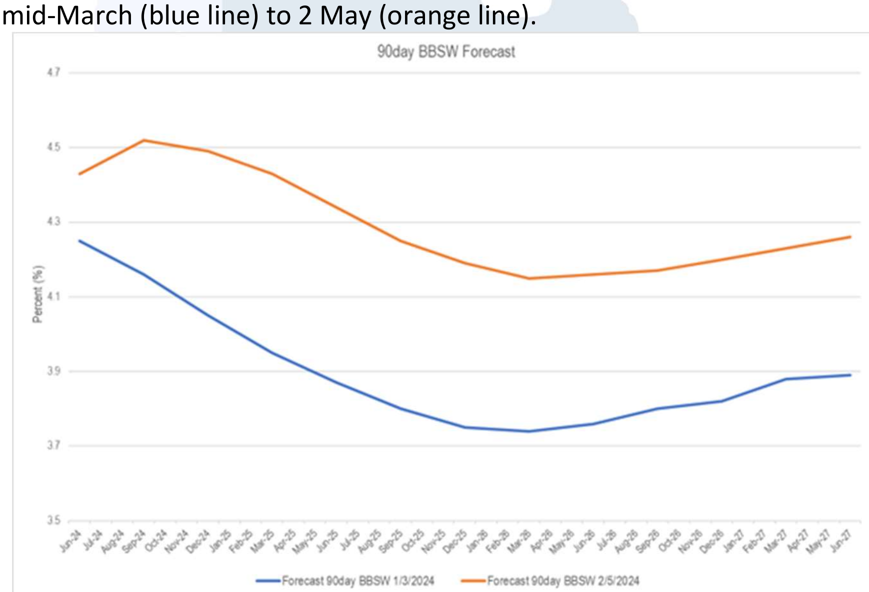


***Predicting bond market pricing is fraught with danger. Best wait for volatility to subside***

While we are not in the business of predicting 10year bond pricing we have observed that the market has been quite volatile recently despite the cash rate increasing by just 25bps to 4.35% and being stable ever since. The normalisation of the term structure of interest rates is something investors will have to get used to. Certainly, inexperienced money managers will have limited understanding other than what they learned from studying what happens to risk market pricing when interest rates rise. That time is clearly now. It can be a painful process and trying to pick market tops (and bottoms) can be fraught with danger. Best wait until the volatility subsides and the runway becomes clearer. To share a quote from renowned AFR journalist Jonathon Shapiro "The lesson here is that bond markets aren't the stable and reliable arbiters of policy rates we assumed they were. They are disposed to bouts of panic and downright dysfunction".

***Convinced that the higher for longer narrative will play out Australian money markets are now pricing zero interest rate cuts***

While inflation has now seemingly been contained it is still uncomfortably higher than it should be which is posing problems for policy makers at central banks and investors in risk assets alike. The higher for longer narrative seems entrenched now as the US Federal Reserve continues to bat away speculation that it will cuts rates this year. The US 2year Treasury bond, which currently yields 5.00% (30/4/2024) is telegraphing that the markets are expecting the cash rate to average 5% for the next 2years. The Fed Fund's Rate is currently 5.25% - 5.5%. Meanwhile the money markets in Australia have transitioned over the last month or so from pricing in up to 60bps of interest rate cuts over the next 2years to none, zero! While this is not welcome news for indebted households looking for interest rate relief, it is excellent news for investors in floating rate instruments like hybrids. The chart below is sourced from ASX24. It details the change in the money market's expectation of 90day BBSW since mid-March (blue line) to 2 May (orange line).




***While high headline coupon rates remain the driver of premium pricing the***

While there can be no doubt that if investors in hybrid capital used traded spread margins (or the premium price paid for securities) as the sole measure of whether the market represented fair value or not, then the market would be deemed to be expensive. We articulated in last month's commentary the reasons why. The underlying driver is the headline coupon rate. While traded spread margins sit (now) below their long-term median levels annual hybrid coupon rates are at 10year highs and if the money markets are correct in their collective thinking, likely to remain there for the next 4years. There can be no denying this is a big driver. It is however supported by a raft of



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***support acts of suppressed TD pricing and a rerate of Australia's banking system are helping to underpin market pricing***

other factors, two of which, will likely change the structure of the hybrid landscape for the foreseeable future. The first is the pricing of term deposits. We have discussed this *ad nauseam*, but it bears repeating. Because the banks are awash with term deposit funding, they have no need whatsoever to pay up for it. We also know that 75% of the term deposit market is controlled by the Big 4 which makes it difficult for competitors to gain traction and grow market share. This simply means that terms deposit rates will likely remain suppressed and, as a consequence, relatively unattractive to alternative investments such as hybrid capital (we understand of course that hybrid capital and term deposits are not fungible because of the different risk inherent in hybrid capital). The second factor is a rerate by S&P of the Australian banking system and AT1 and tier 2 securities issued by those entities. What the rerate means in laymen terms is that unsecured instruments such as hybrid capital issued by an Australian bank should be priced closer to more senior instruments of the same issuer

***The proof is in recent pricing as investors become more confident that the higher for longer narrative will likely play out***

How the market perceives these factors is represented by the market's current pricing structure. As an example, the broader hybrid market as determined by the Elstree Hybrid Index (including franking) returned 9.38% over the 12months ending 30 April which is well in excess of the income return (including franking) over the same period of about 7.35% (i.e 90day BBSW + 3%). The difference represents the quantum of the price premium investors are willing to pay for the cash flows over the last 12months and into the future. However, that quantum was largest and most pronounced over the last 6months, coinciding, it must be said, with a heightened probability that the higher for longer narrative would likely play out. Over the 6month period to end 30 April the broader market as represented by the Elstree Hybrid Index returned 5.85%. This compares with the income return over the period of approximately 3.675%. By contrast for the 6month period ending 30 October 2023 (i.e the prior 6month period) the market return of 3.33% approximated quite closely to the income return of c3.675%. While term deposit pricing has made a positive contribution to hybrid security pricing, the recent rerate of Australia's banking system by S&P provided additional impetus for investors to push prices higher still over the last month or so. Despite the changed pricing structure, we see little to change the status quo, save, a supply shock, induced by an unexpected event or IPO. While the former is unlikely, the latter cannot be ruled out and should it occur should be viewed as a buying opportunity.


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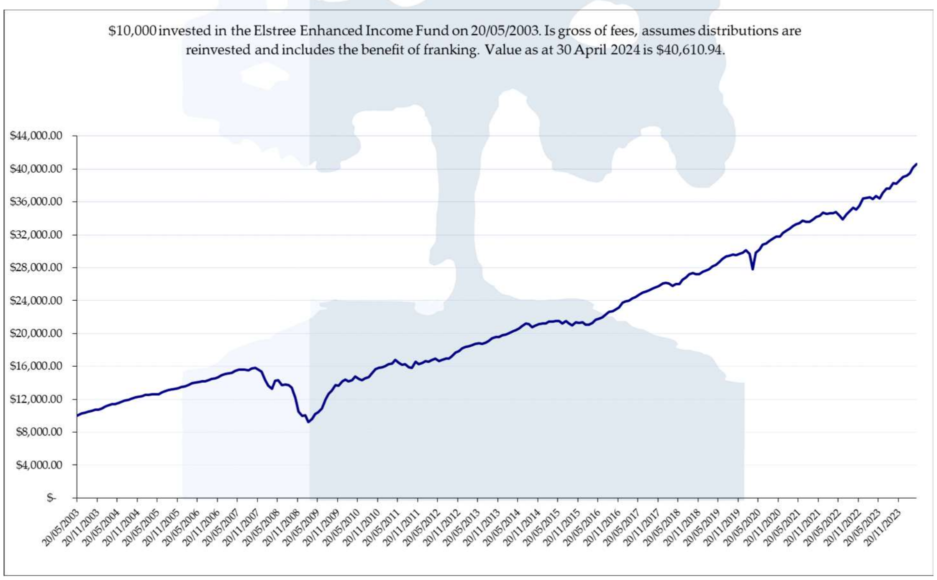
## Elstree Enhanced Income Fund portfolio metrics as at (close of business) 30 April 2024

| Performance Table | 1 month | 3 months | 1 year | 3years p.a. | 5years p.a. |
|---|---|---|---|---|---|
| Elstree Enhanced Income Fund * | 1.13% | 3.61% | 10.57% | 6.84% | 7.44% |
| Elstree Enhanced income Fund (Basis NAV) | 1.05% | 3.02% | 7.91% | 4.86% | 5.64% |
| UBS Australia Bank Bill Index | 0.35% | 1.07% | 4.24% | 2.19% | 1.55% |
| Betashares Hybrid Fund (HBRD)# | 0.86% | 2.18% | 6.44% | 3.55% | 3.86% |

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.

| | |
|---|---|
| Yield to Maturity | 6.3% |
| Cash yield to maturity (excludes franking) | 4.7% |
| Credit term duration (average years) | 3.42 |
| Default cost (per annum) | 0.09% |
| Investment grade issuer (% holding) | 92.8% |
| Bank tier 1 exposure (% holding) | 54.1% |
| Value at Risk (VaR) | 3.15% |

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

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