December 2024 Review – Listed Hybrid Sector

Fund and market performance

The Elstree Enhanced Income Fund's investment return net of fees and including the value of franking credits for the month of December 2024 was 0.89%. This compares with the Elstree Hybrid Index return of 0.87%. In other markets the All-Ordinaries Accumulation Index returned (3.07%) while the All Maturities Bond Index returned 0.5%.

"()" Denotes negative return outcome

While APRA has determined the parameters for the AT1 market going forward where demand will exceed supply the market also looks "cheap" in relative terms

On 9 December APRA confirmed that its proposal of September that bank issued alternative tier 1 (AT1) capital instruments would be phased out by 2032 would go ahead almost unimpeded. Between September and December investors were uncertain of the outcome hedging their bets albeit with a skew toward the proposal going ahead as planned. Typifying the uncertainty, volumes and volatility since the initial surge in prices in September have been unusually low. Now that the market knows definitively, it can move toward 2027 and then 2032 with confidence and certainty. Without fear of contradiction the most glaring thing is that demand will exceed supply. And where demand exceeds supply prices go up! We know that spread margins, relative to risk free rates in "like" asset markets including Australian bank issued Tier2, high yield and CoCo's (European bank issued hybrids) are as narrow as they have been in a long time. AT1 spread margins, while narrow have not narrowed as much in relative terms. As such AT1 margins are relatively more attractive. If you combine the relative attractiveness of Australian bank issued AT1's vis-à-vis other "like" assets with an excess of demand over supply, it is not hard to mount a strong case for AT1 prices to move higher and spread margins to narrow. It would be reasonable to expect spread margins to not only narrow in absolute terms but to narrow more and at a faster rate than comparable assets including tier2, high yield and CoCo's.

While there is a possibility of qualifying banks calling and rolling between now and 2027, we would welcome such an occurrence as it would maintain greater market depth and liquidity for longer

We know that beyond 2032 the AT1 market will no longer exist. Beginning in 2025 there will be a gradual run off as securities are called by the issuer at the first available call date. While the new capital rules will apply from 2027 APRA has effectively placed a blanket ban on banks calling (redeeming) and rolling (issuing) securities at their first available call date before 2027, the exception being that should a bank expect its AT1 capital ratio to fall below 1.5% of risk weighted assets (RWA) by the end of 2027 it can, after submitting a capital plan and with APRA's approval, opt to call an existing security and issue a new one (i.e call and roll). Analysis undertaken by Westpac and published in its "Around the Grounds" commentary of 10 December, suggests that CBA, ANZ and MQG are likely to qualify for this "exception" with their AT1 ratio expected to fall below the 1.5% threshold before end 2027. The caveat(s) applied by APRA under such circumstances is that any new security that is issued as a consequence of a call and roll, must have a call date of longer than 5years, with the call date not to exceed 31 December 2031, while the $ amount of AT1 should not be increased the 1.5% threshold of AT1 to RWA is not to be breached as well. The question, asked by Westpac in their commentary is where a bank qualifies and be allowed by APRA to call and roll, will they do so early? While that is a fair question, as an investor seeking greater issuer and security diversification, we would welcome any call and roll as it will maintain greater market depth and liquidity ensuring longevity until 2031 at the very least.

While the AT1 market is set to

While we can speculate all we like about which securities will be called and rolled it doesn't deflect from the fact that the ASX listed AT1 market will shrink, in a reasonably orderly fashion, over the next 7years (refer chart below and overleaf detailing the run off by bank sourced from Westpac

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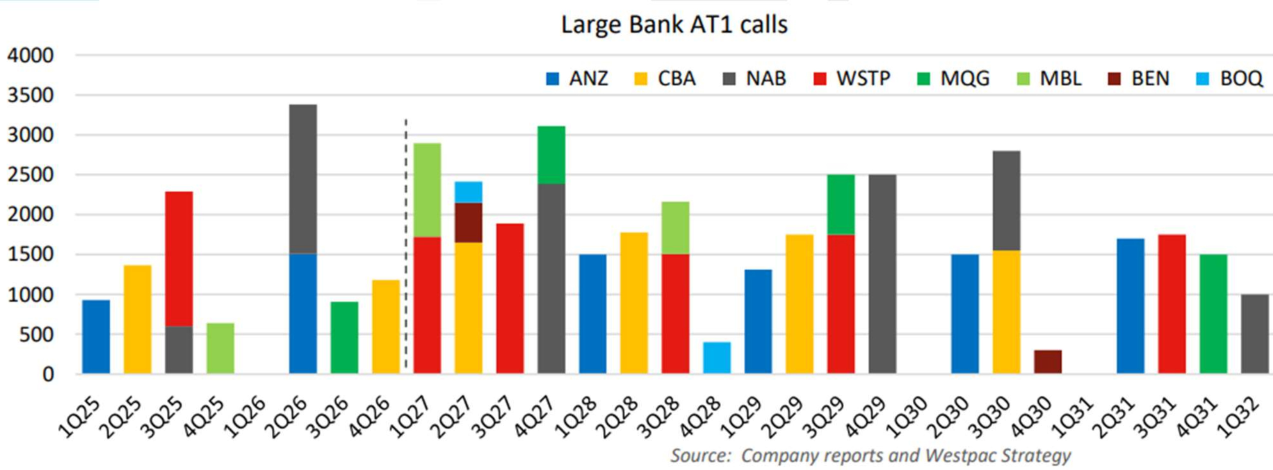
shrink in an orderly fashion the shining light is this will create an excess of demand over supply underpinning the market's pricing structure between now and 2032

Strategy and published in their "Around the Grounds" commentary of 10 December). It is the shrinkage that will create the demand supply mismatch. For over 15years investors have been able to purchase a plethora of (in most cases) fully franked AT1 securities, enjoying along the journey, exceptional risk adjusted returns. Liquidity, transparency and governance was ensured by the securities being listed on the Australian Securities Exchange (ASX). The question now is, as the market shrinks what will the investors choose to do? We estimate that of every security call and roll approximately 50% is rolled (so 50% is rolled and 50% is unrolled and is invested elsewhere). Should the market shrink by (say) $5billion over the next 12months or so, this means that approximately $2.5billion will be looking to be reinvested into the AT1 market, which is reducing in size. With security prices across the term structure already at a premium to PAR of about 3% on average (i.e $103 per $100), this means, everything being equal, that security prices can only go higher. But how high will they go and how high is too high? One thing we can be reasonably sure of is that existing holders will be unlikely to sell as they continue to enjoy, the mostly fully franked cash flows and excellent risk adjusted return outcomes. All will be revealed in the fullness of time, and we are going to be so bold as to predict where security prices will top out (and spread margins to risk free rates to narrow), suffice to say it will likely be higher that where it is now, remembering of course, that a security valued at $103 today will be redeemed at PAR of $100 (plus accrued interest) at its first call or maturity date in the future.



Source: Westpac Strategy. "Around the Grounds" commentary published 10 December 2024.

With central banks subscribing almost in unison to the "higher for longer" thematic the outlook is excellent

When you combine the reality of the shrinking market with the likelihood that central banks, including Australia's RBA, are now uniformly subscribing to the higher for longer interest rate philosophy, flagged again recently by the US Federal Reserve, you have a near "perfect" scenario for the maintenance of a higher pricing structure for floating rate investments including AT1 capital securities in the future. Data for the chart below and overleaf is extracted from Trading View on 19 December (the day after the US Federal Reserve cut rates by 25bps before announcing that it expected only 2 more 25bps cuts in this cycle due to a combination of a favourable economic outlook and the Fed's preferred inflation measure moving slightly higher). The chart details 90day BBSW futures from January 2025 to December 2027 (blue line) and the expected average AT1 annual coupon rate (including franking) orange line. We have assumed an average coupon margin of 3%.

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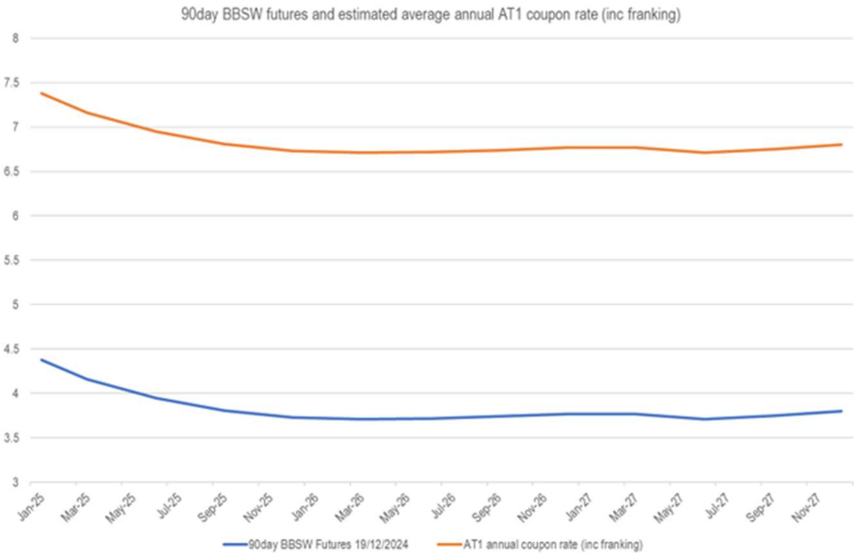

A higher term structure of interest rates looks like playing its role adding further support and stability to the market's pricing structure

The key takeaway from the chart is the money market is predicting only two 25bps rate cuts over the next 2 years after which interest rates are predicted to rise again. The second takeaway is that should the money market be correct in its collective thinking the AT1 annual coupon rate (including the value of franking) will not fall much below 6.75% over the same period. This compares favourably with like assets including term deposits where the RBA's benchmark all terms average special rate is priced at 3.35%. As we argued previously, the banks are awash with term deposit funding and have no incentive whatsoever to pay up for it, so it is reasonable to expect the margin between term deposit rates and the annual cash flows applied to AT1 securities to remain (we acknowledge of course that AT1's and TD's are not fungible and we also acknowledge that the yield to maturity or YTM of bank AT1's as a collective is less than the annual cash flow reflecting investor willingness to currently pay a premium for the franked cash flows). Now that APRA has established the ground rules there is a case to argue that the market's pricing structure will be less prone to disruption as it was previously, and where pricing might be disrupted, it presents as a unique buying opportunity.

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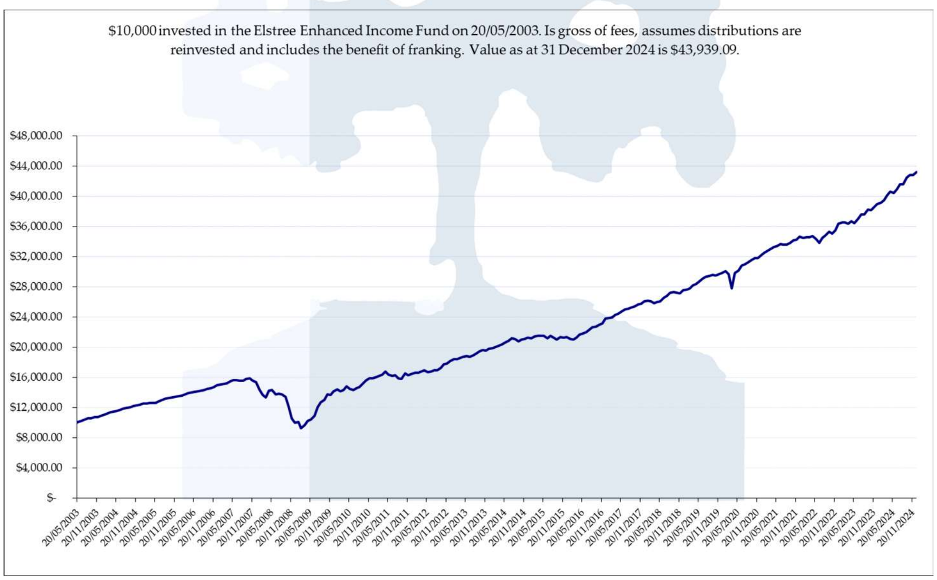
Elstree Enhanced Income Fund portfolio metrics as at (close of business) 31 December 2024

Performance Table	1 month	3 months	1 year	3years p.a.	5years p.a.
Elstree Enhanced Income Fund *	0.89%	1.65%	10.21%	6.98%	7.05%
Elstree Enhanced income Fund (Basis NAV)	0.53%	1.22%	8.46%	5.45%	5.83%
Betashares Hybrid Fund HBRD (Basis NAV)#	0.54%	1.53%	7.07%	4.34%	3.98%
UBS Australia Bank Bill Index	0.38%	1.12%	4.47%	3.19%	1.98%

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

Yield to Maturity (includes franking)	6.20%
Cash yield to maturity (excludes franking)	5.00%
Credit term duration (average years)	3.95
Default cost (per annum)	0.09%
Investment grade issuer (% holding)	94.2%
Bank tier 1 exposure (% holding)	63.5%
Value at Risk (VaR)	3.20%

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



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