

## January 2025 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 January 2025 was 0.05%. This compares with the Elstree Hybrid Index return of (0.04%). In other markets the All-Ordinaries Accumulation Index returned 4.38% while the All Maturities Bond Index returned 0.19%.

"()" Denotes negative return outcome

### *Where to from here?*

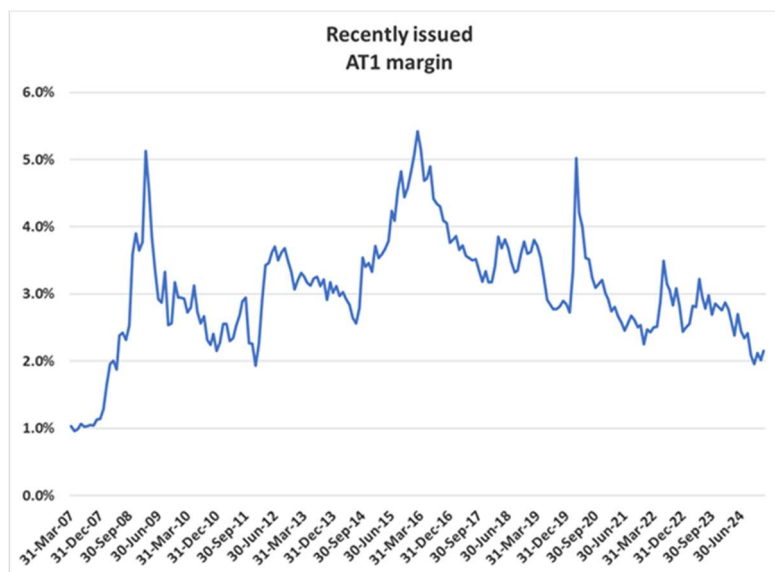
With APRA's decision to close down the bank alternative tier 1 (AT1) market beginning in 2027 where to from here? Notwithstanding APRA has created an excess of security demand over supply that is expected to underpin the market's pricing structure between now and 2032 has there been any changes in the risks associated with investing in AT1 capital to justify the premium price investors are prepared to pay for the franked cashflows? Certainly, if one takes APRA's determination on face value extension risk, the risk that a security is not called at the first available call date, has been eliminated (APRA is insistent that outstanding AT1 securities are called at the first available call date). Contrary to that ascertain however, APRA did state in its representation that from 1 January 2027 while outstanding AT1 securities would be eligible to be included as Tier 2 securities until their first scheduled call date, those securities would still be subject to the existing legal terms and conditions, including subordination, of the outstanding instruments. In other words, the risks inherent in the outstanding inventory of AT1 securities remain largely unchanged.

### *We have tended to downplay the well documented risks associated with AT1 securities. There are other less well documented and understood risks that are the focus of our attention*

As a manager of AT1 securities for over 20years we have tended to downplay the risks including credit risk, extension risk, distribution risk and equity conversion risk. While we clearly acknowledge their presence, in terms of their probability of occurrence we see them as relatively benign. As an example, investors in our fund will be aware that we assign an estimate of the default cost to the portfolio. We calculate, using Moodys historical default cost data, that the annual default cost of our portfolio, which on average and in aggregate, is investment grade issuer rated and has a term of c3.9years to be approximately 0.10%. To put this in perspective as an excess margin over the risk-free rate (where there is zero probability of default) as an investor in Australian bank issued AT1 securities we currently receive in compensation, approximately 225bps or 2.25% per annum. This means we are being compensated many times over for the default risk calculated to be only 0.10% on an annual basis. We have claimed for some time that the sum of the risks including, default, equity conversion, missed distribution and extension is small relative to the compensation received. Long term investors both in our Fund and individual AT1 securities will be familiar with the fact that in the AT1 market in Australia there is no history of defaults, no 'forced' equity conversions, no missed AT1 distribution payments and one case of term extension. One thing however that investors in bank issued AT1's (and indeed our fund) will be conversant with over the journey is "mark to market" risk. Mark to market risk is the risk of the value of an investment decreasing (or increasing) in value as a result of unpredicted and volatile movements in market prices. Periods of heightened mark to market risk, dominated the immediate Covid period where bank issued AT1 security prices fell from top to bottom by as much as 20%. This means that there are risks other than default, equity conversion, missed coupon and extension risk that we should be more cognisant of.

**The AT1 market's pricing structure is subject to disruption caused by an imbalance between supply and demand**

As we have opined previously the pricing structure of the hybrid and AT1 market is subject to periodic imbalances between the demand for, and supply of, securities. Where imbalances become sufficiently large the market's pricing structure can become disrupted. Investors should not lose sight of the fact that the AT1 market is small. While wholesale sophisticated investors have a strong presence in the market there is also a large cohort of small(er) unsophisticated investors. The market turns over approximately \$180m a week (i.e there is \$180m of buy transactions matched with \$180m of sell transactions). Where turnover exceeds this level due to demand/supply imbalances prices move either upwards or downwards. Where there is a sufficiently large imbalance of demand and supply market pricing can become disrupted and compromised. We call this risk, "liquidity risk". We model liquidity risk and express it as a "loss rate". We use it internally as an input to determine the overall risk inherent in our portfolios. During normal return periods liquidity risk presents as very low (because buyers and sellers approximate one another) but when turnover and volatility increase it rises. So, liquidity risk is an important component and should not be underestimated.



**Demand and supply imbalances can be from either primary market sources or secondary market sources. Primary market source risk no longer exists**

The chart above details traded spread margins of the most recently issued AT1 securities since March 2007. It highlights the 3 drawdowns where traded spread margins (traded spread margins move in the opposite direction to price) reached or exceeded 5% or 500bps over 90day BBSW. An excess supply over demand can originate from 2 sources. The first is the primary market where the issuance of new securities exceeds the demand for securities. Most notably this occurred in the period between 2014 – 2015, initiated, it must be said, by the material upsizing of the CBA's PERLS VII issue CBAPD. The CBAPD issue not only disrupted pricing in the immediate aftermath of its issuance, but it lay the foundation for a materially weaker pricing structure for the ensuing 12 - 18months as the regional and major banks scrambled to issue AT1 capital in order to fulfill their regulatory requirements. The second source of excess supply comes from the secondary market and is typically precipitated by a material equity market drawdown (we define "material" as 20% or greater than 20%) resulting from an event shock such as the GFC or Covid. With APRA's decision to close the market down the risk of an oversupply being generated by new security issuance has been eliminated (while a handful of securities may be "called and rolled" there will be no "new" security issuance). This means the only supply risk investors have to concern themselves with between now

and 2032 is supply generated from secondary market sources. While an increase in supply from secondary market sources cannot be totally ruled out, it is fair and reasonable to expect that should pricing be disrupted, it would likely be disrupted for a short period of time. The reason for this lies embedded in the scarcity factor created by APRA's decision and the desire of investors more broadly to continue to hold until the market's expiry, securities that are characterised by excellent risk adjusted return outcomes along with a high level of income most of which is fully franked.

*Secondary market supply risk is likely to be tempered, as such price stability is almost assured*

So, primary market supply risk has been reduced to zero and secondary market supply, while still concerning should the equity market drawdown heavily, is likely to be tempered and should it be disruptive, would present as a unique buying opportunity. Underpinned by annual franked cash flows not expected to decline below 6.75% for the next 3years (and beyond) there is a high probability that the market's pricing structure will be stable through until the market's termination in 2032. Should it turn out this way, as we think is likely, it means that the AT1 market remains a long-term capital stable high yield investment that should form an integral part of any investor's portfolio. We are reasonably confident in saying in risk (volatility) adjusted terms it will likely remain without peer through until 2032.



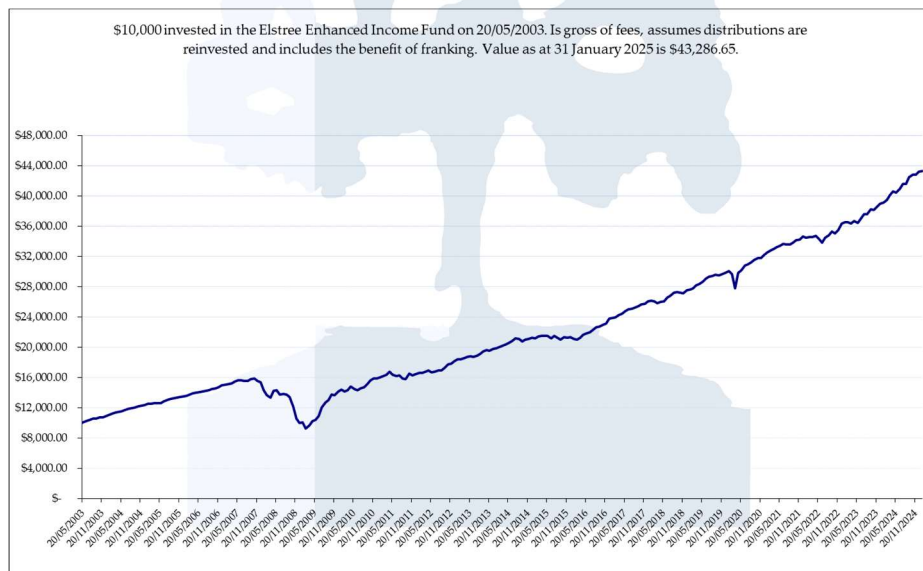
## Elstree Enhanced Income Fund portfolio metrics as at (close of business) 31 January 2025

Performance Table	1 month	3 months	1 year	3years p.a.	5years p.a.
Elstree Enhanced Income Fund *	0.05%	0.99%	9.84%	7.17%	6.88%
Elstree Enhanced income Fund (Basis NAV)	0.05%	0.59%	8.11%	5.64%	5.65%
Betashares Hybrid Fund HBRD (Basis NAV)#	0.34%	1.07%	7.03%	4.64%	3.97%
UBS Australia Bank Bill Index	0.38%	1.12%	4.48%	3.32%	2.05%

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)	6.30%
Cash yield to maturity (excludes franking)	4.90%
Credit term duration (average years)	3.86
Default cost (per annum)	0.09%
Investment grade issuer (% holding)	94.2%
Bank tier 1 exposure (% holding)	62.8%
Value at Risk (VaR)	3.20%

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



#### Disclaimer

The information and opinions contained in this report have been obtained from sources of Elstree Investment Management Limited (ABN 20 079 036 810) believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate or complete and it should not be relied upon as such. Information and opinions contained in the report are published for the assistance of recipients, but are not relied upon as authoritative and may be subject to change without notice. Except to the extent that liability cannot be excluded, Elstree Investment Management Limited does not accept liability for any direct or consequential loss arising from any use of material contained in this report