Elstree

February 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 February 2025 was 0.52%. This compares with the Elstree Hybrid Index return of 0.60%. In other markets the All-Ordinaries Accumulation Index returned (3.96%) while the All Maturities Bond Index returned 0.93%.

"()" Denotes negative return outcome

"You got your easing". Now what?

When the author was working in the NAB in the 1990's he recalls the well thought out and articulated words of the Treasury Economist of the time over the microphone to the entire dealing room referencing the RBA's decision to cut the cash rate at the time, "well, you got your easing". And so, it would have been a similar scenario in dealing rooms around the country on 18 February, when the RBA did what was widely expected and broadly telegraphed and reduced the cash rate by 25 basis points to 4.1% from 4.35%. However, the excitement of an interest rate reduction was short lived when RBA Governor Bullock went on the defensive (in market speak this is termed "hawkish") and warned the markets not to get too far ahead of themselves about expecting another interest rate cut. Clearly, there is more work to be done on inflation with Governor Bullock hosing down the likelihood of future rate cuts. "Be patient" was her response to just about everything she was asked in her post release press conference. The interest rate markets "got it" going from pricing in a terminal cash rate of around 3.6% only a week prior to 3.85% the day after. Spooked, in part, it must be said, by a higher-than-expected inflation "print" in the US, with the sobering rhetoric of Governor Bullock adding to the overall sentiment. December Quarter 2024 GDP data released only this week in Australia did the money market bulls few favours either with the detail surrounding productivity (declining) and unit labour costs (increasing) providing the RBA Governor and Board with additional hawkish material to digest when considering whether or not to cut interest rates again anytime soon. As we well know for the RBA wage inflation is a major stumbling block to a lower cash rate.

Reaction of bank bill futures markets to RBA Governor's hawkish rhetoric

While the money markets can be fickle, the 90day bank bill futures market in Australia has been a reasonably good predictor of the market's expectation of the RBA cash rate since 2022. The chart below, which we have published before, was sourced from data extracted from Trading View on 19February (the day after the rate cut announcement). It is of 90day BBSW futures – a cash rate proxy - from the March contract of 2025 to March 2028. The chart shows the money market's expectation of the RBA cash rate over the next 3years. The market expects a terminal cash rate of about 3.8% which is predicted to occur in the December quarter of 2025 after which time the market is expecting the cash rate to plateau before going back up again (as a postscript we note that at the time of writing the money markets now expect a terminal cash rate of around 3.65% predicted to occur sometime in 1H2026).

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Due to AT1 market being in "run-off" it is no coincidence that greater pricing certainty will be accompanied by reduced risk

For investors in securities that pay a fixed coupon margin over a floating benchmark reference rate linked to the cash rate this remains a good news story. Investors in AT1 securities and our funds can (now) expect to receive annual cash flows including the value of franking credits on average over the next 4years (and potentially beyond) of c6.6% per annum (please note the expected yield to maturity or YTM is around 0.6% lower at c6.0% reflecting the premium price investors are currently prepared to pay for the cash flows). If, as an investor, you combine this with the fact that the AT1 market is transitioning to run-off by 2032 which, in and of itself, will create a supply shortage, you have a backdrop for reducing drawdown risk and ensuring stable pricing. As we flagged in the January 2025 market review supply risk has been materially reduced leading to a greater degree of pricing certainty. We understand that floating rate AT1 securities issued by banks are not the same as more senior instruments including term deposits and Tier 2 securities of the same issuer, but there is an increasing case to mount that due to the unique and extenuating circumstances as the AT1 run-off commences and the transition period gets closer to maturing it's no coincidence that greater pricing certainty will be accompanied by reduced risk. It's almost akin in AFL football parlance, to being awarded a down field free kick in front of goal.

The narrowness of traded spread margins reflects the market's sanguine view of risk

Investors in AT1 securities are in broad agreement as evidenced by current market pricing with average weighted prices across the breadth of the AT1 invisible universe priced above PAR at around $103 (this means that traded spread margins are narrower than fixed coupon margins). Should AT1 investors be at all concerned about the sum of the risks then it would be reasonable to expect, that as a collective, securities would be priced closer or perhaps below PAR. They aren't. We know that as a security approaches "first call" (and at APRA's determination it will not be rolled but rather redeemed) its price will move closer and closer toward $100 (securities are redeemed at PAR or $100). With the exception of extremely 'short' to first call securities, the market is not differentiating all that much by term with traded spread margins from 12months to 7years to first call, broadly similar across the term structure of the universe. Traded spread margins, on average present at around 210 basis points over 90day BBSW. This compares with the average weighted fixed coupon margin of about 300 basis points. The key takeaway is that the narrowness of traded spread margins embodies the market's sanguine view about the risk between now and 2032.

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We agree with the market's assessment of risk and have positioned our portfolio accordingly

As a portfolio manager of AT1 securities we are cognisant of term risk and what it means for security pricing. We actively manage this risk against that of the market at large. Keen observers of our "Ready Reckoner" on page 4 will note that at c3.89 years our term to first call (referred to as "credit term") is currently as long as it has been in a long time (3.89years to first call compares with the broader market as determined by the Elstree Hybrid Index Franked Series of 3.08years). This is a "window" to our view on both risk and where we think we can extract the most value. We are of the view that longer term to first call securities represent better value than shorter term to first call securities. This means we think that the prices of long term to first call securities will rise whereas we think that short(er) term to first call security prices will plateaux and then fall as they approach their call date. Our view is based on the expectation that as securities are called and redeemed a percentage of the redemption monies (there is c$2.3bllion to be redeemed by the ANZ and CBA banks by 15 April) will likely be reinvested in existing securities. It is reasonable to expect, assuming investors are happy to continue to invest in the outstanding inventory of AT1 securities which have served them so well in both a return and risk sense over the last decade, that longer term to first call securities will be the preferred investment (investing in longer term to first call securities also reduces reinvestment risk). With rolling into a new security now not an option (because of APRA's determination) this lays the foundation for a demand/supply mismatch. The potential of this mismatch is driving our thinking at present. Our portfolio is positioned for such an occurrence. The table below details our positioning by sector and term *vis-à-vis* the broader market as at, 28 February 2025. The portfolio's tilts are highlighted with overweight positions being represented in green and underweight positions in light orange.

Sector Description	Market Weight (%)	Portfolio Weight (%)	Difference +/-
Short Majors	10.5	1	-9.5
Medium Majors	27.3	23	-4.3
Long Majors	31.8	37.9	6.1
Short Regional	5.8	2.6	-3.2
Medium Regional	5.7	3.3	-2.4
Long Regional	10.3	20	9.7
Short Corporate	1.2	1.9	0.7
Medium Corporate	0.6	2.4	1.8
Long Corporate	0.5	0.5	0
Uncorrelated	1.5	5.8	4.3
Near Cash (cash)	4.8	1.6	-3.2
Term to call	3.08 years	3.89 years	0.81 years

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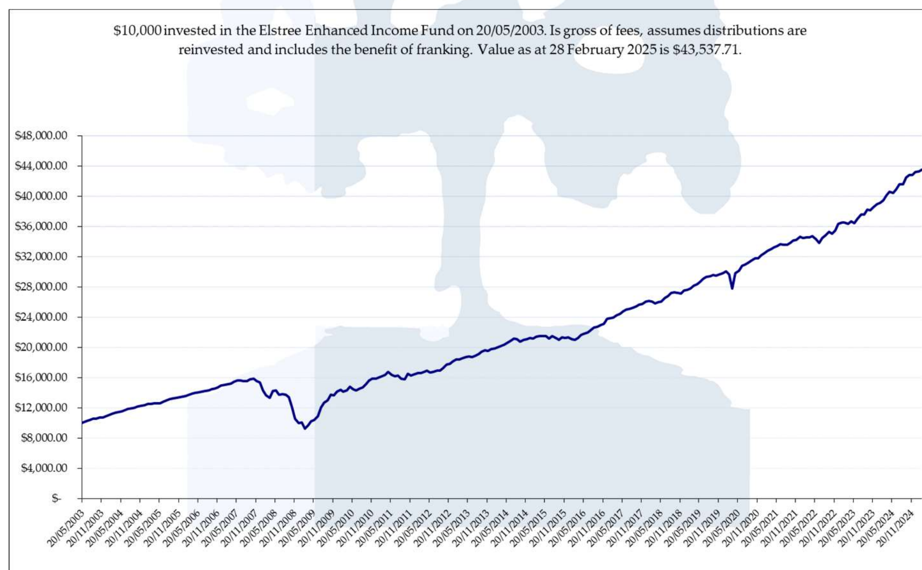
Elstree Enhanced Income Fund portfolio metrics as at (close of business) 28 February 2025

Performance Table	1 month	3 months	1 year	3years p.a.	5years p.a.
Elstree Enhanced Income Fund *	0.52%	1.47%	9.57%	7.27%	7.28%
Elstree Enhanced income Fund (Basis NAV)	0.48%	1.06%	7.86%	5.74%	6.04%
Betashares Hybrid Fund HBRD (Basis NAV)#	0.51%	1.39%	6.81%	4.77%	4.38%
UBS Australia Bank Bill Index	0.34%	1.10%	4.48%	3.44%	2.10%

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.

Metric	Value
Yield to Maturity (includes franking)	6.20%
Cash yield to maturity (excludes franking)	5.00%
Credit term duration (average years)	3.89
Default cost (per annum)	0.09%
Investment grade issuer (% holding)	94.4%
Bank tier 1 exposure (% holding)	61.9%
Value at Risk (VaR)	3.20%

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



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