April 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 April 2025 was (0.26%). This compares with the Elstree Hybrid Index return of (0.17%). In other markets the All-Ordinaries Accumulation Index returned 3.60% while the All Maturities Bond Index returned 1.70%.

"()" Denotes negative return outcome

April was indeed an extraordinary month for risk markets. Al least the AT1 market behaved as we expected it would.

How to make sense of something that in nonsensical. It's nigh impossible. The most concerning thing is that the events of April have few precedents. Yes, it is a type of "event shock", however, it is one that we are unfamiliar. Managing risk assets under such circumstances is extremely difficult. Price movements of large market capitalisation indices such as the S&P500 in the US of 10% in a day are disturbing. Even the US treasury bond market, the so called, safe haven asset, was not immune to the volatility - the benchmark US 10year bond had its worst week in 25years rising in yield over the week beginning 7 April from 3.99% to 4.49% (it is currently priced at 4.31%). The upward movement in yield equates to a 4% reduction in the capital value! Thankfully, AT1 securities are typically not all that volatile and while there is a correlation to ordinary equity it is only around 10%. The broader hybrid market as determined by the Elstree Hybrid Index (franked series) behaved pretty much as our modelling predicted it would, falling by around 1.0% in the week beginning April 7 - not a bad outcome in the scheme of things. Meanwhile 90day BBSW futures, a cash rate proxy, oscillated in the same week between pricing in 3 and then 4 and then back to 3 again, 25 basis point interest rate cuts. The pricing behaviour of risk markets of this magnitude is very disruptive and erodes investor confidence. Unfortunately, it flows through to "main street" as well. One can only empathise with those superannuants who decided to cash out their portfolios on Monday April 7, only to have the US equity market rally 10% overnight! Unfortunately, it did happen.

The Rip Van Winkle moment

The month of April was eventful for a number of reasons. The first was the volatility of risk markets as we articulated above. The second was what we coined the "Rip Van Winkle moment", where if, as an investor, you had fallen asleep on the last day of March and woken up on the last day in April, you would have been blissfully unaware of the extraordinary events of the month. The chart below and overleaf details the performance over the month of the All Ordinaries Accumulation Index (orange line) and the ASX listed hybrid market as denoted by the Elstree Hybrid Index (Franked Series, blue line). Base 100 is 31 March, and the last data point is 30 April. The performance of both markets is typical of what we have come to expect. While the broader Australian equity market finished 3.6% higher over the month it did drawdown heavily. By contrast the hybrid market drew down by about 1% closing 0.17% lower over the month and of course, it was much less volatile.

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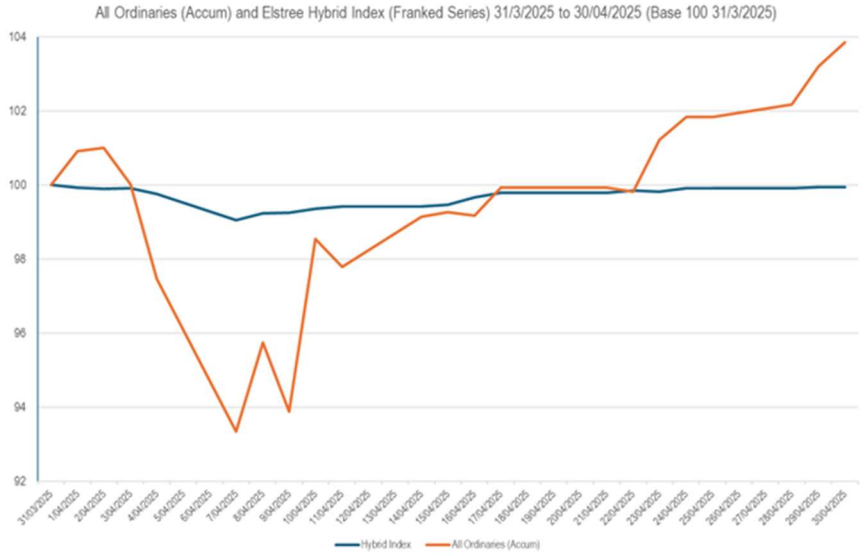

Price disruption and a market that is being closed down by the regulator make for a unique confluence of events

To say that we are living in interesting times would be an understatement. Not only has the AT1 market been subjected to price disruption and volatility, but it is being closed down by the regulator as well. This is indeed a unique confluence of events. Without question the risk associated with investing in AT1 securities is declining. Readers will understand that the biggest risk posed by an investment in AT1 securities is supply risk. And we know supply risk has been materially reduced because the banks are no longer permitted to issue AT1 securities in the primary market (i.e IPO). While secondary market supply still poses a risk and will until the market's expiration, it is decreasing by day, just as extension risk, equity conversion and default risk are. Along the pathway to 2032 there will be at point where investors will show a preference, after considering the additional compensation they receive, for investing in AT1 securities over more senior instruments including term deposits of the same bank. There is a case to argue that point is approaching with the total expected return outcomes of AT1's as a collective around 3.0% above the average term deposit rate as determined by the RBA (Source RBA Average All Terms advertised deposit rate). Based on historical default cost data the risk of an Australian bank defaulting on its unsecured AT1 obligations over the average 3.5year life of the AT1 market is approximately 10bps per annum. The question investors have to continually ask themselves, is the 300bps or 3.0% differential between the average term deposit rate of 3.10% and the yield to maturity of the AT1 market in aggregate (6.10%) sufficient to compensate for the sum of the risks, which of course are declining? Certainly, if default risk, arguably the greatest risk posed by an investment in AT1 securities, is calculated to be only 10bps on an annual basis there is no case to answer and while the probability of extension and equity conversion risk are not zero (APRA has stated that while outstanding AT1 securities can be counted as tier 2 securities they will still be subject to the existing legal terms and conditions, including subordination until redemption), the probability of their occurrence is extremely low.

Declining risk not the only driver of spread margin

Amid a backdrop of declining risk, we continue to mount a case for traded spread margin contraction. Our outlook is based not only on a reduction of the various risk factors over time but on a demand/supply mismatch as well. We have opined before about the demand/supply mismatch, but it makes absolute sense that investors will continue to invest in the outstanding inventory (albeit a declining one) of AT1 securities which have served them so well in both a return and risk sense

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contraction and a higher pricing structure

over the last decade. We continue to believe that that longer term to first call securities will be the preferred investment vehicle and have weighted our portfolio accordingly. The question is far can AT1 traded spread margins contract? On face value every individual AT1 security that is approaching redemption should be priced closer to more senior instruments of the same issuer as default, extension and equity conversion risk approach zero. Without wanting to quantify just exactly how far traded spread margins of the broader AT1 market in aggregate and on average can contract or to what absolute level, it is not inconceivable they could approach those of unlisted, and less liquid, bank issued tier 2 securities which are currently priced around 175bps over swap.

Because of declining risk, risk and return models such as the Sharpe Ratio will continue to get better and better over time

There is little doubt that APRA's decision, has, in and of itself, created a more stable pricing structure. While the AT1 market is not devoid of volatility (as evidenced by its behaviour in the week beginning April 7), it is moderating and is expected to moderate further still, its moderation being a function of greater redemption certainty as the market is run down. Declining volatility will impact risk adjusted models such as the Sharpe Ratio that uses volatility as an input. The Sharpe Ratio is a metric widely used by investment advisers to compare the returns outcomes across different asset classes. The ratio is calculated by deriving the excess return, or the difference between the total investment return and the risk-free rate and then dividing the excess return by the volatility. The higher the outcome the better the excess return is adjusted for volatility or risk. The Sharpe Ratio of the ATI market is currently around 1.25 (i.e 6.1% (YTM) less 3.6% (3year bond/swap rate) divided by 2% (annual volatility). By contrast Australia's S&P200 Index is currently expressing a Sharpe Ratio of about 0.15. As the denominator (i.e the volatility) declines, as it is expected to do, the Sharpe ratio of the AT1 market can only go up. With annual investment return outcomes predicted to average around 6%p.a. (inc franking) and volatility transitioning lower and lower over time, in a risk adjusted return sense an investment in the AT1 market will have few, if any peers.

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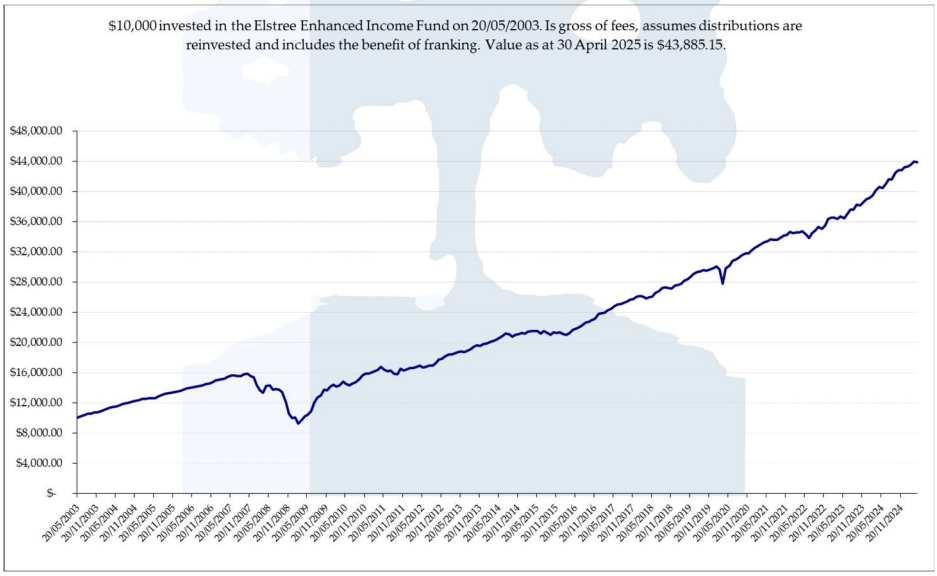
Elstree Enhanced Income Fund portfolio metrics as at (close of business) 30 April 2025

Performance Table	1 month	3 months	1 year	3years p.a.	5years p.a.
Elstree Enhanced Income Fund *	(0.26%)	1.26%	7.48%	7.45%	7.37%
Elstree Enhanced income Fund (Basis NAV)	(0.29%)	0.85%	5.84%	5.84%	6.09%
Betashares Hybrid Fund HBRD (Basis NAV)#	(0.18%)	0.46%	5.23%	4.65%	4.65%
UBS Australia Bank Bill Index	0.35%	1.04%	4.46%	3.68%	2.21%

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)	6.26%
Margin to maturity (over swap)	2.44%
Credit term duration (average years)	3.79
Default cost (per annum)	0.07%
Investment grade issuer (% holding)	94.2%
Bank tier 1 exposure (% holding)	60.1%
Value at Risk (VaR)	3.14%

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



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