October 2025 Review – Listed Hybrid Sector

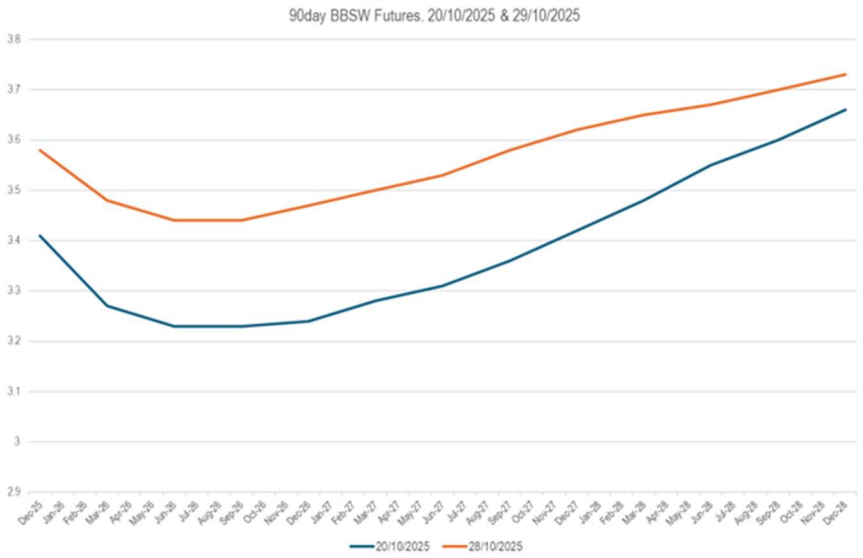
Fund and market performance

The Elstree Enhanced Income Fund's investment return net of fees and including the value of franking credits for the month of October 2025 was 0.69%. This compares with the Elstree Hybrid Index return of 0.55%. In other markets the All-Ordinaries Accumulation Index returned 0.49% while the All Maturities Bond Index returned 0.36%.

"()" Denotes negative return outcome

The money markets have all but given up on any further cuts to the OCR with a terminal OCR of 3.45% now priced in. As an investor in floating rate instruments, we are happy with this prediction

There can be no denying that the money markets are reactive. They are extremely sensitive to economic data releases and central bank rhetoric and are prone to changes in direction and thinking as indeed they should and are entitled to be. As an investor in floating rate instruments that pay a fixed coupon margin over 90day BBSW – 90day BBSW being a cash rate proxy - it is hard to not get caught up in the "noise" from time to time. The chart below, which is of 90day BBSW futures is sourced from "Trading View". The chart details the money markets expectation of 90day BBSW on 22 October (blue line) and 29 October (orange line). On 22 October the Australian money markets were pricing in a terminal cash rate of circa 3.2% (i.e a 40bps reduction in the official cash rate or OCR) having digested an unexpected rise in the unemployment rate around the same time. On 29 October, following a surprise surge in the trimmed mean rate of inflation (the RBA's preferred inflation measure) saw the money market almost give up on a rate cut entirely (this expectation was subsequently confirmed by the RBA's Cup Day decision to hold the line on interest rates). The money markets now expect a terminal cash rate of around 3.45% which is only 0.15% or 15bps below the current cash rate of 3.6%. The 90day BBSW futures curve has shifted sharply higher. As an investor in floating rate instruments, we are happy with the money market's expectations (orange line) as it now means, if the money markets are correct in their collective thinking, that the annual cash flows on bank issued AT1 securities will not likely fall below 6.45% (assumes a fixed coupon margin, including the value of franking of 3%) between now and the expiration of the market timed for 2032. We note that the expected yield to maturity or YTM is around 5.75% reflective of the robust investor demand for the high yield franked cash flows.



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As the risks typically associated with a subordinated investment of the type decline, there is a case to argue that over time an investment in it will present more like a cash plus investment albeit with a higher expected return outcome

While the AT1 is not risk free there is a case to argue that as the risks typically associated with a subordinated investment of this type decline steadily over time due to the enforced call, an investment in it, will behave more like a "cash plus" investment, albeit one with a higher expected return outcome. Certainly, liquidity is excellent, credit quality sound (Australian banks and insurers) and volatility low (and getting lower) - all the hallmarks of a cash plus "type" investment. We can't promote an investment in the AT1 hybrid market or indeed our fund(s) as a cash or near cash alternative because the risks typically associated with a subordinated investment of this type will continue to exist, albeit those risks are accompanied by a declining probability of occurrence as 2032 approaches. And we certainly wouldn't advocate an investor allocate all their liquid assets to the bank issued AT1 hybrid market but there is a groundswell to make an allocation, or if one (an allocation) has already been made, to increase it. Certainly, bank issued AT1's, compare most favourably with more senior instruments of the same issuer including term deposits, recognising, of course that TD's and AT1's are not fungible. The RBA publishes a series called the All-Terms Average Term Deposit Rate. This rate, which is the average deposit rate across all terms (i.e 1month, 3months, 6months 5years etc), on 8 October was calculated by the RBA to be 2.85% which is 75bps below the official cash rate and cash rate proxies such as 90day bbsw which stand at 3.6%. We know that the money markets predict 90day bbsw to remain above 3.45% (refer chart above) which means that the average annual cash flow (assuming an average fixed coupon margin of 3% including franking) is not expected to fall below 6.45%. While the expected yield to maturity (YTM) of the broader AT1 market is lower at approximately 5.75%, reflecting the strong demand and premium price for the high franked cashflows, the differential between the RBA's average TD rate and a bank issued AT1 hybrid market's expected yield to maturity is compelling as it approaches 3%. In view of the decreasing risk associated with a bank issued AT1 investment, for each year in advance of 2032, as an investor, what you have to ask yourself is, is the additional 3% annual return worth the risk? The average TD rate is only just keeping pace with the rate of inflation while a bank issued AT1 will return an investor almost 2 times the rate of inflation all the while displaying, excellent liquidity and low volatility. While term deposits that carry a government guarantee are default risk free, they are not without liquidity and refinance risk.

The Australian banks are rock solid from the capital, funding and quality of loan perspective. The data according to the RBA's chart pack of October 1

In referencing the risks associated with Australian bank issued AT1 securities we thought it would be timely using RBA sourced data to consider some key bank metrics. The charts below are extracted from the RBA's Chart Pack of 1 October 2025. The first chart details the total capital position of the banks – it includes common equity tier 1 (CET1), alternative tier 1 equity (AT1) and tier 2 subordinated debt. The second chart details the Australian banks' domestic sourced non-performing loans. The third chart details the banks' funding mix. The takeaways are many. First and foremost, the banks are incredibly well capitalised. From a low of around 10% of risk weighted assets (RWA) just prior to the GFC the banks now have around 20% (green line chart below) comprising common CET1, AT1 and Tier2 capital. In laymen's terms, this means quite simply, they are safe entities. With the benefit of hindsight, the banks weren't all that well capitalised around the time of the GFC and as such carried greater risk. From the capital perspective they have been materially de-risked. The second chart highlights the composition of bank non-performing loans. While there is a small uptick it is not material. The key takeaway is that there little or no stress in their home loan books which comprise far and away the biggest proportion of their loans. The third chart highlights the change in the banks' funding mix. The key takeaway is that short term funding is not overrepresented as it was prior to the GFC. A fraction more than 60% of bank funding – a percentage of which is government

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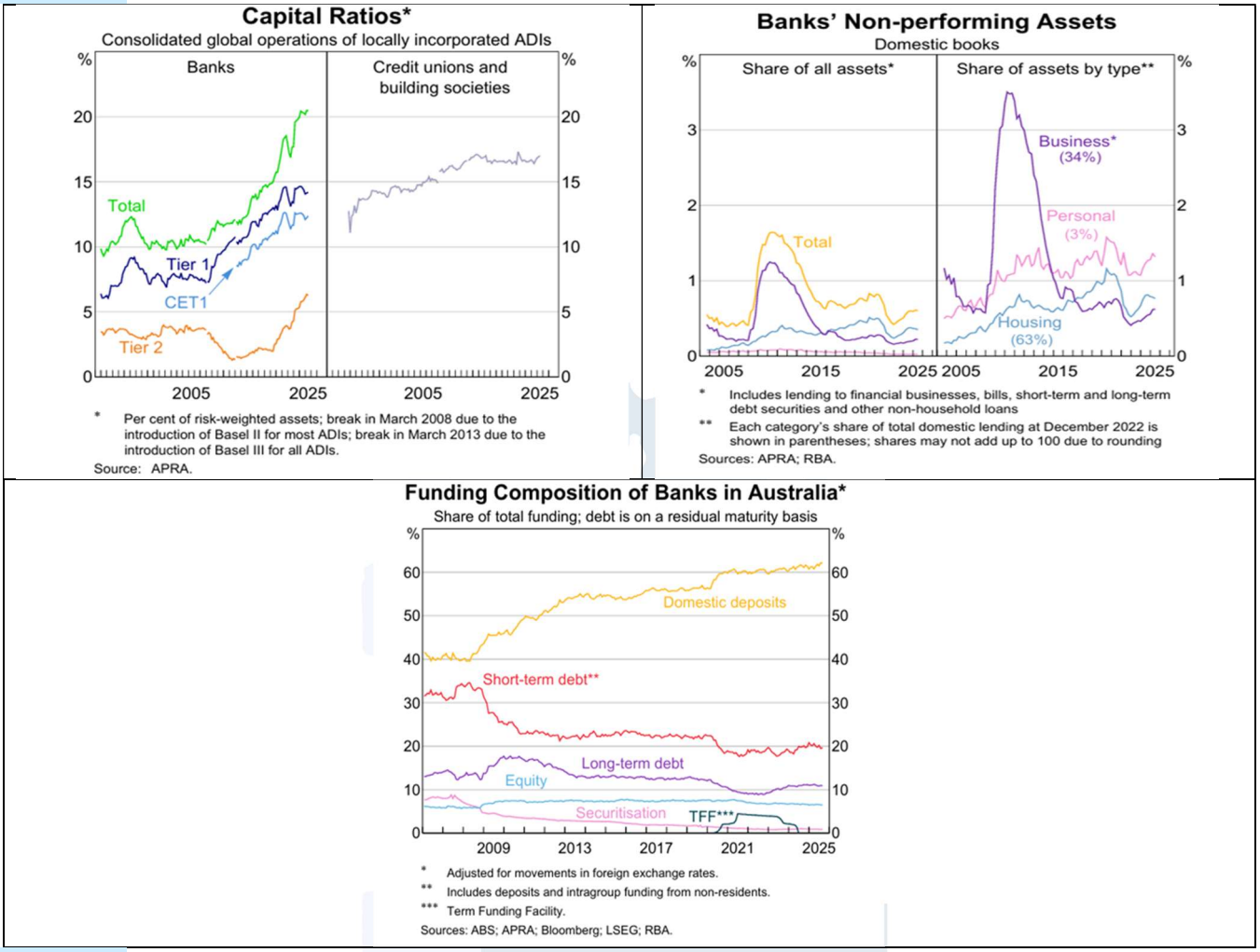
guaranteed - is now sourced from domestic term deposit funding from a low of around 40% pre GFC. As we opined previously it's not hard to see the direct impact that the margin between term deposit and lending rates has on Australian bank profitability.



….this begs the question, just how at risk is an investment in a bank issued AT1 security?

The author was at a conference about a fortnight ago where one of the keynote speakers described the Australian banks as "bullet proof". And you know, he is most likely right! Not only are they well capitalised and well-funded and their non-performing loans underrepresented but they are extremely profitable as well which enables them to bolster capital organically. It almost seems incredulous that an Australian bank could get into any difficulty whatsoever, indeed APRA has deemed them simply "too big to fail". This begs the question, just how *at risk* are bank issued AT1 instruments given the underlying balance sheet strength and profitability of the issuing entities in an environment where the AT1 market faces extinction in 2032? The answer is rather obvious.

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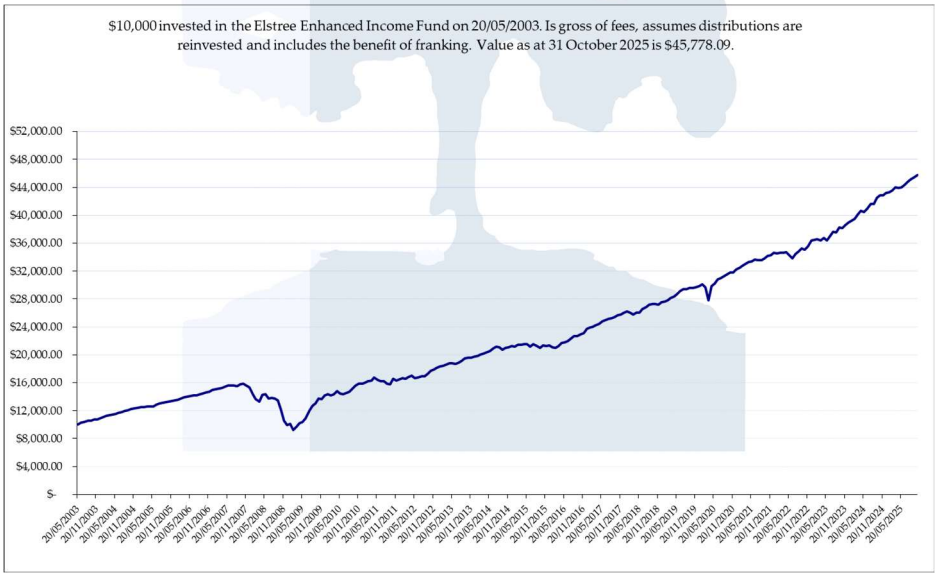
Elstree Enhanced Income Fund portfolio metrics as at (close of business) 31 October 2025

Performance Table	1 month	3 months	1 year	3years p.a.	5years p.a.
Elstree Enhanced Income Fund *	0.69%	2.02%	6.30%	8.62%	6.90%
Elstree Enhanced income Fund (Basis NAV)	0.67%	1.63%	4.63%	6.90%	5.54%
Betashares Hybrid Fund HBRD (Basis NAV)#	0.49%	1.50%	4.99%	6.04%	4.45%
UBS Australia Bank Bill Index	0.30%	0.91%	4.11%	4.07%	2.58%

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)	5.85%
Cash yield to maturity	4.55%
Credit term duration (average years)	3.76
Default cost (per annum)	0.07%
Investment grade issuer (% holding)	89.0%
Bank tier 1 exposure (% holding)	63.1%
Value at Risk (VaR)	3.17%

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



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