Elstree

February 2017 Review – Listed Hybrid Sector

Performance

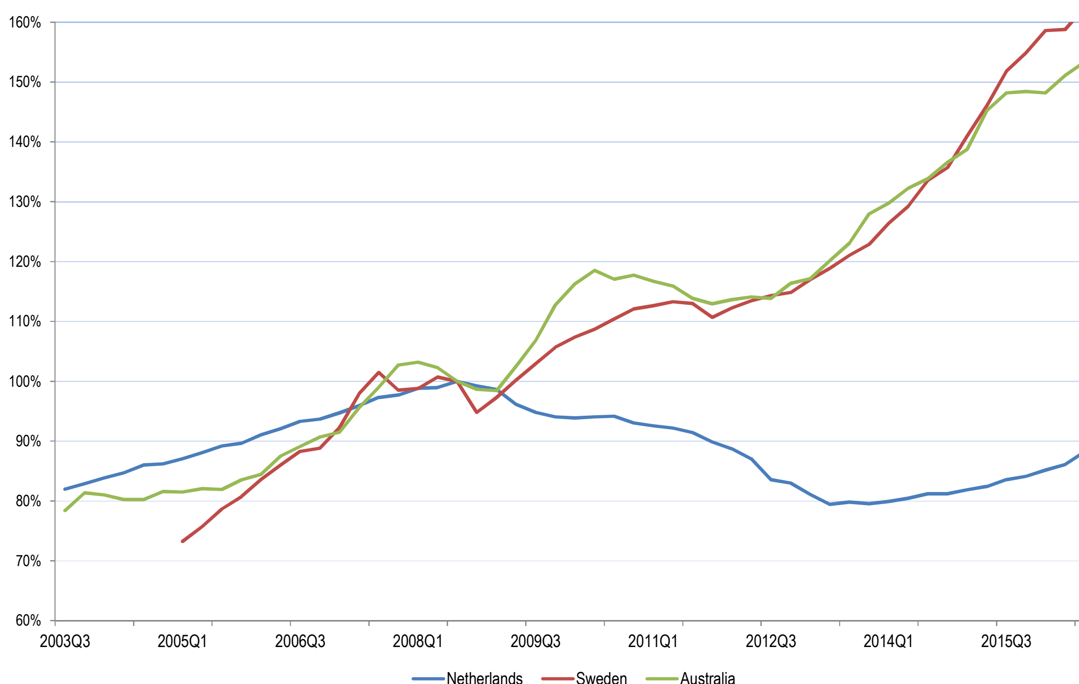
The Elstree Enhanced Income Fund's total investment return for February 2017 was 0.32%. This compares with the Elstree Hybrid Index return of 0.22%. In other markets the All Ordinaries Accumulation Index returned 2.09% while the All Maturities Bond Index returned 0.17%.

Events

Reporting season only produced a few surprises and unsurprisingly Crown Resorts was one of them. At their result they announced a large dividend, a reversal of their previous announcement that they would spin off some of their assets into a (partly) externally funded REIT and a buyback of the CWNHA note. We suspected that after the sale of their Macau interests, they would have sufficient capital to maintain their rating and do all their casino building, but we underestimated it. They have loads of excess capital. We thought it was unambiguously good news for the CWNHA/HB notes, so we added to our positions. Interestingly there was one institutional broker selling (we don't understand their actions), so that makes a market and allowed us to get set. The notes are up by around $2 since the announcement.

Who cares about the Cloggies?

We're always interested in what makes banks go bust, so the chart below interests us for a few reasons. It shows house prices in the Netherlands, Sweden and Australia since 2002 (base 100% is Q3, 2008). It is uncanny how highly correlated the Scandie and Australian house prices are, but more interestingly, the Netherlands has a housing market that has experienced a 20%+ fall in prices. We don't often think about the Netherlands except they have a language that nobody speaks, invented Holstein cows (the king of dairy) and enjoy bad summers, but there are some interesting parallels to Australia.



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So what happened in Holland?

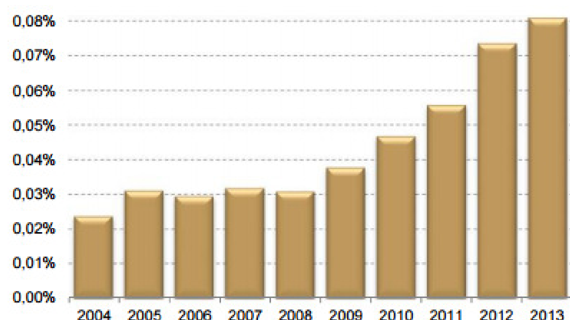
Prior to the house price fall, the Dutch economy shared many attributes with Australia: strong growth in house prices (💣✓), high house prices (💣✓), high and increasing gross (but low net) household debt levels (✓😐), tax deductible interest (✓☺: investment loans are c40% of Australian bank mortgages), lack of housing supply (✓☺) , so it's pretty easy to make some meaningful comparisons.

From 2008, the Dutch economy suffered the following problems:

- GDP fell 3.2%,
- Unemployment went from 3.8% to 8.5%,
- House prices fell 21% and
- Housing turnover fell by half and banks stopped lending.

Clearly it was a nasty episode, but more interesting was the effect on banks. The chart below shows mortgage losses for Dutch banks. The losses were a rounding error. The second chart shows the loan losses/total loans of the Dutch banking system and NPAT/Loans (we've added ANZ loan loss data as a comparison). Mortgage lending isn't a big part of the Dutch banking system (large rental market, large business lending), and banks have larger business loan books which are more volatile. As you would expect, the large business loan book meant that there were reasonable losses during the 2008 - 2013 crisis/recession, almost all of which was not attributable to residential mortgages. Total loan losses were peaked at around 1.5% of loans (which is similar to Australia early 90s) and the system made a loss in 2009. At the same time, the effect of a nasty economy on the banking sector was relatively muted, less than other countries and relatively short lived with only one year of zero/negative profits before recovery.

Figure 4: Losses incurred on mortgages by Dutch banks



Source: main Dutch mortgage lenders (ABN AMRO, ING, NIBC, Rabobank, SNS), calculations by Periscoop Consult

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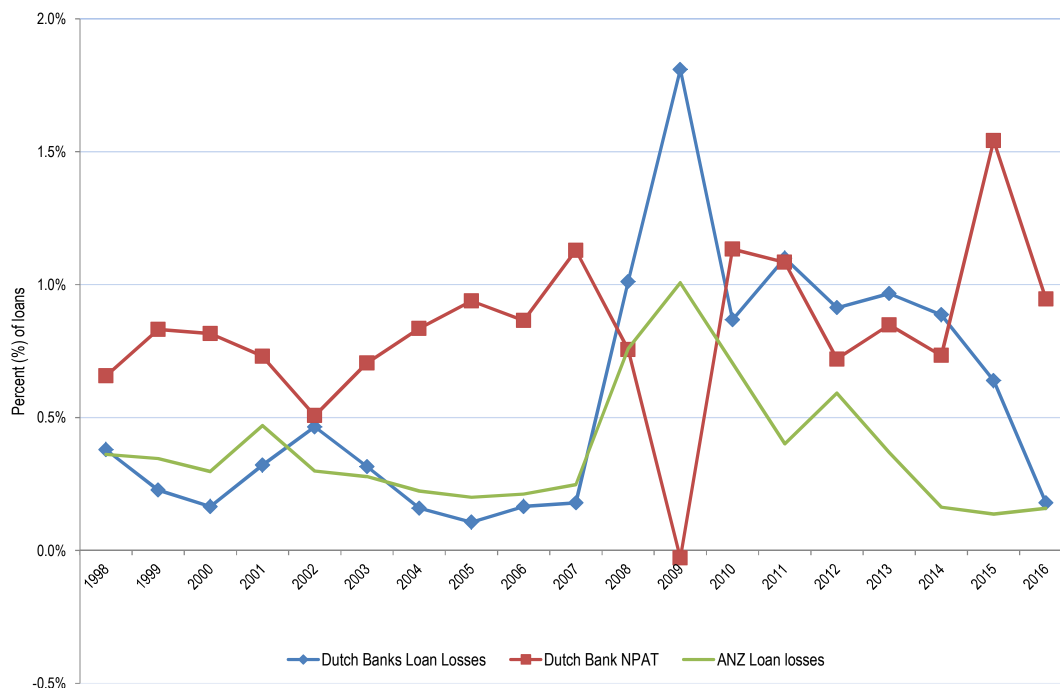

So why didn't Dutch banks lose money on mortgages?

This is the dog that didn't bark. With all the structural issues, there was a recession and still no losses. Part of us doesn't understand that, but the other part of us is still on our, fruitless to date, 5 year quest to find a bank that only did sensible <80% loan to valuation (LTV) prime mortgage lending and went bust. Even in the depths of the GFC in the US, it was only the banks doing really stupid things that went bust. We think the lack of losses in the Netherlands can be attributed to;

- The Dutch have a very good system of unemployment insurance so incomes didn't drop much when unemployment rose. This is not the case in Australia.
- By and large mortgagees had other assets, so even though the incidence of negative equity reached 30%, very few defaulted. This is the case in Australia where, generally, mortgagees have lots of equity or lots of other assets.
- A cracker of a bankruptcy system. If you default you lose your house in about 12 months. You either come up with additional collateral, sell the house before the bank does or lose your house and still owe the outstanding debt. By comparison, in much of the US you can hand back the keys and in Italy, it takes about 8 years to be bankrupted. Australia is more like the Netherlands than Italy. Although it's hard to quantify, Dutch people also pay their debts; it's a cultural thing.
- Low moral and structural risk. Most mortgages and all the first losses are kept on bank balance sheets, so compared to the 'originate and sell model' of the US, Dutch mortgage lenders are in the "you break it, you pay for it" class. Consequently loan underwriting is not particularly risky. In addition, the central bank has demanded some quite tough prudential lending criteria. There is a clear parallel to Australia and a clear contrast to the US.

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So what are the implications for Australia?

APRA conducted a series of stress tests in 2014 using factors which were around twice as tough as the Dutch. This resulted in a (modelled) loss of around $40b which is around the peak loan loss rates experienced by Dutch banks. APRA expected residential mortgage losses of around 1%, which is a multiple of Dutch losses and a multiple of the 1990s experience. Even given the APRA stress test results, bank capital levels did not fall into the "non-viable" range. Two other major issues are that (i) Australian banks are more profitable by a factor of 2 – 3 times and (ii) bank equity levels have doubled since 2009 increasing by around 15% since 2014. Regardless of whether the world turns out like the Netherlands or the APRA stress test, it's really difficult to come up with scenarios where residential mortgage lending destroys an Australian bank. However, it's easy to come up with scenarios whereby bank share prices are pressured by the gradual roll down of return on equity to single figures. Increasing regulatory capital requirements, slow growth and increased competition, all point to much lower RoE's and pressure on dividends and prices.

Implications for hybrids

The biggest concern for many investors in hybrids has been the non viability equity conversion clause and that has been part of the reason why spread margins have been so high (and returns so good) for so long. We've always had a more benign view than the market given the super viability of Australian banks, but clearly there is still a lot of pessimism present in the market. At current spread margins, investors are getting compensated for the fat tail event (if banks do fail), scar tissue remaining from the GFC experience, and expectations of a medium (high?) probability that non viability clauses will be triggered in the lifetime of the current AT1 securities. We think that eventually pricing will reflect much less of the 2nd and 3rd factors.

Fund characteristics as at 28 February 2017

Yield to Maturity	5.2%
Cash yield to maturity + franking (income yield)	4.8%
Investment grade issuer	89%
Fund average term (years)	3.7
Bank Tier 1 exposure	40%
Property exposure	7%

Performance Table	1 month*	3 months	12 months	3 years (p.a.)	5 Years p.a.
Elstree Enhanced Income Fund	0.32%	3.55%	13.95%	6.17%	6.76%
UBS Australia Bank Bill Index	0.13%	0.45%	1.98%	2.32%	2.44%

*Returns are gross of fees and include the benefit of franking credits. Past performance is not necessarily a guide to future performance.

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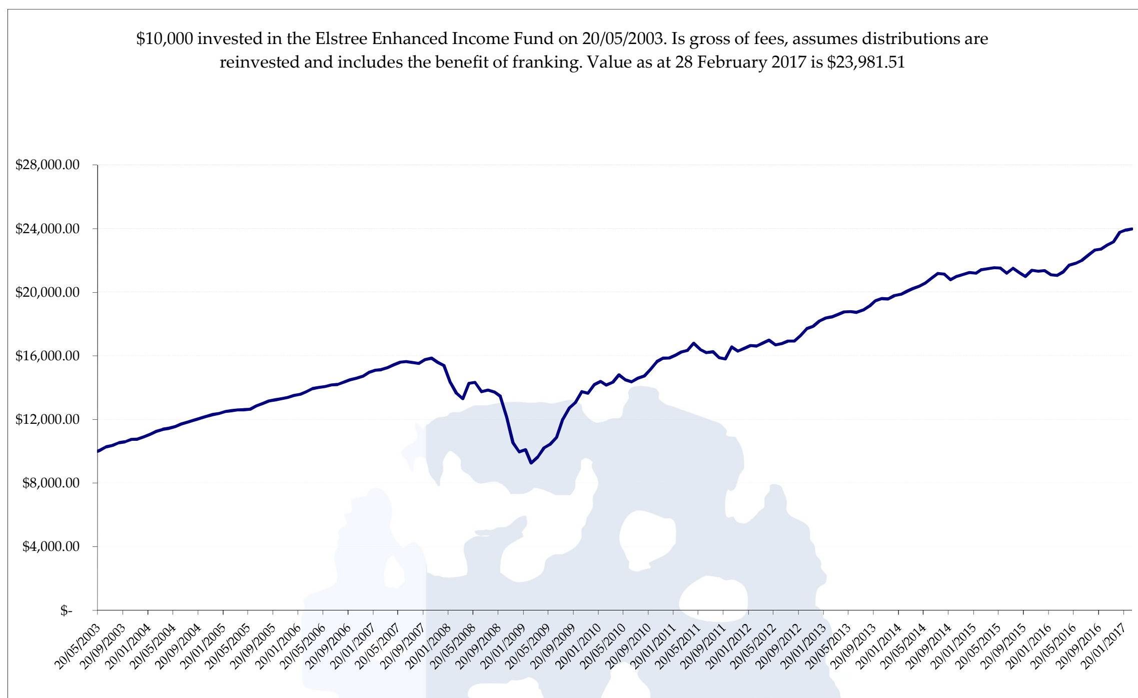
Value of $10,000 Invested on 20/05/2003



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