February 2018 Review – Listed Hybrid Sector

Performance

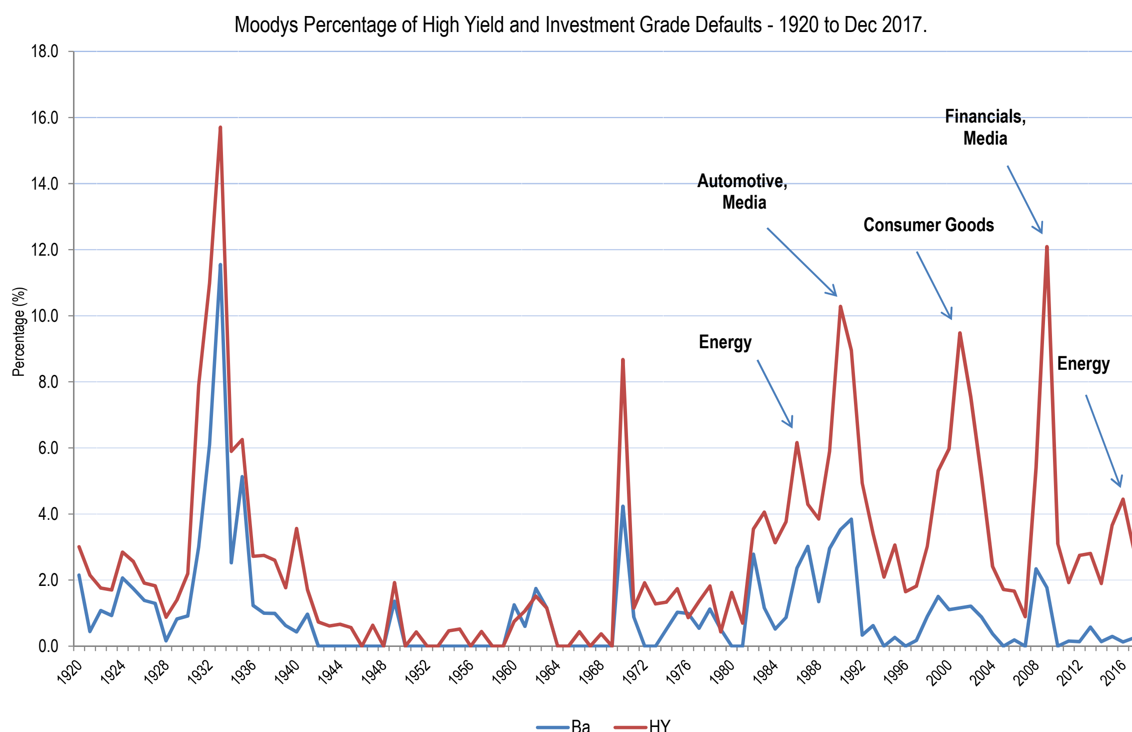
The Elstree Enhanced Income Fund's total investment return for February 2018 was (0.48%). This compares with the Elstree Hybrid Index return (0.38%). In other markets the All Ordinaries Accumulation Index returned 0.18% while the All Maturities Bond Index returned 0.29%.

Events

That was a volatile month. Equity markets fell 4% in early February before recovering to finish 'flat' over the month. Hybrids finished lower, which was a combination of the equity market volatility, a WBC hybrid issue which was around $200m more than investors expected (and they had to sell stock to fund their bids), and expectations of an upcoming CBA offering. WBC will now move to the 'naughty corner' with CBA in regards to having to be more certain about their issue sizing.

Defaults: another uneventful year

February is Groundhog day month for credit market nerds. Moodys publish their annual default study and for 7 out of 10 years, not much happens (groundhog day: go back to sleep). This year was one of those, which is good because it means it's been a boring year. Nothing that was investment grade as at 1/1/2017 defaulted during the year and around 3% of sub investment grade issuers defaulted. Overall default rates were just over 1%, which is around median levels. However, over the last few decades, the overall default and high yield default rates have been boosted by a higher proportion of lower rated issuers (who default more often). The chart below shows this with default rates of "Ba" and all 'high yield' since 1920. We've also shown the industries which were over represented during default spikes.



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Once a decade

Since the 1970's, it's a once a decade spike in defaults for investment grade and the upper end of the high yield market. Defaults in those sectors invariably coincide with recessions. For the lower end of the high yield market, there are always defaults, and they can get quite chunky in recessions. Interestingly, there are always industry clusters of defaults. Energy is the most cyclical of industries and the large majority of defaults over the last 3 years have been due to energy (particularly shale energy) when the oil price fell. However, other sectors which have been disproportionately represented in high yield defaults include media, construction and finance (during recessions).

Default predictions going forward: pretty clean

Two of our forward indicators are indicating another sleepy year. Moodys use a model to predict high yield defaults and it is forecasting that default rates will fall to 1.7% in 2018. If that occurs, it will be the second lowest default rate since 1981. The chart below shows the Kamakura Troubled Company Index, which has been an excellent predictor of the default rates 12 months ahead. It forecast the GFC default avalanche over a year before it happened, and also it picked the peak of defaults in 2009 about 12 months before. Currently conditions are in the best 28% of observations since 1990 and it's predicting subdued default activity over the next 12 months.

TROUBLED COMPANY INDEX

Current Index Value: 8.93 | Period Percentile Rank: 28.14% | Period Average: 14.53 | Period High: 46.26 (12/26/2008) | Period Low: 3.76 (9/1/2014)

Description	% of Universe	1 Day Change	1 Month Change	3 Month Change	6 Month Change	1 Year Change
KDP > 1%	8.93	-0.54	0.45	1.43	0.90	0.62
KDP > 5%	1.53	-0.11	0.15	0.35	0.10	0.00
KDP > 10%	0.42	-0.08	0.01	0.12	0.02	0.01
KDP > 20%	0.08	-0.01	-0.01	0.03	0.01	-0.01

So where are we at?

We'll start with the observation that the default position for an investment grade credit investor is to be invested. The reason is that the margin over risk free rates is sufficient to compensate for the default risk. If you bought every 5 year "BBB" bond at the start of every year, you would have outperformed the risk free government bond for that 5 year period in every year but one since the 1950s. The default cost on that cohort of bonds has (almost always) been less than the additional yield investor's receive over the risk free government bond rate. It's more cyclical the lower you go down the credit spectrum, but over the long run there is always a gain. However, if you can forecast a recession or near recession, selling can be extremely profitable. Notwithstanding the extremely positive non recession forecasts, there are some issues. These issues are;

- The non-default cycle is now very long lived and over the post 1970's pain free average (but still well below the 1940-1970 experience) ☹
- There has been an overall increase in leverage and other negative debt metrics over the past few years, and valuations are expensive☹

- There's no recession in sight and if that continues, we'll see little stress on investment grade or high non-investment grade debt.☺
- We can't see any obvious industry bubbles and the 2 largest debt widow makers (energy and Commercial Real Estate) seem okay and within normal valuation parameters.☹

Hybrids

Most Australian investment portfolios have material exposures to banks and as a credit investor, we're similarly non-plussed. Although we expect disappointing growth, a recession looks unlikely and bank credit metrics are still strong. There's over valuation everywhere, but real bubbles are hard to find (outside of some real estate markets). In these circumstances, we expect most of the downside to be taken by bank share prices with limited effect on hybrid security prices.

Fund characteristics as at 28 February 2018

Yield to Maturity	5.06%
Cash yield to maturity + franking (income yield)	5.50%
Investment grade issuer	93%
Fund average term (years)	4.3
Bank Tier 1 exposure	54%
Property exposure	2%

Performance Table	1 month*	3 months	12 months	3 years p.a.	5 Years p.a.
Elstree Enhanced Income Fund	(0.48%)	1.12%	8.70%	6.77%	7.15%
UBS Australia Bank Bill Index	0.13%	0.43%	1.75%	2.00%	2.30%

*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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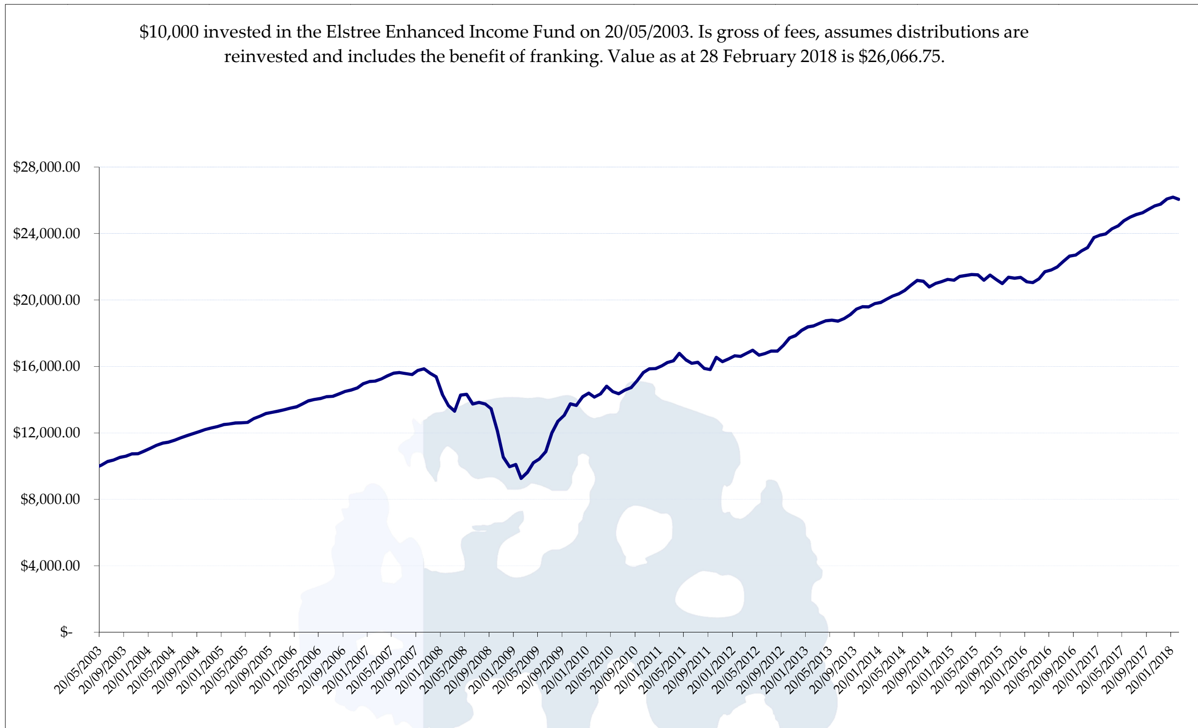
Elstree

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



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