January 2018 Review – Listed Hybrid Sector

Performance

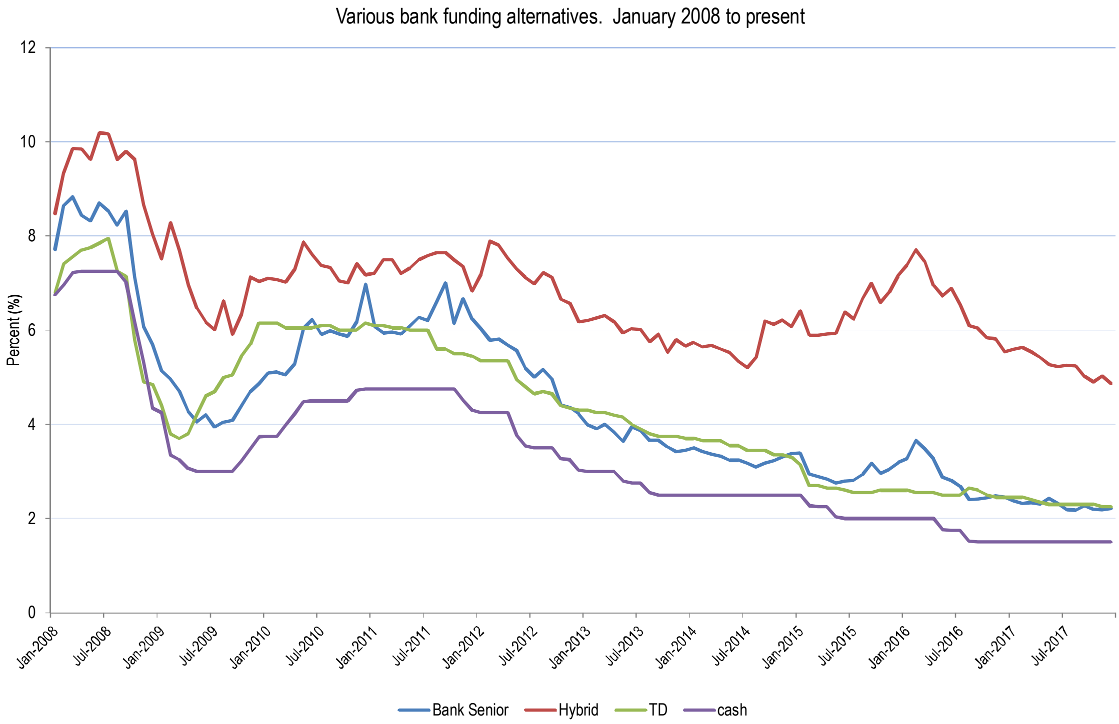
The Elstree Enhanced Income Fund's total investment return for January 2018 was 0.39%. This compares with the Elstree Hybrid Index return 0.37%. In other markets the All Ordinaries Accumulation Index returned (0.33%) while the All Maturities Bond Index returned (0.27%).

Events

Major bank hybrids issues were newsworthy this month. Westpac announced an issue to replace the $1.2b WBCPC and it's likely that CBA will follow shortly and market an early replacement for their $2b issue that comes to first call date in December 2018. ANZ also announced that it would redeem the remainder ($0.95b) of the ANZPC security. The recent sale of some of the ANZ's Asian & Wealth Management exposures means that it has too much capital: both equity and AT1. There is going to be net domestic market redemptions of hybrids this year.

Bank Funding: cheaper and cheaper

Most investors have fond memories of the post GFC Term Deposits era: 6%, no risk and they were available from 2009 until the end of 2011. However, bank funding costs have fallen dramatically since then. The chart below shows the cost of various ways banks fund themselves: cash, bonds (as measured by Westpac 5 year CDS), Term Deposits (RBA average "special" TD rate) and Hybrids (the average yield of the latest major bank AT1 issues).



Base rates fall but margins fall further

It's clear that cash rates have fallen. It's a little less clear that the margins over cash for senior debt and term deposits have fallen as well, leading to much higher falls in headline yields. In 2012 the term deposit rate as denoted by the RBA Average "Special" TD rate was around 1.25% higher than cash rates, but that margin has been in a gradual downtrend since then and is currently only 0.75%

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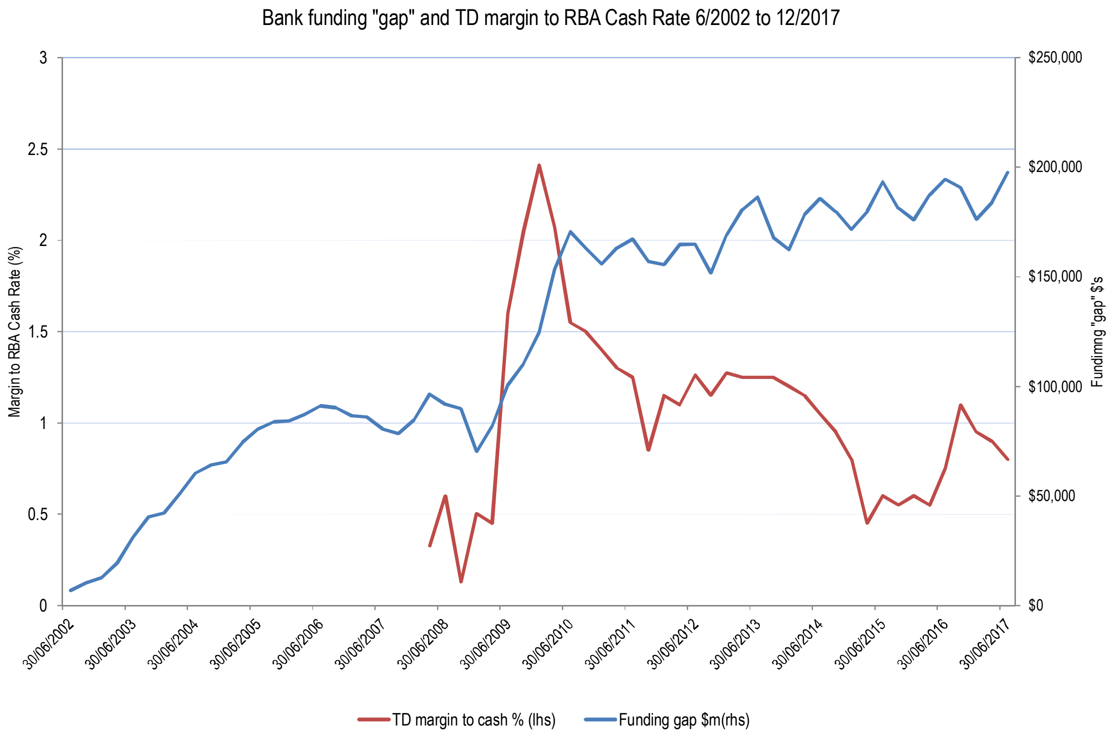
over the 1.5% cash rate. The cost of senior bond funding cost has followed a similar path. This is not that surprising as there is an explicit linkage. Banks need a high amount of "certain" funding and deposits and senior bonds are considered equally "certain". So if either the margins on bond funding or term deposits get majorly out of synch, the bank should switch funding strategies to minimise costs.

So what happens to TD rates: will we see 1%+ margins to cash again?

We acknowledge there is a strong cause and effect relationship with senior debt rates, but there have been times when TD/Senior bond costs have diverged. In the early post GFC days, TD rates went well above bond rates (because banks couldn't actually issue bonds) and between 2013 and 2015, TDs offered rates of c0.25% better than bonds. While it's a simplification of the bank funding issues the chart below illustrates the concept of a funding gap. In a simple and perfect world, a bank's deposits should fund the loans, but it's not as easy as that because both loan demand and deposit funding can be volatile. When that occurs, banks can borrow from wholesale investors or in short term markets until they can re-establish equilibrium. The chart shows the amount of mortgage lending less non-financial deposit funding. In 2009, mortgage lending grew substantially, but the amount of TDs lagged, so there was an increase in the funding gap. In the short term this was filled by borrowing from other financial institutions or cash. To attract larger sums of TDs (and reduce the gap to an appropriate level), the banks raised the TD levels (partly because the senior bond market was closed post GFC).That margin was maintained until the funding gap stabilised. The 2013 - 2015 experience was a function of reasonably strong asset growth (c10% p.a.) but less growth in bond funding. Hence, banks paid up a bit more for TD's.



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1%+ rates probably goneski

We don't think we'll see super high TD rates again (absent a GFC type catastrophic event) for a few reasons.

(i) We think there is a good chance that bank asset growth will decrease even further and possibly contract. This makes the bank funding task much easier and reduces the need for TD funding.

(ii) TDs are the largest part of bank funding and one of the two most important drivers of bank profitability. Managing the borrowing cost lower is the most important job in the bank.

(iii) We think there's little chance of bank bond margins increasing. The world remains awash with investible funds, investor concern about banks continues to abate and, except for the immediate 5 year post GFC period, bank funding margins are not expensive.

And Hybrids?

From the first chart, it's apparent that falls in hybrid yields have lagged other bank funding costs. We suspect this continues to place downward structural pressure on hybrid spread margins.

Fund characteristics as at 31 January 2018

Yield to Maturity	4.6%
Cash yield to maturity + franking (income yield)	5.3%
Investment grade issuer	93%
Fund average term (years)	4.4
Bank Tier 1 exposure	57%
Property exposure	2%

Performance Table	1 month*	3 months	12 months	3 years p.a.	5 Years p.a.
Elstree Enhanced Income Fund	0.39%	2.02%	9.58%	7.37%	7.34%
UBS Australia Bank Bill Index	0.16%	0.43%	1.75%	2.02%	2.32%

*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