March 2017 Review – Listed Hybrid Sector

Performance

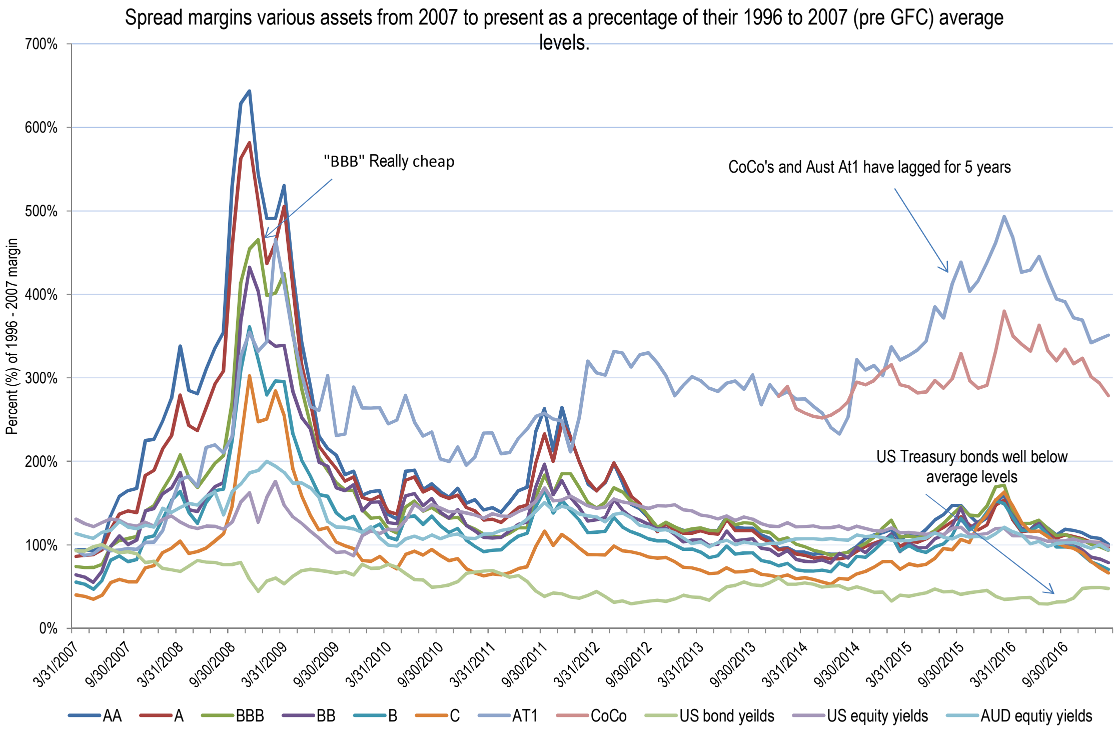
The Elstree Enhanced Income Fund's total investment return for March 2017 was 1.29%. This compares with the Elstree Hybrid Index return of 1.01%. In other markets the All Ordinaries Accumulation Index returned 3.16% while the All Maturities Bond Index returned 0.44%.

Events

There were 4 issues/announcements this month: NAB, Challenger, Suncorp and Villaworld. The first three were swamped with bids. All closed early and scale backs were between 80% and 50% of bids.

Demand eats supply

We wrote a piece for our fund investors this month (let us know if you would like a copy). One of the charts we referenced is included below. It details the spread margins on a whole raft of credit instruments. The vertical axis is the level, represented as a percentage (%) of 1996 - 2007 spread margin averages. It shows the path of investor risk aversion over that period. Bond and equity yields were around decade average levels in 2007 but then followed a different path. Bond yields fell over the next 10 years while equity yields increased and then decreased to average levels again in 2017. Credit margins were around average/below average in 2007, increased dramatically during the GFC and have been on a gradual path back to average with spikes on Europe/US recession/China fears. Anecdotally, bank treasurers have been recently talking about "a wall of money" and "never been easier to issue".



So what's happening to Coco's /AUD AT1?

The obvious outliers are bank capital securities such as CoCo's and AT1 hybrids. Spread margins are significantly higher than pre GFC levels and are still stuck at 2012 levels. The reasons for not participating in the trend to average are pretty clear: bank capital securities entered a structurally riskier phase after the GFC due to issues relating to capital, bad debts, regulation, GFC scars etc. However, it looks increasingly like we're at the end of the beginning (or the beginning of the end) of the GFC

Elstree Investment Management Limited (ABN: 20 079 036 810)
Level 10, 30 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348
Email: info@eiml.com.au

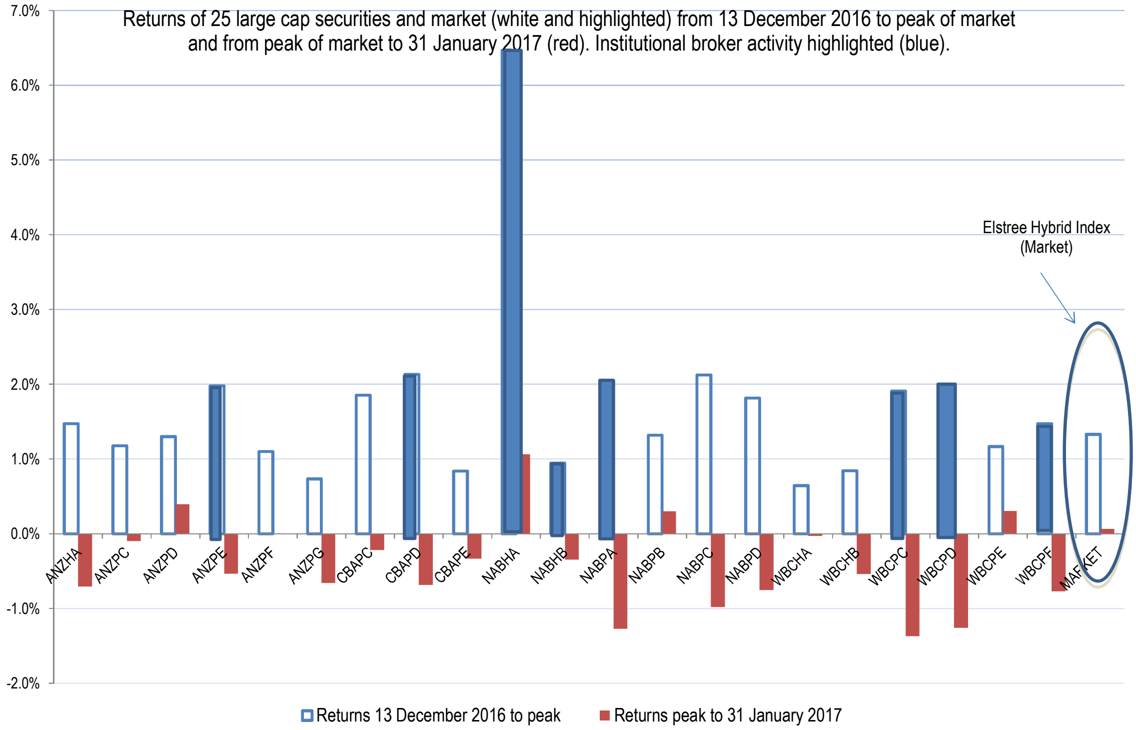
banking crisis. There's no undercapitalisation and bad debts looks like being less of an issue. This combined with the increasing expensiveness of other credit classes seem to be the catalysts for investors becoming interested in bank capital securities.

How does that affect Australian AT1 (hybrids)

There's a dual effect; the last 12 months we've seen institutional investors enter the domestic hybrid market for the first time since the GFC and perhaps even more importantly there seems to be strong demand for AUD bank capital instruments offshore. Currently, the trading margin of the ANZ CoCo issued in May last year is around 0.60% lower than ASX market equivalents. Based purely on that pricing, there will be no AUD major bank hybrids issued in the ASX market this year. Clearly, it's not quite that simple, but there is a real risk that there will be negative net new issuance over the next 12 months and that puts downward pressure on spread margins and upward pressure on prices.

Secondary markets: tricky or not?

Given the lack of IPO issuance investors are going to have to get used to accessing the secondary market to get exposure. Institutional investors dislike listed hybrid market liquidity. Fixed interest funds can't cope/don't understand exchange traded markets and equity fund managers are used to large cap markets which are highly liquid or small cap markets which are still institutional and investors know who to go to move stock. The big difference is that hybrid markets are dominated by retail investors and as a result liquidity is lower and idiosyncratic. We saw a good example of this late last year when an institutional order took place. The chart below shows the returns of the market (Elstree Hybrid Index) and the 25 major bank securities between 13 December (when the institutional order started) the peak price of each security from then until 31 January. We've highlighted in blue those securities where there was a material involvement by institutional brokers.



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It's all over the place isn't it?

The most interesting aspects are that generally the securities with a high institutional broker involvement outperformed in the first phase and underperformed in the second (once the buy order was filled). Effectively, the purchaser paid too much in the transacting and execution of the order. For example, the NABPA increased 2% in less than a month from the start of the order and then fell 1.3%, compared to the overall market increase of 1.4% over the month and then 0.05% until the end of January. It's likely that investors in that period paid 1% too much to get set. And that's not insignificant when you consider if your return target is (say) 5% and your entry cost is 1%, you've paid around 20% of your return in transaction costs.

Doesn't have to be that way

That wasn't done very well. We've seen transition managers do better than that and we don't incur anywhere near the transaction costs. One advantage we have is we use our proprietary data base to model the cost of transacting and what volume we can transact without materially impacting prices. We've also been doing it for a long time, so we're used to retail markets and don't throw the tantrums we sometimes see from institutions trying to transact in retail markets.

Fund characteristics as at 31 March 2017

Yield to Maturity	5.2%
Cash yield to maturity + franking (income yield)	5.3%
Investment grade issuer	90%
Fund average term (years)	3.9
Bank Tier 1 exposure	38%
Property exposure	7%

Performance Table	1 month*	3 months	12 months	3 years (p.a.)	5 Years p.a.
Elstree Enhanced Income Fund	1.29%	2.22%	14.20%	6.26%	6.88%
UBS Australia Bank Bill Index	0.15%	0.44%	1.94%	2.30%	2.42%

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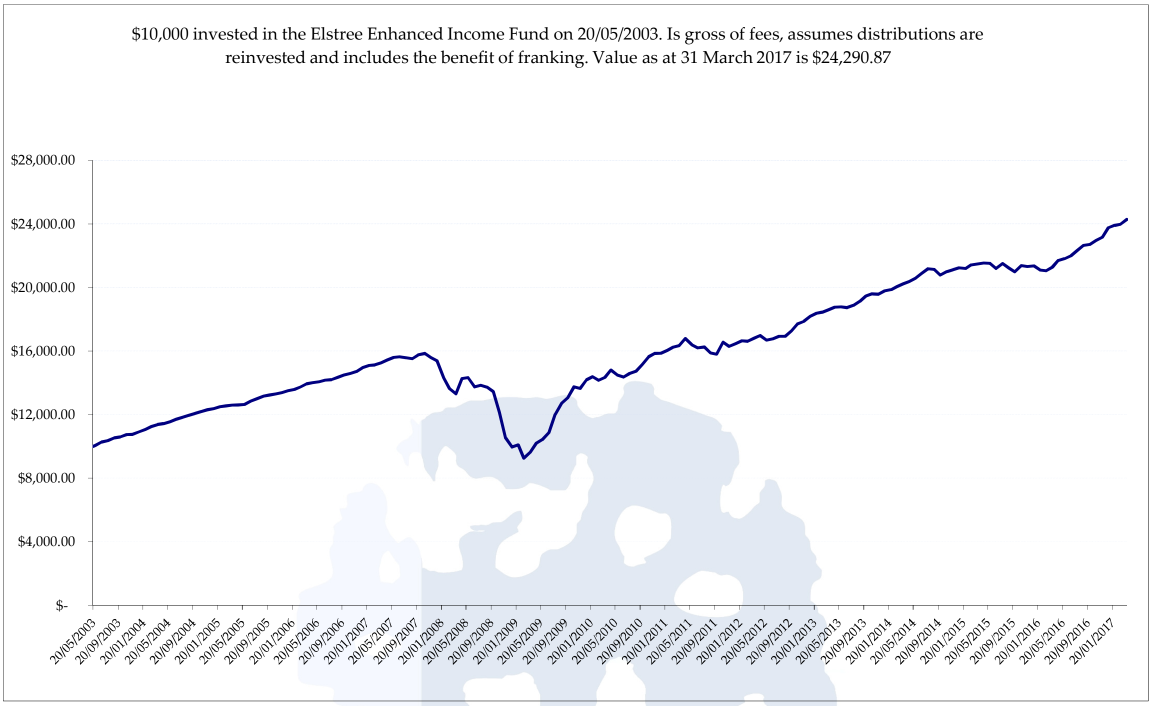
Value of $10,000 Invested on 20/05/2003



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