Elstree

November 2017 Review – Listed Hybrid Sector

Performance

The Elstree Enhanced Income Fund's total investment return for November 2017 was 0.41%. This compares with the Elstree Hybrid Index return 0.25%. In other markets the All Ordinaries Accumulation Index returned 1.91% while the All Maturities Bond Index returned 0.87%.

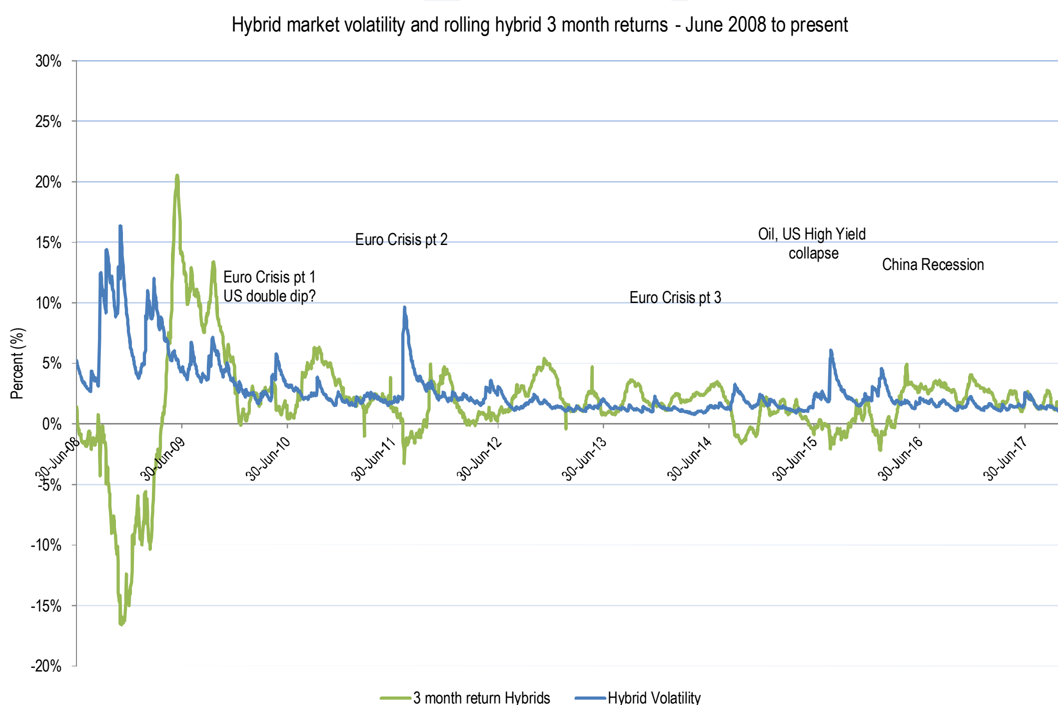
Events

Following Adelaide Bank and Suncorp, Bank of Queensland announced a new hybrid to replace its March 2018 BOQPD security. The changing supply outlook for hybrids has affected the market in a number of ways. Issuers are generally only rolling over their issues and the major banks are not issuing or if they are issuing they are issuing offshore. This means that new issues are heavily oversubscribed. Bidders in some recent issues are only receiving 10% of their demand. This leaves investors and advisors, who traditionally relied on primary markets in a quandary: either wade into secondary market and try and guess which securities represent value, or leave the funds in cash, or invest in another asset class. This change of mindset for hybrid investors will continue for a while as we think there is a small possibility that there will be no major bank issues in the next 12 months and a material probability there will be only 1.

Low volatility comes to the hybrid market

Everyone's talking about low volatility, but no one really knows what low volatility actually means for future returns. The low volatility trend has happened across all markets and it's also occurring in hybrid markets. In the post GFC periods hybrids have been low volatility investments, but this has accelerated and they are now at historical lows with a return volatility of 0.9% p.a. (cf with "normal" equity market volatility of 15% p.a.). The chart below (Chart 1) shows the path of volatility from just prior to the GFC. We have also included rolling 3 month hybrid market returns.

Chart 1



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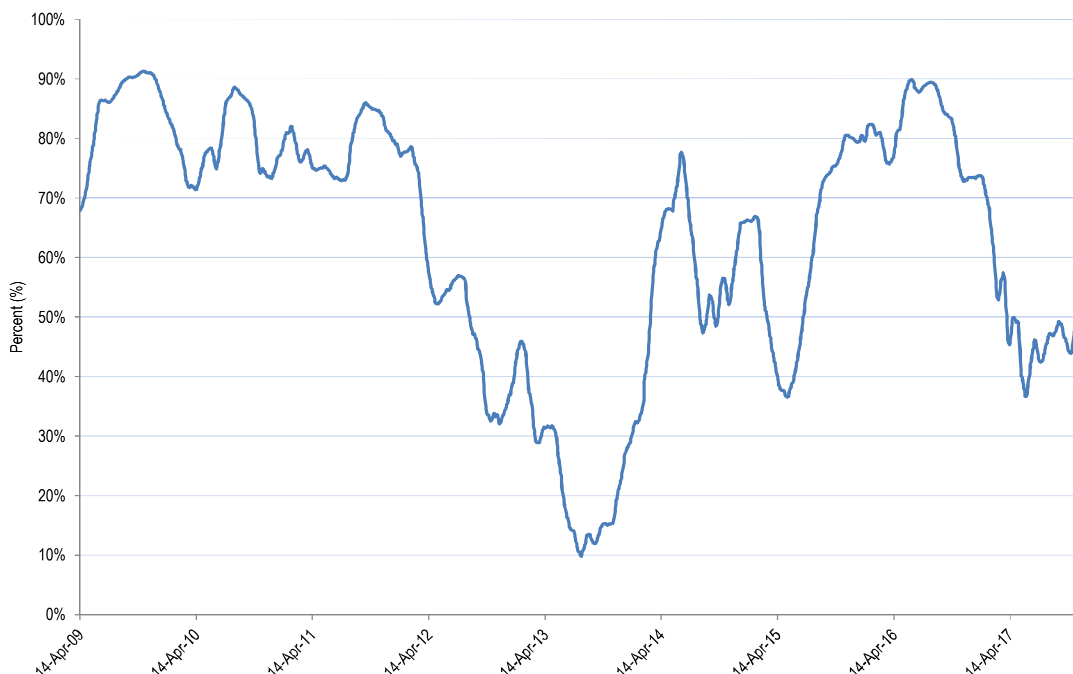
So what are the points from this chart?	
	- Low volatility is not new. Volatility has been falling since the GFC interspersed with various spikes along the way. - An important question for hybrid investors (and all other investors) was whether the GFC experience was, or was part of, the normal pattern of market events or whether it was an "outlier". In hindsight a decade after the GFC, there was a lot of overreaction to events occurring soon after the GFC, but that has decreased over time. - As with most markets, returns dislike volatility. There have been various events since the GFC which have seen volatility spikes and corresponding periods of market weakness. Given we don't see the same spikes on the other side it indicates that predicting changes in volatility can be a valuable aid in market timing. - There's a bit of Minsky going on. When there are either large falls in, or very low volatility, there is a negative reaction within the next 3 months. That's perfectly rational; if markets are priced for perfection, they will sell off on less than perfection. Clearly, we're in that phase of low volatility now. When the next event and volatility spike will occur is less clear. - The chart below (Chart 2) shows the correlation of 12 month returns of the hybrid and equity market. Although the low volatility of the hybrid market distorts the interpretation of results, it shows that, generally, hybrids are not highly correlated to equity markets. Interestingly the very low correlations occurred when the equity market went through a weak and volatile period. As can be seen from the charts both above and below, hybrids weren't much affected during those periods, with small spikes in volatility and short periods of negative returns.

Chart 2



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Implications for hybrids

We're well aware that the low volatility period is not infinite, but we're less sure why and how it unwinds. As we pointed out last month, the higher yield of the hybrid market makes staying out of the market very expensive and you have to be either very sure of weakness or expect a large bout of weakness to outperform a "stay invested" strategy. We think it's interesting that in the post GFC period, hybrids become uncorrelated to equities during weakness. Overall, we think the market is still reasonably safe, despite margins falling below post GFC averages and volatility at post GFC lows.

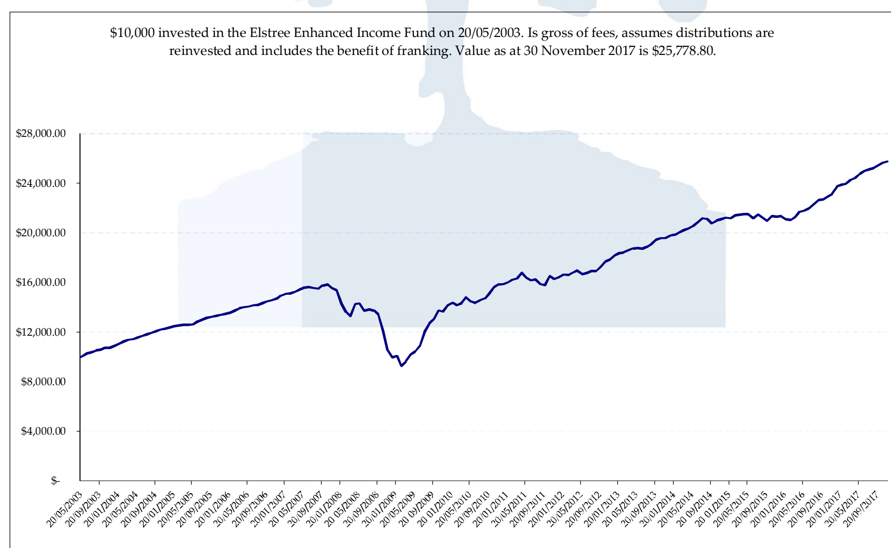
Fund characteristics as at 30 November 2017

Yield to Maturity	4.9%
Cash yield to maturity + franking (income yield)	4.9%
Investment grade issuer	93%
Fund average term (years)	4.5
Bank Tier 1 exposure	52%
Property exposure	2%

Performance Table	1 month*	3 months	12 months	3 years p.a.	5 Years p.a.
Elstree Enhanced Income Fund	0.41%	2.05%	11.31%	6.89%	7.61%
UBS Australia Bank Bill Index	0.13%	0.42%	1.76%	2.09%	2.37%

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

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



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