October 2017 Review – Listed Hybrid Sector

Performance

The Elstree Enhanced Income Fund's total investment return for October 2017 was 0.82%. This compares with the Elstree Hybrid Index return 0.85%. In other markets the All Ordinaries Accumulation Index returned 4.06% while the All Maturities Bond Index returned 1.09%.

Events

Both Bendigo Bank and Suncorp announced new hybrids to replace rolling off securities. In the case of Suncorp, the new issue is around 2/3 the size of the old issue. We think that the trend of low issuance continues next year. It's possible (but unlikely) that the 2 major bank issues that come up for rollover/call/redemption next calendar year are either not refinanced or refinanced offshore. In that case there will be net $3 billion of security redemptions.

Trigger happy investors

By most standards, all asset classes are on the expensive side, and the most important decision an investor can make over the next few years is, if and when, to reduce exposure to markets. But it's not easy. One of the recent *weltschmerz articles* about the 1987 crash recalled that John Spalvins, one of the titans of Australian capitalism at the time, got really bearish about the equity market in late 1986 and sold as much as he could. He was right, but wrong. The market crashed, but it never fell below the late 1986 level at which he sold. So he would have been better off just hanging in there. In the chart below we try and illustrate the conundrum facing investors. Readers have probably seen drawdown charts before but for those that haven't it's a chart where the index value at 100 is when the index is at it's all time high and any figure below 100 is the percentage amount it has fallen below it's all time high. So if you go back to 1987, the All Ordinaries fell around 40% and then took a little less than a decade to create a new all-time high. So the chart goes from 100 to 60 and then back to 100, as the blue line in the chart below shows. We've also included the drawdown chart for both the S&P 500 (green line) and created a return series for the "credit component" (red line) of a 5 year duration "BBB" bond.

Credit returns explained

The credit component of that return series is the additional yield and change in value due to margin movements of 5 year "BBB" bonds (for the technically minded there are some survivorship bias issues in these returns which results in a very small overestimation of the returns, but it's not material). In all cases we're trying to measure what the risk of deviating from risk free assets is; in the case of equity indices it is the price movements and in the case of credit, it is the additional return volatility offset by the higher income. We've also shaded (in light blue) the times of US recessions to illustrate one of the major drivers of equity markets.

The explanation

Patterns of drawdowns are important for investors. Even if the asset class generates a high ultimate return, if drawdowns are long or deep, many investors sell on fear or impatience. As can be seen equity markets have deep and long drawdown periods and this probably part of the reason why the average investor does less well than the equity indices. They tend to buy at the top and sell after getting discouraged.

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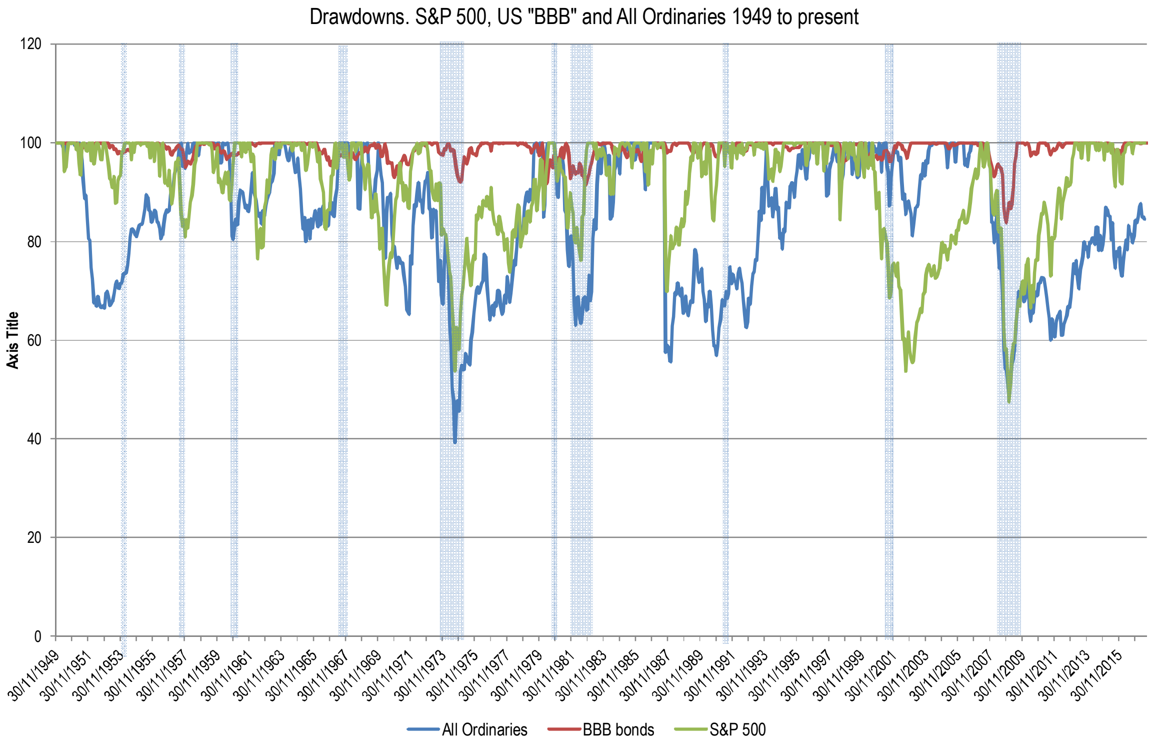

So what happens in equity markets?

You would expect equity markets to perform badly in recessions and this is clearly the case with equity markets showing a c25% fall (on average) either shortly before or during a recessionary period. However, even outside of recessions they are volatile. If you are able to have a vaguely accurate view on equity markets valuations, go your hardest at 'market timing' as it will be profitable. Since 1987 there have been about 10 separate 10% drawdowns in the All Ordinaries with the index spending around 1/3 of the time below all-time highs. Around 7 of these drawdowns come outside of recessions. The US is not as volatile with fewer drawdowns with less time spent below all-time highs. In the US it becomes more of a case of predicting recessions. However, in both cases, if you can predict a recession or when markets are "too" overvalued (remembering the lessons of John Spalvins above) you will generally do well.

Credito jugulare ursi

Credito jugulare ursi is an old Latin saying that translated means "Credit Carry Kills Bears". The situation for investment grade credit is entirely different to equities. The straight-ish red line at the top of the chart tells its own story, but the statistics support the principal that there is little point in trying to pick when "BBB" credit is too expensive. Outside of a recession, there are very, very few instances of material drawdowns. The drawdown value is only below 97 (ie a 3% loss) 10% of the time and there has only been 1 time outside of a recession (2 months in 1998). And the average duration of a drawdown is not very long: 3 months as a median and ex-recession the longest period is 11 months (when oil and China both imploded in late 2016). So even if you are clever enough to pick the overvaluation point, you have to be quick to buy back in or you'll underperform a less active strategy.

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Why?

It's simple maths that the additional income derived from investing in "BBB" over and above the risk free rate (currently around 2% which is a little bit less than the post 1987 average of 2.3%) is enough to make up for any volatility over a reasonably short time period. Put another way, if it was a super efficient market, margins would be lower or "BBB" credit would be more volatile. But this anomaly has existed since data began in 1925. Investors should appreciate it and enjoy it. We should note that the situation for non-investment grade credit is entirely different.

And hybrids?

Australian hybrids are generally issued by investment grade issuers, so in the long run they resemble "BBB" credit. In the short run, they are more volatile, particularly when equity markets are weak, but they are also higher yielding than "BBB" bonds, so you generally get the same outcome; it is difficult to underperform cash. We adjust our cash position within the portfolio frequently on the basis of perceived valuations, but recognise that taking a long holiday out of hybrid markets (ex recessionary periods) is a fool's game. Our biggest challenge however, and the one we are spending the most intellectual effort on, is picking the next recession either before it happens or recognising it early. Successfully achieving that will be of enormous value add to our investors.

Fund characteristics as at 31 October 2017

Yield to Maturity	4.90%
Cash yield to maturity + franking (income yield)	5.20%
Investment grade issuer	93%
Fund average term (years)	4.6
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	0.82%	2.10%	11.76%	6.93%	7.70%
UBS Australia Bank Bill Index	0.15%	0.43%	1.76%	2.11%	2.40%

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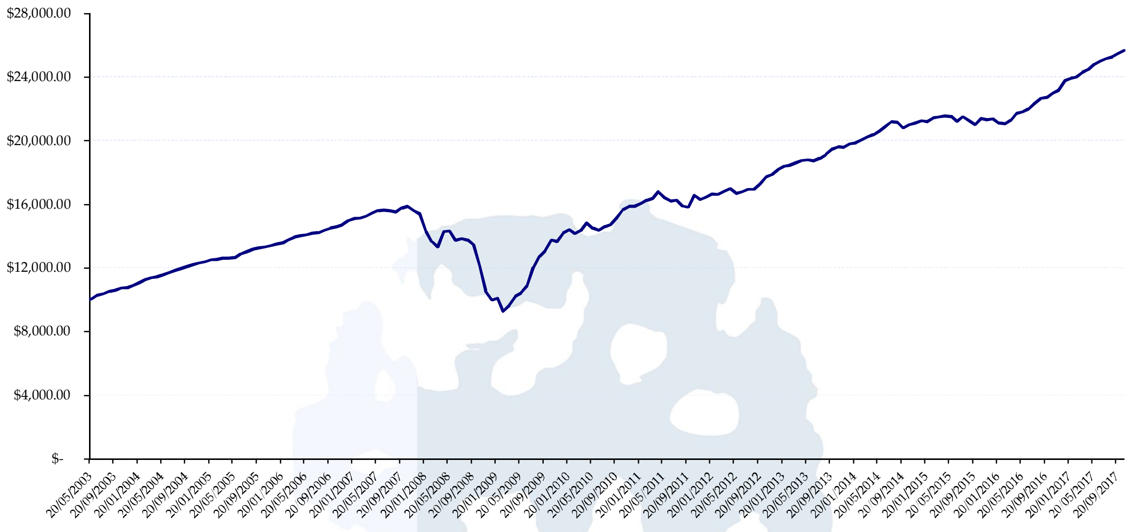
Value of $10,000 Invested on 20/05/2003

$10,000 invested in the Elstree Enhanced Income Fund on 20/05/2003. Is gross of fees, assumes distributions are reinvested and includes the benefit of franking. Value as at 31 October 2017 is $25,673.53.



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