Elstree
HYBRID FUND (EHF1)

August 2024
INVESTMENT UPDATE

RETURNS

The Fund and market returned 0.0% this month and there wasn't much going on during the month either. Hybrids avoided the volatility in equity markets, where the All Ordinaries fell almost 5% early in August after a flash crash in the US. Longer period hybrid returns remain healthy. They reflect c4.2% cash rates, hybrid margins and some capital gains which have occurred over the past 12 months as margins narrowed. We have also added value over the index.

Going forward, we continue to see returns at healthy mid to high single % levels. We don't see much probability of margins declining, which would produce capital gains. We also struggle to see what will push trading margins materially higher with subsequent capital losses.

The underlying bank and insurer issuers are all in extremely good health and a long way from the "non viability" risk that would increase risk premiums.

Stable cash rates, healthy issuers and a strong equity market mean it's been a low volatility period, but as always there will be left field events which will add volatility in the future. Caveat: we don't know when.

PERFORMANCE FIGURES

Performance as of 31 August 2024	1 month	3 months	1 year (p.a)	3 years(p.a.)
ELSTREE HYBRID FUND NAV + FRANKING (EHF1)	0.0%	2.6%	9.9%	6.6%
Distribution (cpu) (% franked)	2.2c(10%)	8.7c(49%)	34.55c(59%)	
Expected 3 month Income Distribution		5.5c(92%)		
ELSTREE HYBRID INDEX (P.A.) *	0.0%	2.6%	9.3%	6.1%
BANK BILLS	0.4%	1.1%	4.4%	2.7%

* Elstree Hybrid Index includes the value of franking credits.

CREDIT MARGINS; WHY DO YOU GET c2.5% MORE INVESTING IN HYBRIDS THAN GOVERNMENT BONDS?

Hybrids offer higher yields than government bonds and investment grade corporate bonds and less than private debt. The really quick reason is that the higher risk investments should justify a higher return. But how much of an extra return is appropriate.

No one knows how much is enough. There's loads of pseudo analysis by some commentators about what should be the appropriate margin for a BBB corporate bond, or a bank Tier 2 subordinated bond or bank AT1(hybrids) but it's pretty much all garbage. In the short and medium term, the only explanation is behavioural, and that pretty much translates to "it is what it is". (The caveat is that all non-government bonds have some default risk; For all classes except high yield, it is not significant)

The chart over the page shows margins for 4 types of non government debt: US BBB bonds, US High Yield, European AT1 (Coco) and Australian AT1(hybrid) since 2003.

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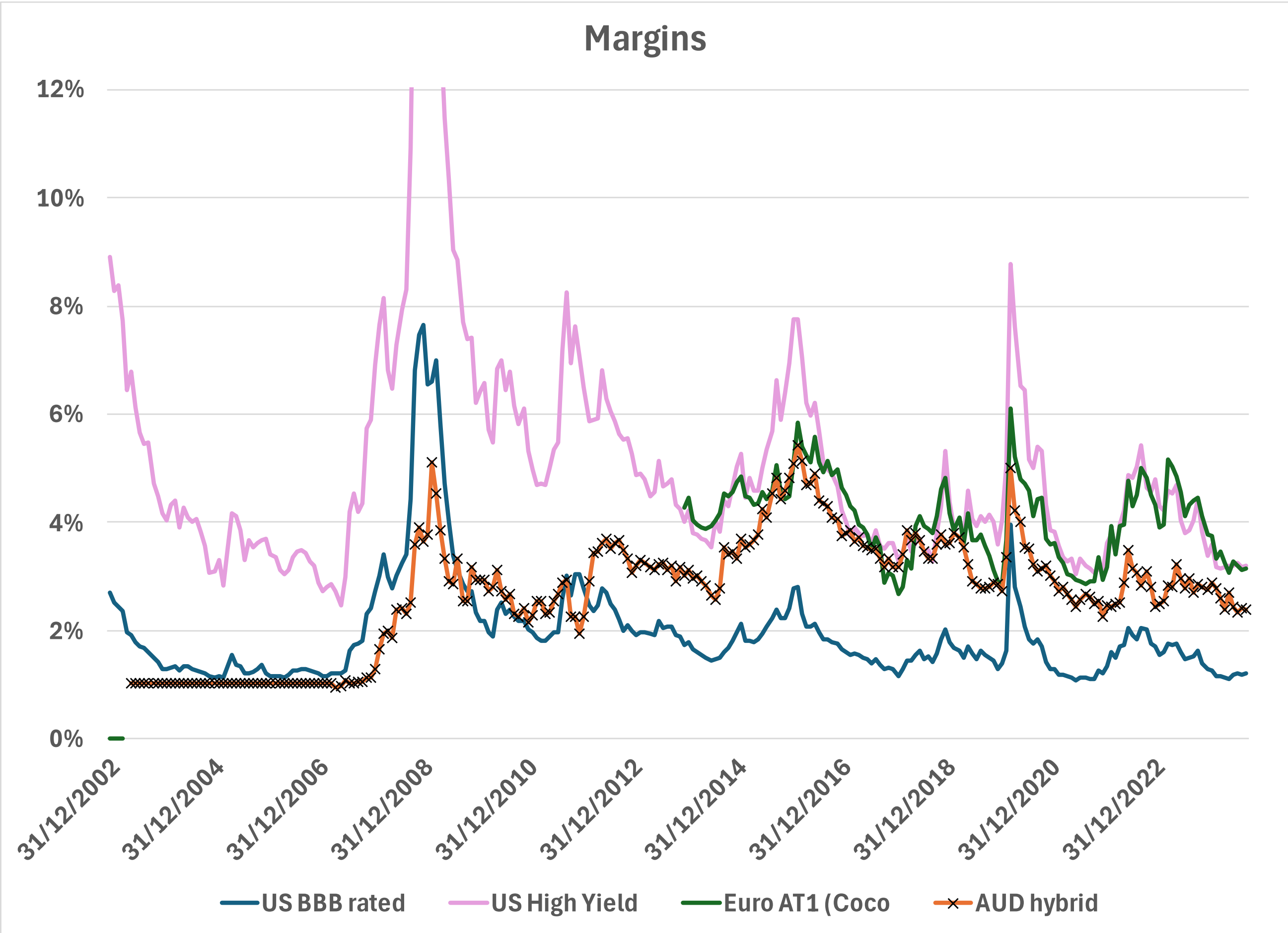

The chart above gives some clues about what happens, even if you can't accurately quantify it. For all the bonds shown, margins increase when things get really messy and investors get scared (GFC, Covid, 2016). It's worst for High Yield, and recessions also mean increased defaults for High Yield issuers, so you get a double whammy of lower prices and default losses a year later

But even though default losses for BBB rated bonds are about the same as Carltons chances of winning grand finals again, their margins still increase materially in the nasty periods. Behaviourally this is people thinking this time is different and these bonds will suffer losses this time.

The same is true for Australian hybrids. Bank Credit ratings have been rock solid for 20 odd years, and they have never missed distributions. But, when there is angst, margins increase, and prices decrease. If you buy at the once in a decade events, you can get them at least 10% cheaper than the rest of the decade. In hybrid land we seem to reach the peak margins at 5%. Historically this has been when there are enough investors who think the banks will survive and 5% is a good enough margin. More buyers than sellers and prices improve.

So, buying and holding hybrids (and BBBs and Euro CoCos) in times of stress is a great investment strategy, but it's not easy.

And in anticipation of questions as to why CoCos are now more higher yielding than AUD hybrids? Australian banks have much better credit ratings than the average Euro bank, and EUR Cocos are still digesting the Credit Suisse debacle, but we think the differential is within the range of us not being able to make a judgement as to whether it is cheap or expensive.

And margins now? The chart above gives you an indication that buying BBB bonds at 2.5% margin and hybrids at 5% margin is a good move, but its far less conclusive as to when you should sell. Both margins are close to historical lows. In the case of BBB's, they have remained at historical lows for 4 or 5 years before there is a shock and reversion.
Similarly, hybrid margins are expensive historically, but we can't see many reasons to go higher. And not being in hybrids is expensive. You give up c3% p.a. for the period you are not invested. That adds up to unnecessary underperformance, unless you can predict imminent weakness.
Moral of the story: selling hybrids in vague anticipation of weakness has been a widow maker trade for us. It should be for you investors as well.
One last pearl of wisdom: The only conclusion of lots of studies into credit margins is that non government bonds outperform government bonds over almost any time period. They earn more than they should. That's either because they are priced too cheap or there is going to be stuff that happens that will result in returns falling. We're up to over 50 years of history in High Yield, 100 in BBB and 25 years in hybrids and we haven't seen it yet. So maybe, all credit margins are too high, and we could see continued contraction?

BBSW WATCH

Out comes the easing cavalry, with slowdown sentiment charging back after northern hemisphere holidays. US Fed governor Powell talking about easing at the Fed holiday camp in Idaho and weak employment numbers in September has markets expecting a cut at the next meeting.
Locally markets have been a bit less gung ho, partly due to the RBA warning that cuts are not imminent. Although we think the RBA is very much a cut above the usual frothy commentariat looking for headlines and lower rates, they're a bit weird at times as well (Looking at Phil Lowe and 0% rates until 2024).
But markets are coming around to the idea of lower rates, with a small fall in the expected 2 year BBSW rate and a lower low rate. They have 3 cuts anticipated before middle 2025 and then flat after that. Hybrids look like they will generate income of 6.5%-7.0% for a few years yet.

	ACTUAL 90DAY BBSW	LOWEST EXPECTED BBSW RATE	EXPECTED 2 YEAR AVERAGE BBSW	DATE OF LOWEST 90DAY BBSW RATE
7 June 2024	4.3%		4.2%	
12 July 2024	4.3%		4.2%	
9 August 2024	4.3%	3.5%	3.8%	June 27
9 September 2024	4.3%	3.3%	3.7%	March 26

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NEWS & MEDIA

Elstree Hybrid Fund (EFH1) has been mentioned in the following articles throughout the last six months, many of which are educational in nature.

livewire

- https://www.livewiremarkets.com/wires/is-the-asx-home-to-the-longest-dividend-paying-company-in-the-world
- How Hybrids fit into 2021 Income Portfolios – Campbell Dawson I Elstree Hybrid Fund
- The Hitchhiker's Guide to Hybrids (Part 1) – Bella Kidman I Livewire Markets
- This is the secret to a diversified portfolio (Part 2) – Bella Kidman I Livewire Markets
- The forgotten asset class presenting exciting opportunities – Bella Kidman I Livewire Markets

FINANCIAL STANDARD

- New Hybrid ETF on Chi-X – Staff Reporter I Financial Standard

ADVISERVOICE
Education and information for financial advisers

- Hybrids remain attractive alternative for income generation – Evergreen Ratings

Firstlinks
a Morningstar company

- https://www.firstlinks.com.au/hey-boomer-first-home-buyers-fuss
- https://www.firstlinks.com.au/bank-hybrids-equity-market-weakness
- https://www.firstlinks.com.au/ddo-change-hybrids-bank-treasurers-nightmare
- Fascinating Hybrid Journey Last Year – Campbell Dawson I Elstree Hybrid Fund

MONEY|MANAGEMENT

- Support for Elstree Hybrid Fund – Staff Reporter I Money Management

More about Elstree Hybrid Fund (EHF1)

Elstree Hybrid Fund (CBOE Aust-X: EHF1) is an Exchange Traded Product or ETP. The fund is designed to allow retail investors to access the same successful and long-term investment strategy as our actively managed unlisted wholesale fund, the Elstree Enhanced Income Fund.

The Elstree Hybrid Fund is an ideal investment for investors seeking a cash or bank term deposit alternative investment that displays an acceptable and appropriate risk adjusted return outcome.

The Elstree Hybrid Fund has 'on market' liquidity provided by a market maker. The iNAV which is estimate of the live NAV, is updated every 20 seconds.

Additional details can be found on the Elstree Hybrid Fund website or email Norman Derham for further information.

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