Betashares Active Australian Hybrids Fund (Managed Fund)

ASX: HBRD

Quarterly Report - December 2023

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Performance[1]	1 month %	3 month %	6 month %	1 year %	3 years % p.a.	Inception % p.a.[2]
Fund Return (net)	0.63%	1.33%	3.55%	4.01%	3.27%	3.69%
Growth return	-0.08%	-0.08%	0.69%	-1.23%	-0.36%	0.17%
Income return	0.71%	1.41%	2.86%	5.24%	3.63%	3.52%
Solactive Australian Hybrid Securities Index (Solactive Index)	0.46%	0.94%	3.44%	3.37%	3.53%	3.83%
Active Return	0.17%	0.39%	0.11%	0.64%	-0.26%	-0.14%

Past performance is not a reliable indicator of future performance.

[1] As at 29 December 2023. Returns are calculated after fees & expenses have been deducted and distributions have been reinvested.

[2] Inception date for the Fund is 13 November 2017.

Yield and portfolio characteristics	
Running Yield (% p.a.)[1]	5.83%
Gross Running Yield (% p.a.)[2]	6.61%
Fund Constituents	89

[1] Average yield (weighted by market value) of the hybrids portfolio, divided by the current market price of the securities. This provides an indication of expected current income from making an investment at market price. This value will vary over time.

[2] Average estimated gross yield (weighted by market values and inclusive of franking credits) of the hybrids in the portfolio, divided by the current market price of the securities. This provides an indication of the expected current income from making an investment at market price. This figure is indicative only and will vary over time. Not all investors will be able to obtain the full value of franking credits.

Investment objective

The Fund provides investors with a convenient way to access attractive income returns, including franking credits, from an actively managed, diversified portfolio of hybrid securities. As the Fund is overseen by a professional investment manager, it actively seeks to reduce the volatility and downside risk that may otherwise be experienced by direct holders of hybrids.

Responsible entity

Betashares Capital Ltd

Investment manager

Coolahbah Capital Institutional Investments Pty Ltd

Distribution frequency

Monthly

Suggested minimum investment timeframe

At least three years

Fund facts	
Inception Date	13-Nov-17
Fund Size	$2154.44m
Historical Tracking Error (annualised)	0.75%
ASX Code	HBRD
Bloomberg Code	HBRD.AU
IRESS Code	HBRD.ASX

Fees	% p.a.
Management fee	0.45
Recoverable expenses	~0.10
Performance fee[1]	15.5

[1] A performance fee may be payable. This fee is 15.5% of the Fund's performance above the performance benchmark in a calendar quarter.

Investment strategy

The Fund will invest in an actively managed portfolio of hybrid securities, bonds and cash. If and when the hybrids market is assessed to be overvalued or presents a heightened risk of capital loss, the Fund can allocate more of the portfolio to lower risk securities.

Top 10 positions[1]	
WBCPM	WBCPJ
ANZ	CBAAU
NAB	CBAAU
WSTP	CBAAU
NABPH	NABPI

[1] As at 29 December 2023

Sector exposure[1]	Fund Weight %[2]	Index Weight %[2]	Active Weight %
Listed Hybrids	37.3	99.4	-62.1
Capital Notes	0.0	0.6	-0.6
Subordinated Bonds	48.6	0.0	48.6
Senior Bonds	10.1	0.0	10.1
Cash	4.1	0.0	4.1
TOTAL	100.00	100.00	0.00

[1] As at 29 December 2023

Fund performance summary

Over the December 2023 quarter, HBRD returned 1.33% unfranked and after fees, and 1.53% franked after fees, outperforming the benchmark Solactive Australian Bank Hybrids Index's return of 0.94% unfranked. HBRD closed the quarter with a gross running yield of 6.64% pa and a yield to call of 5.64%. Credit spreads on 5-year investment-grade (BBB- rated) major bank hybrids started the quarter at 255bps above the 3-month BBSW, before moving wider to 303bps above BBSW, and then closed the period back where they started at +258bps.

Hybrid yields have benefitted from rising interest rates with the 3-month BBSW rate climbing from 0% in 2021 to 4.36% in December, giving investors greater baseline yields regardless of overall spread levels. In particular, 5-year major bank hybrids paid a running yield of 6.91% (a combination of the 5-year hybrid spread level of 255bps and the 3-month BBSW rate of 436 bps) and a yield-to-call of 6.31% (a combination of the 5-year hybrid spread level of 255 bps and the 5-year quarterly swap rate of 376 bps) at the end of December.

Hybrid market and outlook

During the quarter, we saw the issuance of the $1.75bn Westpac Capital Note 10 (WBCPM) hybrid, which was a surprise to investors as it was a cash-for-cash buyback of their Capital Note 6 (WBCPI), which is not due to be called until July 2024. WBCPM was issued at 310bps above 3-month BBSW and ended the quarter tighter at 288bps. There were no maturities during the quarter other than those investors selling their WBCPI positions back to Westpac in return for WBCPM securities (note that WBCPI will continue to be traded by investors who did not roll to WBCPM). Coming up in 2024, we have call dates due for AN3PG in March, and CBAPH in April (plus WBCPI in July) for the majors, and BENPG, SUNPG, BOQPE and MQGPC amongst the other banks.

It is likely that APRA's current review of the hybrid market will result in regulatory changes such that future hybrid securities will carry higher Common Equity Tier 1 (CET1) capital triggers relative to existing securities, amongst other possibilities, which would likely raise the required returns on the new hybrids that emerge once APRA's analysis is concluded.

Recall that existing bank hybrids automatically convert into ordinary shares once a bank's CET1 ratio falls to 5.125%, amongst other terms and conditions. Coolabah expects this CET1 equity conversion trigger to increase materially on the new hybrid securities that are eventually approved by APRA (the review should be completed by the end of 2024), which would raise their risks. Coolabah's analysis of the global hybrid market finds that boosting the CET1 trigger from 5.125% to 7% typically results in a circa 100 basis point increase in the credit spread on these securities.

Banks may seek to mitigate the ensuing impact on their cost of capital by issuing hybrids more actively in 2024 ahead of APRA's regulatory changes, which could prompt some to follow Westpac's lead and do cash-for-cash rolls ahead of their scheduled call dates.

HBRD continued to increase its allocation to Australian bank Tier 2 subordinated bonds from 46% to 49% over the quarter. Tier 2 bonds rank higher in the bank capital structure than hybrids and have superior credit ratings. The fund benefited from 5-year major bank Tier 2 spreads tightening from 193bps at the beginning of the quarter to 172bps at the end, which helped to drive outperformance over the hybrid benchmark (which moved wider and then closed the quarter almost unchanged). During the quarter, CBA issued $700m of Tier 2 bonds with 5 years to call at 205 bps over 3-month BBSW. The deal performed well, tightening by 33bps by quarter end. The fund participated in the deal.

HBRD also increased its exposure to Australian bank senior bonds from 8.4% to 10.6% over the quarter. These bonds are considered even safer and more liquid than Tier 2 bonds and hybrid securities remain attractively priced versus historical levels. This allocation to highly liquid securities provides the Fund with the optionality to participate in any attractively priced hybrid issuance over the next few months.

Hybrid spreads are currently paying a multiple of 1.49 times Tier 2 spreads, which is higher than its historically low levels last year but well below its long-term mean of 1.8. This multiple has increased from 1.36 times over the quarter, driven by the strength of the Tier 2 bond rally. It indicates that while hybrids remain attractive due to their overall yields, and Tier 2 bonds have performed well, Tier 2 bonds are still relatively cheaper and a source of possible alpha.

There are risks associated with an investment in HBRD, including interest rate risk, credit risk, hybrids complexity risk and sector concentration risk. For more information on risks and other features of HBRD, please see the Product Disclosure Statement.

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