BETASHARES ACTIVE AUSTRALIAN HYBRIDS FUND (MANAGED FUND)
ASX: HBRD
Quarterly Report - March 2023

Performance[1]	1 Month %	3 Months %	6 Months %	1 Year %	3 Years % p.a.	Inception[2] % p.a.
Fund Return (net)	-0.79%	-0.72%	1.06%	1.78%	4.72%	3.31%
Growth return	*-1.14%*	*-1.82%*	*-1.08%*	*-1.81%*	*1.68%*	*0.08%*
Income return	*0.35%*	*1.10%*	*2.14%*	*3.59%*	*3.04%*	*3.23%*
Solactive Australian Hybrid Securities Index (Solactive Index)	*-0.99%*	*-1.26%*	*0.96%*	*1.86%*	*5.45%*	*3.49%*
Active Return	0.20%	0.54%	0.10%	-0.08%	-0.73%	-0.18%

Past performance is not a reliable indicator of future performance.

[1] Returns are calculated after fees & expenses have been deducted and distributions have been reinvested.

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

Yield and Portfolio Characteristics

Running Yield (% p.a.)[1]	5.01%
Gross Running Yield (% p.a.)[2]	6.57%
Fund Constituents	71

[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

Coolabah 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	$1962.58m
Historical Tracking Error	0.71%
ASX Code	HBRD
Bloomberg Code	HBRD.AU
IRESS Code	HBRD.ASX

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

[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]	
NABPH	WBCPH
WBCPJ	CBAPH
AN3PG	CBAPJ
WBCPI	AN3PI
NABPF	CBAPI

[1] As at 31 March 2023

Sector exposure	Fund Weight %[1]	Index Weight%[1]	Active Weight%
Listed Hybrids	75.9	97.1	-21.2
Capital Notes	0.0	0.6	-0.6
Subordinated Bonds	18.8	2.3	16.5
Senior Bonds	3.6	0.0	3.6
Cash	1.7	0.0	1.7
TOTAL	100.00	100.00	0.00

[1] As at 31 March 2023

Fund performance summary

Over the March 2023 quarter, HBRD returned -0.72% before franking credits and after fees, and -0.36% after franking credits and after fees, outperforming the benchmark Solactive Index's -1.26% pre-fees and unfranked over the same period. HBRD ended the quarter with an annual gross running yield of 6.56% pa.

Over the quarter, the credit spreads on 5-year investment-grade (BBB- rated) major bank hybrids widened from 228bps above the 3-month Bank Bill Swap Rate (BBSW) to a peak of 316bps above BBSW, and have since started mean-reverting back to 290bps (6.55% running yield).

Hybrids market and outlook

The major market event during this quarter was the sale of Credit Suisse (CS) to UBS following a deposit run. In this transaction, CS depositors and all CS investors in its senior-ranking and Tier 2 bonds were fully protected. On the other hand, CS shareholders lost about 90% of their money from 12 months prior while CS hybrid holders, including some Aussie investors, were completely wiped-out.

Australia's major banks are universally recognised as amongst the best capitalised and most liquid in the world, and they have benefited from a "flight to quality" as capital shifted from riskier entities, such as US regional banks and European investment banks, to safer concerns like the majors. Our regulator, APRA, is also regarded as amongst the toughest banking supervisor globally.

The CS hybrids, which were rated junk or "B" by S&P, were also radically different to Aussie bank/insurer hybrids in many respects (major bank hybrids are rated an investment-grade "BBB-"). First, they did not convert into equity, or bank shares, in a "non-viability" (blow-up) event, as Aussie hybrids automatically do. Instead, they had to be written off.

Second, the Credit Suisse write-down had to be 100% in the event of a government bail-out: the securities did not allow for a partial write-down. In the case of Aussie hybrids, they are converted into stock at 101% of par value (until the equity has dropped by 80%), diluting shareholders to the extent the bank needs additional equity.

Hybrids market and outlook cont.

Third, most Credit Suisse hybrids had to be wiped out at an equity capital ratio trigger of 7%, which is much higher than the 5.125% equity threshold at which Aussie hybrids convert into shares. The current average major bank equity ratio is about 12%. In the case of CBA, it would have to suffer unprecedented losses of $31.5 billion (and not raise compensating equity in the process), for its equity ratio to fall to 5.125%.

In its regular stress-testing, the APRA runs a scenario where Aussie house prices fall 30%, commercial property values decline by 40%, the jobless rate jumps from 3.5% to more than 13%, and GDP contracts by 15%. In this extraordinarily severe recession, Australian banks' equity ratios decline to 6.6%, notably above the 5.125% threshold at which hybrids convert into shares.

A final important difference is the sacrosanct capital structure "hierarchy", the protection of which is an essential feature of the global Basel 3 banking regulations and is embedded explicitly into Aussie hybrid prospectuses.

In short, this means shareholders need to bear losses first. The Swiss bizarrely inverted the capital structure hierarchy: CS shareholders recovered modest value and hybrid investors lost everything.

This has led to widespread condemnation from global regulators, including the European Union, the Bank of England and others, which have confirmed that in their jurisdictions shareholders would lose 100% of their investments before higher-ranking creditors suffered losses.

APRA's regulations state that bank shares must be "the most subordinated claim in liquidation of the issuer" and "take the first and proportionately greatest share of any losses as they occur". They further declare that after equity suffers losses, hybrids must be converted into equity before any Tier 2 bonds are at risk.

Aussie hybrid prospectuses expressly state that they cannot be converted into shares until equity first bears losses. And the issuers pre-arrange all approvals for equity conversion before a hybrid is launched to ensure the process cannot be perturbed.

By the end of March, the combined effects of governments guaranteeing their banking sectors, investors recognising that Aussie banks are some of the best capitalised and most liquid in the world, and that Aussie bank hybrids are radically different to the CS securities, resulted in ASX hybrid spreads tightening materially.

During the quarter we also saw the call of ANZs AN3PF $970m issue, which was replaced by their new $1.5b issue AN3PK. This issue did not perform as it was priced pre-Credit Suisse and launched post-Credit Suisse, closing at $99.50 on its first day (at the end of the quarter it closed at $99.93, and had not traded at par).

This contrasts with the other new issue from Challenger, CGFPD (replacing CGFPB), which launched in the higher yielding market following CS, and has gained in value as confidence returns and credit spreads tighten. The retiring issue was sized at $460m, but as Challenger did not need to fully replace the issue the new CGFPD is much smaller ($360m). The scarcer replacement issue and larger coupon relative to major bank issued hybrids made this an attractive line, and it closed its first day of trading at $100.30.

Following the call of AN3PF and CGFPB, the market should enter a lull in issuance – IAGPD has its first call date in June, then there are no more issuances due to call until CBAPH in Q2 2024.

More broadly, we've seen yields on all hybrid coupons improve as the BBSW rate they are tied to has increased from 3.26% to 3.72% over the quarter, giving investors an additional 46bps in base-line coupons regardless of overall spread levels. 5-year major bank hybrids ended the quarter with a running yield of 6.55%. By comparison, the fund, which is 23.3% invested in more secure senior and Tier 2 bonds, and 75.3% hybrids, had a running yield of 6.56%.

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