BETASHARES ACTIVE AUSTRALIAN HYBRIDS FUND (MANAGED FUND)
ASX: HBRD

Quarterly Report - December 2020

Performance[1]	1 Month %	3 Months %	6 Months %	1 Year %	3 Years % p.a.	Inception[2] % p.a.
Fund Return (net)	1.10%	1.44%	3.16%	3.07%	3.88%	4.07%
Growth return	*0.88%*	*0.78%*	*1.77%*	*0.12%*	*0.33%*	*0.64%*
Income return	*0.22%*	*0.66%*	*1.39%*	*2.95%*	*3.55%*	*3.43%*
Solactive Australian Hybrid Securities Index (Solactive Index)	*0.92%*	*1.39%*	*3.14%*	*2.49%*	*4.07%*	*4.10%*
Active Return	0.18%	0.05%	0.02%	0.58%	-0.19%	-0.03%

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]	2.51%
Gross Running Yield (% p.a.)[2]	3.47%
Fund Constituents	38

[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	$965.15m
Historical Tracking Error	0.85%
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 to present a heightened risk of capital loss, the Fund can allocate more of the portfolio to lower risk securities.

Top 10 positions[1]	
CBAPD	NABPF
NABHA	WBCPI
NABPH	WBCPH
ANZPE	WBCPG
ANZPG	NAB25

[1] As at 31 December 2020

Sector exposure	Fund Weight %[1]	Index Weight%[1]	Active Weight%
Listed Hybrids	89.7	90.0	-0.3
Capital Notes	6.6	7.2	-0.6
Subordinated Bonds	0.0	2.8	-2.8
Senior Bonds	0.2	0.0	0.2
Cash	3.5	0.0	3.5
TOTAL	100.00	100.00	0.00

[1] As at 31 December 2020

Fund performance summary

HBRD returned 1.10% before franking credits and after fees in December 2020, outperforming the benchmark Solactive Australian Hybrid Securities Index's 0.92% by 0.18%, and ending the month with a net running yield of 2.51% (gross running yield of 3.47%). Over 2020, encompassing the unprecedented COVID-19 shock, HBRD has returned 3.07% before franking and after fees, outperforming the RBA Cash Rate return of 0.25% and the Solactive Australian Hybrid Securities Index's ('Solactive Index') unfranked return of 2.49%.

Since inception, HBRD has returned an unfranked 4.07% annualised after fees, with only an average 87% portfolio weight to ASX hybrids, relative to the Solactive Index's 4.10% unfranked, return and the RBA Cash Rate +2.5% return of 3.49%. HBRD's since inception volatility of 5.87% has been lower than the Solactive Index's volatility of 6.31% and less than a third of the 18.58% volatility of the All Ords Accumulation Index. At the end of December, HBRD was diversified across 38 hybrids/bonds, and had a 96.2% allocation to hybrids, 0.2% to subordinated bonds, and 3.6% to cash. With the 5 recent new hybrid issues in November and December now listed and performing well, and no more issuance expected until March, hybrid spreads have compressed, and the Investment Manager sees potential for a rally back to pre-COVID levels.

Hybrids market and outlook

The ASX-listed hybrid securities sector performed well in the December quarter, with broad optimism around COVID-19 vaccine rollouts, economic recoveries buoying assets in general, and a large amount of new hybrid supply being met with strong investor demand.

HBRD gained 1.44% over the quarter (net of fees but before the benefit of franking credits), exceeding the 1.39% return of the benchmark Solactive Australian Hybrid Securities Index by 0.05%. During the fourth quarter, the credit spread on 5-year major bank hybrids initially rose from 319 basis points (bps) above the quarterly Bank Bill Swap Rate (BBSW) to 338bps as new hybrid issues were launched with credit spread premiums, before falling to 297bps at the end of December 2020.

Hybrids market and outlook continued

The December 2020 quarter saw five new hybrid issues raise a total of $5.37bn. NAB (NABPH), Westpac (WBCPJ), Bank of Queensland (BOQPF), Bendigo Bank (BENPH) and Challenger (CGFPC) all issued new securities, with the NAB and Challenger securities ostensibly replacing issuance that was cancelled in March-April 2020. The new securities were issued with attractive credit spreads that were between 10bps and 110bps higher than fair value, which attracted strong investor demand. HBRD participated in all five issues, which are now trading between 1% and 4% above their issue price of $100. The issuance also saw three existing hybrids fully or partially called – NABPB, BENPE, WBCPF – resulting in $2.9bn being repaid to investors and net new hybrid issuance of $2.5bn.

The pipeline for new issuance looks light in the first half of 2021. Challenger is expected to repay the remaining $47.5m of its CGFPA security in February; Westpac is due to repay the $458m left of its WBCPF security in March; Macquarie Group may refinance the $543m MQGPB hybrid in March; and Bendigo Bank has signalled that their $282m BENPF hybrid will likely be repaid without refinancing in June. Despite this clear net redemption profile in the first half of the year, it is possible a major bank issues into what is likely to be strong latent demand. The second half of the year is more crowded, with refinancings expected for ANZPD, CBAPE, WBCPG and AMPPA, which is why one or more of these issuers may bring their transactions forward into the first half.

Hybrid holders may see more cash returned to them in the first quarter, with shareholders authorising NAB at its December AGM to repay the $2bn NABHA security that has been outstanding since 1999. While it has qualified for Additional Tier 1 Capital under transitional relief from APRA, that relief expires on 1 January 2022, and NAB has stated that it will need to begin attaching franking credits to distribution payments when that occurs. NAB's hybrid issue in December, along with its landmark $600m over-the-counter wholesale-only hybrid issue in July, are likely preparing for this loss of Additional Tier 1 Capital.

The favourable supply/demand outlook should help drive hybrid spreads tighter in the first quarter of 2021. Five-year major bank hybrid spreads are still 22bps higher than the levels they reached pre-COVID in January 2020 (275bps), 38bps higher than their marks in late 2019 (259bps) and 60bps higher than the post-GFC tights achieved in 2014. This presents better value than other parts of the major bank capital stack, including senior (subordinated) bonds, where spreads are around 36bps (5bps) tighter than pre-COVID levels. The hybrids sector could therefore offer ongoing performance as spreads compress to pre-COVID levels and beyond.

Another way to think about hybrid valuations is through the multiple of their spreads over equivalent-tenor senior paper that sits higher up the capital structure, which is a heuristic commonly employed by institutional investors. Five-year major bank AT1 spreads have historically traded at about 4 times 5-year major bank senior bond spreads. With senior bond spreads at lows not seen since pre-GFC, that multiple has jumped to a never-before-seen 9.56 times, making hybrids look extremely cheap.

A final tailwind for the hybrids sector is APRA's proposal to adjust the way banks calculate and report their first-loss common equity tier 1 (CET1) capital ratios. This will result in the big banks' capital ratios rising by about 1 to 1.5 percentage points. Whereas CBA currently reports an 11.8% CET1 ratio, this could be expected to increase to 12.8% to 13.3%.

Aussie bank hybrids contain a clause that stipulates they must automatically convert into bank equity if the CET1 ratio declines to 5.125%. The current distance to default in the case of CBA would require its 11.8% CET1 ratio to shrink by 56.6% for its hybrids to be converted into equity. Under APRA's proposal, CBA would have to suffer greater losses that reduce its new 12.8-13.3% CET1 ratio by about 60% to get down to the conversion trigger. APRA's aggressive stress-tests of the Aussie banking system have shown that the banks were able to comfortably withstand two recessions over 2020 and 2021 encompassing a 30% drop in house prices, a 40% decline in commercial property values, and an increase in the jobless rate to 14% that resulted in cumulative credit losses of $163 billion.

Hybrids market and outlook continued

Although 2021 is bound to be bumpy, there appears to be foundations for a secular rebound in global growth, which is Coolabah's central case. Coolabah believes that the dominant narrative in 2021 will be the newly intensified search-for-yield dynamic, which is particularly acute locally.

Australian savers have never had to confront term deposit rates below 0.5 per cent or at-call rates and three-year government bond yields that are sitting near the zero lower-bound. For many this will undermine the value of cash and government bonds as an asset-class, forcing them to look for superior yields elsewhere. Coolabah has already observed the inception of this process, which is compressing spreads on high-yielding assets.