Lonsec Investment Grade

FundMonitors.com Trusted Targeted Research — Highly Commended

seed FUNDS MANAGEMENT

Fund Dashboard

31 January 2025

6.11%
% Yield to Call
(Portfolio as bought)

6.00%
Running Yield

4.7 Years
Weighted Average Term to Call

96%
Portfolio Floating Rate

0.46 Years
Interest Rate Duration^

31%
Top 5 Holdings As % of Fund*

41
Number of Holdings*

BBB+
Weighted Average Portfolio Rating

$400 million
Current FUM

Source: Seed Funds Management.
As at 31 January 2025.

*Excluding cash.
^Maximum duration of 1.

Hybrid Income Fund Strategy Net Performance

31 January 2025

FIGURE 1.

	1 Month	3 Months	6 Months	1 Year	3 Years Annualised	5 Years Annualised	SI (Sep 15) Annualised
HYBRID INCOME FUND STRATEGY	0.46%	1.64%	3.70%	8.25%	6.36%	5.29%	6.45%
Hybrid Benchmark (Solactive*)	-0.03%	0.48%	2.22%	6.43%	4.50%	3.86%	4.82%
RBA Cash Rate	0.36%	1.09%	2.19%	4.44%	3.33%	2.06%	1.80%

Figures to 31 January 2025. The performance table above represents The Hybrid Income Fund Strategy ("Strategy"). The Strategy commenced in September 2015 and has been continuously operated with identical investment parameters and processes by its portfolio manager, Nicholas Chaplin. The Strategy began in 2015 as the Paraclete Investment Fund until June 2022. The Hybrid Income Fund commenced in June 2022 operating under Evolution Trustees Limited as trustee. Investment management services were novated to Seed Funds Management Pty Ltd in March 2024. Accordingly, Seed Funds Management Pty Ltd receives a management fee for managing the Fund. Performance figures for the Strategy have been reviewed in accordance with ASRS 4400 "Agreed-Upon Procedures Engagements" by Hall Chadwick Corporate (NSW) Limited up to June 2024.

Monthly Commentary

The primary bond market experienced a robust start in the first days of 2025, marked by notable senior and subordinated bond issuances. Key issuers included the Commonwealth Bank of Australia (CBA) and Newcastle Greater Mutual Bank for senior bonds, while ANZ issued a significant subordinated bond. However, this initial momentum waned by mid-January. The total volume of bonds issued in the first three weeks of the year was roughly half of what was issued during the same period last year. Despite this decline, we anticipate a resurgence in activity in February, driven by upcoming maturities and the need for refinancing.

Listed hybrid margins continue to remain historically tight, with the likelihood of calls for bank hybrids now approaching 100%. This shift is largely due to the Australian Prudential Regulation Authority's (APRA) clear preference for these instruments to be called. Consequently, the risk profile of bank hybrids has significantly improved. Their natural trading margins are now expected to sit well inside their original issue margins.

Nonetheless, risks persist. These include the discretionary nature of distributions and the potential for non-viability as determined by APRA. However, given APRA's decision to phase out bank hybrids by 2032, it is understandable that these instruments are now trading significantly tighter than in previous years.

Key Portfolio Moves in January

Due to lower primary issuance at the start of the new year, we focused on adjusting our portfolio through secondary trades. Following cash inflows, we transitioned some of our senior holdings into Tier 2 subordinated bonds, thereby achieving an approximate 1.00% additional yield for those holdings.

We incrementally increased our listed hybrid holdings as value opportunities presented themselves, notably AN3PI. This move extended our average term to call for hybrids, as we realized profits from the soon-to-be-called WBCPH.

We participated in the better-value primary issues of the month, witnessing a very solid initial performance for the Newcastle Greater Mutual Group Senior bond, which issued at a margin of 1.25%. Mutuals maintain very conservative capitalization and balance sheet management, making the premiums on new capital market issuances highly attractive compared to larger bank issues. This deal was no exception and is trading very well. Notably, we also extended our holdings in P&N Bank and MyState Tier 1 capital issues—rare finds in the secondary market.

*Solactive Australian Hybrid Securities Index (Net)

CPI Eases Further

Annual CPI inflation eased to 2.4% in the December quarter, down from 2.8% in the September quarter. The key drivers behind this decline were lower prices for electricity and automotive fuel.

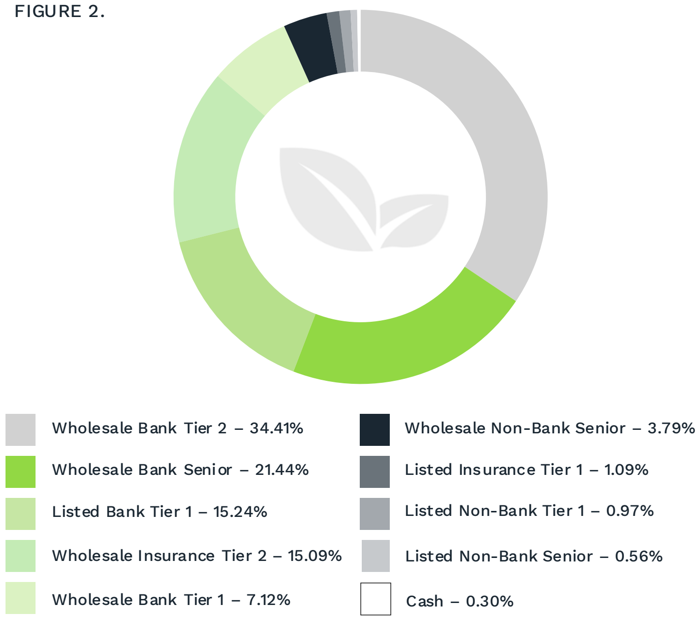
Following the release of this data, media outlets quickly speculated that the Reserve Bank of Australia (RBA) may lower the cash rate target at its next meeting on 18 February. However, the crucial question remains: Has inflation sustainably returned to the RBA's 2-3% target band, or is this just a temporary dip?

The RBA has been clear that it will only cut rates once inflation is sustainably within the target range. While pressure is mounting from various sources—including the media, the federal government, and mortgage holders—the RBA must remain independent and act only when economic conditions justify a change.

Portfolio Holdings

(as at 31 January 2025)

FIGURE 2.



Listed Hybrids Have Scope For Even Tighter Margins

Hybrid margins have tightened significantly since the Australian Prudential Regulation Authority (APRA) first indicated that bank hybrids would be phased out starting in 2027. The official confirmation in December 2024 has removed major uncertainty in hybrid structures, particularly regarding the risk of discretionary call dates. Now, it is expected that APRA would prefer banks to repay each hybrid on its first call date.

As a result, the risk gap between hybrids and traditional bonds is narrowing. If an investor believes there is a low probability of either missed distributions or a non-viability/capital trigger event, hybrids could increasingly trade closer to more senior bonds. Even the issue of subordination could be seen as more of a theoretical risk—only relevant in the event of an issuer's failure.

Market Implications

Given these factors, listed bank hybrids should be trading at tighter margins than they currently are. For example:

- AN3PK is a hybrid currently trading at a 218-basis-point margin with a 5-year term to call (March 20, 2030).
- A newly issued 5-year senior bond from ANZ would currently price at around 82 basis points.
- This results in a 136-basis-point difference, indicating that the market still perceives hybrids as significantly riskier than senior bonds.

However, as hybrids continue to reach their call dates and are repaid as expected, it is conceivable that this spread differential will narrow considerably over time.

Investment Opportunity

For investors comfortable with the limited risk of non-payment or a non-viability event, current hybrid margins present an attractive opportunity, offering elevated yields relative to more senior bonds despite a diminishing risk premium. As confidence in APRA's direction grows and call patterns are reaffirmed, hybrids should continue to reprice tighter, rewarding those who position early.
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However, investors looking to take advantage of this trend must carefully consider distribution accrual values and clearly track call dates. Since hybrids trading tighter will be priced well above the $100 face value returned at call, timing the exit will be crucial. Additionally, trading liquidity will become an important factor as the number of hybrids on the market declines and the pool of active investors shrinks.

As we manage a long transition to more Tier 2 capital investment, we intend to continue monitoring value availability in the listed hybrid market in light of the realistic risks of these instruments. With seven years until the last hybrid is called, investing in listed hybrids will continue to require patience and careful strategy.

Expert Management

The HIF provides access to specialist management, with extensive expertise in regulated capital products including hybrids and subordinated debt.

Senior Portfolio Manager

Nicholas Chaplin is an authority in the Hybrid and capital issuance market having structured, originated, distributed, and educated on many issues since 1998.

Nick has originated over $200 billion in hybrid & capital issues. From 2009 to 2021, Nick was Head of Hybrid & Structured Capital at NAB and prior to that he was Head of Hybrid Origination at Westpac.

Portfolio Manager
Chair, Investment Committee

John Corr has worked in the finance industry for 40 years and is a highly regarded authority in portfolio risk management. He has experience in banking, broking, proprietary trading and funds management. John was a founder and CIO of Aurora Funds Management.

Portfolio Analyst

Ned Silva joined the Diocese Development Fund as an Investment Analyst in 2020, managing Hybrid and Subordinated Capital. In 2023, he moved to ANZ's Capital Markets Debt Syndicate, before joining Seed in 2024.

Unit Pricing:	Daily
Applications:	Daily
Distributions:	Monthly
APIR Code:	EVO3184AU
Management Fee:	0.55% per annum
Performance Fee:	Not Applicable
Website:	Click here
Offer Document:	Click here
How to Apply:	Click here
Contact Details:	Click here

Fund Information

The Hybrid Income Fund strategy was established in September 2015.

Hybrid Income Fund (HIF) actively invests in a diversified portfolio of financial capital with a heavy weighting to Australian-regulated capital instruments. The underlying securities include hybrids (Tier 1 capital notes and convertible preference shares), Tier 2 bonds, subordinated debt, senior debt, mutual capital instruments and cash. The Fund typically holds ~40 positions whose underlying issuers are banks, insurance companies and non-bank lenders.

Fund Objective

HIF aims to provide returns that exceed the Hybrid Benchmark on a net basis over the suggested investment timeframe (five+ years). The Fund has a meaningful track record of exceeding its target after fees through active management with low volatility and access to franking credits.

Our Product Universe

The universe for the Hybrid Income Fund portfolio includes prudential capital instruments issued by Banks, Insurers, and non-bank financial corporations as well as other instruments from these issuers such as senior bonds. Prudential capital includes hybrids and subordinated bonds (sometimes referred to as Tier 1 and Tier 2 securities respectively). Senior bonds add significant additional liquidity to the portfolio as well as adding important product diversity.

The Investment Strategy

The investment manager intends to apply a tactical approach in terms of which securities it invests in and the timing of such investments with a focus on delivering a robust risk adjusted yield through market and interest rate cycles.

The investment manager will:

- Manage interest rate risk by holding predominantly floating rate instruments;
- Provide portfolio diversity by security type, credit risk, duration and issuer;
- Aim to distribute franking credits;
- Aim to provide regular income.

Platform Availability

HUB24 · FNZ · Mason Stevens · netwealth · Australian Money Market · Powerwrap · APEX · praemium · connexion

Unit Price and Core Data

The unit price on 31 January 2025 was $1.0782. This is inclusive of the January distribution which will be paid in early February. The unit price is published daily on our website here.

Franking credits provide an additional return which will depend on the investor's own tax situation. Currently, 15% of the portfolio is receiving full franking value. The remainder is receiving full cash returns. Franking credit exposure is reduced with additional investment in Tier 2 securities or senior bonds as these are debt instruments for tax purposes.

Fund returns are made up of three key aspects: 1) regular distributions (either taken as cash or reinvested according to your preference, 2) franking credits associated with these distributions, and 3) changes in the capital value (unit price) over time.

We continually measure the relative value of the prime asset classes of the fund and adjust weightings actively. On 31 January, the fund was holding 24.4% Tier 1 instruments (including both listed and wholesale), 49.5% Tier 2 instruments, 25.8% senior bonds, and 0.3% cash. Figure 2 on Page 2 depicts these current allocations.

The average credit rating of the portfolio is investment grade at BBB+.

Glossary

The following details are provided to assist in understanding of terms used in this report:

Credit Spread Duration: Measures the sensitivity of a bond's price to changes in its credit spread. This measure reflects the potential change in the bond's value in response to a 100-basis point (1%) change in the credit spread. For example, if credit spreads tighten by 100 bps for a portfolio with a credit spread duration of 2.5 years, it will result in a + 2.5% return assuming all else is equal.

Interest Rate Duration: The weighted maturity of a fixed-income investment's cash flows, considering all coupon interest payments and the maturity date - used in the estimation of the price sensitivity of fixed-income securities for a given change in interest rates i.e. shorter duration bonds are less sensitive to interest rate movements than long bonds.

Running Yield: The ratio of interest to the current market price of the bond, stated as a percentage. For example, a bond with a current market price of $100 that pays $6 per year in interest would have a running yield of 6%.

Yield to Call: A yield on a security calculated by assuming that interest payments will be paid until the call date, when the security will be redeemed at the call price.

Yield to Maturity: A yield on a security calculated by assuming that interest payments will be made until the final maturity date, at which point the principal will be repaid by the issuer. Yield to maturity is essentially the discount rate at which the present value of future payments (investment income and return of principal) equals the price of the security.

General Disclosures

The material contained within this Report (The Report) has been prepared by Seed Funds Management Pty Limited (ABN 25 675 247 506) (Seed), a Corporate Authorised Representative (no 001308397) of its related body corporate, Seed Partnerships Pty Ltd (ABN 32 606 230 639) the holder of AFSL No. 492973. It is issued by the Responsible Entity of the Fund, Evolution Trustees Limited (ABN 29 611 839 519, AFSL 486217) (Evolution). Seed receives a management fee for managing the Fund.

Figures referred to in The Report are unaudited.

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