seed FUNDS MANAGEMENT

Hybrid Income Fund

Monthly Report – May 2024

Fund Dashboard

31 May 2024

7.56%
% Yield to Call
(Portfolio as bought)

6.39%
% Yield to Call
(Portfolio if bought today)

6.26%
Running Yield

4.2 Years
Weighted Average Term to Call

97%
Portfolio Floating Rate

0.31 Years
Interest Rate Duration^

25%
Top 5 Holdings As % of Fund*

37
Number of Holdings*

Source: Seed Funds Management. As at 31 May 2024.

*Excluding cash.
^Maximum duration of 1.

Hybrid Income Fund Strategy Net Performance

31 May 2024

FIGURE 1.

	1 Month	3 Months	6 Months	1 Year	3 Years Annualised	5 Years Annualised	SI (Sep 15) Annualised
HYBRID INCOME FUND STRATEGY	0.40%	1.97%	4.26%	8.54%	5.66%	5.61%	**6.32%**
Hybrid Benchmark (Solactive*)	-0.73%	1.26%	2.89%	7.13%	3.73%	3.73%	**4.69%**
RBA Cash Rate	0.36%	1.09%	2.19%	4.32%	2.36%	1.60%	**1.60%**

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 as trustee. Investment management services were novated to Seed Funds Management in March 2024. Performance figures for the Strategy have been reviewed in accordance with ASRS 4400 "Agreed-Upon Procedures Engagements" by Hall Chadwick Corporate (NSW) Limited.

Monthly Commentary

May saw an increase in market volatility in hybrid prices as equities swung around searching for direction mainly in response to US and Australian CPI outcomes with hybrid investors continuing their bad habit of crossing asset classes (i.e. selling hybrids to buy equities and vice versa). Australian markets continue to expect a rate reduction from the RBA this year with November touted as the most likely time. However, the resilience in the economy continues to suggest there will be no need to move rates until 2025.

The volatility noted above had a negative impact on listed hybrid prices. Consequently, a typical portfolio focused solely on listed hybrid investment, represented by the Solactive Australian Hybrid Index benchmark, experienced a materially negative month in May.

Conversely, our portfolio, which is actively managed to achieve a high quality defensive income strategy, deliberately diversifies our hybrid holdings with subordinated and senior bond issues from Australia's bank and insurance industries. These assets operated through the month with materially more stability. I am extremely proud of the outcome this strategy has demonstrated through May as we outperformed the more risky pure-hybrid strategy by 1.13%.

The fact that our strategy achieves this outcome while delivering a lower-risk exposure mix is particularly pleasing. Subordinated and senior bonds are higher ranking than hybrid capital in a bank's capital structure. They should provide a lower return for that lower risk. But when this lower risk cooperates with lower volatility and active management of the blend of these assets, the results can be very positive as we have particularly seen this month in the Hybrid Income Fund.

Key Portfolio Moves in May

We didn't hold onto the new SUNPJ very long as it traded to $101.50 on day 1. This price action, and the higher trading volumes in the first week of issue, allowed an exit at an immediate capital gain as the margin on the insurance issuer traded down through +270 bps.

We sold out of NABPI in anticipation of the settlement of the new NAB Capital Notes issue as it traded to near historic price highs.

The new NAB Capital Notes 8 will have the ticker NABPK and at issue offers just under a 7% yield. Please note our comments in this report about the capacity for hybrids to trade tighter over time, despite this issue being at a record tight margin for a Basel 3 structure.

*Solactive Australian Hybrid Index (Net)

After some strong progress over recent weeks, we sold the Westpac April '29 call Subordinated Notes to generate cash for higher yielding investment elsewhere in the Tier 2 space. Tier 2 has strengthened almost as much as Tier 1 in recent months and is holding its value with less volatility than Tier 1, particularly recently.

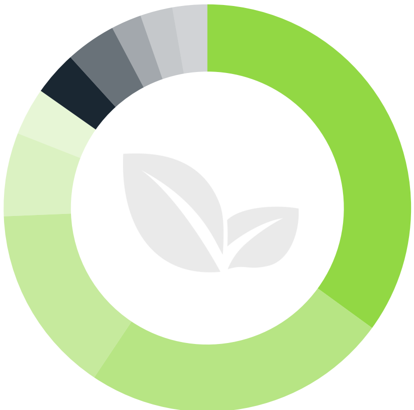
Excess cash was put to work in the new NABPK security plus some topping up in other Tier 1 issues via the secondary market. This increased our holding proportion in Tier 1 relative to Tier 2. This tilt back towards risk in the portfolio is relatively small on its own but is justified following significant performance in the Tier 2 holdings within the portfolio recently.

The NABPK issue doesn't commence trading until 7 June and our exposure to hybrids remains less than total Tier 2 subordinated bond exposure at this stage.

Portfolio Holdings

(as at 31 May 2024)

FIGURE 2.



- Wholesale Bank Tier 2 – 34.8%
- Listed Bank Tier 1 – 27.7%
- Wholesale Insurance Tier 2 – 14.9%
- Wholesale Bank Tier 1 – 6.5%
- Listed non-Bank Senior– 3.9%
- Wholesale non-Bank Tier 2 – 3.8%
- Wholesale non-Bank Senior – 3.4%
- Listed non-Bank Tier 1 – 2.4%
- Listed Insurance Tier 1 – 2.5%
- Cash – 0.1%

APRA Update on Potential Tier 1 Changes Expected

APRA has stated in its “Targeted Changes to ADI Liquidity and Capital Standards” paper that the consultation process will be finalised by 30 June with implementation of any changes by 1 January 2025. This means an update from APRA could be expected this month.

A variety of different outcomes have been doing the rounds in the market including the most likely result being an increase in the CET1 capital trigger in the structures of Tier 1 instruments from 5.125% to at least 7.00% (flagged here as expected), as well as views on whether retail investors will still be able to access the hybrid market. On this latter point, there has been no additional comments provided by APRA and so it remains a point raised in the original consultation paper only. We will report our views on any relevant market impact as soon as more information becomes public.

The most relevant market reaction we would expect from an increased capital trigger would be an immediate widening in margins for the new structure. The outstanding capital notes issues would be expected to be ‘grandfathered’ in that they would stay on foot until ultimately called (with APRA’s permission). These outstanding issues would be perceived by the market as having a lower risk than any future new issue with a higher capital trigger. This would mean that, over time, we would expect margins on prevailing hybrids to maintain their tight margins (all other things being equal). However, if investors become comfortable with the risk trade-off in the higher capital trigger hybrids as they come to market, then we expect to see some investors selling older hybrids to buy the higher margin new issues. We would anticipate the arbitrage in the margins of the different structures to be ultimately traded away over time.

Capacity for Tighter Margins Remains

We have taken many questions from the market over the last month about relative value of hybrids and subordinated bonds with questions on whether the market can go tighter noting secondary levels for typical 5-year tier 1 and tier 2 securities trading in the low +200's and mid +100's over 90-day BBSW respectively.

Provided market conditions remain steady, there is scope for these trading margins to tighten further. Investors in the market agree that the structural features introduced to prudential capital instruments a decade ago with the Basel 3 reforms did increase the risks in the instruments, however, they feel that the Australian banking and insurance industries have also subsequently strengthened in terms of capitalisation, liquidity, and a general derisking in these industries.

As more investors in the market have accepted the above view, margins have tightened and this may continue as yields stay comparatively high versus recent years and Australian banks focus on mortgage lending as opposed to the diverse investment banking styles of overseas banks.

We will continue to particularly monitor and act on relative value movements in these asset classes.

Expert Management

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

Senior Portfolio Manager

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

Over his career he 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.

Unit Pricing:	Weekly
Applications:	Weekly
Distributions:	Quarterly
APIR Code:	EVO3184AU
Management Fee:	0.70% 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. The Fund has a meaningful track record of exceeding its target after fees through active management with low volatility and access to franking credits.

The Hybrid Market

The listed hybrid market includes issues totalling approximately $45 billion across a broad range of financial and corporate issuers. In focusing on the financial issuers in this market, over 90% of listed hybrid issuers will be available for investment. Additional diversity and liquidity will be achieved via investment in wholesale unlisted senior, hybrid capital issues and subordinated bonds issued by banks, insurers and other financial entities.

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 listings

HUB24 · Australian Money Market · præmium · Powerwrap · netwealth

Unit Price and Core Data

The unit price on 31 May 2024 was $1.0623. The unit price is published weekly on our website here.

As at 31 May, the weighted average yield to call of the portfolio was 7.56%. This is the yield of the portfolio to its collective call dates based on the prices at which each security was purchased. Please note we also show below the yield to call based on security prices today. The running yield of the portfolio was 6.26%.

Franking credits have added an additional 0.93% to returns over the last 12 months with 34% of the portfolio receiving full franking value. 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 May, the fund was holding 43.9% Tier 1 instruments (including both listed and wholesale), 48.6% Tier 2 instruments, 7.4% senior bonds, and 0.1% 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

Wholesale Fund Material
The material contained within this document about the Hybrid Income Fund ('Fund") has been prepared by and is issued by Seed Funds Management Limited (ABN 25 675 247 506) Corporate Authorised Representative (no. 001308397) of its related body corporate, Seed Partnerships Ltd the holder of AFSL No. 492973.

APIR Code: EVO3184AU

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