seed FUNDS MANAGEMENT

Fund Dashboard

30 September 2024

6.36%

% Yield to Call
(Portfolio as bought)

5.75%

% Yield to Call
(Portfolio if bought today)

6.03%

Running Yield

4.4 Years

Weighted Average
Term to Call

98%

Portfolio Floating Rate

0.28 Years

Interest Rate Duration^

35%

Top 5 Holdings
As % of Fund*

41

Number of Holdings*

$290 million

Current FUM

Source: Seed Funds Management.
As at 30 September 2024.

*Excluding cash.
^Maximum duration of 1.

FundMonitors.com Trusted Targeted Research — Highly Commended

Hybrid Income Fund

Monthly Report – September 2024

Hybrid Income Fund Strategy Net Performance

30 September 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	0.76%	2.03%	3.93%	8.23%	6.11%	5.13%	6.38%
Hybrid Benchmark (Solactive*)	1.00%	2.09%	3.55%	6.56%	4.51%	3.85%	4.86%
RBA Cash Rate	0.36%	1.09%	2.19%	4.41%	2.85%	1.84%	1.71%

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 for the Strategy to March 2022 have been reviewed in accordance with ASRS 4400 "Agreed-Upon Procedures Engagements" by Hall Chadwick Corporate (NSW) Limited.

Monthly Commentary

Hybrids are trading tighter after APRA's unexpected announcement to phase out Additional Tier 1 instruments, starting in 2027 and concluding by 2032. Listed hybrids are now trading at their tightest levels in 10 years, following Basel 3 structural changes in 2013. This is driven by the market's belief that APRA is firming up call dates for each bank hybrid. As these instruments become rarer, we expect they are to be increasingly sought after by investors.

We strongly oppose APRA's plan to phase out AT1. If the goal is to exclude retail from capital instruments, APRA should disallow future listings instead of weakening the banking industry for depositors and investors. Standard & Poor's has already warned that Tier 2 instruments will be downgraded following this move. The deterioration in Tier 2 credit quality could also impact senior bonds and deposits. We believe this decision would be one of the most detrimental made by a global regulator, as it undermines APRA's core mission—to safeguard depositors and the banking industry.

Seed Funds Management has submitted its response to APRA and arranged a roundtable with the regulator and a dozen brokers to discuss the proposal. APRA will consider market submissions until early November.

Key Portfolio Moves in September

There was plenty of activity this month with new subordinated note issues from QBE, and new senior issues from Westpac and Suncorp. We also saw a new non-regulatory capital issue from ANZ Holdings NZ and what could be the final listed hybrid from Macquarie Bank (MQGPG). We participated in all of these issues and witnessed some of the most positive price movements we've seen in a while.

The MQGPG listed on Day 1 at $101.90 and has since moved higher. Similarly, the ANZ NZ issue is now trading at $102.46, delivering very pleasing gains. To take on these new issues, we reduced some senior holdings that had performed well in the short term. We will continue to shift from senior to subordinated positions to capture the yield advantage as new issues come to market.

We also invested in both the floating and fixed tranches of QBE subordinated notes, with the fixed tranche performing particularly well, quickly moving to $101.40. We chose to enter both tranches after reducing some fixed holdings in August.

Fixed-rate exposures will remain rare in this fund, with only specialised investments made when conditions are highly favourable. We are not willing to gamble on duration, even when rate reductions seem certain. Floating-rate instruments generally perform well in all interest rate environments, and timing duration is not our focus.

*Solactive Australian Hybrid Securities Index (Net)

We took profits in our AYUHE holdings, but this issue continues to show significant price volatility, and we will monitor for opportunities to increase our holding at a more attractive price.

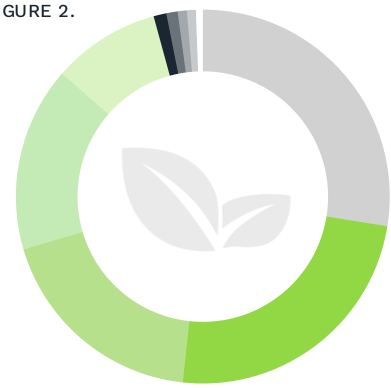
We expect new Tier 2 security issues from banks to continue through the last quarter of the year and expand in 2025. The original deadline for banks to increase risk capital, as mandated by APRA, is 1 January 2026—just over a year away. APRA's potential changes to AT1 for banks are likely to drive even more Tier 2 issuances over the next eight years. While Tier 2 securities are also issued in foreign markets and currencies, we expect the majority of issuance to be local.

We aim to capitalise on wider margins in Tier 2 over time, though we anticipate increased demand as investors seek yield replacements for bank hybrids.

Portfolio Holdings

(as at 30 September 2024)

FIGURE 2.



- Wholesale Bank Tier 2 – 27.52%
- Wholesale Bank Senior – 24.20%
- Wholesale Insurance Tier 2 – 18.73%
- Listed Bank Tier 1– 15.98%
- Wholesale Bank Tier 1– 9.33%
- Listed non-Bank Tier 1 – 1.12%
- Listed Insurance Tier 1 – 0.97%
- Listed non-Bank Senior – 0.79%
- Wholesale non-Bank Senior – 0.78%
- Cash – 0.59%

CPI Tempering But RBA Must Complete The Job

We continue to hear calls for the RBA to lower the cash rate target, despite inflation not yet being confirmed within the 2-3% range by a quarterly CPI report. The 2.7% monthly CPI figure for August 2024 is the lowest inflation rate Australia has seen since August 2021. This significant drop from 3.5% in July is largely attributed to government rebates on electricity and declining fuel costs, which have temporarily eased inflationary pressures. However, it's important to note that underlying inflation—excluding volatile items like fuel and electricity—remains elevated at 3.4%. This indicates that inflationary pressures, particularly in non-tradable goods and services such as housing and food, persist.

While the headline CPI is currently within the Reserve Bank of Australia’s (RBA) target range of 2-3%, the RBA is likely to focus on core inflation when guiding future rate decisions. The moderation in inflation is encouraging, but the RBA remains cautious, projecting that inflation may not sustainably return to the target range until 2026.

Banks Have Reason to Still Issue Perpetuals

Even if APRA proceeds to phase out Additional Tier 1 hybrid issues, the banks should still have interest in issuing hybrids in the future owing to the importance of supporting credit ratings. The Risk Adjusted Capital (RAC Ratio) calculations that S&P complete are vital inputs to their credit rating analysis for the banks.

Banks may continue to issue innovatively structured hybrids that mimic some of the beneficial features of AT1 instruments, such as:

- Perpetual term with call options: Providing long-term funding stability.
- Deferrable coupons: Offering flexibility to the bank during periods of financial strain.

While these new instruments would not contribute to regulatory capital, their features could still be beneficial to a bank’s overall financial profile and help maintain investor confidence. In turn, this may have a positive, indirect effect on how S&P assesses the bank’s RAC ratio by reducing pressure on liquidity or funding.

With a month to go until APRA concludes its consultation period on its AT1 proposal, we will keep a close eye on developments and, as we have done since the initial announcement, we will send out updates directly to investors.

Please feel free to contact us directly with any additional questions you may have on these developments.

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 Chaplin 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.

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.

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 listings

Unit Price and Core Data

The unit price on 30 September 2024 was $1.0665. This is ex-distribution price. The unit price is published daily on our website here.

As at 30 September, the weighted average yield to call of the portfolio was 6.36%. 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 6.03%.

Franking credits provide an additional return which will depend on the investor's own tax situation. Currently, 14% 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 30 September, the fund was holding 27.4% Tier 1 instruments (including both listed and wholesale), 46.2% Tier 2 instruments, 25.8% senior bonds, and 0.6% 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 Limited (Seed), a Corporate Authorised Representative (no 001308397) of its related body corporate, Seed Partnerships Ltd 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).

Figures referred to in The Report are unaudited. The NAV Unit Price has been used for performance reporting, however if an investor is to come out of the fund that would be done at the exit price.

The Report is not intended to provide advice to investors or take into account an individual's financial circumstances or investment objectives. This is general investment advice only and does not constitute advice to any person. Neither Evolution nor Seed guarantee repayment of capital or any particular rate of return from the Fund. Neither Evolution nor Seed gives any representation or warranty as to the reliability, completeness or accuracy of the information contained in this Report.

Investors should consult their financial adviser in relation to any material within this document. Past performance is not a reliable indicator of future performance. Investors should consider the PDS, Reference Guide, TMD and any other material published by Seed or Evolution in deciding whether to acquire units in the Fund. This information is available at https://www.seedpartnerships.com/hybrid-income-fund.html