Clean Air For Tier 1's

30th May 2016

The Realm High Income Fund has gradually built a tactical overweight in AT1 securities (commonly referred to as Bank Hybrids) over the last eighteen months.

In mid to late 2014 the fund maintained negligible exposure to this market. However this changed as a number of issuers created a supply side distortion which has only recently shown any real signs of dissipating.

This led to the sector comparing favourably versus other fixed income and capital securities on price for risk using our in-house risk/return modelling. This has been a position which we have needed to justify almost constantly, given the higher volatility of these assets and of course the performance of the AT1 sector, which at times has looked diabolical.

The weakness was pronounced with a number of 2014 minted issues seeing the lower reaches of 90 cents on the dollar, with the odd one exploring the mid 80's.

This was all too much for hybrid investors who had understood these instruments to be fixed income like investments and indeed the advisers that guide them. This led to a capitulation of sorts that was fuelled by conflicted parties within the media and other fixed income managers for whom the hybrid market was perceived as being a competitor for client demand.

Ultimately our position has always been that, these securities are complex, however the ambiguity of the instruments is overstated, very often while the safety and simplicity of the rest of the fixed income complex is fundamentally understated. We have always chosen to focus on the risks and the price.

While our quantitative metrics have long put a line in the sand around our fair market level, it is the qualitative aspects of the market which are leading to an alignment of stars that are likely to provide a strong tailwind to this market.

- Deflationary forces will continue to provide a drag for inflation, this will continue to deliver a headwind to interest rates rising.
- Supply side factors are likely easing and could even reverse from here as domestic tier 1 supply is reduced and banks once again open their foreign funding curves.
- New sources of demand have availed themselves to the market with institutional investors seemingly setting up camp.
- Europe's corporate bond buying program will crunch spreads tighter, and likely lead to a global reach for yield.
- The equity market is losing the confidence of income investors in being able to deliver stable outcomes.

Just as rates continue to plummet and concerns rise around equity market performance and dividend payouts, the AT1 market is beginning to look like a veritable three course meal. Add to this the fact that term deposits are rolling off into this low rate environment and you have fertile ground for a capped equity type outcome to be gobbled up by income hungry retirees who are just horribly short of options.

The bad news for domestic retail investors is that institutional investors have now set up camp and are likely here to stay for a while. This was particularly evident to many in the scaling of demand in the recent Westpac Hybrid which saw retail investment adviser bids savaged.

Additionally, it seems that 2016 will see the major Australian banks once again head oversees for their AT1 capital needs. The ANZ seems to be exploring a USD AT1 issue in the current year, which will effectively reverse a 5-year trend of foreign issues being rolled over into Australia and increasing supply to breaking point.

In a yield starved global market this issuance is likely to be well received and will mean that retail investors are likely to have to share less and less supply among themselves just as rates continue to plunge headlong into un-chartered territory.

For our part we have anticipated this supply demand dynamic reversing and are well positioned to capitalise. The Realm High Income Fund maintains exposure of approximately 20% to the Australian AT1 market across 18 separate issues. This provides the fund with a diversified exposure of longer duration names which allow the manager to benefit from any outperformance, while the diversity and smaller average size allows us to maintain the liquidity that is necessary to lock in profit through a reduction of exposure when the time is ripe.

While our AT1 Holding has remained a position of high conviction for over a year now, it is important for investors to understand that we are not tied to this allocation, indeed our long-term strategic allocation sits at closer to 15%, furthermore if and when the sector trades at fundamentally expensive levels, you can expect to see the allocation reduce below the strategic level.

All of that said we have shown a great deal of patience in holding this position and are pleased to say that the stars seem to be finally aligning from a supply side perspective for the sector.

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