

## April 2010 Performance Review – Listed Hybrid Sector

### Performance

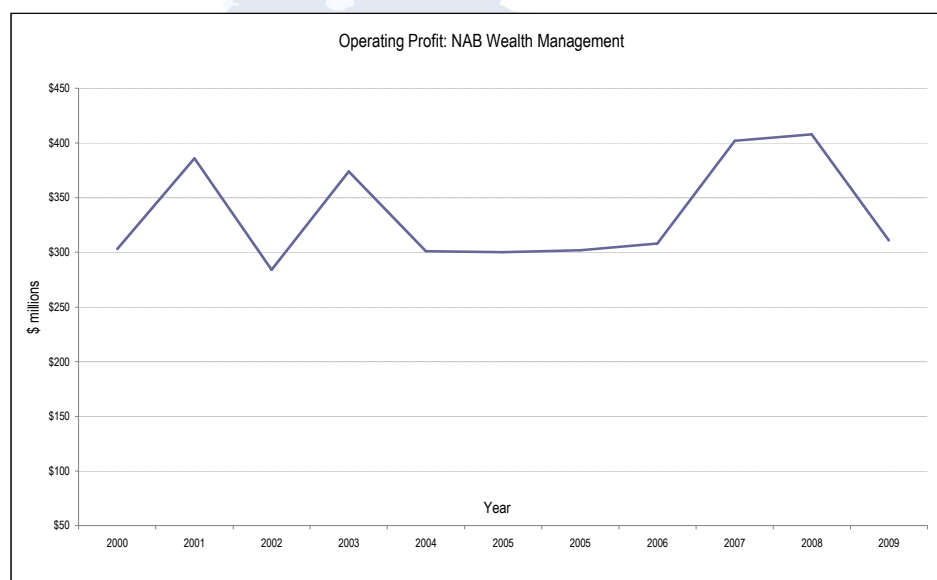
The Elstree Enhanced Income Fund's Net Asset Value (NAV) increased over the month of April 2010 from an ex distribution price of 0.7355 per unit to 0.7587 per unit. This represents a return of +3.15%. This compares with the All Ordinaries Accumulation Index and the UBS All Maturities Bond Index returns of -1.18% and +0.55% respectively. The Fund's over the year net return (after fees and before adjusting for the value of franking credits) decreased to +42.9% from +46.6% previously.

### Events

Bank reporting season commenced late in the month with BOQ and ANZ reporting lower bad debts, slightly better margins and abundant capital. We expect that WBC will follow a similar trend. We sensed there was a lot of sandbagging going on at ANZ who talked up bad debts and the cost of funding. If the experience of the last post recession period repeats itself, bad debts will plummet and the cost of funding decreases materially as economies improve. The one concern for equity investors is that ROE's are still below desired levels despite what seems to be a nearing of peak pre-provision profits. In other news this month the ALE note listed but is yet to trade.

### Australian banks: not great at managing outside the cartel

The chart below shows the operating profit history of the NAB wealth management operations since they purchased MLC from Lend Lease in 2000. Prior to the purchase of MLC, the National's wealth management business generated around \$130m in operating profits. When NAB purchased MLC for \$4.56b it generated around \$200m p.a. On a pro - forma basis operating profits were between \$300 - \$330m in 2000. Despite the enormous growth in wealth management, operating profit has barely changed. At the same time we suspect there is in excess of \$8b invested in wealth management entities, which on a simple return on capital equates to less than 3% operating margin (or around a 10% ROE), which is well below their banking business.



*Increasing systemic risk not good for investors*

We're firmly of the view that the domestic banks aren't capable of managing outside of a cartel (at which they are very successful) or in any place where they don't have an ANZAC day holiday. Normally, this view is a peripheral issue for debt investors, but most of the major banks are looking to grow beyond their current domestic base through wealth management or offshore. This increases the systemic risk in what is the one of the most risky financial systems of the world. Domestic banks now recognise that they will be bailed out if there is a further systemic crisis, so effectively the Australian taxpayer is subsidising the forays into wealth management and Asia.

*And where are we on Basle 3*

Basle 2 is close to dead and buried and the framework for Basle 3 is starting to emerge. Not surprisingly, given the scope of the GFC, it's tougher on banks. Banks will be required to hold more capital, of better quality and with greater liquidity. It's the latter that is concerning the domestic banks: in Australia there are not enough government bonds for banks to hold. As with the previous few Basle revisions, we expect the process to take a while and for the really gnarly aspects to not appear until further discussion has taken place. The big nasty change from Basle 1 and 1.5 to Basle 2 was that capital became much more pro-cyclical i.e. the banks needed to raise more capital as things became worse (when they could least do it) rather than anti-cyclical. Although this was noted at the time, it was only recognised as the great flaw of Basle 2 in the middle of the GFC.

*Credit growth:*

It seems that credit growth has finally bottomed out at around a 1% annualised rate. This is well below the 2 decade average of 9.7%. However the composition remains worrying with both business lending and owner occupied housing decreasing and investor housing and personal (read credit card and margin lending) increasing. Business lending is now around \$70b (or 4% of GDP) below its peak levels and shrinking at around an 8% annualised rate.

| Performance Table            | 1 month | 3 months | 12 months | Since Inception % Per Annum |
|------------------------------|---------|----------|-----------|-----------------------------|
| Elstree Enhanced Income Fund | 3.15%*  | 2.48%    | 42.94%    | 5.8%#                       |
| UBS Warburg Bank Bill Index  | 0.35%   | 1.05%    | 3.6%      | 5.7%                        |

\*Returns are net of fees and do not include the benefit of franking credits. Past performance is not necessarily a guide to future performance. # Return is gross of fees and includes the benefit of franking.

**Disclaimer**

The information and opinions contained in this report have been obtained from sources of Elstree Investment Management Limited (ABN 20 079 036 810) believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate or complete and it should not be relied upon as such. Information and opinions contained in the report are published for the assistance of recipients, but are not relied upon as authoritative and may be subject to change without notice. Except to the extent that liability cannot be excluded, Elstree Investment Management Limited does not accept liability for any direct or consequential loss arising from any use of material contained in this report.