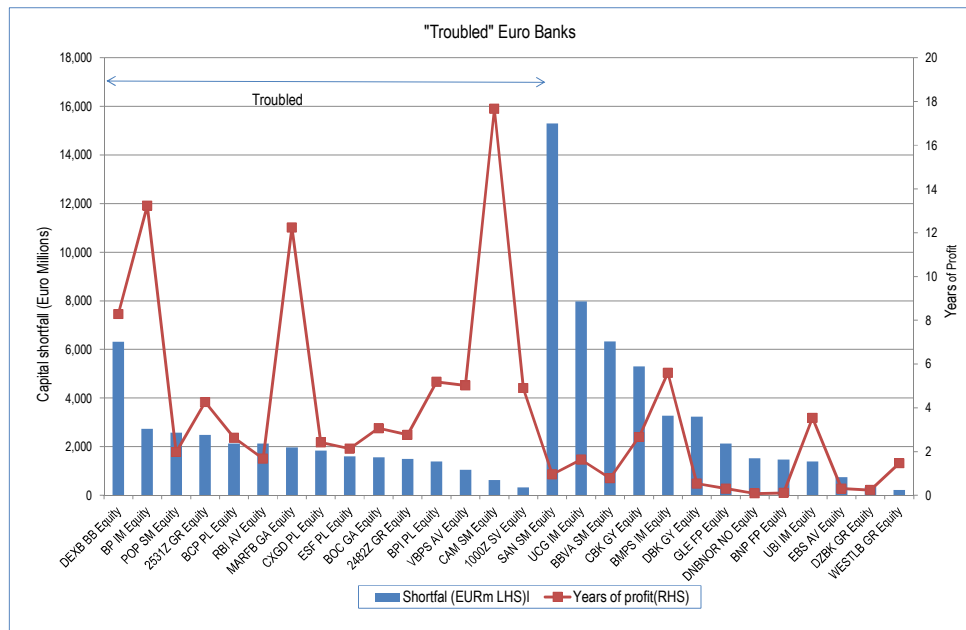


December 2011 Performance Review – Listed Hybrid Sector

<p><i>Fund Performance</i></p>	<p>The Elstree Enhanced Income Fund's Net Asset Value (NAV) increased over the month of December from a price of \$0.7349 per unit to \$0.7413 per unit representing a return of +0.87%. This compares with the All Ordinaries Accumulation Index and the UBS All Maturities Bond Index returns of -1.57% and +0.77% respectively. The Fund's performance this month was influenced by the poor performance of 2 discounted securities the Fund owns. The Fund's over the year net return (after fees and before adjusting for franking credits) increased to 2.18% from 1.20% previously. The Fund's over the year gross return increased from 2.76% to 3.70%.</p>
<p><i>Events</i></p>	<p>In a year when the average equity IPO returned double figure negatives, the 2 hybrids listed this month both posted (by hybrid standards) good returns, despite both issues being upsized. The AFIC note finished the month at around 3% higher with the Origin note a little less. The average "stag" in 2011 was 2.3%.</p>
<p><i>Banks: where liquidity and insolvency get mixed up</i></p>	<p>Leverage changes the nature of corporations: they can be solvent on a going concern basis, but if they can't repay borrowings when they fall due, they become insolvent. Banks are the most highly leveraged entities around and that's why liquidity becomes important and why central banks are so important in providing liquidity. There is an interesting case in point in Europe at the moment, where banks are incapable of borrowing on an unsecured basis (i.e.) counterparties think they are, or they may become, insolvent. There was also a lot of press and negative analytical content on the recent European Banking Authority Stress Tests which flagged a need for an additional \$80b of capital for European banks; that looks like a chunky amount. However, the context needs to be examined. The \$80b is the amount of capital needed to restore core equity levels to 5% (remember core equity levels were around 3% pre GFC) after a stress test which includes a 4% fall in GDP (GFC equivalent) and falls in sovereign debt prices. The other important aspect is that many of the banks are profitable and it's quite probable that margins will increase as the banks recapitalise (i.e.) the socialisation of losses result in a transfer of wealth from the household sector to banks.</p>
<p><i>What is "trouble"?</i></p>	<p>The chart below shows the entire \$80b which we have split up into those banks that will have trouble raising the capital, and those that won't because its either a small sum or because the bank is profitable enough to raise the money quickly. As a definition of "trouble" we've used a lack of profitability and a threshold of more than 20% of their equity (i.e.) if the capital shortfall under the stress test is less than 1 year's normalised earnings and the bank has to issue less than 20% of new capital, the bank really doesn't have a solvency problem. It might have a liquidity problem and it definitely has a dilution/dividend payment problem. For example, the Spanish bank, Santander (shown as SAN in the chart) has to raise 15bEUR. While 15bEUR is a large amount it is only 1year of normal profits for Santander.</p>



Not so bad after all

Some of the troubled banks are already state owned and/or in the process of restructuring. The others are a combination of Cypriot and Portuguese banks and the odd Italian and Spanish bank. When we ‘strip’ out the state owned group, the amount of capital required by “troubled” banks falls to around \$18b. By comparison Australian banks raised around \$40b of capital over the GFC.

Who says markets are dumb?

Even though the amount of capital needed by “troubled” banks is way less than the headline, markets have got a whiff of the numbers and have marked share prices down dramatically to an average price to book of 0.7, which means banks will be reluctant to issue equity. We expect sales of businesses and assets, running down of loan books and some regulatory arbitrage, as well as some dilutive capital raisings.

Where the recent ECB actions fits in

Once again the press has been pontificating over the latest ECB action to allow unlimited borrowing for up to a 3 year term for all European banks. We think there are 3 (all positive) aspects to the program, which is, in effect, a repeat of the US Fed’s successful 2009 actions we discussed last month. The aspects are: (i) there are no liquidity issues facing banks for the next few years of refinancing, (ii) once lenders realise the solvency issue is overblown and start lending to banks again, the European banks will have a lot of cheap long term funding available and (iii) the banks will eventually buy assets with the cheap funding which will stave off a repeat of the negative asset price bubble experienced in 2008.

Credit: still woeful

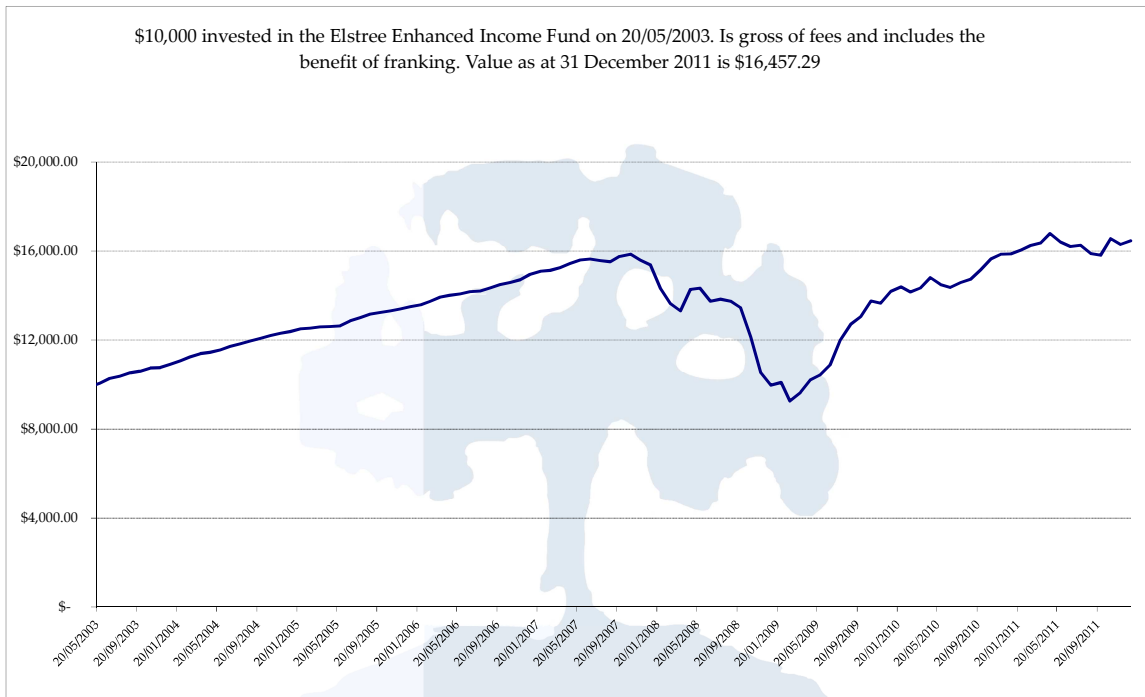
The economy continues to deleverage with credit approaching its third year of negative real growth. Money supply aggregates have started to decelerate which is probably not a good thing. The slow credit growth is a positive for financial stability and bank funding, but means that economic activity will remain subdued.



Performance Table	1 month	3 months	12 months	Since Inception % Per Annum#
Elstree Enhanced Income Fund	0.87%	3.72%	2.18%	5.31
UBS Warburg Bank Bill Index	0.39%	1.21%	4.99%	4.95%

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

Value of \$10,000 Invested on 20/05/2003



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