

February 2010 Performance Review – Listed Hybrid Sector

Sector Performance

The Elstree Enhanced Income Fund's Net Asset Value (NAV) decreased over the month of February 2010 from a price of 0.7494 per unit to 0.7368 per unit. This represents a return over the month of -1.68%. This compares with the All Ordinaries Accumulation Index and the UBS All Maturities Bond Index which returned +1.82% and +0.53% respectively. The Fund's over the year net return (after fees and before adjusting for the value of franking credits) increased to +50.7% from 40.7% previously. In gross terms the over the year return increased to +52.9% from +42.6% previously. In a flight to quality, bank hybrid securities, which the Fund has a below market weighting, out performed non bank hybrid securities which the Fund is overweight.

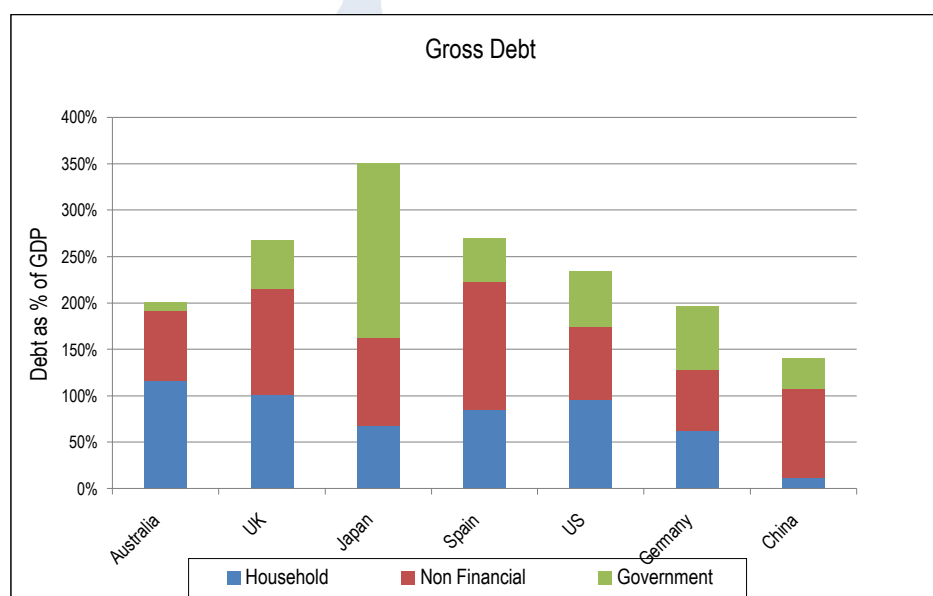
Events

Reporting season revealed that, in general, hybrid issuers posted improved results. Gunns was the major exception with profit falling by 99%. In a not unexpected move, Multiplex elected to step up their SITES, rather than redeem them. We think that if they really wanted to, Brookfield/Multiplex could fund cheaper than the 3.9% step up margin, but margins are falling and availability of funds is tight. It makes perfect economic sense to pay the higher coupon for a year or so and then fund at a much lower margin in the future.

Debt: when markets get upset by national leverage

With all the talk about public indebtedness we discovered an interesting report that McKinsey published. The report detailed the total and component leverage of a number of economies. McKinsey split the leverage of each economy into 4 categories; Government, Household, Non Financial business and Financial institutions and compared it to GDP. We're a bit sceptical about how to measure financial institutional debt, and its value in analysis, so we've used McKinsey's figures for the first 3 categories and compiled the equivalent data for Australia as a means of comparison.

Leverage by country



Leverage in Australia is not approaching danger levels yet

From the chart it's apparent that Australian total leverage is not anywhere close to extreme levels. While household leverage is high it is offset by low corporate borrowing and negligible government debt. Not surprisingly, the generally low degree of leverage in Australia was one of the reasons it sidestepped the worst economic effects of the GFC. We look with amazement at Japanese total debt levels. The Japanese had their GFC type asset crisis 2 decades ago and followed it with huge government spending and have not taken appropriate steps to resolve it. It's a lesson for other countries who are currently deficit binging.

Household debt the only vulnerability

Australia does operate with relatively high levels of household debt and it has been growing quickly. In addition, the high levels of current account deficits need financing. These are both warning flags, but from a structural point of view, there is little to be worried about in the absence of a global (or Chinese) meltdown.

And Greece?

Greece's total debt is around 230% of GDP - not extraordinarily high and not much above Australia's. However, Greece does have government debt levels of over 100%, which is a world class result. If markets are concerned about Greece, they should be more far more concerned about some of the other countries.

So? Lessons for investment markets

And in the world economy Greece, by itself, is not material. It accounts for around 0.4% of world GDP and has a total GDP that is somewhere around that of Maryland's (US state; home of Baltimore Orioles). In other terms it equivalent to the difference between China's GDP growing by 8% instead of 10%. Either the markets are getting themselves into a tizz over nothing or the connectedness and contagion issues of the past 2 years that lead to fear and loathing in capital markets have re-emerged. We think it's a little bit of both. Markets do have a right to be concerned about the connectedness but ultimately the world solved bigger contagion issues last year. We think the domino effect implied in prices is overdone. The more important message for us is that fear is still the driver of world markets and that minor issues will be magnified until the market deems them unimportant, either because another issue arises or until rationality emerges. This applies to hybrid security prices as well, where investors become periodically panicky, despite fundamentals being reasonable.

Credit growth: 2 speed economy

We're finding it difficult to do any other than repeat ourselves when we look at the RBA January credit growth data. Housing is doing fine, business credit growth is hugely negative and monetary aggregates (M3, Broad Money) are approaching recession levels. While we suspect we'll see green shoots in corporate lending, there is a very long way to go. We suspect this reflects a 2 speed economy where resource companies and big corporates are doing fine, but smaller businesses and those that rely on them are finding it difficult.

Performance Table	1 month	3 months	12 months	Since Inception % Per Annum
Elstree Enhanced Income Fund	-1.68%	3.43%	50.7%	5.3%#
UBS Warburg Bank Bill Index	0.37%	1.02%	3.5%	5.7%

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



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.