

January 2012 Performance Review – Listed Hybrid Sector

Fund performance

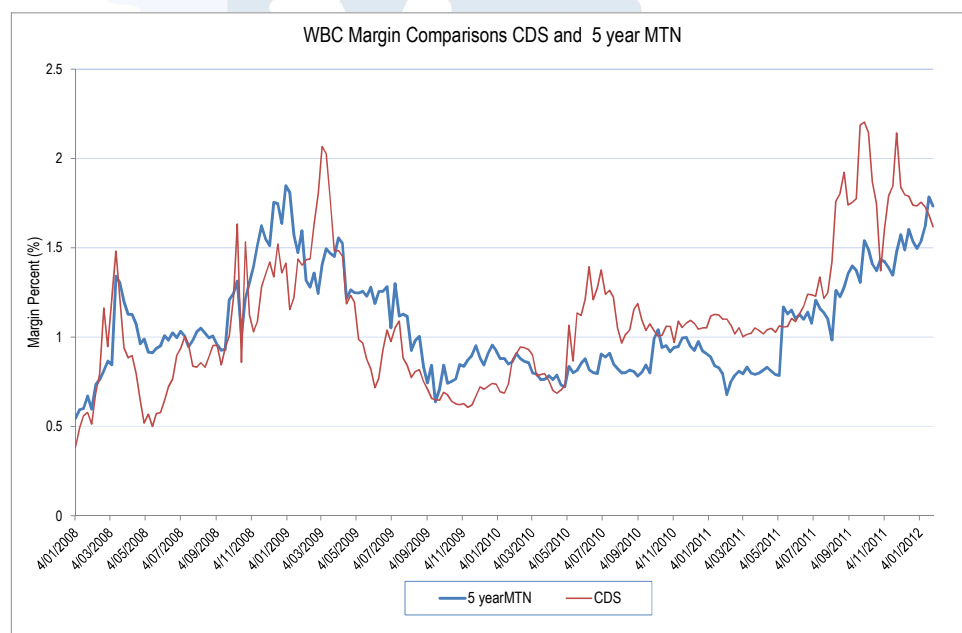
The Elstree Enhanced Income Fund's Net Asset Value (NAV) increased over the month of January from a price of \$0.7283 per unit to \$0.7365 per unit representing a return of +1.13%. This compares with the All Ordinaries Accumulation Index and the UBS All Maturities Bond Index returns of +5.23% and +0.15% respectively. The Fund's performance this month was positively influenced by the Fund's underweight position in bank hybrids which underperformed. The Fund's over the year net return (after fees and before adjusting for franking credits) increased to 2.30% from 2.18% previously. The Fund's over the year gross return increased from 3.70% to 4.01%.

Events

European banking issues continued to amaze this month along with a negative rates on German and Danish short term government debt auctions. This turbulence is washing down to domestic banks, who all issued expensive covered bonds as they attempted to get on top of their funding task.

Bank margins: we're back to 2008

The chart below shows the margins on longer term WBC bonds and the WBC credit default swap. Although not a perfect match both indicate that margins are now approaching GFC levels. Time desensitizes, but what's happening now doesn't feel anything like a GFC type event and we're not seeing any of the associated equity market falls and volatility.



How did we get here?

As we've mentioned the past few months, the European banking system is not functioning correctly. Unfortunately, much of the Australian bank borrowing comes via Europe and Australian banks have reasonably chunky borrowing targets this year of

around \$90b. Domestic banks were allowed to issue covered bonds late last year and had been expecting to use them to replace the maturing government guaranteed debt issued in 2009 and 2010. However, the Euro crisis meant that the effective cost of the covered bonds issued in Europe in late 2011 and early 2012 came in at a margin of about 2.25%, which was around 1% higher than they hoped. At the same time, GPT an “A-” rated property company, which was almost un-fundable during the GFC, issued 5 year debt at the same rate. What should a bank treasurer do? Refrain from issuing and wait for margins to fall with the risk that the bank may not be able to fund itself? Or issue at whatever price and pass on the cost to consumers. We think it’s not a difficult decision and banks have issued in excess of \$12.5b over the last month. Eventually the banks decided to issue covered bonds to domestic institutions at a margin of around 1.7%, which helped pushed the margins on domestic bank bonds to current levels.

And are we concerned?

To us, it still looks more like a liquidity issue rather than a solvency, issue. The difference is that liquidity issues eventually get solved and are a buying opportunity.

Have hybrids been affected?

Most of the high coupon, major bank hybrids have been trading at margins of mid 2%. The recent movement in wholesale margins has seen prices weaken by around 1% which translates to a margin increase of around 0.30%. The non-bank hybrids were not affected by this and posted a 2% return for the month.

Credit: not much to report

Credit growth continues at an annual rate of c3% with housing growing at 5% and non-housing at 1%. The first cut in RBA cash rates was in November, so if there is to be any boost to borrowing it should flow through in the next 2 months. Otherwise it looks to be a further grim 12 months for the domestic economy.

Who said this?

Governor of Federal Reserve (GFR) “Under present circumstances, there is little, if anything, that can be done”

Congressman “You mean, you cannot push on a piece of string”?

GFR “.....As I have said several times before this committee, beyond creating an easy monetary situation, there is little, if anything that the reserve organisation can do toward bringing about recovery. I believe that in a condition of business activity that is developing to a point ofinflation, monetary activity can very effectively curb undue expansion”.

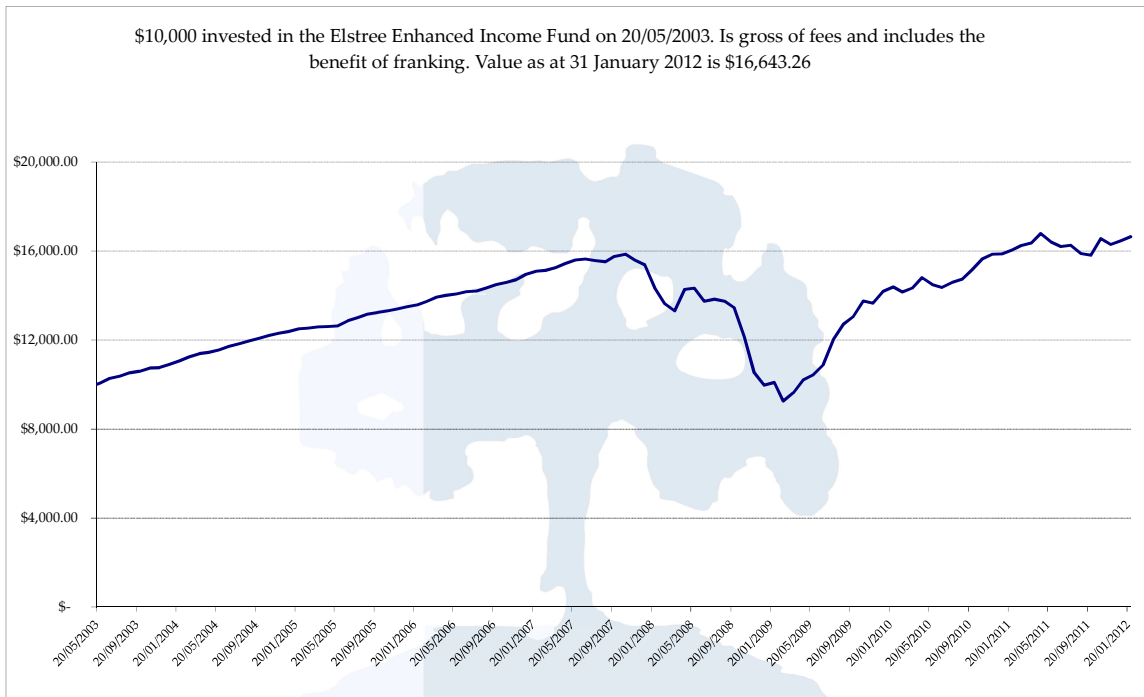
If you thought it was Ben Bernanke, you’re wrong. It was in fact Governor Eccles in 1935. He was too pessimistic as the economy picked up in 1936/37 before it was snubbed out by the Federal Reserve tightening policy in 1938. While the complete lack of hope and lack of explanation of why nothing has worked is similar to then, it’s interesting to contrast the 1935 approach with what the US Fed’s current explicit expansionary approach. It’s not surprising given that Bernanke’s post graduate work was on Depression era economics. Who knows, a 1936 expansion might be just around the corner. The S&P 500 doubled between 1935 and 1936 before almost halving in 1937 when the Fed tightened.



Performance Table	1 month*	3 months*	12 months*	Since Inception % Per Annum#
Elstree Enhanced Income Fund	1.13%	0.23%	2.30%	6.06%
UBS Warburg Bank Bill Index	0.40%	1.19%	4.96%	5.54%

*Returns are net of fees and do not include the benefit of franking credits. #Return 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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