June 2010 Performance Review – Listed Hybrid Sector

Fund Performance

The Elstree Enhanced Income Fund's Net Asset Value (NAV) decreased over the month of June 2010 from 0.7411 per unit to 0.7337 per unit. This represents a return of -1%. This compares with the All Ordinaries Accumulation Index and the UBS All Maturities Bond Index returns of -2.6% and +1.4% respectively. The Fund's over the year net return (after fees and before adjusting for the value of franking credits) decreased to +30.3% from +37% previously. The fund's performance this month was driven by profit taking on some of the non bank hybrid securities the fund owns amid a new bout of heightened global risk aversion. While the fund's performance over the year was satisfactory at +30.3% the rate of improvement has tapered off slightly over the last few months.

Year in review

The ASX listed hybrid sector staged a strong recovery over the year returning +17.3%. While volatility was around 2 times long term levels, it is on a declining trend. Issuance was muted with 5 new issues while issue redemptions numbered 3 in total. Individual company event risk continued to remain high with Babcock & Brown Infrastructure (BBI), Gunns and Elders contributing most to the volatility. On a positive note Paperlinx announced it would resume coupon payments from June 30 this year with some prospect of making one of two missed coupon payments.

Lags and leads

Fitch Ratings released an interesting report noting that High Yield default rates are running at an annual rate of around 1% i.e. virtually nothing is defaulting. This compares to last year's default rate of around 13% and a cycle average of around 4% - 5%. We expect default rates will continue at below average levels over the next few years. While we've mentioned previously that default rates decline in the period immediately following a recession, the more interesting and intriguing aspect is the lag in security prices. All credit investments have weakened since mid April and are still priced well above the level implied by the default forecast.

Remember Asia in 1998?

We do; it was the first new era 'event' where 'fundamental' economics was overridden by events in capital markets. In other words 'the tail was wagging the dog'. In this case, the Korean economy was particularly affected. Despite reasonable fundamentals, it was borrowing an enormous amount on short term money markets and the ensuing contagion from Thailand produced a liquidity crisis which produced a collapse in currency and bond markets. The chart overleaf shows prices of a (quasi government) KEB bond and the currency. The magnitude of these movements, prior to the GFC, was unprecedented and considered absolutely astonishing.

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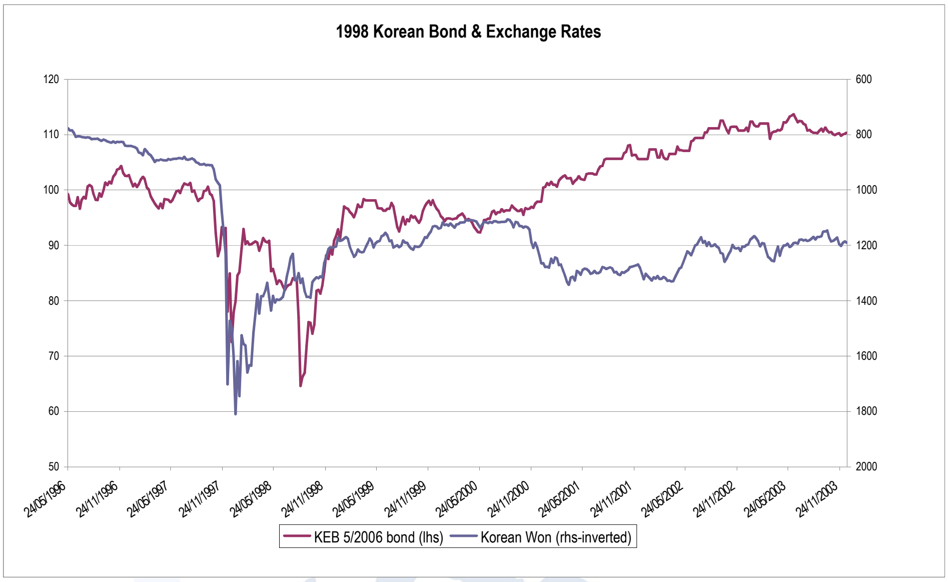

Bonds take longer to recover

At the worst point of the crisis, the currency had halved and bond prices had fallen by around 1/3. Within 12 months, the currency improved to stabilise around 20% lower than initial levels before staying at that level for the next few years. Our view was that the currency market reflected the economic reality that the Korean problem had more or less been solved by late 1998. However, bond prices took 5 years to get to fundamentally appropriate levels. Over that time returns were excellent (c 9% p.a.) and volatility fell from around 40% p.a. to around 4% p.a.

Why?

We suspect that after events like the Asia crisis in 1998 or the recent GFC, the investor base becomes structurally smaller either due to investment constraints or much lower risk appetite, and the supply/demand imbalance take time to unwind. There is actually a large body of academic research that indicates that fire sale/fallen angel assets outperform other asset classes with less risk, which indicates that in bonds, at least, momentum in prices is not a good indicator of future returns.

Australian Hybrids?

We think we are seeing something like this happening in the Australian listed credit market. By any standards, hybrid securities are cheap and only becoming less cheap slowly. Returns since August are at about 10% annualised (higher for longer periods) and markets are becoming less volatile. While it's not sexy we continue to expect a combination of declining return volatility and higher income yields.

Credit growth:

Recent RBA data revealed that credit growth was anaemically positive for the month of May. We have seen the bottom of the credit cycle, but annualised growth remains in the region of 4%, which is below nominal GDP growth and well below the 11.6% of the last decade. Composition however, remains skewed towards housing with business credit not growing on an annual basis. More encouragingly, monetary aggregates are heading upwards indicating that the threat of a recession has most likely passed.

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Fund Summary

3 months	-0.25%*
12 months	+30.3%
Since inception (20 May 2003)	5.2%
Risk per annum (Standard Deviation)	12.2%
% of positive return months since inception	80%
Expected default cost (per annum)	0.35% p.a.
Yield to Expected Maturity	12.8%

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

Additional Information

Portfolios	ASX listed hybrid securities
Liquidity	Weekly (cob Tuesday and month end)
Distributions	Quarterly (June, Sept, Dec and March)
Published unit price data	www.eiml.com.au www.morningstar.com.au
Buy/Sell spread	0.2%
Responsible Entity	Elstree Investment Management Limited