Elstree

June 2017 Review – Listed Hybrid Sector

Performance

The Elstree Enhanced Income Fund's total investment return for June 2017 was 0.90%. This compares with the Elstree Hybrid Index return of 0.63%. In other markets the All Ordinaries Accumulation Index returned 0.28% while the All Maturities Bond Index returned (0.90%). Over the year returns of 13.7% for the Fund and 11.1% for the Elstree Hybrid Index compared favourably to the All Ordinaries Accumulation Index @ 13.1%.

Alpha

If you are going to generate market outperformance, the best way to do it is to do things that other people are not doing. This month was an interesting case. We use our database extensively and analyse the relationships between ordinary equity and hybrid prices. Movements in the equity market in early June triggered a hybrid sell signal. So we sold 10% of the portfolio and increased our cash weighting. The hybrid market then weakened – we responded by decreasing our cash weighting. The net result is an outperformance of 0.27% attributable to that strategy. Individual investors can't do this kind of thing and institutions don't have the depth of data we do, so it's impossible for them to make these kinds of judgements. Sometimes these signals don't happen or we're wrong on the timing, but it worked really well this time. In any case, it's consistent with our view that the Fund will outperform the sector in aggregate (as represented by the Elstree Hybrid Index) by 1.0% - 1.5% p.a. and the typical retail hybrid portfolio by 1.5% - 2.5% p.a. (before fees).

Australian housing: not much different to the rest of the world

There's a lot of press about house prices and how the unwinding of the house price boom will destroy the banks and cause systemic issues. We think it's interesting that on a global scale, the Australian housing experience is not unprecedented. Pretty much every country in the OECD has had, or is experiencing, what is going on here in Australia. We've got two very noisy charts below: one shows the path in house prices to the peak and beyond for the 33 OECD economies (and we've also included Sydney and Perth) for the 10 years before peak house prices and up to 10 years afterwards. We've based it to a peak year at 100%, so a value of 80% 3 years before indicates a 20% increase in house prices over that period. The second chart shows the house prices to household income ratio and is based to 2010. The current house price/household income for Australia of 120 compared to the 100 score for 2010 indicates that house prices/income have increased by 20% since 2010. Similarly the house price to income ratio for the United Kingdom is based to 2010, but was around 60 10 years before the peak, and 120 at the peak. So house prices there became twice as expensive over that time.

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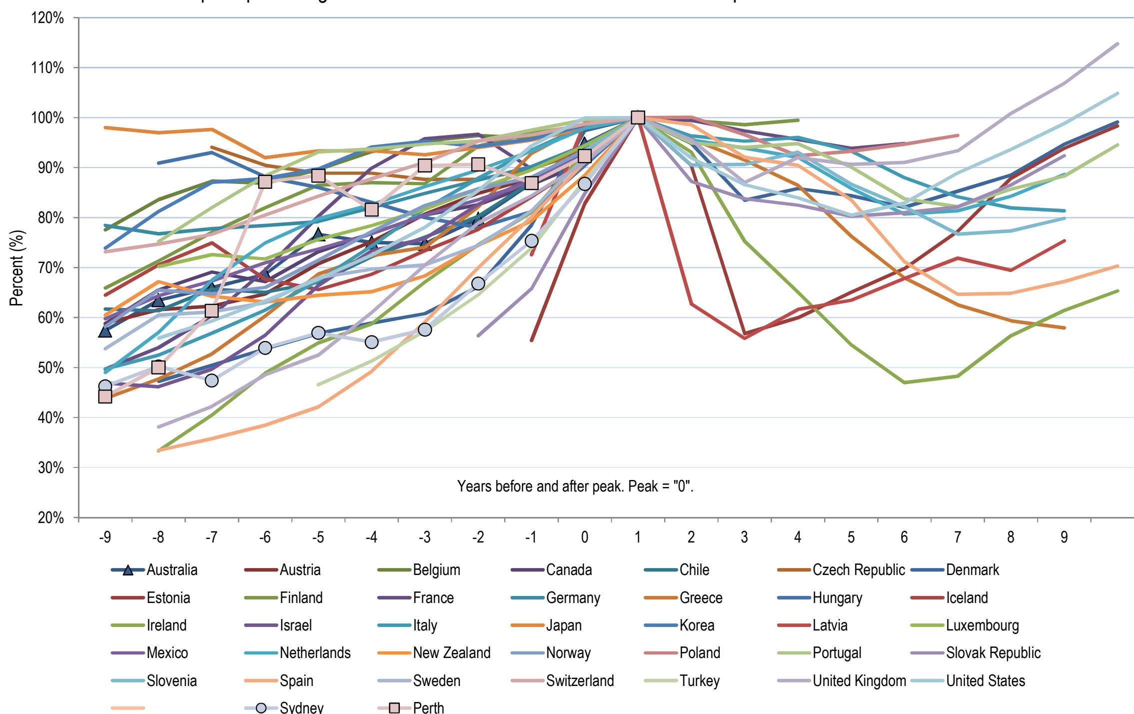

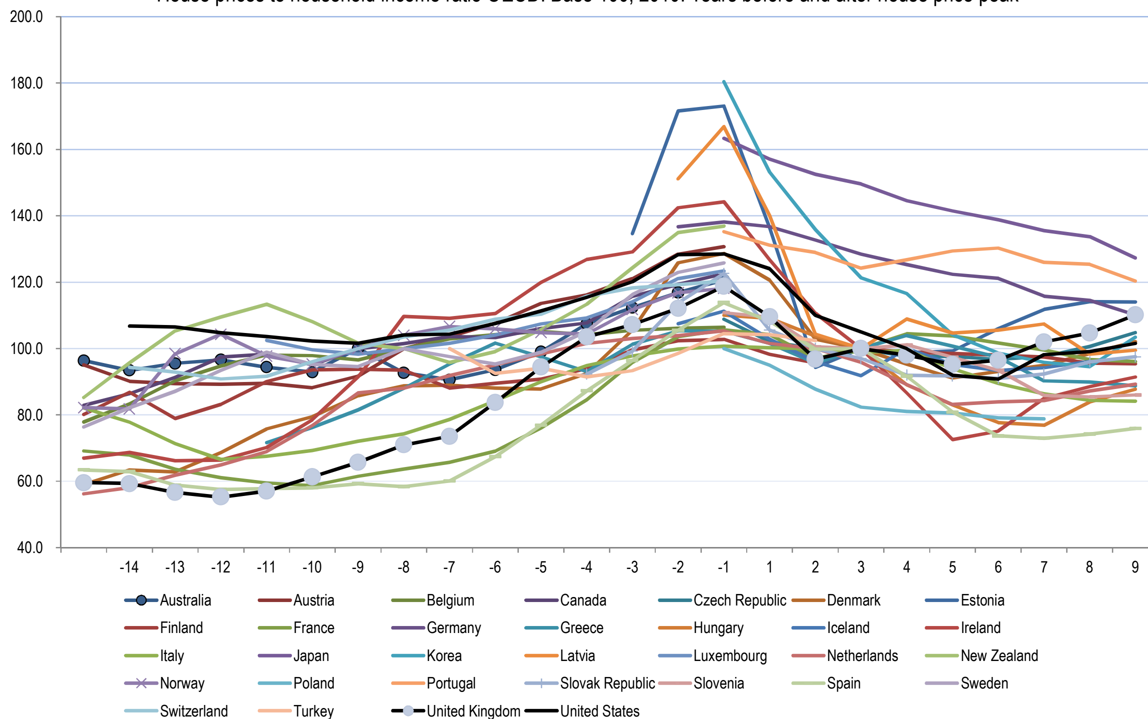

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So what does this tell us?

There are a couple of interesting points;
- If you can't easily recognise the line for Australian house prices amongst all the others it tells you a big story: the path of house prices is not much different to the average of OECD countries. Either it's not a bubble or it's a common bubble. Sydney and Perth increases were well above the average.
- House price affordability has worsened far less than the OECD average (albeit from expensive levels to start with). House price/household income is around 20% higher than a decade ago, which is less of an increase that most other OECD economies.
- We know that both Australian LVR lending characteristics and lending growth are far less aggressive than those economies which had their house price peaks before or around the GFC (such as Ireland).

It looks to us that the story of house prices (and the high household debt levels) is that the upper income households have been borrowing to fund asset purchases, but have been borrowing at relatively low LVRs. Add overseas housing purchases and a inelastic property supply curve and you get large house price increases without an explosion in lending. So while it's clear that it's a boom and we agree that it's totally unsustainable and concerning, it's not quite a bubble (ex-Sydney). Importantly, the nature of the owners of the assets (and accompanying debt) means it's not fatal for banks.

What happens next?

The most interesting part of the chart is what happens after the boom. Typically, house prices fall by around 5% - 15% over a period of 5 - 10 years – and it typically happens quite slowly. There are outliers on the chart which had larger falls such as Ireland, Latvia, Greece, Estonia; but they all had obvious problems which aren't going to get repeated here. Given that the overvaluation in Australian housing is bad, but isn't a bubble in the terms that was seen in the US, Ireland etc we think it's entirely probable that we will see 10% falls and a much smaller chance of 15% falls. For house price falls of less than 10% we don't think the banks will be affected at all. The amount of high LVR lending is very small, the owners of the debt are generally earn higher incomes and are of higher net worth and there is previous house price growth to consider. What this all means is that losses aren't absorbed by banks. Over 10% we start to see increased bad debts and some profit impact and over 15%, we'll see the odd really chunky losses start to emerge. Even at that level, we can't see systemic issues arising from house price falls.

So it's plain sailing?

Not really. While prime mortgage lending has never brought a bank undone, the greater unknown is what happens to the economy if house prices do fall 10%. Clearly there may be a wealth effect, and the RBA recently expressed an interesting view. The RBA believes it won't be a systemic shock like 2008, but a long period of stagnant growth as households reduce consumption and pay down debt. This in turn may have implications on corporate bad debts. If you want an inductive reasoning example of what may happen, you don't need to look any further than Perth, where house prices have fallen by 10% over the past 3 years. Perth housing losses haven't shown up in bank results but there is a 30% office vacancy rate and many businesses report much tighter cashflow.

So any implication for hybrids

We're still of the view that it's not going to be much of an issue for hybrids (except for their reaction to bank share price movements). Capital levels are still going up (and we expect another ½% increase), bank profitability is still high and the losses (if any) from housing will be absorbable. We expect that losses from non housing lending will be more important, but will still not be enough to affect viability. All this will happen over a period of years, which gives banks time to raise more capital. We do think there is some possibility that banks will experience negative asset growth at some time over the next five years.

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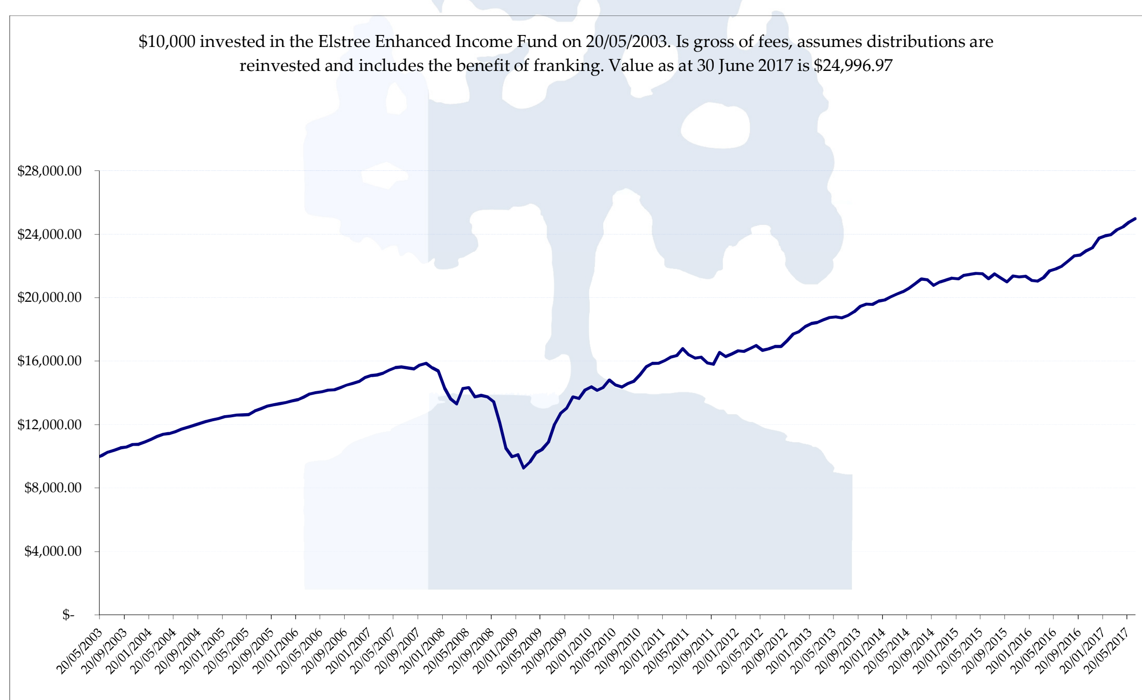
Fund characteristics as at 30 June 2017

Yield to Maturity	4.9%
Cash yield to maturity + franking (income yield)	5.1%
Investment grade issuer	93%
Fund average term (years)	4.3
Bank Tier 1 exposure	50%
Property exposure	6%

Performance Table	1 month*	3 months	12 months	3 years (p.a.)	5 Years p.a.
Elstree Enhanced Income Fund	0.90%	2.90%	13.69%	6.15%	8.31%
UBS Australia Bank Bill Index	0.14%	0.44%	1.82%	2.22%	2.53%

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

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



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