

March 2010 Performance Review – Listed Hybrid Sector

Performance

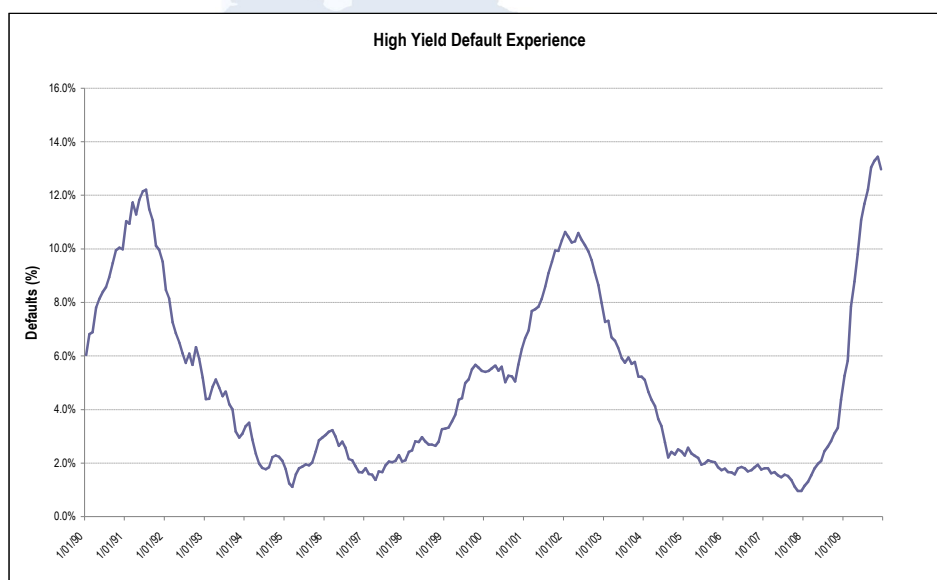
The Elstree Enhanced Income Fund's Net Asset Value (NAV) increased over the month of March 2010 from a price of 0.7368 per unit to 0.7445 per unit. This represents a return over the month of +1.05%. This compares with the All Ordinaries Accumulation Index and the UBS All Maturities Bond Index which returned +5.83% and -0.58% respectively. The Fund's over the year net return (after fees and before adjusting for the value of franking credits) decreased to +46.6% from 50.7% previously. In gross terms the over the year return decreased to +48.7% from +52.9% previously.

Events

We saw the opening of the 2010 issuance program with hotel operator ALE issuing \$100m+ of notes. We expect a reasonable amount of non bank issuance this year as corporate borrowers attempt to diversify funding. Banks arrived at their balance dates in a substantially better position than 12 months ago. We expect to see record pre-credit loss profits and falling bad debts and ROE's in the high teens. All this is in the context of an enormous amount of government support with around \$150 billion of government guaranteed bonds issued since 2008. Interestingly, Australian banks were the largest issuers of government guaranteed bank debt in the world in 2009. At the same time Westpac's Gail Kelly is hinting that she needs a higher ROE.

2009 Defaults: not that different to any other recession

Credit nerds get excited during February when Moodys release their annual default data for corporate bond issuers. Over the long term, investing in credit is an equation of what extra yield you get versus how many defaults you suffer and the Moodys data enables investors to quantify default trends and outcomes. And guess what? Despite dire predictions, the default experience for 2009 was not much different to either 1991 or 2001. The chart below shows 12 month rolling defaults for high yield bonds since 1990 and its apparent that 2009's peak was only marginally higher than 2002 and 1982.



And the same industries defaulted

Some industries are always overrepresented in default peaks. As with previous years automobiles, real estate, hotels and buildings punched above their weight. The one material difference between 2009 and the default spike of 2001 was last years near absence of telecommunication defaults.

However, it was nasty for investment grade

Investors expect some sub investment grade bonds to default; hence the name. However, investment grade bonds aren't meant to default. For many years that was the case. Between 1941 and 1981 only 5 investment grade bonds defaulted. From 1981 to the turn of the century 13 defaulted. Over the past 2 years 23 have defaulted. We suspect that this contributed to the panic that occurred over the past few years. The large number of high profile defaults engendered a lack of confidence and a feeling that this was not a normal cycle: perhaps Armageddon was going to happen after all.

Forecast?

Moodys also produce a default forecast, although we tend to treat them with a high degree of scepticism after some of the outlandish numbers the model generated in mid 2008. The model assumes that default rates will decline to 3.3% over 2010 compared to the actual 13% rate experienced in 2009. This enormous drop off is typical of post recession default history.

Credit is very attractive at particular times in the cycle

As we mentioned previously, credit investing is about the margin earned over the risk free rate less the default costs. The chart below shows the excess return (i.e. margin less the default cost) if you purchased every 3 year BBB and BB bond issued each year since 1996. BBB bonds always earned a rate above the risk free rate while BB bonds produced excess returns in 9 out of 10 years. However the returns after recessions are exceptional and that's where we are now; you get a combination of high yields and minimal defaults. Even though it can get a bit messy, credit is a worthwhile investment and less well rated credit assets offer excellent returns at certain times of the cycle.



Credit growth:

It's still not great news on the credit growth front: lending to housing remains reasonable, business credit growth remains negative, although we're getting "green shoots" with the rate of decline of business credit growth slowing.

Performance Table	1 month	3 months	12 months	Since Inception % Per Annum #
Elstree Enhanced Income Fund	1.05%	0.73%	46.62%	5.4%
UBS Warburg Bank Bill Index	0.33%	1.02%	3.5%	5.7%

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



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