

## May 2010 Performance Review – Listed Hybrid Sector

### Manager Performance

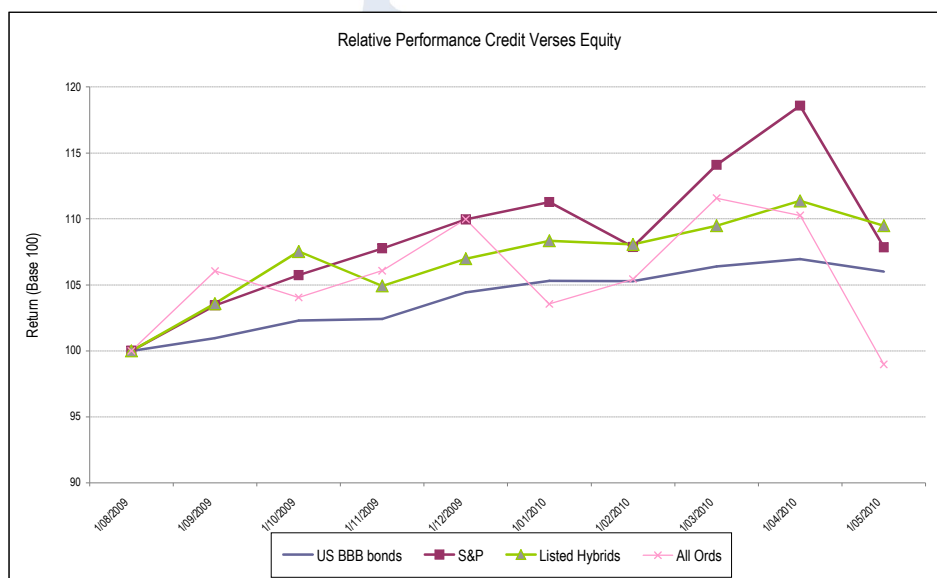
The Elstree Enhanced Income Fund's Net Asset Value (NAV) decreased over the month of May 2010 from 0.7587 per unit to 0.7411 per unit. This represents a return of minus 2.32%. This compares with the All Ordinaries Accumulation Index and the UBS All Maturities Bond Index returns of -7.6% and +1.65% respectively. The Fund's over the year net return (after fees and before adjusting for the value of franking credits) decreased to +37% from +42.9% previously.

### Events

Despite reasonable economic data, the month of May was dominated by continued fears over the European debt crisis. The equity market response produced the 6<sup>th</sup> worst performance in the 3 years since the GFC commenced. The listed credit market response was more muted with the monthly return of -1.5% being the 9<sup>th</sup> worst in the same period. The listed credit/equity delta of around 20% is typical of the delta that prevailed before the GFC. At a company level, Gunns ordinary shares were sold off heavily before recovering sharply on news that Chairman John Gay had resigned all posts. The Gunns hybrid was well supported by some strong buying.

### Credit versus Equities: 9 months post recession

In one of our previous articles we compared the performance of equities and credit instruments in the period after recessions. Generally, credit outperforms equity for the first few years and then equity markets outperform in the latter stages of economic cycles, which interestingly enough is the only time equities outperform credit markets. Since 1990, US BBB credits have provided returns that are 2% p.a. higher than equity markets. The chart below shows the return profile of US equities, US floating rate BBB securities and the hybrid index (which is marginally lower credit than US BBB) since the end of the recession in the middle of last year.



<i>Plus ca change.....</i>	It looks like we are heading for a repeat of previous cycles. Despite what some commentators are describing as a stellar bull market (up until last month), listed hybrids have easily outperformed the All Ordinaries and in the US BBB securities have only marginally underperformed equities. In an absolute sense, both credit markets have performed well, producing returns of between 6% and 9% for the 9 months.
<i>Why is this so?</i>	Credit markets perform well because margins contract from high levels and defaults fall abruptly once recessionary periods end. These 2 factors are present today with defaults on high yield bonds falling to a sub 3% annualised level from the 13% rate at the end of 2009. Margins have contracted as well, notwithstanding the spike over the last month. Equity markets have to cope with what seems to be a case of formidable optimism clashing with reality. Price earnings ratios at the end of recessions are at their highest and inevitably earnings growth disappoints. This all leads to relatively flat equity markets for a few years.
<i>Outlook</i>	With the aggregate yield of the Australian listed hybrid market at over 10%, we expect a continuation of the relatively high, but marginally volatile earnings profile. We expect that equity markets will continue to be choppy.
<i>Interest rates: on hold?</i>	The RBA has raised rates by 1.5% since late last year. While this doesn't seem to be a lot, housing debt as a percentage of disposable income is around 3 times what it was at the end of the 1990 recession. Although it's not quite a 1:1 ratio, this means that it only takes about 1/3 of the tightening or loosening to have a similar monetary policy effect compared to 2 decades ago. And while the growth in household debt is matched by a corresponding growth in household assets, the segment with the debt is now hurting the most. We think this is a quandary for the RBA which is now faced with a 3 speed economy: the resource states of WA & Qld are feeling no pain, households with assets are doing well but it is the mortgagees who are suffering. We expect the RBA to pause for a while to see how jobs and income growth pan out.
<i>Credit growth</i>	Credit grew over April and is now in positive territory on a rolling 12 month basis. However at around 1% it is still well below nominal GDP growth. Business credit remains worrying with a further decline. As business lending continues to contract it is difficult to see where the foundation for sustainable economic growth will come from.

Performance Table	1 month	3 months	12 months	Since Inception % Per Annum#
Elstree Enhanced Income Fund	-2.32%*	1.81%	37.0%	5.4%
UBS Warburg Bank Bill Index	0.38%	1.05%	3.8%	5.7%

\*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.

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