

October 2011 Performance Review – Listed Hybrid Sector

Sector Performance

The Elstree Enhanced Income Fund's Net Asset Value (NAV) increased over the month of October from an ex distribution price of \$0.7147 per unit to \$0.7479 per unit representing a return of +4.65%. This compares with the All Ordinaries Accumulation Index and the UBS All Maturities Bond Index returns of +7.17% and -0.57% respectively. The Fund's performance this month was positively influenced by the strong performance of a number of the discounted securities the Fund owns. The Fund's over the year net return (after fees and before adjusting for franking credits) increased to 4.25% from 2.78% previously. The Fund's over the year gross return increased from 4.36% to 5.83%.

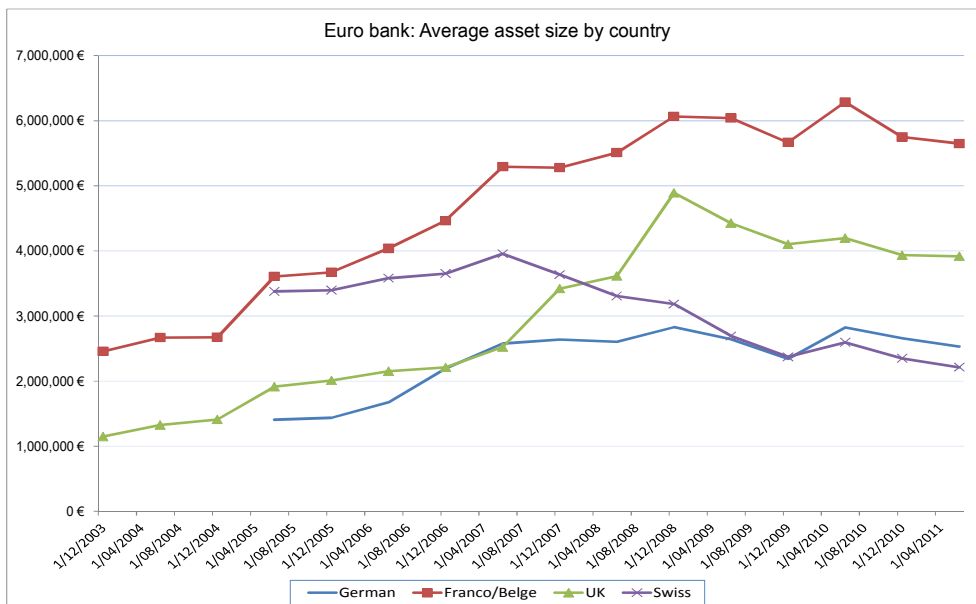
Events

The agreement on the Euro/Greek palaver prompted a strong late month rally in all markets. Hybrid markets improved and are getting back to June levels for most securities. Woolworths announced a new listed note, which was well received with a ridiculous bidding process resulting in the book build process being oversubscribed by about 5 times.

French banks: naughty since 2003

The recent Euro "Merkozy" announcements had a number of components, including the recapitalisation of European banks. We've commented previously about the massive leveraging of banks prior to the GFC and the progress of deleveraging since then. The chart below shows assets of the top 20 European banks, divided by country. A number of things are apparent;

- The banks that went through prodigious asset growth pre GFC and a near death experience in 2008 have taken drastic steps to reduce assets: assets of UK and Swiss banks have fallen by 20% and 50% respectively.
- Asset growth of French banks was enormous (BNP is the largest bank in the world by asset size; does that make sense to anybody?) and they haven't made any attempt to reduce assets, or raise more equity. Capital levels remain at around 80% of UK bank levels.
- The large German banks didn't really participate in the pre GFC punchbowl to the same extent as their European brethren and haven't done much to remedy the situation. Capital levels have been improved, but remain low.



Implications:

You can understand why Sarkozy was so keen for a European, rather than national, bail out of banks and why Merkel wasn't having any part of it. French banks are undercapitalised and have way too many assets while German banks need a bit more capital. French, and to a lesser extent German banks are about to experience their very own, early 2009/post Lehman moment where banks raise lots of capital and commence shrinking their balance sheets. The TARP process was an unambiguous success in saving the US financial system but has contributed to slow output growth as the economy increased savings. We think that the Euro version will provide much the same outcome. It's not an enormous amount of capital and the confidence effect far outweighs the cost of additional capital. We suspect that even though the fault lines of the Euro remain, the quasi resolution and the incredibly low expectations mean that debt markets are in for a few reasonable months.

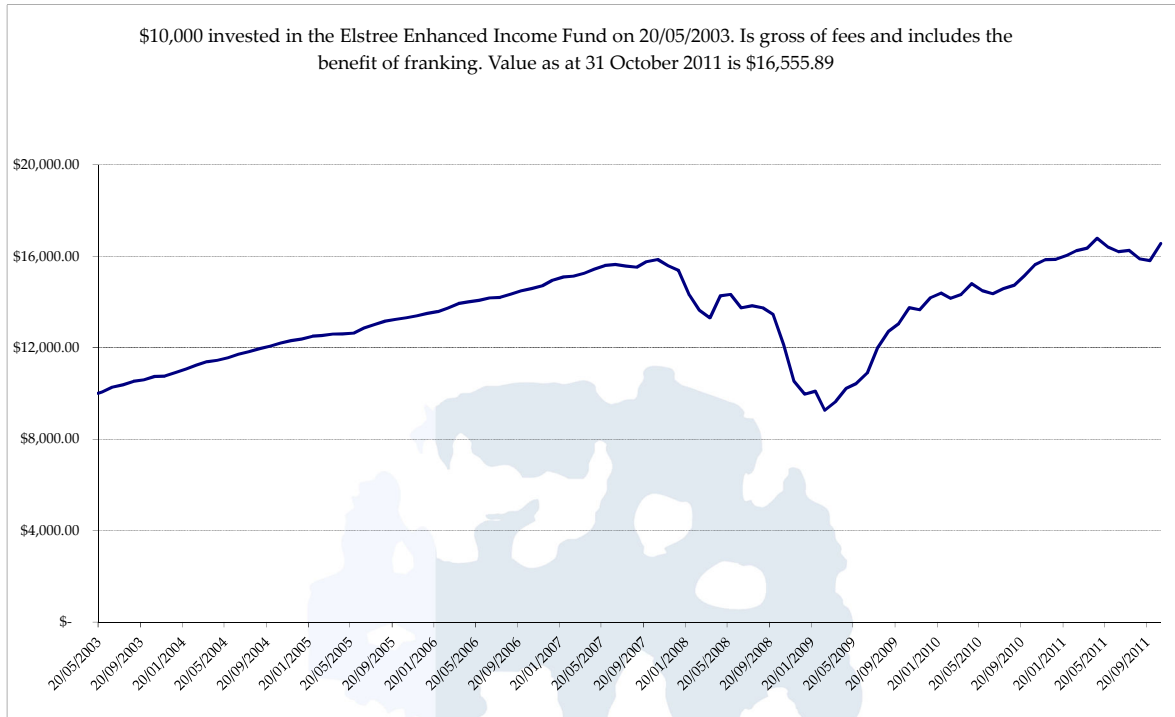
Credit: we now get excited by 6% p.a credit growth

Aggregate monthly credit growth popped from its usual 0.0% to 0.3% growth to record a 0.5% increase in September (i.e a 6% annualised rate). Credit advanced to business is still at 2007 levels. The credit data does not catch direct bond market borrowing but it continues to show the lack of borrowing by everything except large corporate Australia. Without borrowing there will be limited investment and that's why the painfully slow speed of the non mining, domestic economy will continue.

Performance Table	1 month	3 months	12 months	Since Inception % Per Annum
Elstree Enhanced Income Fund	4.73%	1.83%	5.83%	6.14%
UBS Warburg Bank Bill Index	0.42%	1.27%	5.02%	5.56%

*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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