4 macro'ish - type questions

- Our portfolios are bottom up constructed, but we do look at bigger picture issues as we think they influence retail investor behaviour
- We've summarised what we think are the important questions that investors should be asking.
- Some of the issues have been important in the past and some haven't, and we have strong views on some and no idea on others.
- Others will have different opinions and that's what makes a market.

Who gets elected?

Our views about what may happen if the ALP is elected are well known. We think it's highly probable that the ALP will implement the removal of franking credits for SMSF in pension fund/0% tax mode. Nobody else seems as worried as us, so we're either wrong or people haven't twigged, or they are waiting for the election. Potentially there is $1b - $4b of selling by 0% tax paying investors who can't use the franking credits and potential front loading of issuance by banks who might want to issue before the investors disappear. Of course, we acknowledge the SMSF data is very rubbery, and maybe the average SMSF investor who has $30 - $50k of hybrids may well conclude it's not worth bothering to re-arrange their portfolio. The franking credits foregone on a portfolio of this size totals c$700, which pales compared to the c$6k - $10k of franking credits the SMSF investor will lose from a typical equity portfolio. But it's still a big driver for future issue yields, if the Pension fund/0% market disappears. The chart below is from **Betfair** and shows what the "money" thinks is the likelihood of the ALP winning the next election. We like betting markets more than polls, as self-interest and greed usually win. The horizontal axis is the last 2 years and it shows that ALP are still favourites, but less so than a few months ago. It's at an interesting juncture. We watch with interest.

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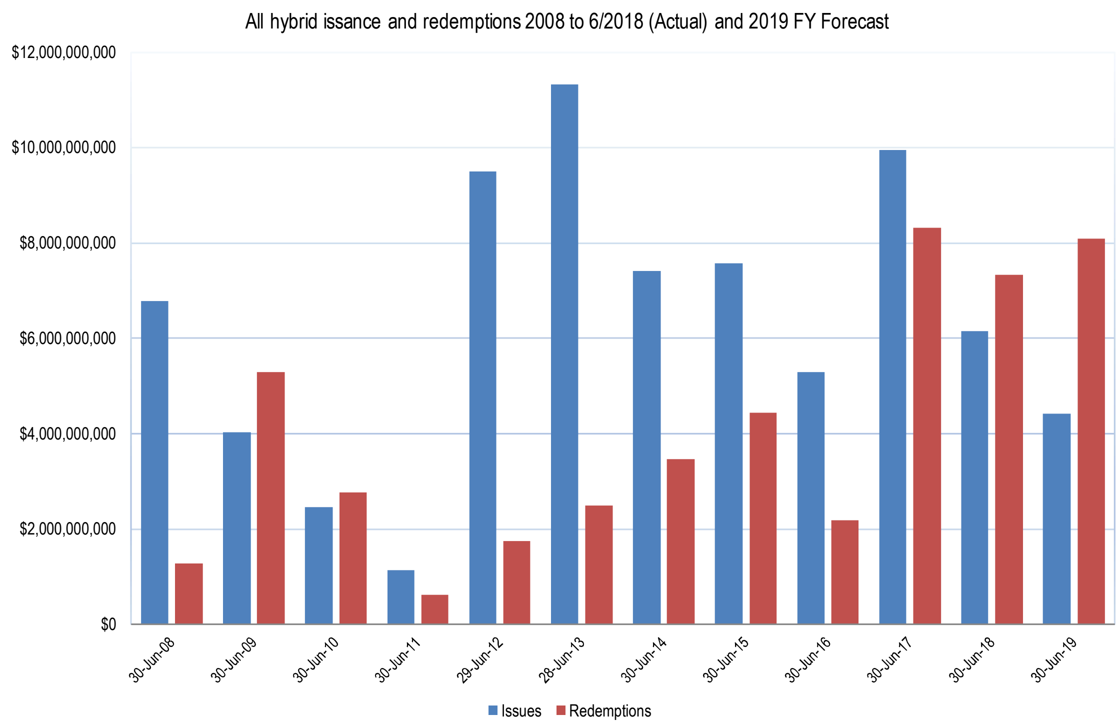
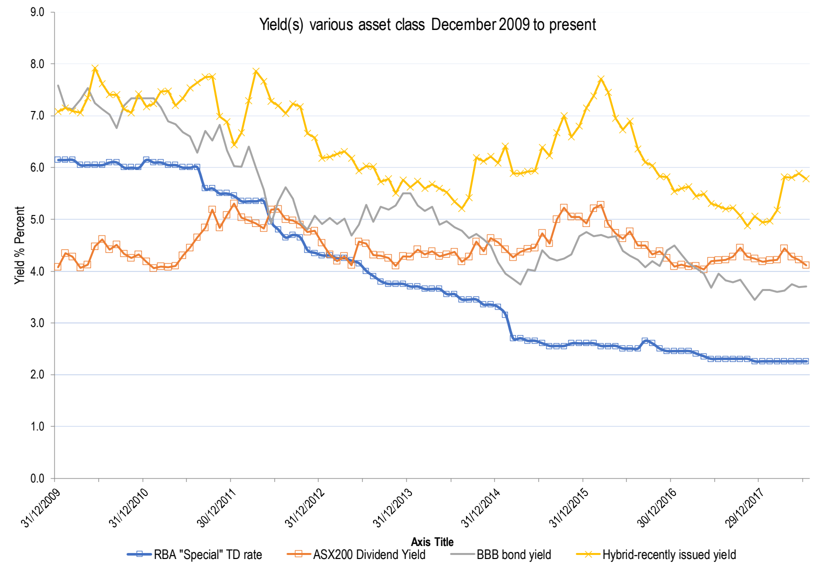
What happens to supply?

The chart below shows the issuance/redemption profile over the last decade. Typically, periods with high issuance see margins increase and vice versa. The chart shows that it's going to be the 3rd year in succession of high redemptions, so we're expecting that to be supportive of market. We haven't allowed for any pre-issuance by banks concerned about investors disappearing if the ALP is elected. Even if that does occur, we might get issues = redemptions which is not a big deal in a market which has adequately absorbed c$3b of net issuance p.a.



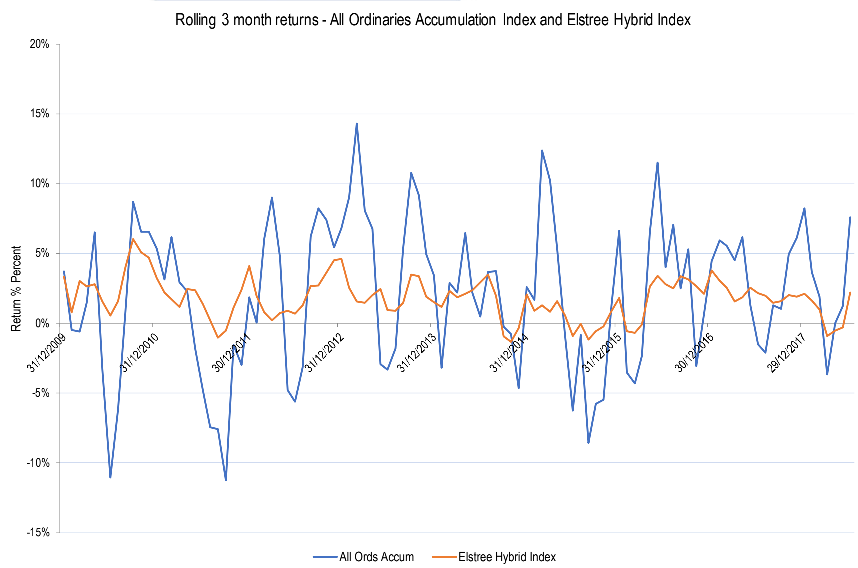
What does retail do?

Retail investors have been the marginal price setter for hybrids for around 9 of the last 10 years, so their actions are important. It's an intriguing time for retail investors: what do you do when income yields on anything safe are at generational lows? The chart below shows the income yields of various asset classes and shows the collapse in yields on Term Deposits and BBB bonds (which we admit not many retail investors own directly). Equity dividend yields have held up well, but most retail investors have been slaughtered by Telstra and bank share prices generally, so they now no longer perceive it's a "safe" income category. While hybrid yields have fallen, they have not fallen to the same extent. We can't see any warning signs for hybrids here. Retail investors aren't going to sell the market because it's too expensive.



What happens if it all goes pear shaped?

It has happened before and it's every investor's nightmare. The chart below shows 3 month movements of the All Ordinaries Accumulation the Elstree Hybrid indices. Up until last year, the All Ordinaries had a tantrum around once a year on its way to its post 2009 7.3% p.a. return. Hybrid returns of 6.9% p.a. over the same period are influenced by these falls in the short term, but only to a limited extent (i.e) hybrid returns don't dip much below the zero-return line and if they do, it is not for very long. Does this behaviour continue? And what if there's a bigger drawdown? We've got our views on the former and we think that if we do get a bigger drawdown in the equity market, the delta of the hybrid market (i.e) the extent to which it will react to the equity market fall, will probably increase. And the probability of a big equity market correction? It will only happen if there is a recession and everything we see is suggesting that is highly unlikely.



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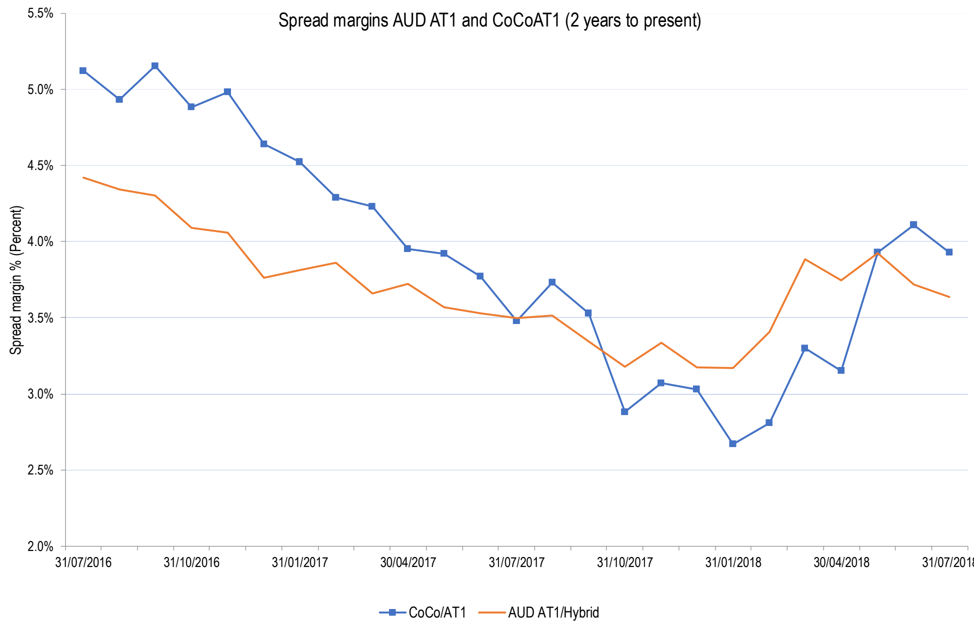
Slightly pear shaped events: bank share price volatility

What we think is more interesting are the events in the CoCo market, as it gives us a reference point as to what happens when there is stress in the banking system. The CoCo market is EUR AT1 market, and the European banking sector has had some troubles recently, largely over the Italian election and potential exit from the Euro. The chart below shows margins of Australian AT1 (as shown by the margins of the last 4 issues) and CoCo market. Margins on CoCo's had contracted more than AUD hybrid margins but that was reversed this year, with margins increasing by around 1.6% from bottom to top. If this happened in the AUD market, it would represent a c6% capital loss, which would be just sufficient to offset the c5% income from the sector. The stress in the banking sector was reflected in a c25% fall in bank equity prices. We think that's a reasonable stress test for a non recessionary event. Given we think a recession is currently remote, but local bank stress (house price fears, regulation, growth etc) drivers are still live, that's the kind of outcome that is most likely, albeit still at very low probability.



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