April 2017 Review – Listed Hybrid Sector

Performance

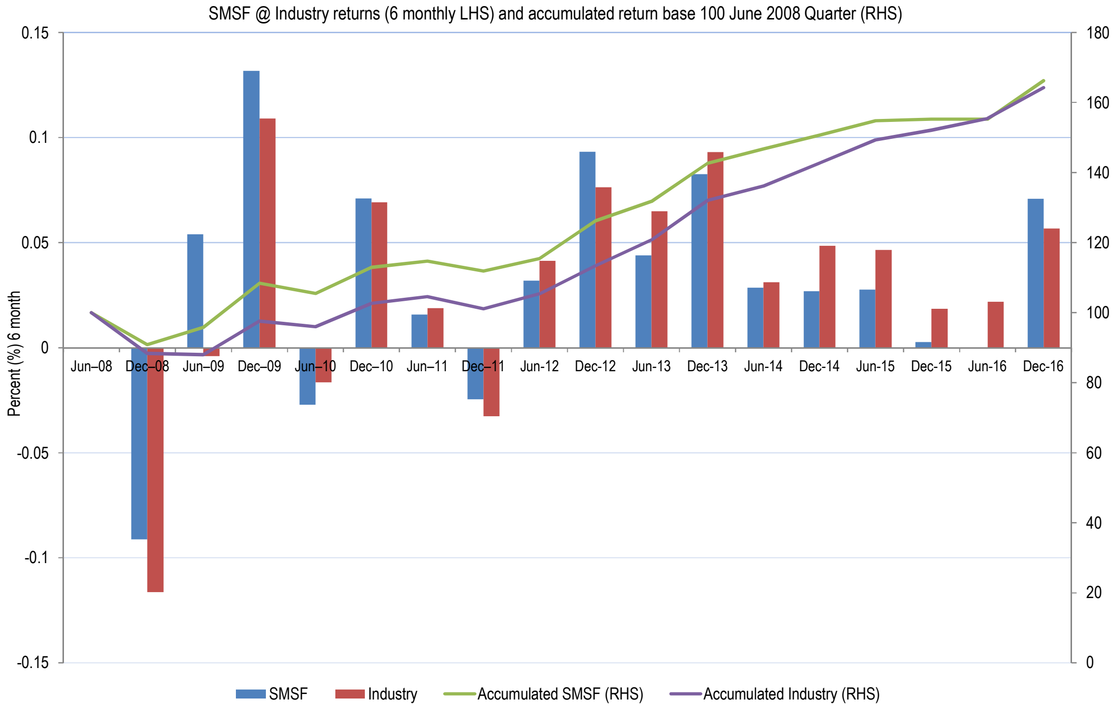
The Elstree Enhanced Income Fund's total investment return for April 2017 was 0.70%. This compares with the Elstree Hybrid Index return of 0.61%. In other markets the All Ordinaries Accumulation Index returned 0.78% while the All Maturities Bond Index returned 0.75%.

Events

Two securities listed in April with small stag profits and a new SUN hybrid will list this month. Over in deepest Canada we saw the first real post GFC bank collapse when Home Capital, a fringe housing market lender (think higher LVR, higher risk assets) experienced a deposit run. At this stage it looks controlled, but it gives us a pointer to future problems, particularly given the housing boom similarities Australia shares with Canada.

Revenge of the nerds

Prompted by the writers spouse's complaints that the muppets at <enter name of well know super fund> had mucked it up again and the apocryphal monkey with a dartboard could do better, we thought it would be interesting to compare the performance of Industry Superfunds and self-managed super funds or SMSF's. When we looked at this in 2014, SMSF's were outperforming the better credentialed industry funds. Australian equities had done really well and the high SMSF weighting to cash worked well; cash rates were relatively high while other asset markets stagnated. The chart below shows the 6 monthly returns and accumulated value (since June 2008) for SMSF and Industry Superfunds. We've calculated the SMSF returns by assuming benchmark returns based on the actual asset allocation of the SMSF universe. The Industry Super Funds returns are post management fees whereas the SMSF are just gross returns, so take off whatever management fee you think is appropriate to get a true comparison. Returns from June 2008 to date are around 5.4% p.a for both strategies: not great, but not bad either.



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Not so muppety after all(at least over the past 5 years)

Over the whole period, it looks like industry funds have done better (assuming SMSF pay some fees), but that has magnified over the past 5 years with Industry funds outperforming by 2% p.a. (10.9% cf 8.9%) . As the bar charts show, SMSF returns were been close to 0% between June 2015 and June 2016 before a recovering in 2H 2016. The poor performance of SMSF's in FY 2016 might explain the large number of angsty 70 year olds retirees in Mosman and South Yarra cafes in the middle of last year reading their AFR and complaining about investments. It looks to us that there are a couple of explanations;

(i) Industry super funds have greater to allocation to infrastructure which has had a number of years of double digit plus returns. That's not going to continue.

(ii) SMSFs still have a massive cash position. Even though cash holdings have fallen from a peak of 33% to just under 25%, that's going to impact returns. And more importantly, it's indicative of a very risk averse set of investors.

We think it will be interesting to see what it's going to require for SMSF's to bring their cash holdings back to more sensible levels.

Shorters carted out

One of the perennial themes of the past 6 years has been that European banks would kill the world and it's been a great trade to 'short sell' European banks. Monday 26 April saw an extra-ordinary event with Unicredit's (the previously troubled major Italian bank) share price increasing 13%. The only event on the weekend before that was the first round of French Presidential elections and the performance of the Emmanual Macron (the middle ground candidate) exceeded expectations. That normally would be enough to invoke the chaos theory of butterfly's wings producing a hurricane in Japan, but we thought it was far more interesting and it's got important investment implications. We think the logic goes as follows;

- Unicredit was the last suspect systemically important European bank (even though they did a massive capital raising in February).
- It surprised us, but clearly in hindsight there were still large numbers of 'shorts' in the market who still thought there was a reasonable chance of systemic collapse.
- The general consensus is that Macron will win and that means no French exit from the Euro: ergo Italy won't leave, ergo the chance of Euro collapse has decreased dramatically.
- So short sellers had to cover and they got their clock cleaned again (after getting DBK wrong last year).
- We think it indicates the end of the European bank short. If this is the case, bank capital securities, which were assuming a material chance of systemic failure, should benefit. This seems to be the case as the chart below which shows the share price of Unicredit, (LHS) the price of the largest Unicredit AT1 security and the average price of all European AT1 (both RHS). Notwithstanding Excel's dodgy scaling, this seems to be the case with the broader Euro sector AT1 price level rising by around 1EUR (0.4% fall in trading margin). We think there is a follow through to Australia where there is still a lot of fat tail (read 'bad') event risk built into the price (in contrast to other debt sectors where is no bad news built into pricing).

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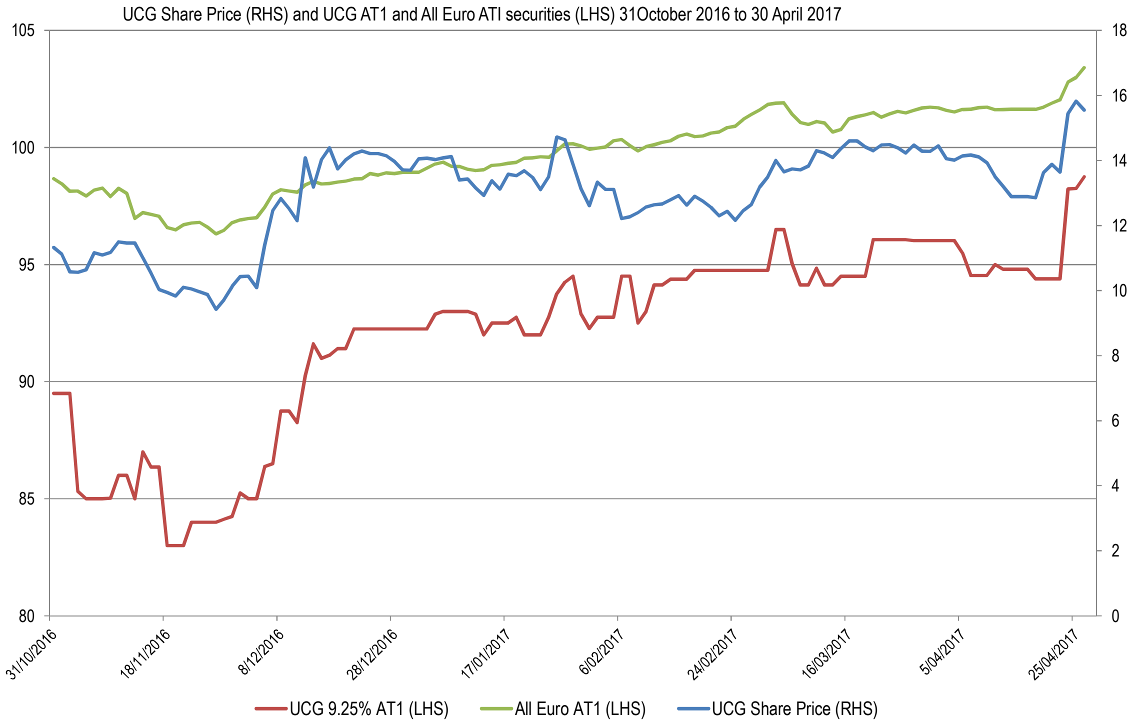

Fund characteristics as at 30 April 2017

Yield to Maturity	5.2%
Cash yield to maturity + franking (income yield)	5.0%
Investment grade issuer	92%
Fund average term (years)	3.6
Bank Tier 1 exposure	36%
Property exposure	6%

Performance Table	1 month*	3 months	12 months	3 years (p.a.)	5 Years p.a.
Elstree Enhanced Income Fund	0.70%	2.33%	12.79%	6.26%	6.85%
UBS Australia Bank Bill Index	0.15%	0.43%	1.88%	2.27%	2.39%

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

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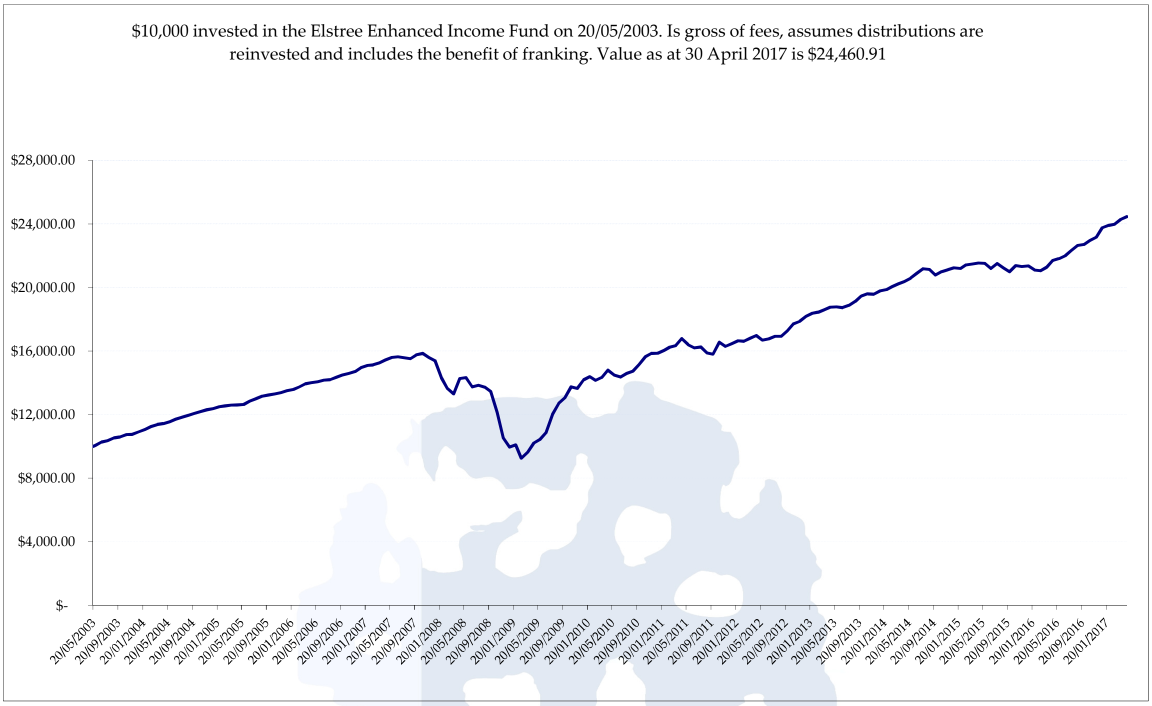
Value of $10,000 Invested on 20/05/2003



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