January 2017 Review – Listed Hybrid Sector

Performance

The Elstree Enhanced Income Fund's total investment return for January 2017 was 0.60%. This compares with the Elstree Hybrid Index return of 0.32%. In other markets the All Ordinaries Accumulation Index returned (0.77%) while the All Maturities Bond Index returned 0.61%.

Events

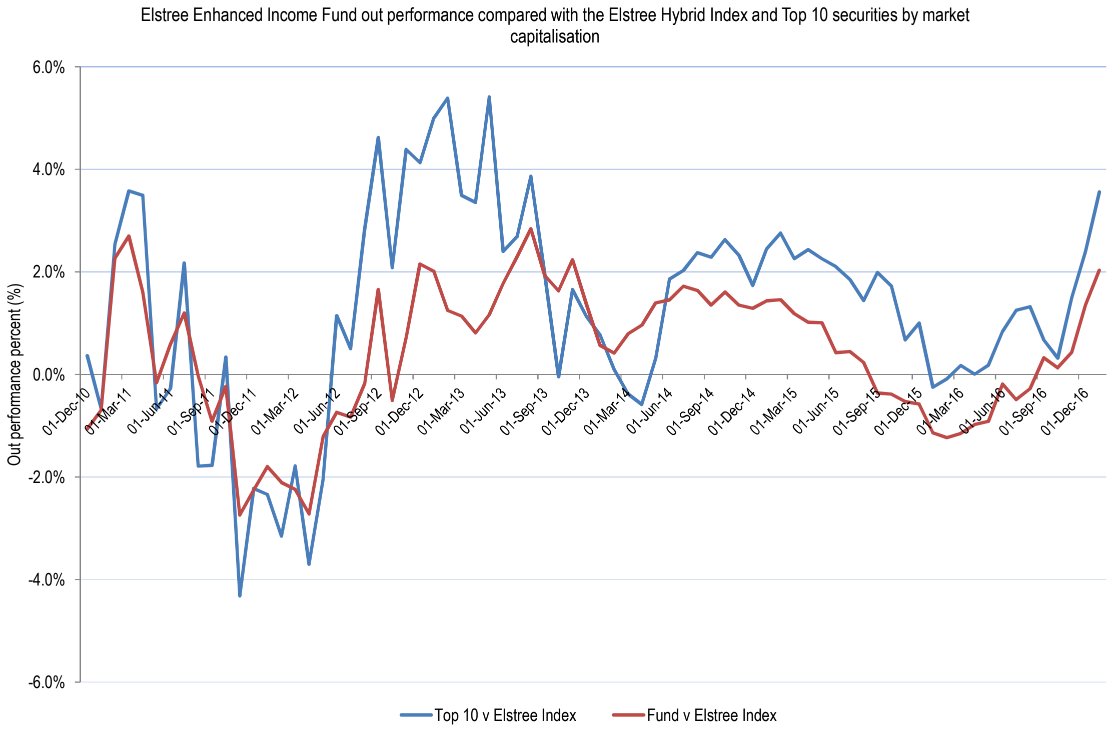
The Street Talk column heralded a return to issuance season with CBA set to announce a new hybrid, presumably to coincide with their results on 15 February. Crown Resorts seems to always be in the news and this month was no exception with major Board changes. After last month's sell down of their Macau interests, investors continue to scratch their heads as to what is happening. We agree, in part, at the sudden changes in direction, but we think it's a bit like a supertanker that changes its captain and crew all the time and occasionally throws stuff off the bows. There looks to be a lot of activity, but it's going one way and the course is unchangeable. In Crown's case the supertanker bit is the Australian monopoly gaming assets; they're big, they only go at one speed and they need their investment grade credit rating. It looks messier than it really is.

Alpha

Warning: Fund manager "selfie time". The table and chart below shows some aspects of outperformance with the table showing the performance of the Fund, the Elstree Hybrid index and the Top 10 hybrid securities index by market capitalisation ("Top 10 Index") over various time periods. The chart below shows the rolling 12 month alpha (i.e the fund return minus the relevant index return) of the Fund compared with the Elstree Hybrid Index and the Top 10 Index. Where the red or blue lines are above the 0% level it indicates outperformance by the Fund. We've included the Top 10 index, because for most investors, market index replication is simply not possible. It is unlikely there will ever be an exchange traded fund or ETF that gives true index beta/replication because the sector is too small and not sufficiently liquid on a minute to minute basis to allow the ETF providers to offer a safe product. So most investors end up with portfolios that are somewhere between the Top 10 Index and Elstree Hybrid Index.

Period	Elstree Enhanced Income Fund	Elstree Hybrid Index	Top 10
1 year	13.3%	11.3%	9.7%
2 year p.a.	6.2%	5.8%	4.6%
3 year p.a.	6.3%	5.6%	4.5%
5 year p.a.	7.5%	6.6%	5.2%

Elstree Investment Management Limited (ABN: 20 079 036 810)
Level 10, 30 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348
Email: info@eiml.com.au



What we think about alpha

The more important question is: how important is it? Fund managers are obsessed about alpha, but fund owners (i.e our readers) should be more interested in how investments fit into their total portfolio and investment goals. The writer's wife will often ask, why the "muppets at <**insert name of high profile Super Fund**>" couldn't beat the cash rate, but she's pretty quiet when it does. Typical client, and that's why fund managers want to talk about "alpha" rather than have discussions about what the client needs and the client needs to have some perspective about timing and volatility. We are interested in alpha, but it gets overridden; for example, we thought major bank AT1 hybrids were by far the cheapest sector in the market over the past few years. If we were true alpha hunters, we would have had 100% of the fund invested in them. But that's not appropriate for unit holders so we only held c40% of the Fund in them.

So what about the alpha?

- First point is that the most recent 1 year outperformance figure is unsustainably large; it's a combination of poor months dropping out and a number of things aligning at the right time.
- 12 month excess returns were less than The Elstree Hybrid index for 10 months in 2012 and for 12 months from August 2015 to August 2016. We rarely underperform the Top 10 index. The most sustained period of under-performance was in late 2011 and early 2012.
- 5 year returns of 1% per annum plus over the Elstree Hybrid Index and 1.5% over the Top 10 index are what investors can reasonably expect.

Our approach to generating alpha

We aim to add value by a number of approaches. They are, not in order of magnitude;
- On average the market gets an individual stock 'wrong' once or twice a year and we will adjust portfolio weightings accordingly. An example is the problems associated with Crown Resorts. The hybrid price fell from the mid $90s to $67 on privatisation speculation. We thought privatisation was unlikely so we didn't sell on the way down. On a catalyst announcement, we bought some more in the low $80s and took our

Elstree Investment Management Limited (ABN: 20 079 036 810)
Level 10, 30 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348
Email: info@eiml.com.au

holding to 5%, which is the maximum we could prudently own. That position added around 0.70% over the past year or so. Not an enormous position, but a material value add and the Fund retains its integrity and is still able to generate capital stable type returns.

- We take views on the relative value of classes of securities. For example in the immediate post GFC period, we were of the view that corporate issued hybrids were undervalued relative to bank issued hybrids (retail investor risk aversion etc). Latterly we were of the view that bank hybrids were undervalued.
- We take views on the relative value of margins overall. This is probably the most interesting for us, as while we're quite good at adding value from the two approaches mentioned above we're less good at timing value decisions (we think this is because retail investors are 'slow' to recognise value and this means that the market can remain very, very, undervalued for extended periods, rather than very undervalued). As you can see there were 2 periods where we underperformed, 2011/2012 and late 2015. In the first case, the market became very risk averse when the US was potentially 'double dipping' and the Euro was having troubles. The market bought the "safe" bank hybrids. While we were not as concerned, we added to our positions too early. Our move was right a year later as can be seen by the massive outperformance. It was much the same in late 2015. The market weakened substantially and entered what we thought was exceptional value territory, so we increased our exposure. As it turned out, the market continued to weaken for around 4 - 5 months after we made the decision, so we underperformed. As with the 2011/12 episode, the performance recovery was strong and the decision was vindicated. So that's our dilemma: we can change our view of value and potentially miss out on sensible and profitable trades, or stick with our views of value, live with the underperformance and see if there is some way we can better evaluate just how inefficient the retail investor will be on each occasion.

Fund characteristics as at 31 January 2017

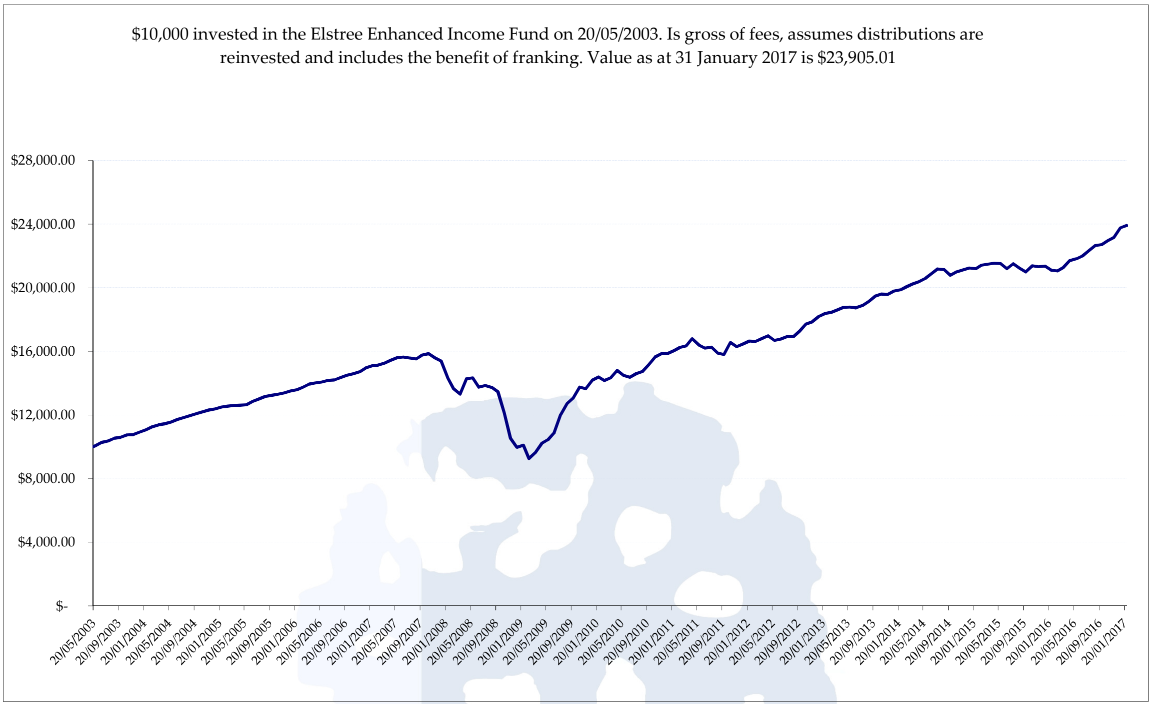
Yield to Maturity	5.3%
Cash yield to maturity + franking (income yield)	5.0%
Investment grade issuer	90%
Fund average term (years)	4.4
Bank Tier 1 exposure	45%
Property exposure	7%

Performance Table	1 month*	3 months	12 months	3 years (p.a.)	5 Years p.a.
Elstree Enhanced Income Fund	0.60%	4.07%	13.32%	6.34%	7.5%
UBS Australia Bank Bill Index	0.16%	0.45%	2.34%	2.34%	2.7%

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

Elstree Investment Management Limited (ABN: 20 079 036 810)
Level 10, 30 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348
Email: info@eiml.com.au

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



Disclaimer

Elstree Investment Management Limited (ABN: 20 079 036 810)
Level 10, 30 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348
Email: info@eiml.com.au