May 2017 Review – Listed Hybrid Sector

Performance

The Elstree Enhanced Income Fund's total investment return for May 2017 was 1.28%. This compares with the Elstree Hybrid Index return of 0.90%. In other markets the All Ordinaries Accumulation Index returned (2.58%) while the All Maturities Bond Index returned 1.17%. Over the 12 month period to end 31 May 2017 the Fund out-performed the Elstree Hybrid Index by 2.71%. Over 5 years, on a per annum basis, the Fund out-performed the Index by 1.03% p.a. On the same basis the Fund has out-performed an index consisting of the Top 10 securities by market capitalisation by 3.2% p.a. over 12 months and 2.2% p.a. over 5 years.

Events

The ASX Listed market reached a milestone of sorts when the size of the Elstree Hybrid index reached $50b in market capitalisation this month. On the bank front, there was schadenfreude and (feigned?) outrage in regard to the banks' $6b deposit levy, and there was (surprisingly) not much reaction to S&P's credit ratings downgrades. On the former, we don't get the banks position. It's been obvious to everyone (except the banks apparently) that they've been running one of the most successful cartels in history and were prone to an excess profits tax, which is what Scomo's tax is (in disguise). You had it coming, guys. The lack of reaction to the ratings downgrade might seem mysterious, but there were a number of reasons why it wasn't. Retail investors, who buy 70% - 80% of hybrid issues, are theoretically not allowed to know bank credit ratings (due to ASIC's view that if the ratings agencies don't have an ASIC licence, they can't publish retail research) and in practice they make their bank hybrid investment decisions on other grounds. Institutions, who buy the balance, either understand the limitations of the ratings process and what it means for bank credit ratings, or have mandates that allow them to own non-investment grade assets, so they are not forced sellers either.

Investments too expensive.

Everything is expensive: equities, PE's are at highs, Shiller CAPE at stupid levels, high yield spread margins are at the lowest 15% of readings, real yields are low or negative etc etc. So the obvious first response is to sell everything and wait for the inevitable increase in yields/margins. However, historically that strategy hasn't worked for investment grade credit, unless a recession occurs. The chart below shows the rolling 12 month excess return over risk free bonds for 4 year "BBB" rated credit since the 1950's. The excess return for "BBB" rated credit is a function of the additional yield investors receive at the beginning of the period and the change in spread margins over the period. If the starting spread margin was low/medium and spread margins increased over the period, credit investment underperformed risk free assets. We've further split it into periods of recession and non recession (as defined by the recession wizards at NBER). For example, during the GFC "BBB" rated credit underperformed bonds by up to 12% and then outperformed after the recession ended.

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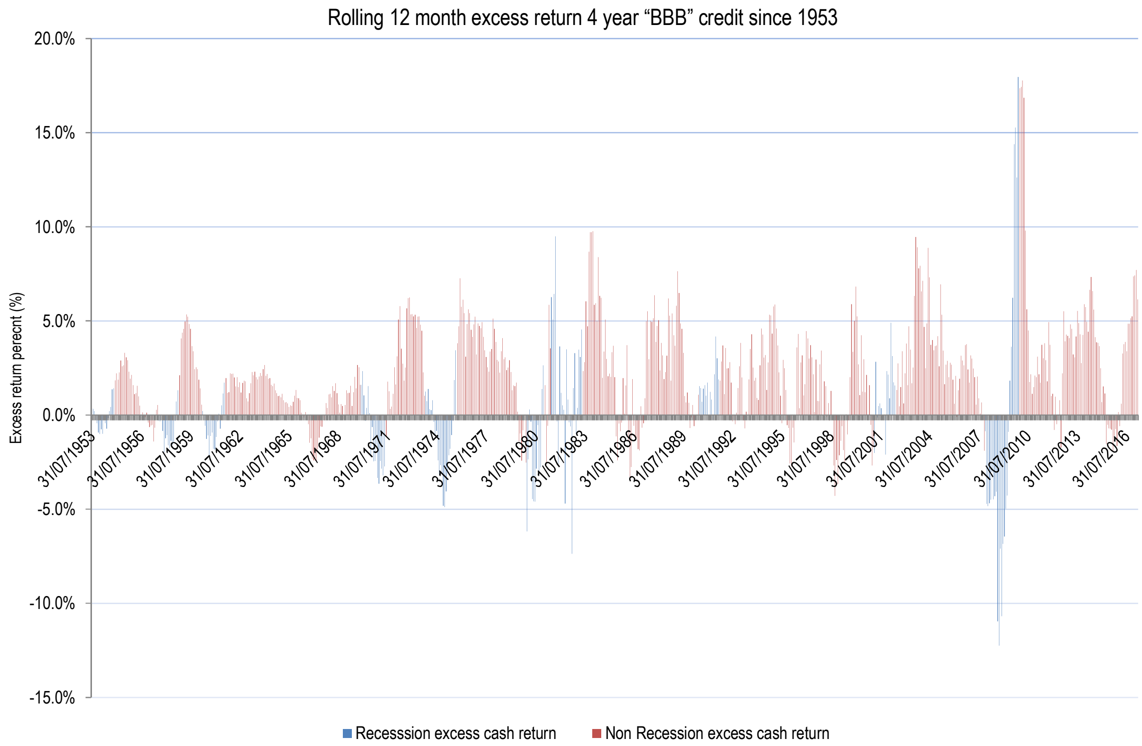

So what do you conclude from that?

Well, it surprised us as well, but with only a few exceptions, the strategy of selling and waiting for the short sharp pull back in "BBB" spread margins doesn't work, unless there is a recession. The only time where you would have looked like an ex post guru was in 1998 (when LTCM and Asia were imploding). Even the oil price/China palaver in 2016 didn't produce long lived or material weakness in "BBB" credit markets. Clearly, if you think a recession is imminent and margins are expensive, selling and waiting is the right thing to do. But that can be expensive and difficult as well, even if you think the world is going to end. The best example is the pre GFC era. At the end of 2003, spread margins on "BBB" credit were around current levels. Investors who sold in late 2003 (because spread margins were looking "expensive"), had to wait around 5 years for a recession and for spread margins to increase.

Does guess, sell and wait work for other asset classes?

It's more likely to work for equities and lower rated high yield bonds. You get sustained periods of cash underperformance in non recessionary periods. The only problem is trying to work out what "expensive is" and even periods of secular, non-recessionary weakness aren't that common. It certainly doesn't work for hybrids, where the initial spread is high and the volatility is too low (in non recessionary periods). The return you earn from the "carry" kills tactical buy and sell decisions.

So when is the next recession?

The rationale for not attempting to 'market time' investment grade credit investment decisions rests on the assumption that a recession is not imminent. This makes successfully predicting the risks of the next recession a very valuable component in investing. We watch a number of indicators to get an early warning, but the best indicator of the last 10 years has been the Kamakura Troubled Company Index. It's a quantitative model that measures the default risk of 38,000 companies. The chart below shows the path of the index since 2007.

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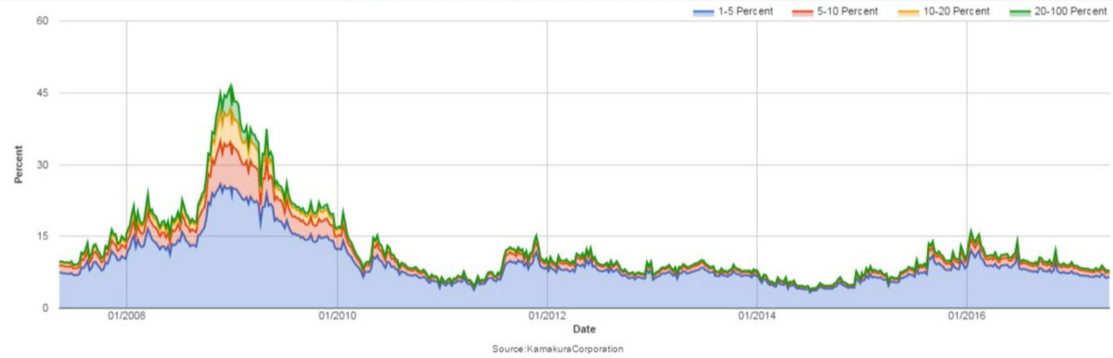
TROUBLED COMPANY INDEX

Current Index Value: **7.77** Percentile Rank From 1990 to Present: **15.69%** Historic Average: **14.71** Historic High: **46.26 (12/26/2008)** Historic Low: **3.76 (9/1/2014)**

Description	% of Universe	1 Day Change	1 Month Change	3 Month Change	6 Month Change	1 Year Change
KDP > 1%	7.77	-0.07	-0.70	-0.58	-1.88	-2.94
KDP > 5%	1.42	0.00	-0.21	-0.11	-0.38	-0.70
KDP > 10%	0.42	0.00	-0.08	0.00	-0.14	-0.28
KDP > 20%	0.07	0.01	-0.03	-0.02	-0.05	-0.10

Range: 1Mo 3Mo 6Mo 1Yr 2Yr 5Yr 10Yr Max Custom Date



What we like about the index is that since 2008 it has consistently been the best predictor of defaults over the next 12 months and it's rules based. Currently it's showing very low default risk (in the best 16% of times since 1990). One of the major reasons is that volatility and equity markets play a big part in the model and they are very favourable at the moment. As we write, we can hear the keyboards banging Minsky, Minsky Minsky and that volatility is stupidly low and markets will imminently fall, so Kamakura underestimates the underlying credit risk. In general however, volatility is low and equity markets are healthy for a reason and the model has worked consistently well in the past. The low volatility/strong equity equation has led to low recession and default risk in the past, so it looks to us as though recession risk is still very low (this is backed up by the other leading recession indicators we look at as well).

So what does an investor do?

We all kvetch about how expensive or uncertain or volatile the market is, and today is no different to November 2016 when investors were worried about Trump or 3 years ago when Greece was defaulting. We suspect that because market timing is really difficult in non recessionary periods, the answer is that investors should have an asset allocation that makes sense. If markets become expensive and recession risk is low, the best path may be to retain the allocation and adjust return expectations. If you are overweight expensive asset classes, you might reduce the overweight position and adjust the return expectations downwards. Otherwise just recognise the 4 truths of Buddhism and that life is suffering.

And hybrids?

The right side of our brain looks at the current run of 14 months of positive returns and says it's due for a pullback. The other side recognises that hybrids are, by the vast majority of methodologies, not expensive, and that guess, sell and wait doesn't work unless you are really good or think recession risk is raised. On that basis we're reluctant to do much yet.

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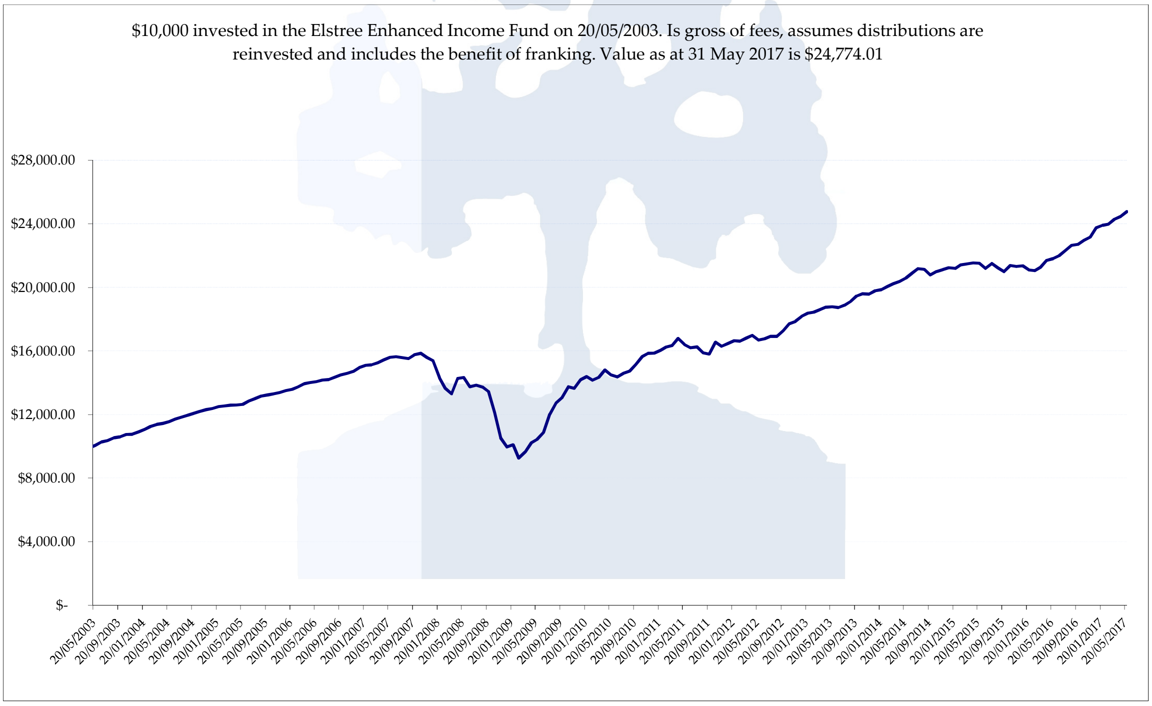
Fund characteristics as at 31 May 2017

Yield to Maturity	5.1%
Cash yield to maturity + franking (income yield)	5.2%
Investment grade issuer	93.8%
Fund average term (years)	4..01
Bank Tier 1 exposure	41.5%
Property exposure	6.0%

Performance Table	1 month*	3 months	12 months	3 years (p.a.)	5 Years p.a.
Elstree Enhanced Income Fund	1.28%	3.30%	13.58%	6.34%	8.24%
UBS Australia Bank Bill Index	0.15%	0.49%	1.84%	2.25%	2.55%

*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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