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5th Annual PortfolioConstruction Conference

23 – 24 August 2006 | AJC Convention Centre, Randwick, Sydney

Pillars for building better
quality investor portfolios...



Hybrids : Why you are getting overpaid to invest PortfolioConstruction Conference 2006

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Agenda

- What are hybrids
 - The sector defined
- Return equation
 - Sector beta
 - Why alpha potential exists
- Correlation benefits
 - How hybrids reduce portfolio risk
- Risks and mitigants
 - De-mystifying the risks
- Why use a manager



Why buy hybrids

– Returns

- Highest of “safe” income sectors
- Most inefficient market in Australia
- Most alpha potential

– Reduced Portfolio Risk

- Low correlation reduces portfolio risk by material amounts

– High risk adjusted return

- Most risks mitigated by diversification
- Residual risks are more than compensated for by the return



Where do hybrids fit in portfolios?

– Capital stable portfolios

- Replaces both low yield, low risk sectors and higher yield higher risk investments
- Low correlation and high Sharpe ratio improves the return/risk profile
- Active management further reduces correlations

– Income portfolios

- Ideally used to provide diversification to other income sectors and higher returns
- Structurally uncorrelated to other income classes
- Offers higher returns than some other income classes



The Hybrid sector.... what is it?

- Definition of hybrids : debt with difference
 - Generally subordinated
 - Issuers always have options
 - Investors sometimes have options
 - Higher coupon than senior debt
- Sector statistics
 - \$19b market capitalisation
 - 60 issues
 - Annual growth of around 5-10 issues and \$3 billion



The Hybrid sector...the return equation

Bank Bill Yield	6.2%
Average Margin (Source; Elstree Yearbook)	1.5%
Passive Return	7.7%
Manager Alpha	1%-2%
Total return (before fees)	8.7%-9.7%



The Hybrid sector...comparison with other income alternatives

Cash	5.8%
Bonds (UBS Composite Bond)	3.4%
Mortgage Trusts (median)	5.7%
Global Fixed Interest (median fund)	0.8%
Hedge Fund of Funds (median fund)	4.3%
Australian Hybrid Sector (Elstree Index)	7.0%
High Yield (median fund)	6.3%



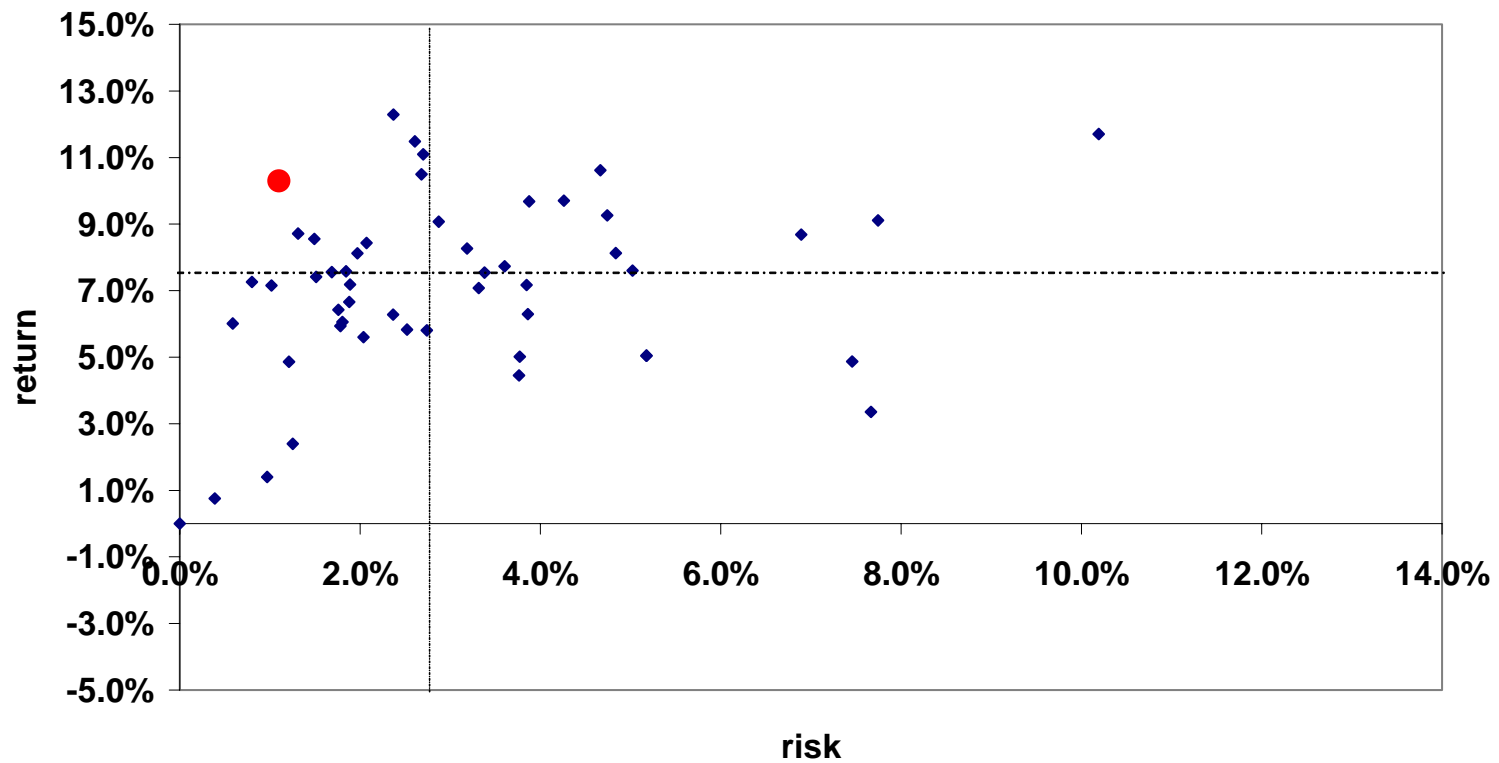
Inefficiencies ...what you have to read before you buy





Inefficiencies ...consequence is wide variation in returns

RETURN AND RISK -2005/2006





Correlation...the only free portfolio lunch

- Sector displays low correlations to other sectors
 - Historic Equity correlations 40%, Fixed Interest 20%
 - Trending towards 20%
- Correlations fall in extremely strong or weak equity markets
 - Mean reversion effect
 - Prices fall, yields increase in weak markets until bargain hunting/leverage occurs
 - Falling correlations in extreme markets is extremely valuable

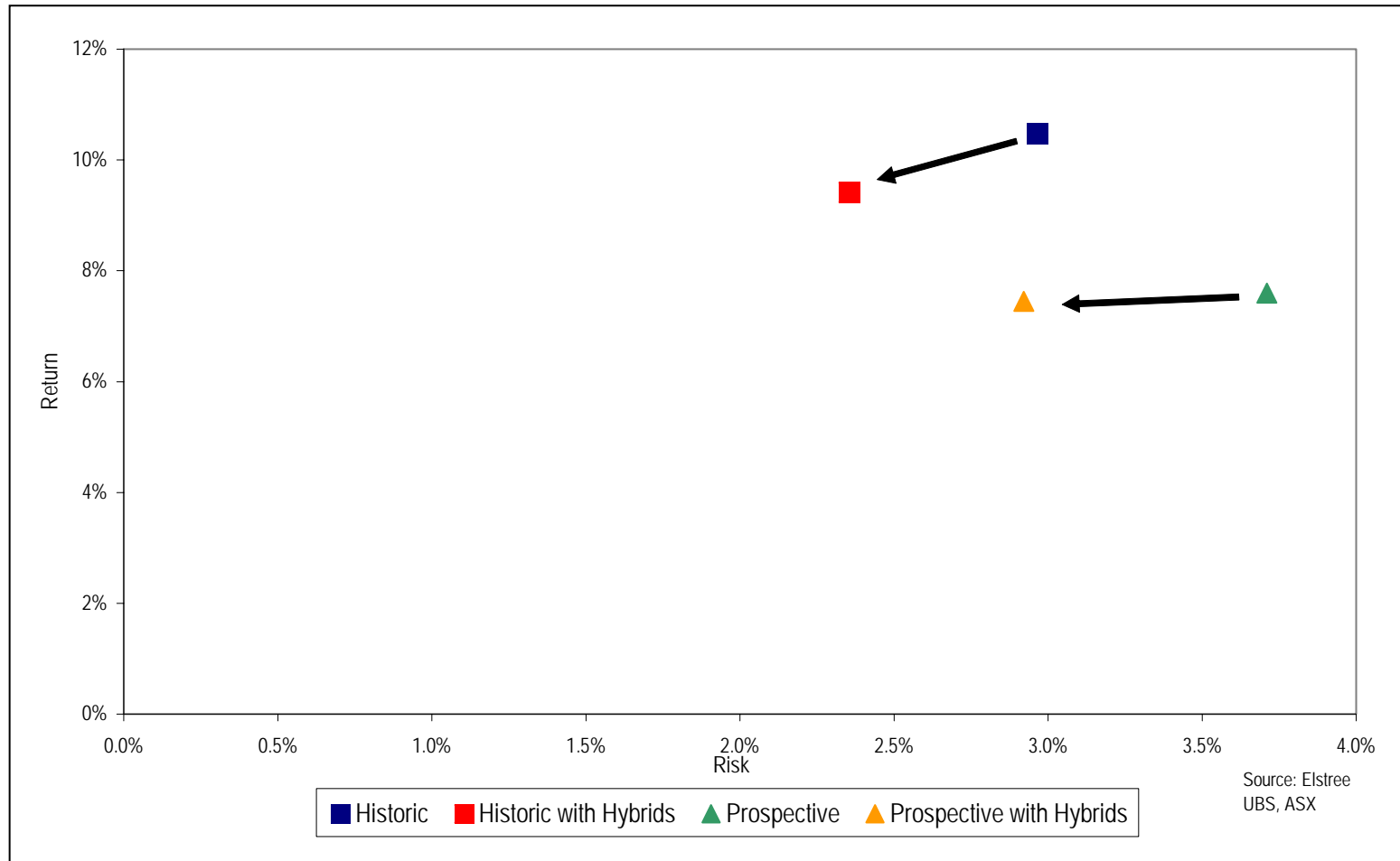


Correlation....how you get the free lunch

- Effect of low correlations & low volatility on portfolios is material
 - Capital Stable structures can see risk reductions of 20%
- Historically effective in high equity return environment
 - Inclusion of 15% hybrids
 - Reduction of 5% cash, bonds, equity
 - Risk reduced 20%, return reduced 10%
- Even more effective if equities don't do 25%
 - Inclusion of 15% hybrids
 - Risk reduced 20%, return stable
- Enjoy the reduced risk or gear up somewhere else



Correlation...the only free portfolio lunch





Risks: what you have to put up with to get 9%

- Always a trade off between risk and return
 - You should always be compensated for the additional risk
- Hybrid Sector demonstrates Sharpe ratios consistently over 1
- Most risks “solved” by a diversified portfolio
 - Typical retail investor portfolio of 5 hybrids magnifies risks
 - Effective diversification achieved in excess of 15 securities



Risks: what you have to put up with to get 9%

Risk	Amount you can lose per annum (%)	Affects principal or return
Default	100%	Principal
Interest rate	0%	Return
Margin	1.4%	Return
Event	15% (single security) 5% (portfolio)	Return
Liquidity	20% (single security) 2% (portfolio)	Return

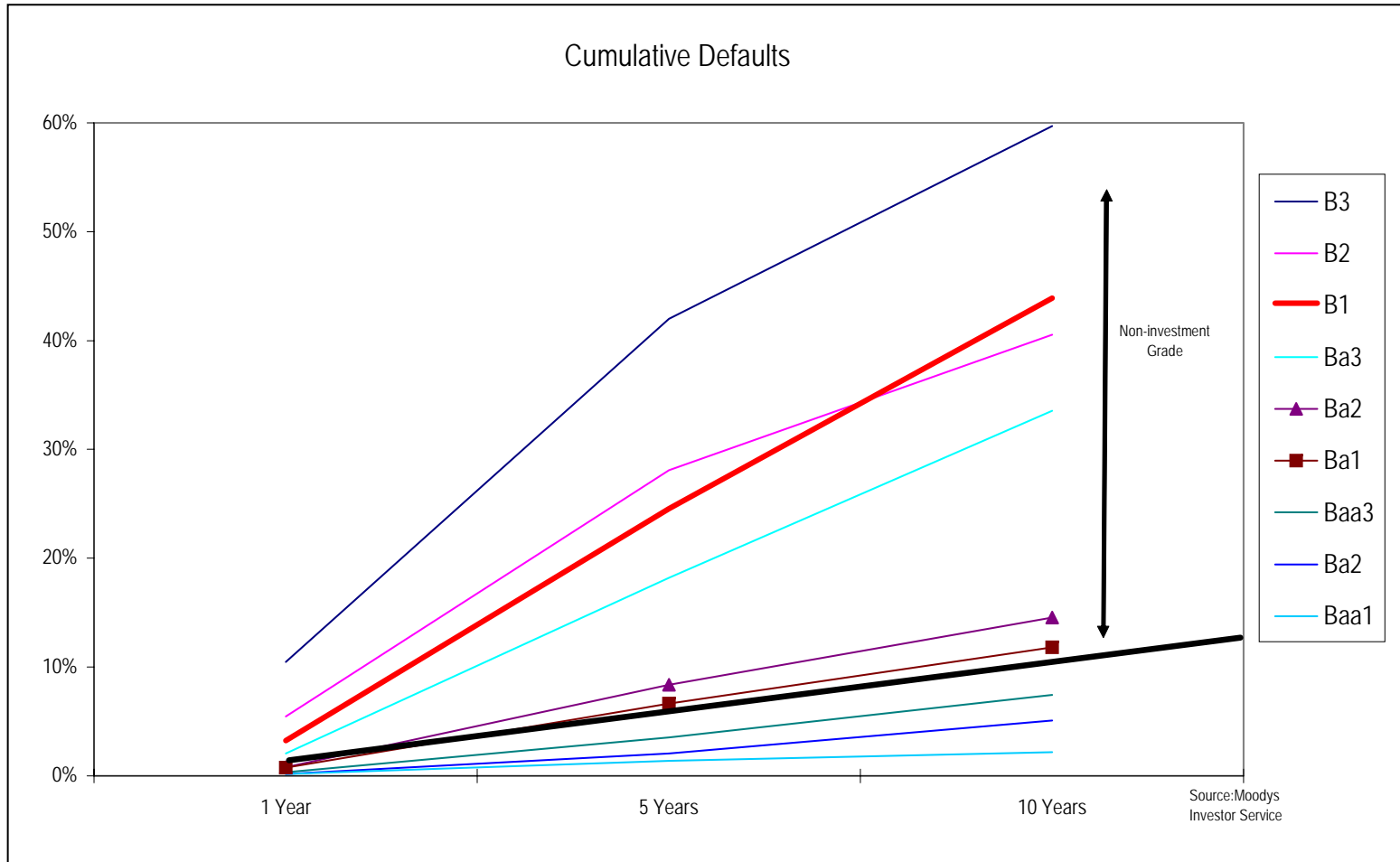


Default risk....misunderstood and overemphasized

- Hybrid sector is BBB/BB market
 - Default provision should be 0.3% p.a.
- Default risk escalates below BB
- 1 default of large company every 5 years
 - HIH was last experience
- 1-2 defaults in “penny dreadfuls” every year



Default risk....misunderstood and overemphasized





Default risk....misunderstood and overemphasized

Year	Number of Rated Issuers	Number of Investment Grade defaults	Number of BB/Ba defaults	Default rate of All Rated Bonds
2005	4,923	2	0	0.65%
2004	4,722	0	1	0.72%
2003	4,633	0	5	1.66%
2002	4,747	16	8	2.97%
2001	5,027	10	Not available	2.2%
1991-2000	C5,000	5	Not available	circa 0.8%
				Source : Moody's Default Studies 2002-2006

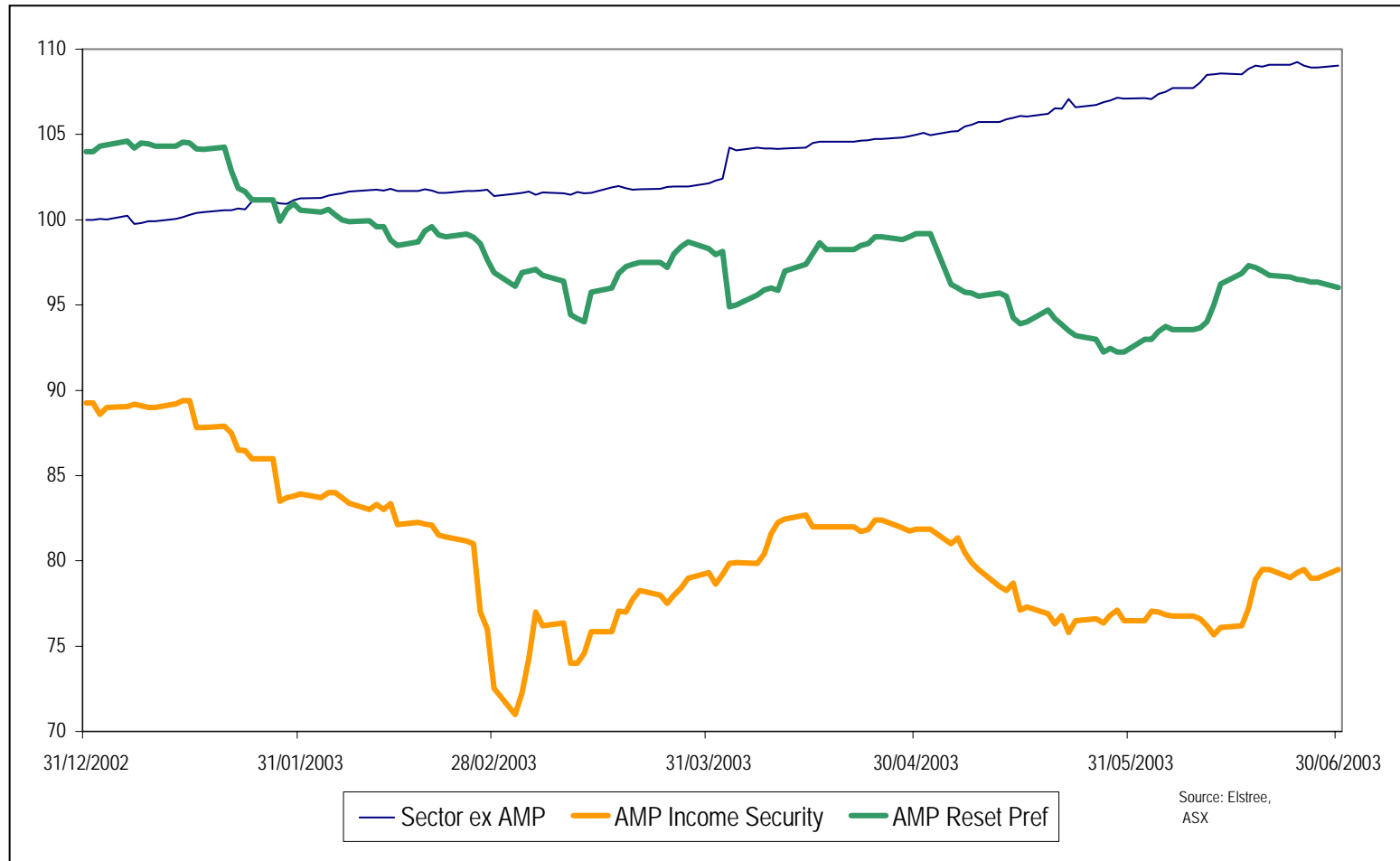


Event risk.....retail investors over-reacting?

- 1-2 events per annum
 - Can turn into default, but hasn't to date
- Uncorrelated to other companies in sector
 - Consequences for portfolio structure
- Strong relationship between retail ownership, liquidity and price movements
- Relatively small "beta" to underlying equity movements
 - 10% for reasonable quality companies, 20% for higher risk companies
- Great buying opportunities if you get it right



Event risk.....retail investors over-reacting?



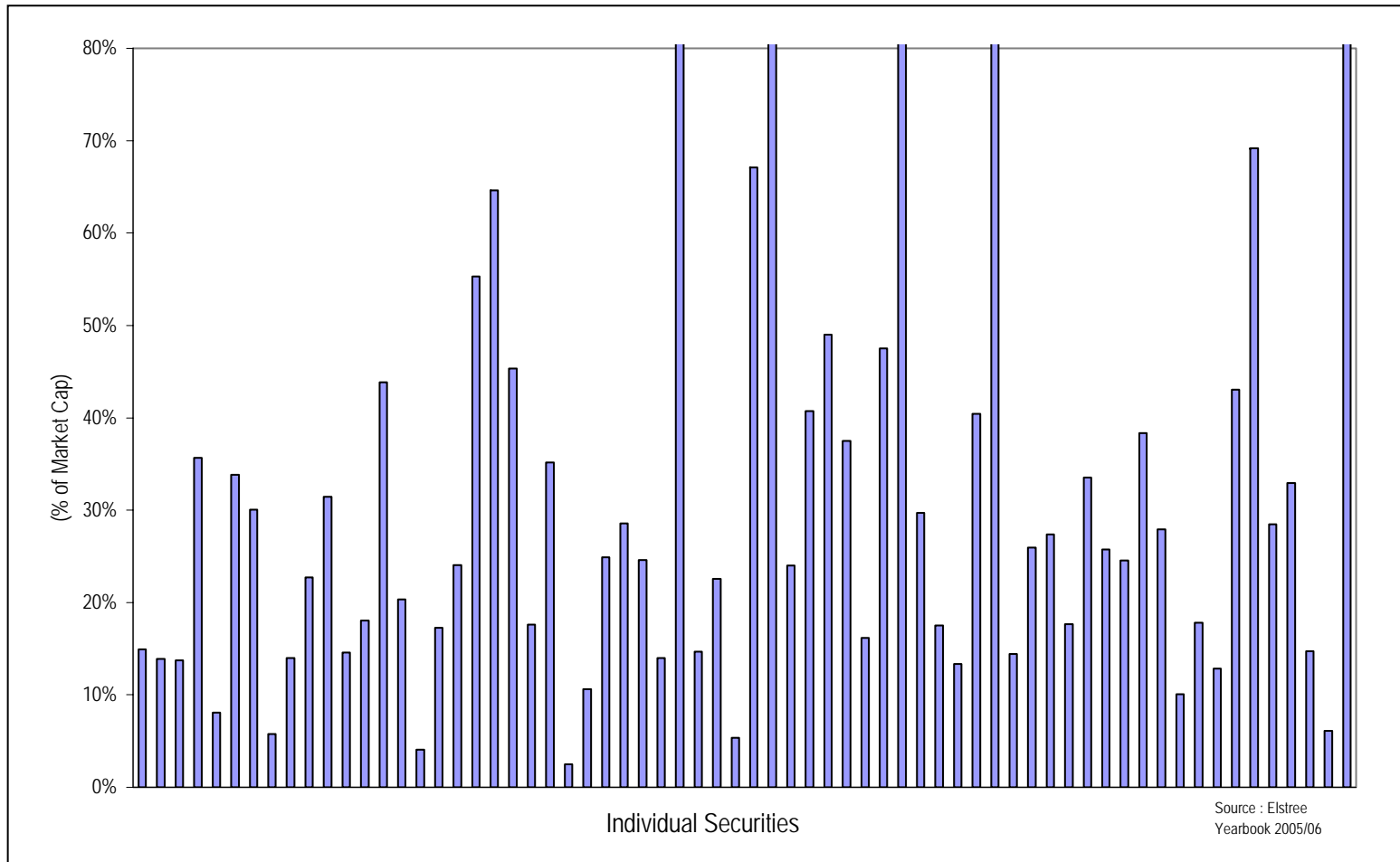


Liquidity risk.....the sleeper

- Liquidity risk has been absent for 5 years
 - Last seen in Australian asset markets early 1990's, UK & US markets 2001
- Hybrids prone to liquidity risk
 - Subordinated nature, narrower investor base
 - Secondary turnover dominated by retail brokers
- Prices revert to fair value eventually
- Hybrid investors only affected if
 - They hold undiversified portfolios
 - They are investors in large open ended funds
 - They are forced sellers



Liquidity risk.....the sleeper





Why use a fund manager to access the benefits

- You can successfully do it yourself
- But only if
 - You buy 15 or more securities
 - You understand your default risk
 - You understand the documentation and the consequences
 - And you miss out on the alpha
- You get the best outcome if you use a manager
 - Much higher return potential
 - Access to active management
 - More effective diversification



Not every manager is appropriate

Most managers too large and not active enough

- Maximum size for active management - \$350m (<2% of market)
 - Reduces performance
 - Increases liquidity risk
- Our record
 - True hybrid specialist with best of sector knowledge
 - 10% p.a. last 3 financial years (before fees and after franking credits)
 - Low volatility (no negative months)
 - Style differentiation
 - Not size constrained and firm commitment to close fund at \$350m



Conclusions

- Hybrids are a great new asset class
 - Higher return
 - Low volatility
 - Low correlations
- Risks are different but manageable
 - More default risk
 - More event risk
 - More liquidity risk
 - Diversification “solves” most problems
- You need a manager to access alpha
 - Best results if not size constrained
 - Methodology to add value



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