November 15, 2016

Chairman's Address. Australian Enhanced Income Fund

We welcome you to the 10th Annual General Meeting of the Australian Enhanced Income Fund.

For the second year in succession, Fund returns were less than income levels, although capital losses were less than the previous year. At the same time, returns were above the cash rate, higher than the broader equity market and well above bank equity returns, which many commentators consider an income substitute.

The 2016 Financial Year was a year of two halves. The period up to February 2016 saw a combination of plummeting oil prices and concerns about Chinese economic growth. This produced weak equity markets with indices falling around 5%. Hybrids were flat over this period with income being offset by small 'mark to market' capital losses.

During the latter part of the Financial Year, hybrids prices improved markedly resulting in the sector returning 3.9% for the year.

We are pleased to announce that the good performance has continued with the sector's investment performance (including the value of franking credits) since the reporting date of 30 June 2016 posting a further 4.4% increase.

There were a number of interesting aspects that the past year or two produced that are worthy of highlighting. They are;

- The sector's underlying return of cash rates plus c4% stacks up favorably compared with other asset classes. Historic equity 'ex-post' returns are generally less than the cash rate plus 4% with much higher volatility. For the 10 years to October 2016, the hybrid market, as represented by the Elstree Hybrid Index returned, on a per annum basis, 5.22% compared to the 3.78% of the All Ordinaries Accumulation Index.

- Hybrids are not very volatile. They are not like term deposits or cash and there is some capital price volatility, but it's consistently around ¼ that of equity markets and even less volatile in in small to medium crisis. To put this in perspective, the average hybrid will see capital prices rise or fall by $2 p.a. per $100 most years.

Australian Enhanced Income Fund (ARSN: 115 632 990)
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Individually some will have larger price variations, but the benefit of a diversified portfolio offsets this.

- Hybrids are not affected by the occasional non catastrophic equity market event. Hybrids were unaffected by the BREXIT equity market tremors and the Chinese and oil worries early this year saw a beta of around 20% (i.e) when equity markets fell 5%, hybrids would fall around 1%, and they recovered more quickly.

- A consequence of the past few years of hybrid price weakness has been that spread margins offered over cash rates are now materially higher than their post GFC averages. This will result in either healthy income returns for the next 4 or 5 years or some capital gains over the next 18 months as margins contract (margins move in the opposite direction to prices) and flatter returns beyond that.

Outlook

When we spoke with you last year we thought the market might be 'flat' with some prospect of capital gains. We did say that the high margins above cash rates would see good returns even if there were no capital gains.

As it turned out while there was some price weakness through until February 2016, prices have increased materially since with the sector 12 month return to 31 October coming in at 7.4%.

The market is in much the same position as last year for many of the same reasons.

- Spread margins over cash rates on hybrids are still well above post GFC average levels. With very limited supply expected over the next year or two, the market is disposed to margin contraction and consequent capital gains as investors bid up the prices of securities in secondary markets.

- The underlying creditworthiness of the Australian banks continues to improve. We saw further equity capital raised last year and we expect equity capital levels to increase over the current year. At the same time, the underlying assets of banks (now mainly <80% LVR residential mortgages) remain low risk over a long term view.

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Elstree

- Hybrids are floating rate instruments and are unaffected by changes in interest, bond and discount rates. Many sectors that are affected by discount rates such as bond markets, REITS and Infrastructure have had a horrible 3 months, which will continue if discount rates continue to rise.

Currently the Fund is yielding 5.95% (after fees but before franking). If cash rates remain stable, the Fund will generate that level of income return over the next 4 or so years. Should spread margins over cash rates contract some of that return will be front loaded. This means that returns will be higher than the income level.

The yield of the Fund compares favorably with other asset categories, such as cash, fixed interest and equity markets and this bodes well for returns.

At the same time, if there are any equity market convulsions, hybrid returns will be flat for while or post small negative returns.

The recent election of Donald Trump as US President sent equity markets into a spin momentarily. While we've got little idea what will eventually happen, it looks like the US economic risks are to looser fiscal policy, higher inflation and a stronger US dollar. We note that a higher inflation outcome will bolster hybrid return outcomes.

Distribution rate

As investors will be aware, we reduced the cash distribution rate by $0.05 p.a.to $0.35 p.a. in the June quarter this year. Since the last distribution change in September 2013, the RBA cash rate has fallen 1.25%. As most of the Fund's investments pay a coupon or interest rate margin linked to the RBA cash rate, a decline in the RBA cash rate meant that the Fund's income declined. This meant that the Fund was paying out capital in order to maintain the distribution rate at a higher $0.40 per annum rate which was unsustainable.

Our intention now is to keep the NAV stable while maintaining as high a distribution rate as possible.

Although we expect the RBA to keep cash rates stable, should the RBA cut the cash rate and if the NAV declines, we expect to reduce the distribution rate to $0.30 per annum.

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This still reflects a c5.1% cash yield and with the addition of franking credits, a c5.8% gross income return outcome.

We thank you once again for your support and we look forward to reporting a more satisfactory year when we next meet.

Campbell Dawson (Chairman)

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