January 13, 2017

Australian Enhanced Income Fund - ASX Code "AYF" December 2016 Investment Update and NAV

December 2016 NAV and Fund performance

The Fund's NAV of a unit at the close of business on December 30, 2016 was $**6.103** per unit. After the payment of the $0.0875 cent per unit cash distribution the NAV of a unit was $6.016. This compares with the NAV of a unit at the close of business on 30 November of $5.976. The change in NAV over the month of December represents a return of 2.13%**.** The franking benefit for December was estimated to be **0.19%**.

Performance	1 month	3 months	12 months	3 Year p.a.
Australian Enhanced Income Fund*	2.13%	3.75%	8.33%	4.23%
UBS(A) Bank Bill Index	0.15%	0.44%	2.07%	2.36%

*Returns do not include the benefit of franking. Past performance is not necessarily a guide to future performance.

Relative performance

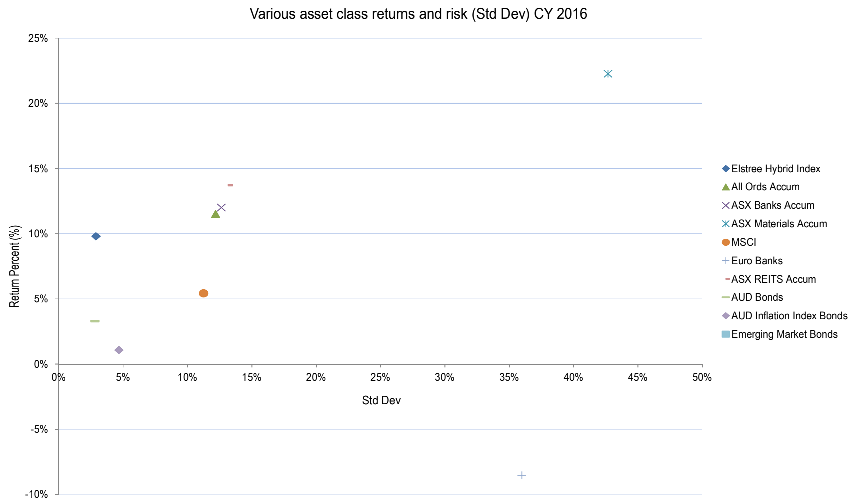
- Including the value of franking credits the ASX listed hybrid sector returned 1.96% for the month. This compares with the All Ordinaries Accumulation Index return of 4.17% and the UBSA Bank Bill Index return of 0.15%.

Fund performance

The Fund outperformed the broader market this month. The Fund's rolling annual net return, which excludes the benefit of franking but is net of all fees, for the 12 month period ending 31 December 2016 increased to 8.33% from 6.20% previously.

2016 – a great year for hybrids

The chart below shows returns and volatility (std dev) for a number of different asset classes for the year ending 31 December 2016. It was a particularly good year for hybrids. The market, as denoted by the Elstree Hybrid Index, returned 9.91% with volatility of 3%. The return outcome was attributable to small positive changes in the capital value of securities and healthy income levels. Outside of ASX Materials Index, it's difficult to find an asset class that did exceptionally well. At the same time, there were few disappointments with European banks being the only real under performer.



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What of the future?

We can continue to mount a case for making an increased allocation to listed hybrid securities based on the points highlighted below.

- The excess return over cash (the excess return is the return an investor receives for investing in a riskier asset over the risk free rate) is similar to the long term ex-post equity excess return. Because hybrids sit above equity in the capital structure they should be represented by a lower excess return than equity. They are not!
- In historical terms the aggregate excess margin for the hybrid market has been as low as 0.95% over cash (in 2007) and as high as 6.0% over cash in 2009. The excess margin is now 3.75%.
- The banks, who are the majority issuers of hybrids, are better capitalised and more securely funded than in any time in their history and as such are less risky.
- Should interest and discount rates increase materially from where they are, bonds, infrastructure, equities and REIT's are likely to perform less well remembering that bond and discount rates have been falling for much of the last 35 years which has had a positive effect on the prices of long duration assets such as infrastructure, equities and REIT's.
- In a higher interest rate environment, hybrids, which are floating rate instruments, will benefit from a higher coupon rate.
- Hybrid IPO supply is expected to be reduced in CY 2017 as the banks have sufficient hybrid capital to satisfy APRA's requirements.
- Institutional demand, which has been absent since the immediate GFC period, is accelerating as the excess return and yields are just so attractive.

Fund ready reckoner. Fund metrics and portfolio characteristics at a glance

	November 2016	December 2016
Net Asset Value (NAV)	**$5.976**	**$6.016#**
Change in NAV month on previous month (mopm)*	**0.61%**	**2.13%**
Total investment return includes the value of franking (mopm)	**0.66%**	**2.32%**
Dividend (declared December 2016 and payable 16 December 2017)	**n/a**	**$0.0875**
Percent franked (*quarterly estimate @ 30% tax rate*)	**n/a**	**42%**
Cash yield per annum (basis NAV)	**5.85%**	**5.80%**
Grossed up yield basis NAV per annum (*estimated*)	**6.69%**	**6.64%**
Investment grade issuer (including cash)	**90%**	**90%**
Fund average term	**3.9 years**	**4.1 years**
Bank Tier 1 exposure	**45%**	**52%**
Property exposure	**4%**	**4%**

* Returns do not include the benefit of franking. Past performance is not necessarily a guide to future performance. # Ex-Distribution

For additional information please contact **Norman Derham** at Elstree Investment Management Limited on (03) 8689 1348 or by email info@eiml.com.au While the information in this report has been prepared with reasonable care Elstree Investment Management Limited accepts no responsibility for any errors, omissions or misstatements however caused. This is general securities information only and is not intended to be a securities recommendation. This information does not account for your individual objectives, needs or financial situation.

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