February 27, 2017

AUSTRALIAN ENHANCED INCOME FUND

- **Hybrid prices strengthened in the December 2016 half year, as a number of the factors that caused the weakness in calendar year 2015 continued to reverse.**
- **The return in the December 2016 half year was the strongest result since 2012.**
- **After the recent strength, hybrid prices have moved from exceptional value to good value, but will continue to outperform cash and term deposits and current yields provide equity type returns with lower risk.**

Period	Change in NAV and distributions	Franking Credits (est) Cents Per Unit	Investor Return	Bank Bill return
3 months ending 30 September 2016	$0.15	$0.01	$0.16 2.7%	0.4%
3 months ending 31 December 2016	$0.22	$0.02	$0.23 4.0%	0.5%
Half year ending 31/12/2016	**$0.37**	**$0.03**	**6.7%**	**0.9%**

Market commentary

The hybrid market was stronger over the half;

- The market realised that the regulatory induced surge in bank capital evidenced over the last 5 years was slowing. This was particularly relevant for investors in subordinated and hybrid capital instruments issued by the banks. The years of >$3b of initial public offering (IPO) supply were about to turn to small issuance or even net redemptions. The scarcity factor drove spread margins downwards and security prices higher.
- Strong equity markets, particularly after Donald Trump's US Presidential victory, assisted sentiment. The hybrid market return of 2.6% in the month of December 2016 turning a good half year into an exceptional one.

Fund

The Australian Enhanced Income Fund outperformed the broader market. The Fund return was around 7.7% (before fees) and 6.7% after fees.

As at 24 February 2017 the yield to maturity of the Fund was circa 4.9% with the Fund displaying an average credit term of 3.4 years.

Australian Enhanced Income Fund (ARSN: 115 632 990)
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Distribution

The Fund paid cash distributions of $0.175 cents per unit during the period. The franking credits accrued by the Fund's investments over the 6 month period from 1 July 2016 to 31 December 2016 were estimated to be worth $0.03 cents per unit.

We propose to maintain the distribution provided cash rates remain at their current level. However, should the RBA lower cash rates again we will review our policy.

Outlook

The surge in hybrid security prices this half year was attributable to reduced supply and the recognition by investors that the banks, who are the majority issuers of hybrid securities, are more strongly capitalised and as such inherently less risky.

- We expect the supply issue to continue to abate this year with only 2 of the major banks to issue, compared to the numerous issues seen over the last 2 years. We do not expect any major bank equity capital raisings either.
- While markets may remain volatile, we are starting to see the hybrid market ignoring equity market volatility.
- The near doubling of bank equity levels since 2007 has made hybrids intrinsically less risky.
- Margins are now near GFC levels and the yield of a diversified hybrid portfolio exceeds the longer term return of the equity market, with lower risk,

Risks

The caveats remain as always. Weak equity markets will lead to flat or slightly weak hybrid markets and if we get an unanticipated increase in supply from issuers, we will see a lag in capital price increases.

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