September 4, 2017

Australian Enhanced Income Fund - ASX Code "AYF"
August 2017 Investment Update and NAV

August 2017 NAV and Fund performance

The Fund's NAV of a unit at the close of business on August 31, 2017 was $**6.114** per unit. This compares with the NAV of a unit at the close of business on 31 July of $6.10. The change in NAV over the month of August represents a return of **0.23%.** The franking benefit for August was estimated to be **0.08%**.

Performance	1 month	3 months	12 months	5 Year p.a.
Australian Enhanced Income Fund*	0.23%	1.31%	8.38%	6.28%
UBS(A) Bank Bill Index	0.14%	0.43%	1.76%	2.46%

*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 0.39% for the month. This compares with the All Ordinaries Accumulation Index return of 0.79% and the UBSA Bank Bill Index return of 0.14%.

After fees but before the value of franking, the Fund out-performed 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 August was 8.38%.

What the Japanese experience can tell us

Whenever we can't adequately explain the way financial risk is priced we have a tendency to refer to the Japanese experience. Despite commentators arguing that most, if not all, asset markets are expensive and that credit spread margins, which are a measure of the riskiness of credit assets, are too narrow, broader measures of financial market risk, such as that developed by the St Louis Fed called the St Louis Fed Financial Stress Index or STLFSI point to a low level of financial market risk.

The chart below shows "BBB" spread margins in the US and Japan. As the chart shows, Japanese and US "BBB" margins were similar in 1998, but Japanese margins have contracted materially since. While credit spread margins are now much narrower in Japan than they are in the US, default loss rates of "BBB" rated securities in Japan have been negligible for 20 years. Not only have loss rates been negligible but they have been far less than non-Japanese "BBB" rated securities. This means that Japanese BBB investors, despite narrow spread margins are still getting adequately compensated for taking credit risk. Typically, a "BBB" rating provides an indication of a low probability of default. If the low growth/secular stagnation/high liquidity does result in lower default loss rates, at current spread margins US BBB margins might not be so "expensive" after all!

Australian Enhanced Income Fund (ARSN: 115 632 990)
Responsible Entity: Elstree Investment Management Limited (ABN: 20 079 036 810)
Level 10, 30 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348
Email: info@eiml.com.au

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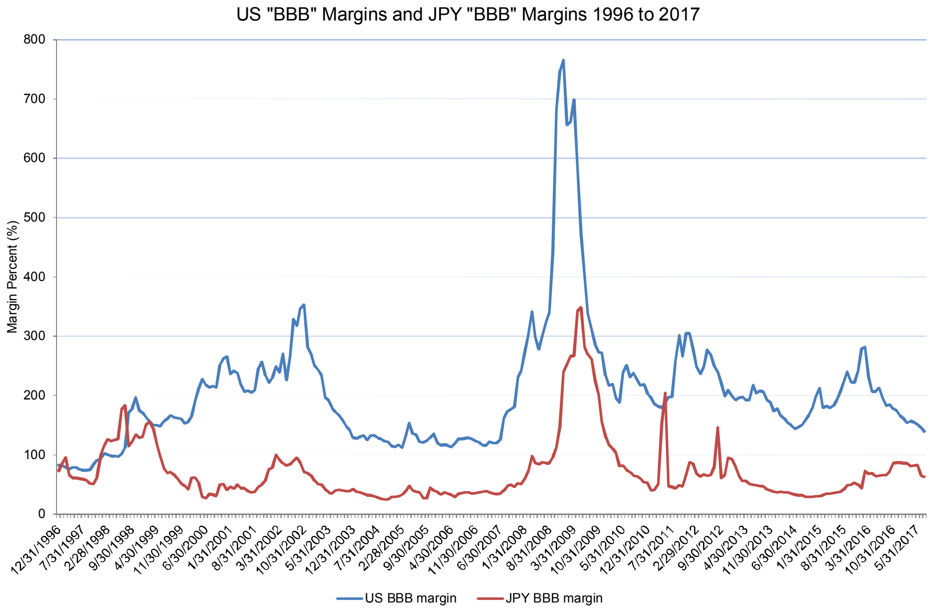

What does this means for bank capital instruments?

From a valuation point of view there is an opportunity. Like the Japanese experience with "BBB" rated securities we think there has been a structural change for bank capital securities. While much of the scepticism and risk aversion directed at bank solvency since the GFC is unwinding amid a backdrop of record high CET1 levels and more secure funding it is not yet, in our opinion, priced fully into bank capital instruments. Herein lies the opportunity.

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

	July 2017	August 2017
Net Asset Value (NAV) - ex-distribution.	$6.071	$6.114
Change in NAV month on previous month (mopm)*	0.59%	0.23%
Total investment return includes the value of franking (mopm)	0.76%	0.31%
Dividend (declared August 2017 and payable 17 August 2017)	$0.0875	n/a
Percent franked (*quarterly estimate @ 30% tax rate*)	40.45%	n/a
Ex-distribution cash yield per annum (basis NAV)	5.77%	5.74%
Ex-distribution grossed up yield basis NAV per annum (*estimated*)	6.59%	6.56%
Investment grade issuer (including cash)	90%	90%
Fund average term	4.3 years	4.2 years
Bank Tier 1 exposure	49%	48%
Property exposure	6%	6%

* 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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