Market and Performance Review

The Australian Enhanced Income Fund produced investor's a total return of 4.6% over the year to end 30 June 2018, which is the first year in 4 where returns have been close to income returns. The total return comprised;

- A decrease in NAV of $0.147
- Cash distributions of $0.35
- Franking credits equivalent to $0.07

The All Ordinaries Accumulation Index over the same period returned 13.73% while the UBS (Australia) Bank Bill index returned 1.77%.

Market summary

FY 2018 was a case of 2 very distinct halves. The period to December 2017 was characterised by a strong market which returned over 4%. The drivers were expectations of limited supply of new hybrids, improved global economic conditions, and strong and low volatility equity markets.

This drove prices up and spread margins on newly issued hybrids approached 3.1%, which is around 0.4% lower than post GFC averages.

This changed in January 2018 when the Volatility/VIX spiked and equity markets fell 4% in the space of a few weeks. While this did not have an immediate impact on hybrid prices there was a weaker tone in early March when the Australian Labor Party (ALP) announced plans to remove the franking credit rebate for 0% tax paying SMSF's should it be elected at the next Federal Election. This was followed shortly after by 2 new issues which were larger than expected. The result was lower prices over much of March and April with spread margins increasing to around the 4% level in late May. The 4% spread margin barrier is hard to breach and has traditionally resulted in good buying and this time was no exception with the market recovering much of its lost ground between late May and 30 June.

Outlook

Over the long term, the drivers of the hybrid market returns are the yields available, the financial health of the issuers and economic conditions. Currently we have a combination of yields which are close to post GFC average levels, much improved financial health amongst the banks and insurers that comprise a large section of the market and an economy that continues to generate low inflation and low growth. The current yield of c5% for the market is a realistic expectation for returns for the next 3 years. This compares with Term Deposit rates of c2%, and equity yields of around 4%, but with much higher volatility.

Over the medium term, returns fluctuate due to equity market volatility, supply factors and the general interaction of the (largely) retail investor base with a fixed supply. However, there tends to be mean reversion in the medium term, so bad years are usually followed by good ones and vice versa.

The past 4 years has seen this mean reversion in play with a poor year in FY 15 and a mediocre year in FY 16 followed by a bumper year in FY 17 while FY 2018 returns were largely in line with income levels. We think the market is currently fairly valued and we expect most hybrids to trade in a $2 range around current prices. We expect that the drivers of price movements over the next few years will continue to be equity market volatility and the occasional supply hiccough.

Cash distributions

The cash distribution of $0.35 p.a. remains above the income generated by the Fund. At the same time the NAV of the Fund has been largely stable at $6.00 for the past 3 years. This has occurred as a consequence of securities increasing in value and management value add.

We think there are still prospects for security prices to increase and as a consequence we expect to retain the distribution at $0.35 for the current year.

With an NAV of around $6.00 per unit this represents a 5.8% annual cash distribution yield which is further augmented by franking credits which add around 1% to the yield on an annual basis.

Once again, we would like to this opportunity of thanking unit holders for their ongoing support.

Campbell Dawson, Chairman (27 August 2018)