February 26, 2015

AUSTRALIAN ENHANCED INCOME FUND

- **Hybrid prices weakened marginally during the half as a supply surge pushed prices down,**
- **As expected, the high income yields resulted in a positive return for the half and**
- **Hybrids remain good value with income yields at attractive levels and the possibility of some capital appreciation.**

Period	Increase in NAV and distributions	Franking Credits (est) Cents Per Unit	Investor Return	Bank Bill return
Ending 30 September 2014	($0.05)	$0.02	($0.03) (0.5%)	0.7%
Ending 31 December 2014	$0.11	$0.01	$0.12 1.9%	0.7%
Half year ending 31/12/14	**$0.05**	**$0.03**	**$0.08** **1.32%**	**1.4%**

Market commentary

The hybrid market was weaker over the half. Reasons for the weakness were;

- There was an unexpected issuance surge when the Commonwealth Bank of Australia (CBA) up-scaled its PERLS VII hybrid to $3 billion. This was closely followed by 4 other issues. This put downward pressure on prices,
- Equity markets went through their worst post GFC period of weakness at the same time deterring some hybrid buyers and
- During the period there was a lot of negative commentary on hybrids.

The net effect of these 3 factors resulted in some capital price weakness which pushed spread margins on bank hybrid securities to levels only seen 3 times since the GFC.

Fund

The performance of the Australian Enhanced Income Fund was equal to that of the market at large.

As at 25 February 2015 the yield to maturity of the Fund was circa 5.1% with the Fund having an average credit term of 4.0 years.

Australian Enhanced Income Fund (ARSN: 115 632 990)
Responsible Entity: Elstree Investment Management Limited (ABN: 20 079 036 810)
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Distribution

The Fund paid cash distributions of $0.20 per unit during the period. The franking credits accrued by the Fund's investments over the 6 month period from 1 July 2014 to 31 December 2014 were estimated to be worth $0.03 cents per unit.

We will maintain the current cash distribution rate of $0.40 per annum per unit providing cash rates remain at their current level. However, should the RBA lower cash rates again we will review our policy and it is likely the cash distribution would be reduced by around $0.025 per annum.

Outlook

Despite the negative commentary, hybrids have produced excellent low risk returns since the GFC and we remain positive on the outlook. The reasons we are positive include;

- The price weakness in 2H 2014 reflects a supply surge that led to an overhang in the market. We expect much more subdued supply this year which will lead to upward pressure on prices.
- Term Deposit (TD's) rates have fallen materially over the last year or so.
- The RBA's recent action to cut cash rates and expectations of further cuts to come will lead to investors reallocating high cash or TD balances to higher yielding investments. Hybrids are one popular avenue and it doesn't require a large allocation from cash or TD's to hybrids to bring about capital price increases to more appropriate levels.

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.

Attractive income

In the meantime, the income levels of circa 5% per annum will dominate returns for the next few years, regardless of the 1% - 2% variation in the capital value that will likely occur each year.

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