November 19, 2014

Thank you for once again for joining us at the 8th Annual General Meeting of the Australian Enhanced Income Fund.

I am pleased to report that fiscal year 2014 was a very good one for the Fund.

The total return of the Fund for the year was 10.79% comprising distributions of $0.40 per unit, a unit price appreciation of $0.23 and franking of around $0.04.

This was well over the return of the Elstree Hybrid Index which returned 10.03%. Most portfolios aren't as diversified as the Elstree Hybrid Index so we also calculate the return of the 10 largest hybrid securities by market capitalisation. This posted a return of 9.7% for fiscal year 2014.

Returns this year were well over cash rates representing a combination of the current spread margin of c3%, capital gains that occurred in the first half of Fiscal year 2014 as spread margins narrowed and we made some investment decisions that added value.

The Fund's returns have been excellent over the past 5 years. Unit holder returns (which include NAV gains, distributions and franking) have been 12.2% per annum which is well in excess of almost everything, including cash, the Elstree Hybrid index and even equities.

The All Ordinaries Accumulation index produced a return over 5 years of just under 11% per annum before fees and it was almost twice as volatile.

The chart below shows the returns from 31 December 1999 of the Elstree Hybrid index and the All Ordinaries Accumulation index based to 1000 as at 16 November 2014. It shows how much you would need to have invested at any one time to have $1000 on November 16. Lower is better, so any time one index series is below the other index series the lower index series is cheaper. As you can see, hybrids give much the same return over the 15 year period with much lower volatility.

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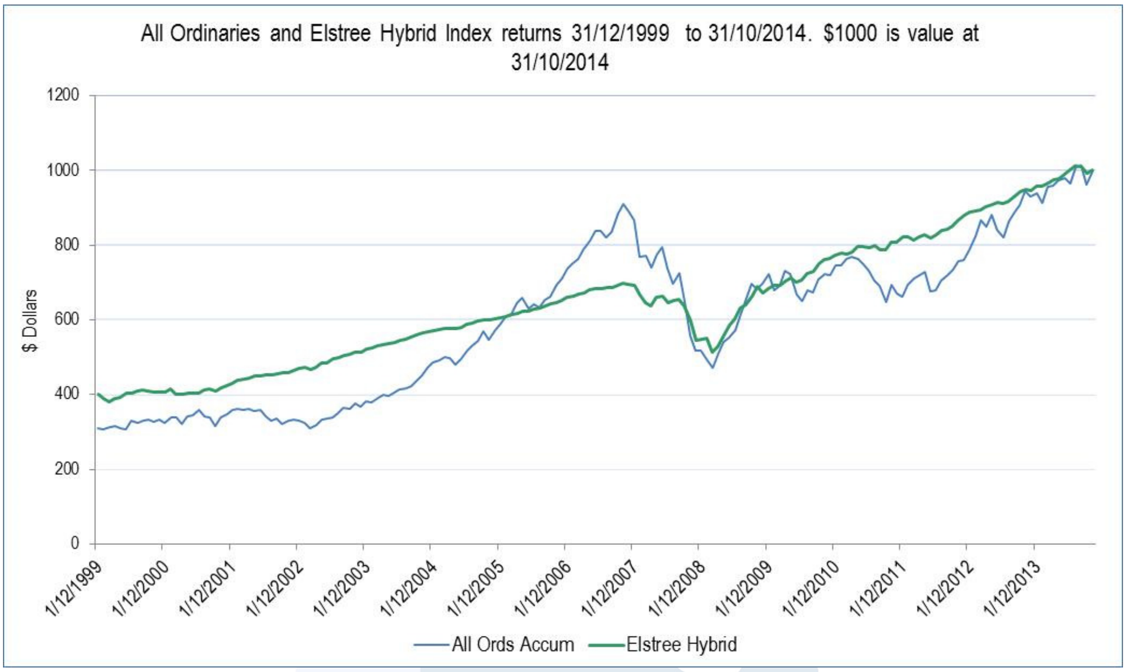

We think the future of this chart will remain interesting as well. Equity markets have been boosted by falling interest rates (and we think that phase is coming to an end) but hybrid margins are now almost 3 times what they were during the first half of this chart, so all other things being equal, hybrids will outperform equities in the medium term.

Given all the above it remains slightly baffling to us why, despite the indisputably good return numbers, the sector continues to attract so much negative press and regulatory attention? We understand all the issues and that the listed hybrids are not fixed interest, but we think that investors are getting well compensated for all the additional risks.

Maybe investors aren't reading or believing the press or those income space competitors with vested interests, because markets have been resilient this year despite equity market weakness approaching a 10% fall , unexpectedly large issuance and a month of headlines.

<u>Outlook</u>

This time last year we predicted a return of 5 - 7% with limited volatility. Despite a weak September quarter we are still tracking to produce a return within that range. Over the 12 months to 31 October the Fund has returned just over 6.7% with low volatility.

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We think the next 12 months will be quite similar to the previous 12 months. Even though cash rates are expected to remain stable, we think that there will be some capital gains to be had from spread margins compressing.

Much of the September quarter weakness came from a massive supply hit, and we don't expect a repeat of that. Absent an unexpectedly large increase in bank capital levels after the Murray Report, next year is shaping as the lowest year of supply since 2008.

At the same time, banks will continue to reduce their term deposit rates and the c$150 billion of SMSF cash holdings will begin to be run down. We expect this will increase the demand for hybrids, which are now trading at spread margins not that far off spread margins last seen at the end of the GFC.

Distribution rate

As investors should be aware, the distribution rate of $0.40 is above the cash income that the Fund receives. Investors would also be aware that the NAV has increased. What is happening is that the $0.40 distribution is above the cash income but below the total return of the Fund including capital gains.

We recognize that investors value regular stable income, so in the absence of large fall in cash rates we will hold the distribution level constant for the next 12 months. We are reasonably confident of more capital gains, so we expect that even with the above income level distribution, the NAV should not fall, and even if it does, it should be by a relatively small amount.

We thank you once again for being shareholders and we look forward to reporting another satisfactory year when we meet again this time next year.

Campbell Dawson

Chairman Australian Enhanced Income Fund. 19 November 2014.

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