August 14, 2017

Market and Performance Review

The Australian Enhanced Income Fund produced an almost unrepeatably strong return outcome in the 2017 Financial Year. The Fund's total return of 11.34% comprised;

- An increase in NAV of $0.25
- Cash distributions of $0.35
- Franking credits equivalent to $0.06.

The All Ordinaries Accumulation Index over the same period returned 13.12% while the UBS (Australia) Bank Bill index returned 1.82%.

In many ways, financial year 2017 was 'repayment' after a very poor 2016 Financial Year. The average return over the last 2 year reflects a more typical return profile with a total return (change in NAV + distributions + franking) of 7.0%.

Market summary

In last year's commentary, we mentioned that the hybrid market had absorbed a lot of bad news and lots of supply and this produced price weakness and poor returns. This year these factors reversed contributing to the exceptional return.

Over the 3 year period to the end of 2016, there had been $15B of major bank hybrid issuance which puts pressure on investors when new issues came to market. Since the end of 2016, there has been one issue and it looks like there will only be one more issue before late 2018. At the same time, there has been c$8b of hybrid security redemptions.

This lack of new supply and a continued flow of investors seeking higher returns from post GFC low Term Deposits saw the market produce strong returns over the whole year. The average margin of ASX listed hybrid securities fell from 4.0% to 2.8% over the year. The fall in margin resulted in capital gains just as in the previous year margins widened and prices fell.

The Elstree Hybrid index produced returns of 11.1% for the year (including the value of franking credits) with no negative return months. It was the highest return year since 2009/2010 which was when hybrids rebounded from their oversold position during the GFC. At the same time, the high return from the market this year came with cash rates at much lower levels than they have been over the past decade.

Australian Enhanced Income Fund (ARSN: 115 632 990)
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Before fees and administration costs the Fund outperformed the Elstree Hybrid index by around 2%. This was a function of correctly positioning the Fund ahead of a contraction in spread margins and some value add by holding overweight positions in a small number of individual securities that performed well.

The high return saw the NAV increase from $5.8195 (ex-distribution) at 30 June 2016 to $6.0705 (ex-distribution) at 30/6/2017.

We do note that the return outcome this year is extremely unlikely to be repeated.

Outlook

Although the hybrid market has had a very strong rally over the past 18 months, and is now trading at levels which are more expensive than the average of post GFC margins, we are not yet willing to call for a correction.

We see some significant tailwinds which should assist the market to maintain these price levels or even strengthen slightly.

- The lack of supply remains positive. We expect that there is a good chance that there will be more security redemptions than IPO supply over the next 12 months and can't see a repeat of the c$4b per annum issuance that we saw between 2012 and 2016.
- We think there is a growing recognition that the banking system is safer after 10 years of post GFC repairs. Bank capital levels are around twice pre GFC levels, there is less risky short term funding and credit risk has diminished. Bank capital securities, such as hybrids, have carried an excess risk premium for the last 10 years. We think there is a good chance that the market will continue to price in a reduction in that risk premium.

Cash distributions

The distribution rate was changed to $0.35c per unit annum for the June 2016 distribution.

The cash distribution yield of c5.75% remains above the income yield of the Fund. This year the Fund earned well in excess of the distribution yield and as a consequence the Fund's NAV increased from $5.82 to $6.07 (ex-distribution).

We anticipate over the next 12 months that the Fund will continue to earn a rate of return over the distribution yield. If that is the case, we do not expect to reduce the cash distribution.

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Should cash rates fall again, or our view of the market changes, we may reduce the distribution target.

Once again we would like to this opportunity of thanking unit holders for their ongoing support. Investors who have owned the Fund (and hybrids in general) since the GFC have received excellent return outcomes. The Elstree Hybrid index has returned 10.0% p.a. since March 2009 which is only 0.6% less than the All Ordinaries Accumulation Index but with 1/3 of the volatility. The Fund has outperformed the Elstree Hybrid Index by around 1.6% over that period (before fees).

Campbell Dawson, Chairman (14 August 2017)

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