January 13, 2020

Australian Enhanced Income Fund - ASX Code "AYF" December 2019 Investment Update and NAV

December 2019 NAV and Fund performance

The Fund's NAV of a unit at the close of business on December 31, 2019 was $**5.951** per unit. Ex distribution the Fund's NAV of a unit was $5.881. This compares with the Fund's NAV of a unit at the close of business on 29 November 2019 of $5.931. The change in NAV over the month of December represents a return of **0.34%.** The franking benefit for December was estimated to be **0.16%.** Including the value of franking the Fund returned **0.50%** over December 2019.

Performance	1 month	3 months	12 months	3 Year p.a.
Australian Enhanced Income Fund*	0.34%	0.25%	5.59%	5.02%
UBS(A) Bank Bill Index	0.07%	0.24%	1.50%	1.72%

*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 the ASX listed hybrid market returned 0.62% for the month. This compares with the All Ordinaries Accumulation Index return of (1.90%) and the UBSA Bank Bill Index return of 0.07%. After fees but before the value of franking, the Fund under-performed the broader market this month. Over 3 years the Fund's rolling annual net return, which excludes the benefit of franking but is net of all fees, for the period ending 31 December was 5.02%.

Risk premia: Using breakeven analysis as a method to assess if the excess return justifies the risk

We comment often about risk premia and what the reach for yield does for the spread margins (or excess returns) investors expect to receive for investing in riskier assets such as high yielding corporate bonds or (even) ordinary equity. As the reach for yield intensifies how, as an investor, do you know if your return on invested capital at 'risk' is sufficient compensation *vis-à-vis* (say) the risk free rate to justify the investment? One method we sometimes use to assess the risk inherent in securities is "breakeven analysis". In essence, breakeven analysis provides us with a relatively simple method of assessing whether the excess return we earn over a prescribed benchmark index or even (say) the risk free rate, provides sufficient compensation for the additional risk. We highlight (below) how breakeven analysis, using an example of a major Australian bank term deposit returning approximately 1% on an annual basis and the PERLS VII hybrid capital instrument, currently yielding approximately 3.5% per annum, might be used to put the excess return in perspective.

Arithmetically, assume you have $100 and you invest it in a term deposit for 2 years (a reasonable time frame) at 1% per annum. Ignoring compound interest, as an investor you earn $2 or 2% over the 2 year period (i.e. 1% in year 1 followed by 1% in year 2). Investing in the CBAPD where we assume the floating benchmark reference rate will be 1% (i.e. BBSW) you return over the same period, including the value of franking, 3.5% in year 1 followed by 3.5% in year 2. A total of $7 or 7%. While you have returned 3.5 times the risk free term deposit rate you have invested in a 'risk' asset where there is some probability, albeit a very low probability, of a capital loss over the period. Using breakeven analysis it is possible to make a value judgement as to the return vis-à-vis the risk.

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Let's assume, for the sake of the argument, there is an 'event' and the capital value of the CBAPD declines. As an investor, the question you should ask yourself is; how far does the capital value of the CBAPD have to fall by the end of the period (i.e 2 years) before, as an investor, you would have better off investing in the term deposit? The capital loss on the CBAPD would have to be greater than $5 (i.e the difference between what you earn on the CBAPD and what you earn on the TD) before you would have been better off in the term deposit. What this means is, if you buy the CBAPD at (say) $100 today you could sell it for $95 at the end of the period (year 2) and be no worse off, than investing in the term deposit at 1% p.a. for 2 years. The table below provides a summary.

	Income (annual rate)	Return @ end 2 years)	Amount Invested	Income earned on $100 over 2 years	At end year 2 ($100 + income)	Breakeven CBAPD price @ end year 2 to = 2 year TD income
2 year TD	1%	2%	$100	$2	$102	n/a
CBAPD	3.50%	7%	$100	$7	$107	$95

The interesting thing however, is that at a price of $95 in 2 years' time (i.e December 2021) the yield to maturity (first call) in December 2022 of the CBAPD would approximate to 9% per annum (i.e change in capital value + coupon and franking). At 9% the spread margin represents an excess margin of 800 basis points or 8% over the risk free rate which would be preposterous, everything being equal, for an asset of that credit quality (CBA risk) and term (one year). While our portfolios are of similar term and similar average weighted credit quality, the difference is, and it is an important difference, our portfolios contain 35 securities spread across a range of sectors and sub sectors, including banking, insurance building and construction and infrastructure. By investing across a broad range of sectors and sub sectors containing securities of different credit quality and term the risks associated with investing in a single individual security are significantly reduced.

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

	Nov 2019	Dec 2019
Net Asset Value (NAV). # Ex distribution.	$5.931	$5.5881#
Change in NAV month on previous month (mopm)*	0.17%	0.34%
Total investment return includes the value of franking (mopm)	0.20%	0.50%
Dividend paid 15 January 2020	n/a	$ 0.07
Percent franked (*quarterly estimate @ 30% tax rate*).	n/a	39.59%
Cash yield per annum (basis NAV).	4.70%	4.80%
Grossed up yield (basis NAV) per annum (*estimated*)	5.56%	5.60%
Investment grade issuer (including cash)	90.0%	92.0%
Fund average term	3.60 years	3.25 years
Major Bank Tier 1 exposure	47.9%	48.5%
Property exposure	1.70%	0.00%

* Returns do not include the benefit of franking. Past performance is not necessarily a guide to future performance. # Refer to change of dividend announcement 2 October 2019.

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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