August 24, 2015

Market and Performance Review

The Australian Enhanced Income Fund produced a flat and disappointing result over the 2015 Financial Year. The Fund's total return of 0.3% comprised;

- A decrease in net asset value (NAV) of $0.42
- Cash distributions of $0.40
- Franking credits equivalent to $0.04.

Over the same period the All Ordinaries Accumulation Index returned 5.6% while the UBS (Australia) Bank Bill index returned 2.6%.

The 2 major drivers of the Fund's return were;

- Oversupply: New supply of $8.2 billion was the second largest year of bank hybrid issuance ever. This was exacerbated by the CBA PERLS VII issue which was far larger than investors anticipated and resulted in an overhang in the market for months.

- Equity and global market volatility. Equity market volatility increased for the first time in 3 years. After a few years of relative calm Greece and the Euro zone erupted again resulting in hybrids producing poor returns in the June quarter of 2015.

Outlook

Last year we commented that while margins were above structural fair value we saw an end to the capital gain of the previous 3 years with some potential for weakness. We were half right, but the extent of market weakness surprised us a little.

The capital losses occurred as spread margins on hybrids increased over the year. At the end of June (and again in mid-August) spread margins are at levels that have only been experienced once since the GFC ended in early 2009.

We remain of the view that the structural fair value of spread margins is much lower but we're less certain of the path to narrower margins.

As we have seen, hybrid returns tend to be flat when equity markets are weaker and we expect continued equity market troubles. Since the GFC, hybrid markets have been largely unaffected by equity market volatility, and this continues to be the case with hybrids in August weaker by around 0.8% compared to the -8.0% return experienced in the equity markets.

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We are more confident on the supply issue. For the 2016 FY we expect issuance will be less than half that of 2015 FY and given the redemption of 2 large issues, the expected net issuance of c$2b will be the lowest net issuance since 2008.

However, given that most investors access hybrids through the primary market (i.e IPO's) the path to narrower spread margins is a little less clear.

While changes in capital values are important in the timing of returns, what is more comforting is the level of yield. With securities the Fund owns yielding around 3.5% over the bank bill swap reference rate of 2.1%, income returns look set to remain well above cash and term deposit levels. We believe that the additional yield more than accounts for the volatility that may be experienced.

Distributions

Despite 2 interest rate cuts by the RBA during the year we maintained the Fund's annual cash distribution rate at $0.40c per annum. This remains above the actual income level of the Fund and without capital gains that come from a narrowing of spread margins the NAV of the Fund will slowly decline. We expect that margins will narrow this fiscal year and it's less likely the RBA will cut cash rates again. In such an environment we anticipate maintaining the $0.40c cash distribution rate for the 2016 fiscal year.

Including an expected level of franking credits of c$0.04, this translates, assuming an NAV of $6.20, to a 'grossed up' cash yield of around 7.10%.

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

Campbell Dawson (Chairman)

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