

November 18, 2015



Chairman's Address. Australian Enhanced Income Fund

Thank you for once again for joining us at the 9th Annual General Meeting of the Australian Enhanced Income Fund.

After 2 years of very strong returns, the 2015 Financial Year was less impressive.

The total return of the Fund for the year ending 30 June 2015 was 0.71% comprising distributions of \$0.40 per unit, unit price depreciation of (\$0.42) and franking of around \$0.063.

The driver of the sub-par returns was the capital losses which occurred in August/September 2014 and June 2015. The weakness late in 2014 was a combination of weaker and more volatile equity markets and larger than expected new issuance program. The weakness towards the end of the financial year can be attributed to tax loss selling.

Over a longer time period, returns remain at attractive levels. Unitholder total returns (which include changes in the NAV, distributions and franking) on an annual basis for the 5 years to June 2015 were 5.60%. This remains well in excess of returns on bank term deposits and close to returns on the broader equity market.

Outlook

Last year we thought 2015 would see limited volatility and mid-single figure returns. It turns out we were a little optimistic. Supply was larger than we expected and there was a high degree of equity market volatility. These combined to push spread margins wider with subsequent capital losses.

However, the weakness has resulted in spread margins on hybrids rising to historically wide levels. At one stage in September, major bank Tier 1 hybrid spread margins were trading at their widest level since the worst 2 weeks of the GFC. We don't think that economic or market conditions justified such an outcome.

We attribute the decrease in prices and increases in spread margins to an inefficient secondary market, a relatively high correlation to bank shares and lagged effect of supply.



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We think we will see some spread margin contraction (capital gains) over the remainder of FY2016, but even if that doesn't eventuate spread margins now offer material compensation compared to risk free rates, to the extent that spread margins can continue to widen and the Fund will outperform cash.

There have been a number of developments for the Fund and the Listed ASX market this year that we will comment further on in our presentation, but the most important factor for investors has been the increasing capitalization of the banking sector. Since 2008, bank loans have increased by 60%, but shareholders equity has doubled. Put another way, the ratio of loans to equity has decreased from 13.5 times to 10.8 times.

Clearly, banks were undercapitalized prior to the GFC, but we think the extent of recapitalization and associated decrease in risk of bank capital instruments has not yet filtered into their pricing of these instruments.

It's a medium term process but we think that the broader investment community will become more comfortable with the resilience of the banking system and recognize the attractive risk return profile of bank hybrid capital instruments.

Distribution rate

As most investors will be aware the distribution rate of \$0.40 remains above the cash income that the Fund receives. This year the NAV decreased. This is a consequence of the higher than income distributions and some capital losses. We have maintained the \$0.40 cent per unit distribution since September 2013 over which time the RBA cash rate has fallen 0.50% and the "Special" term deposit rate detailed by RBA has fallen by 1.15%.

Our intention is to keep the NAV stable while maintaining as high a distribution rate as possible.

Although we expect the RBA to keep cash rates stable, if the cash rate is reduced and if the NAV declines, we expect to reduce the distribution rate to \$0.35 per annum.

This still reflects a c5.8% cash yield and with the addition of franking credits, a 6.40% total cash return outcome.



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We thank you once again for your support and we look forward to reporting a more satisfactory year when we next meet.

Campbell Dawson (Chairman)

