January 12, 2016

Australian Enhanced Income Fund - ASX Code "AYF"
December 2015 Investment Update and NAV

December 2015 NAV and Fund performance

The Fund's cum NAV of a unit at the close of business on December 31, 2015 was $**6.004** per unit. This compares with the NAV of a unit at the close of business on November 30 of $5.997. The change in NAV over the month of December represents a return of **0.12%.** After the payment to unit holders registered on 31 December 2015 of the $0.10 cents per unit cash distribution the Fund's ex-distribution NAV of a unit was **$5.904.** The franking benefit for December was estimated to be **0.07%**.

Performance	1 month	3 months	12 months	3 Year p.a.
Australian Enhanced Income Fund*	0.12%	1.37%	-1.21%	3.90%
UBS(A) Bank Bill Index	0.19%	0.55%	2.33%	2.63%

*Returns do not include the benefit of franking. Past performance is not necessarily a guide to future performance.

Relative performance

- The ASX listed hybrid sector returned 0.43% for the month. This compares with the All Ordinaries Accumulation Index return of 2.65% and the UBSA Bank Bill Index return of 0.19%.

Fund performance

The Fund underperformed the broader market this month on the basis of the Fund's underweight position in bank tier 1 hybrids which outperformed. The Fund's rolling 3 year annual net return (excluding the benefit of franking but after fees) for the period ending 31 December 2015 decreased to 3.90% from 4.86% previously.

Determining appropriate capital levels is perplexing

Determining appropriate bank capital levels is as perplexing for investors as it is for the regulators. Basel 2 and 3 were drawn up with the intention of applying a 'building block' approach to capital levels so that governments would not be required to bail out banks ever again. But 3 years into the transition of Basel 3 the process of building capital is being fudged to the point of irrelevance. The question of determining the level of systemic importance is probably muddying the waters to the point that we think a global quantitative approach will be endorsed as a way of determining systemic importance. The upshot is that the Australian banking regulator APRA wants 'unquestionably strong' capital levels. While exactly what 'unquestionably strong' means has not been clearly articulated it most likely means global first quartile which means the Australian banks will have to raise more equity capital.

Good news for hybrid holders

For hybrid security holders this is unequivocally good news as more equity capital simply means increased security. For equity holders however the future is more uncertain. We think the capital story is far from finished. The chart below shows the RoE (vertical axis) and reported common equity (horizontal axis) for a number of banks including the Big 4 Australian banks. Bank regulators would love to see banks in the upper right quadrant, where profitability and capital levels are highest. The question we ask is; amid a move to higher capital levels and in the absence of remedial changes, what is a sustainable level of RoE for Australia's big 4 banks?

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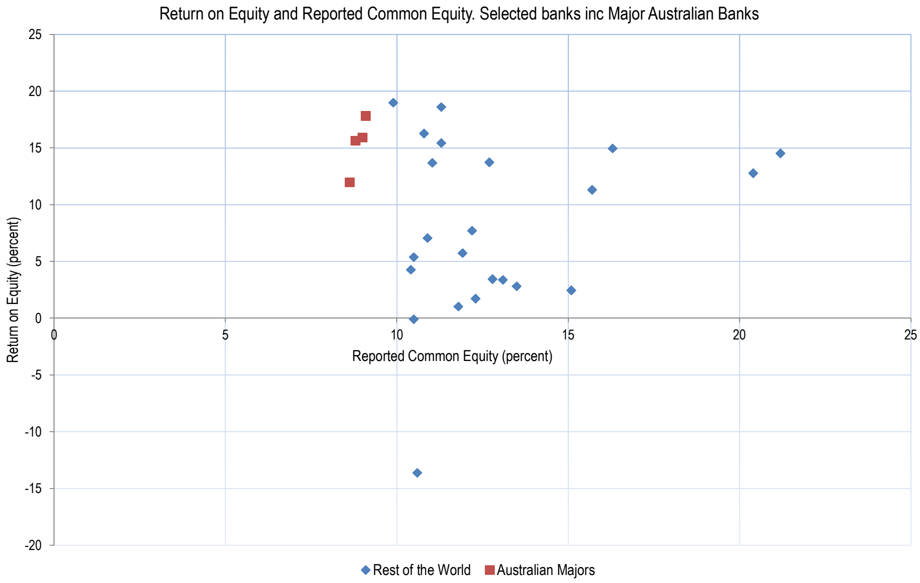

Hybrids over equities at current yields

Amid the uncertainty of not knowing exactly how much equity capital will be required by the banks to satisfy APRA and with the yields on a number of major bank hybrids approaching the yields on bank shares, an investment in hybrids, which are more secure and less volatile than common equity, all of a sudden makes a lot more sense. The Fund is well positioned in a number of these securities which we expect to outperform over the next 12 months. The Fund's worst case total return outcome of income (cash + franking) and change in capital value is expected to be c6.75%. This assumes no capital gain from spread margin contraction. Should spread margins contract by as little as 50 basis points, the total return outcome increases to c8.75%.

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

	Nov 2015	**Dec 2015**
Net Asset Value (NAV)	$5.997	**$5.904#**
Change in NAV (month on previous month)	-0.45%*	**0.12%***
Total investment return (month on previous month)	-0.37%	**0.19%**
Quarterly dividend (declared 17 December 2015)	n/a	**$0.10**
Percent franked (*quarterly estimate @ 30% tax rate*)	26.3%	**26.3%**
Cash dividend yield (basis NAV)	6.67%	**6.78%**
Grossed up dividend yield basis NAV (*estimated*)	7.50%	**7.60%**
Investment grade issuer	90%	**90%**
Fund average term	4.4 years	**4.5 years**
Bank Tier 1 exposure	49%	**50%**
Property exposure	5%	**4%**

* Returns do not include the benefit of franking. Past performance is not necessarily a guide to future performance. # Ex-distribution.

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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