March 11, 2016

Australian Enhanced Income Fund - ASX Code "AYF" February 2016 Investment Update and NAV

February 2016 NAV and Fund performance

The Fund's NAV of a unit at the close of business on February 29, 2016 was $**5.808** per unit. This compares with the NAV of a unit at the close of business on 29 January of $5.837. The change in NAV over the month of February represents a return of **(0.50%).** The franking benefit for February was estimated to be **0.08%**.

Performance	**1 month**	**3 months**	**12 months**	**3 Year p.a.**
Australian Enhanced Income Fund*	-0.50%	-1.51%	-3.50%	2.72%
UBS(A) Bank Bill Index	0.19%	0.57%	2.25%	2.59%

*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 (0.24%) for the month. This compares with the All Ordinaries Accumulation Index return of (1.47%) and the UBSA Bank Bill Index return of 0.19%.

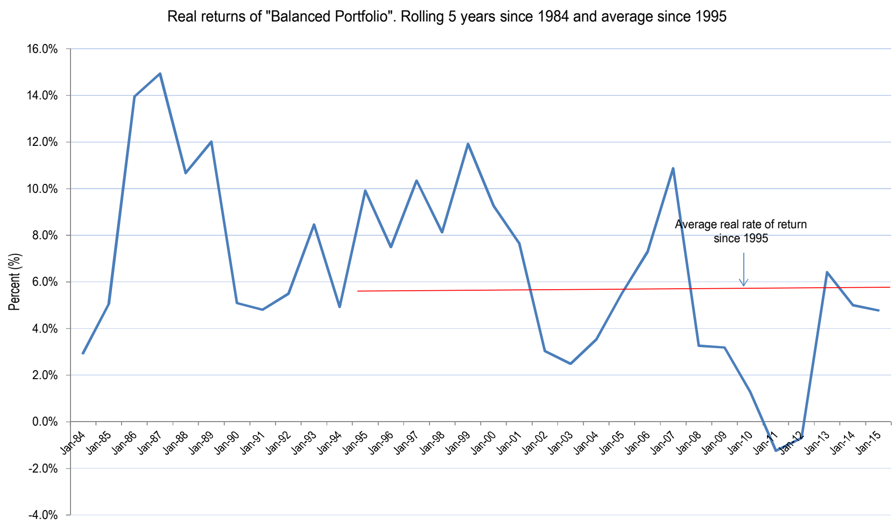
Fund performance

The Fund performed broadly in-line with the market this month. The Fund's rolling 3 year annual net return (excluding the benefit of franking but after fees) for the period ending 29 February 2016 decreased to 2.72% from 3.15% previously.

Real rates

The concept of earning a rate of return sufficiently above the rate of inflation to maintain purchasing power and grow the underlying corpus is one that is integral to investing. One of the positives to come out of a weaker hybrid market is that yields on hybrids are now at levels where they will generate rates of return well above the rate of inflation. The chart below details the real rate of return for a balanced fund on a rolling 5 year basis since 1984 with the 20 year average highlighted in red.

Real rates in a downtrend



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Real rates are in a downtrend

It is evident from the chart that real rates of return are trending down and will continue to trend down as cash and bond yields are at levels where they are unlikely to generate real rate of return outcomes in-line with the 20 year average of 5.7%. Indeed the last 10 years has produced a real rate of return average of only 4.2%. There can be no denying that over the last 30 years falling cash and bond rates have been a major contributing factor to generating rates of return well in excess of the rate of inflation. Where it gets really interesting is should inflation rise, bond yields will rise in response to 'actual' cash rate increases or the expectation that the cash rate will increase. Rising bond yields will generate a loss of capital for bond investors (yield and price move in opposing directions) and equity markets will react negatively too as discount rates adjust upwards. Played out over a long period this can be expected to produce extremely low real rate of return outcomes.

The 'so what' is….

The hybrid market in aggregate currently offers investors a return above the rate of inflation of close to 5% with major Australian bank tier 1 hybrid capital instruments offering a real rate of return outcome of almost 6%. The 'so what' is that the RBA has been consistent in its focus on inflation in determining the level of cash rates and with hybrids being floating rate instruments, it is not unreasonable to expect that real rates of return of this magnitude will be maintained over the life of these assets.

Allocation to hybrids makes sense

At current yield levels and with a 5 year view, it's hard to argue against an allocation to hybrids in a diversified portfolio. During non-event shock periods, hybrids will perform broadly in-line with equities however during an event shock, such as the GFC, hybrids will outperform equities (refer to the chart in last month's review demonstrating that the hybrid drawdown is significantly less than that of equities).

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

	Jan 2015	**Feb 2016**
Net Asset Value (NAV)	$5.837	**$5.808**
Change in NAV (month on previous month)	(1.13%)*	**(0.50%)**
Total investment return (month on previous month)	**(1.13%)**	**(0.42%)**
Quarterly dividend (declared 17 December 2015)	**n/a**	**n/a**
Percent franked (*quarterly estimate @ 30% tax rate*)	**n/a**	**n/a**
Cash dividend yield (basis NAV)	**6.85%**	**6.88%**
Grossed up dividend yield basis NAV (*estimated*)	**7.71%**	**7.74%**
Investment grade issuer (including cash)	**90%**	**90%**
Fund average term	**4.1 years**	**3.7 years**
Bank Tier 1 exposure	**46%**	**46%**
Property exposure	**4%**	**4%**

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

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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