

Australian Enhanced Income Fund - ASX Code "AYF"

June 2016 Investment Update and NAV

June 2016 NAV and Fund performance

The Fund's NAV of a unit at the close of business on June 30, 2016 was \$5.907 per unit. This compares with the NAV of a unit at the close of business on 31 May of \$5.885. The change in NAV over the month of June represents a return of **0.37%**. The franking benefit for June was estimated to be **0.12%**. After the payment to unit holders registered at the close of business on 30 June 2016 of the \$0.0875 per unit cash distribution the Fund's ex-distribution NAV of a unit was **\$5.8195**.

Performance	1 month	3 months	12 months	3 Year p.a.
Australian Enhanced Income Fund*	0.37%	2.57%	1.69%	3.72%
UBS(A) Bank Bill Index	0.17%	0.56%	2.24%	2.51%

*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 0.45% for the month. This compares with the All Ordinaries Accumulation Index return of -2.28% and the UBSA Bank Bill Index return of +0.17%.

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 30 June 2016 increased to 3.72% from 3.41% previously.

Inherent value in hybrids vis-à-vis equities

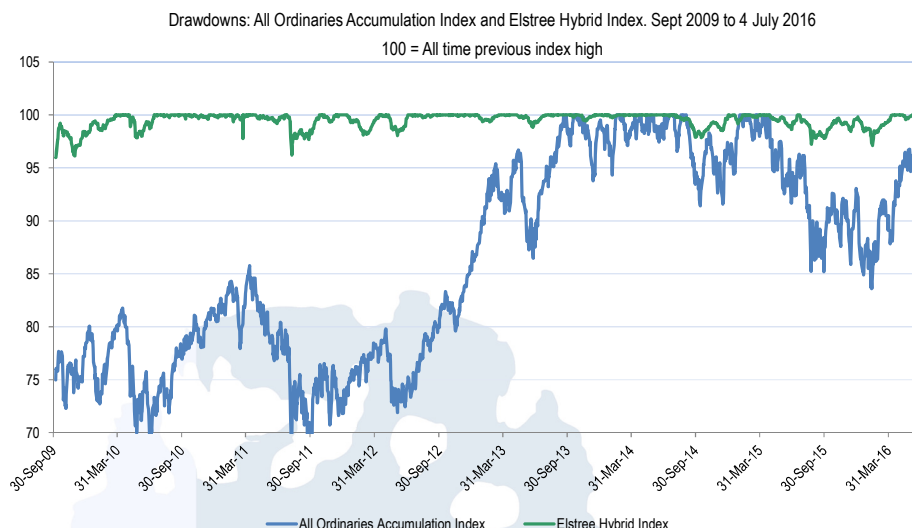
We are continually amazed that investors fail to recognise the inherent value in hybrid capital instruments at spread margins comparable with the long term ex-post (after the event) equity excess return. The equity excess return being the return investors expect to receive over the risk free rate (typically the 10 year government bond rate) for investing in the riskier equity. It makes no sense for an instrument that ranks higher than equity in the capital structure and is less volatile than equity to pay an excess return comparable to equity. This is particularly true in the current uncertain economic environment where the banks, who are the majority issuers of hybrid capital face EPS uncertainty amid a backdrop of increasing capital requirements, a slowing economy and the prospect of some increase in non-performing loans.

Drawdowns tell an interesting tale

The chart overleaf is the drawdown chart of the All Ordinaries Accumulation Index (in blue) and the Elstree All Hybrid Index (in green) from 2009 to the present. The base of 100 (the top horizontal line) is the point at which either index makes a new all-time high. At any point below this line either index is below its previous all-time high. As an investor in any drawdown event you want the drawdown to be shallow and not long in duration. Clearly, the hybrid index experiences very short and shallow drawdowns compared with equity index where the drawdowns are deep and protracted. The thing that is of particular interest is that against a backdrop of record low cash and government bond rates, which point unequivocally to an extended period of weak economic growth, the current drawdown experienced by the All



Ordinaries Accumulation Index may take many months to play out. This compares with the hybrid index which makes new all-time highs on a consistent basis (30 June 2016 being the latest). The chart also serves to highlight the low correlation that exists between hybrids and equities and the low volatility of hybrids.



Conclusion

The conclusion to draw is that during the current period of benign economic growth, which is not conducive to an investment in equities, if, as an investor you can receive an equity type total return outcome from investing in an instrument that is senior (ranks above) equity in the capital structure you should invest in that instrument.

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

	May 2016	June 2016
Net Asset Value (NAV)	\$5.885	\$5.8195#
Change in NAV (month on previous month)	0.34%	0.37%
Total investment return (month on previous month)	0.43%	0.49%
Quarterly dividend (declared June 2016 payable 15 July 2016)	n/a	\$0.0875
Percent franked (quarterly estimate @ 30% tax rate)	n/a	34%
Cash yield per annum (basis NAV)	5.94%	6.01%
Grossed up yield basis NAV per annum (estimated)	6.79%	6.87%
Investment grade issuer (including cash)	90%	90%
Fund average term	3.7 years	3.8 years
Bank Tier 1 exposure	46%	47%
Property exposure	4%	4%

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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.