

Australian Enhanced Income Fund - ASX Code "AYF"

July 2016 Investment Update and NAV

July 2016 NAV and Fund performance

The Fund's NAV of a unit at the close of business on July 29, 2016 was \$5.904 per unit. This compares with the ex-distribution NAV of a unit at the close of business on 30 June of \$5.8195. The change in NAV over the month of July represents a return of 1.45%. The franking benefit for July was estimated to be 0.00% (zero).

Performance	1 month	3 months	12 months	3 Year p.a.
Australian Enhanced Income Fund*	1.45%	2.18%	1.77%	3.98%
UBS(A) Bank Bill Index	0.17%	0.53%	2.24%	2.48%

*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 1.51% for the month. This compares with the All Ordinaries Accumulation Index return of 6.29% and the UBSA Bank Bill Index return of +0.17%.

Fund performance

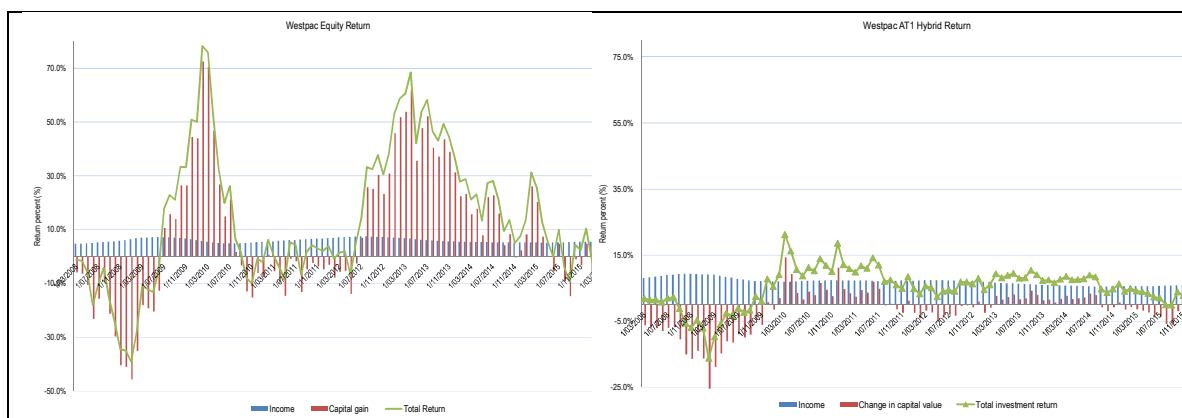
The Fund performed broadly in-line with the market this month. The Fund's rolling 3 year annual net return (excluding the benefit of franking but after fees) for the period ending 29 July 2016 increased to 3.98% from 3.72% previously.

Comparing bank shares with bank hybrids

Amid the mad scramble for income, we thought it might be appropriate to compare an investment in bank shares with bank hybrid capital instruments. In our analysis we consider the three return outcomes; the income return outcome, the capital return outcome and the total return outcome. The latter simply being the sum of the first two. While changes in the capital value almost always determine the total return outcome of an investment in bank shares, bank hybrids by contrast show far less capital volatility with income, which is predictable and stable, being the major driver of the total return outcome. Despite the differences in composition of the total return outcomes perhaps the most interesting thing is that the total return outcomes of both, over almost any reasonable timeframe, are not materially different.

True to label

Perhaps the most compelling reason to make an investment in a bank hybrid is that it is almost certain of delivering what it says it will deliver over a prescribed time frame. A bank hybrid paying a coupon margin of 4% over the bank bill swap reference rate or bbsw will pay 4% over bbsw for the life of the investment. While bbsw may move up or down the coupon margin of 4% remains fixed. Should the capital price of the hybrid move up or down after the date of issuance, the capital price will, almost certainly, revert to \$100 by the maturity/call date. The exceptional circumstances being (i) if the hybrid is not redeemed or converted at the maturity/call date, in which case the \$100 is not realised until an unknown future date or (ii) if the hybrid is forcibly converted to equity by APRA declaring the bank "non-viable", in which case the amount received will be less than \$100.



Conclusion

The conclusions to draw are if you are buying bank shares, be very careful about your point of entry as market prices imply a permanent earning per share (EPS) growth rate. If the implied growth rate is incorrect (i.e too high), there is permanent loss of capital. If you invest in hybrids, you can forget about capital losses being permanent provided the banks stay out of the realms of insolvency. Over time small changes in the capital value will revert to their par value or \$100 at the maturity/call date. The answer, as to which you should invest in for income purposes where capital losses are most unlikely to be permanent would seem to be intuitively obvious.

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

	June 2016	July 2016
Net Asset Value (NAV)	\$5.8195#	\$5.904
Change in NAV (month on previous month)*	0.37%	1.45%
Total investment return (month on previous month)	0.49%	1.45%
Quarterly dividend (declared June 2016 payable 15 July 2016)	\$0.0875	n/a
Percent franked (quarterly estimate @ 30% tax rate)	34%	n/a
Cash yield per annum (basis NAV)	6.01%	5.92%
Grossed up yield basis NAV per annum (estimated)	6.87%	6.60%
Investment grade issuer (including cash)	90%	90%
Fund average term	3.8 years	3.7 years
Bank Tier 1 exposure	47%	46%
Property exposure	4%	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.