August 19, 2016

Market and Performance Review

The Australian Enhanced Income Fund produced a barely adequate result in the 2016 Financial Year. The Fund's total return of 1.9% comprised;

- A decrease in NAV of $0.29
- Cash distributions of $0.3875
- Franking credits equivalent to $0.06

The All Ordinaries Accumulation Index over the same period returned 2.0% and the UBS (Australia) Bank Bill index returned 2.2%

Market summary

Despite absorbing a lot of bad news and experiencing a quantum of supply the hybrid market managed to produce a reasonable return outcome over the financial year to end 30 June 2016.

In the first half year prices were pushed lower by a combination of new security issuance from the major banks and secondary market selling by retail investors to fund major bank equity capital raisings.

After a number of years of heavy new issuance, buyers were scarce and prices of major bank hybrids retreated to levels not seen since the GFC's nadir in 2009. Equity market volatility in late 2015 and early 2016 contributed to further hybrid price weakness.

However, in the 6 month period to end 30 June 2016, the market reversed as supply retreated and institutional investors, buoyed by historically wide spread margins, entered the market after a 8 year hiatus. This saw the market return a solid 2.7% for the 6 month period.

We are pleased to report that since the financial year end, this strength has continued with the hybrid market returning 2.8% in the period 30 June to 19 August 2016.

Outlook

Excess supply was the common driver of broad based market weakness experienced over the last 2 years. After 3 years of net new issuance (issuance less redemptions) of c$12 billion we estimate there will be minimal net new issuance over the next 2 years. This combined with pent up institutional investor demand, means retail investors face the very real prospect of being crowded out of the market. This is expected to put upward pressure on the prices of hybrid securities in the secondary market.

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Amid a backdrop of record low cash and bond rates and an expectation of a flattish equity market further hybrid price appreciation is anticipated as the market looks relatively more attractive.

The new issue spread margin of Major Bank Tier 1 Hybrids has averaged 3.6% since the GFC. The latest ANZ hybrid (to be listed next month) is expected to attract a spread margin of c4.7%. We can see few reasons why spread margins, which move in the opposite direction to price, will not contract towards the average over the next year or so. If this occurs, market returns on a rolling annual basis, will remain in the high single figure region for a while yet.

Cash distributions

After leaving the distribution rate unchanged since 2013 during a period in which the RBA lowered cash rates by 1%, we made the decision to reduce the annual cash distribution rate from $0.40 cents per unit to $0.35c per unit annum for the June 2016 distribution.

The cash distribution yield of c6.00% remains above the income yield of the Fund, but prospective capital gains mean that the unit price should remain stable over the foreseeable future.

Despite thinking that further cuts in the cash rate are more likely than not, we do not anticipate cutting the cash distribution rate again this year.

Once again we would like to this opportunity of thanking unit holders for their ongoing support.

Campbell Dawson, Chairman (19 August 2016)

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