October 13, 2017

Australian Enhanced Income Fund - ASX Code "AYF"
September 2017 Investment Update and NAV

September 2017 NAV and Fund performance

The Fund's NAV of a unit at the close of business on September 29, 2017 was $**6.14** per unit. This compares with the NAV of a unit at the close of business on 31 August of $6.114. The change in NAV over the month of September represents a return of **0.43%.** After the payment to unit holders registered at the close of business on 29 September of the $0.0875 cent per unit cash distribution the Fund's NAV of a unit was **$6.0525**. The franking benefit for September was estimated to be **0.23%**.

Performance	1 month	3 months	12 months	5 Year p.a.
Australian Enhanced Income Fund*	0.43%	1.14%	8.98%	5.99%
UBS(A) Bank Bill Index	0.14%	0.43%	1.76%	2.43%

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

Relative performance

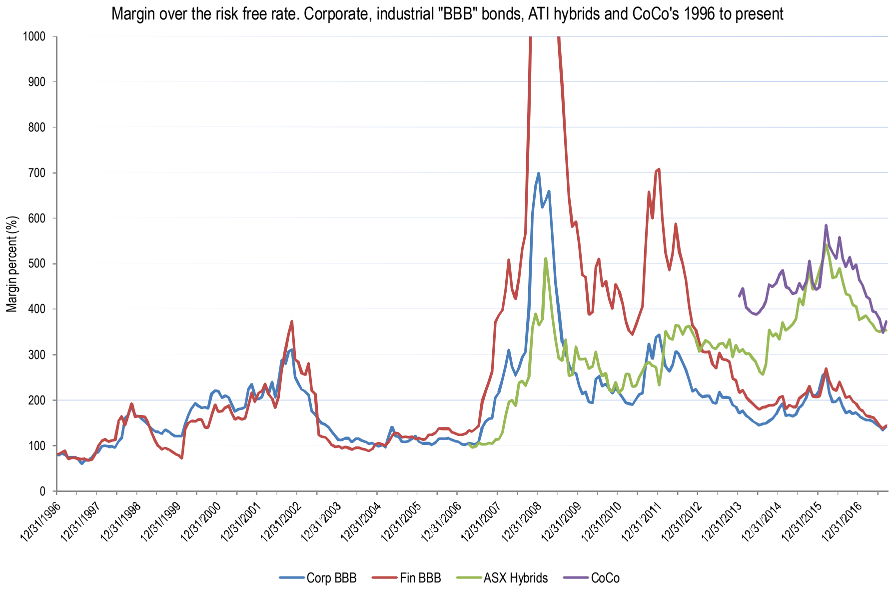
Including the value of franking credits the ASX listed hybrid sector returned 0.75% for the month. This compares with the All Ordinaries Accumulation Index return of 0.05% and the UBSA Bank Bill Index return of 0.14%.

After fees but before the value of franking, the Fund underperformed the broader market this month. The Fund's rolling annual net return, which excludes the benefit of franking but is net of all fees, for the 12 month period ending 29 September was 8.98%.

What "BBB" bank and industrial spread margins tell us.

The chart overleaf shows the spread margin over the risk free bond rate of a pool of 'global' financial and industrial "BBB" rated securities since 1996, AT1 securities listed since 2006 and the European equivalent, Contingent Convertibles or CoCo's, since 2013. The chart clearly shows the relationship between bank and industrial "BBB" rated securities (blue and red lines) with the GFC period and immediate post GFC period producing a divergence of the spread margin as the default loss rates of financial issuers spiked materially. It also shows that the spread margins of corporate and financial "BBB" rated securities have now converged and are approaching pre GFC levels while ATI hybrids are materially away from pre GFC levels. We know that hybrid spread margins were stupidly narrow before the GFC and we understand, of course, that the landscape has changed since the GFC with the implementation of Basle 3 and as a consequence a 'non viability' and 'equity conversion' risk premium has been priced into the spread margin of AT1 hybrids. We also understand that the banks are subject to 'fat tail' event risk and that this risk should be included as well. Everything being equal the risk of fat tail events should be priced into the "BBB" rated securities issued by banks as well as the ordinary equity. But this doesn't appear to be the case if "BBB" bank issued security spread margins and bank Price to Book ratios (P/B) are any indicator. The P/B ratio is a strong indicator of solvency and profitability. Generally, the market thinks that a bank will be less profitable if its P/B ratio is less than 1 or will be less than 1. Currently the P/B ratio of global banks is around 1.2 which indicates that there are no asset issues (i.e generated by fat tail events) and banks will generate high returns on capital.

Australian Enhanced Income Fund (ARSN: 115 632 990)
Responsible Entity: Elstree Investment Management Limited (ABN: 20 079 036 810)
Level 10, 30 Collins Street Melbourne VIC 3000
Telephone: 61 3 8689 1348
Email: info@eiml.com.au



<u>What does this means for the spread margins of bank capital instruments?</u>

We argue that much of the "fat tail risk" has been dissipated by higher capital levels and increased conservatism on funding. The only way the current AT1 risk premium can be justified is on the grounds of impending equity conversion and a non-viability event. Cleary, if it was the case then the spread margins on bank "BBB" debt would be higher and P/B ratios lower. This leads us to believe that investors in AT1 securities are pricing in risk which is not reflected in either "BBB" issued bank securities or the ordinary equity of the banks. This is yet another reason why we to think that AT1 spread margins will continue to narrow over time.

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

	August 2017	September 2017
Net Asset Value (NAV) - ex-distribution.	$6.114	$6.0525#
Change in NAV month on previous month (mopm)*	0.23%	0.43%
Total investment return includes the value of franking (mopm)	0.31%	0.66%
Dividend (declared September 2017 and payable 17 October 2017)	n/a	$0.0875
Percent franked (*quarterly estimate @ 30% tax rate*)	n/a	45.87%
Ex-distribution cash yield per annum (basis NAV)	5.74%	5.78%
Ex-distribution grossed up yield basis NAV per annum (*estimated*)	6.56%	6.61%
Investment grade issuer (including cash)	90%	90%
Fund average term	4.2 years	4.2 years
Bank Tier 1 exposure	48%	48%
Property exposure	6%	6%

* 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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