February 8, 2017

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

***January 2017 NAV and Fund performance***

The Fund's NAV of a unit at the close of business on January 31, 2017 was $**6.045** per unit. This compares with the ex-distribution NAV of a unit at the close of business on 30 December of $6.016. The change in NAV over the month of January represents a return of 0.49%**.** The franking benefit for January was estimated to be **zero (()%)**.

| Performance | 1 month | 3 months | 12 months | 3 Year p.a. |
|---|---|---|---|---|
| Australian Enhanced Income Fund* | 0.49% | 3.25% | 10.12% | 4.28% |
| UBS(A) Bank Bill Index | 0.16% | 0.45% | 2.04% | 2.34% |

*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 0.32% for the month. This compares with the All Ordinaries Accumulation Index return of (0.77%) and the UBSA Bank Bill Index return of 0.16%.

***Fund performance***

The Fund outperformed 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 31 January 2017 increased to 10.12% from 8.33% previously.

***Common theme***

The common theme of our monthly reports recently has been about the risk to asset valuations of rising discount rates. The theory is that a rise in the discount rate will bring about a corresponding fall in the price of bonds, infrastructure, property (REITS) and of course equities. We call this risk 'duration' risk. Floating rate securities including hybrids have little or no duration risk because their periodic cash flows are reset, typically every 90 days. This means that should discount rates go up the periodic cash flow payment will go up correspondingly. Even before Donald Trump was elected, discount rates began to rise in the US. They have also risen in Europe and the UK. While the catalyst has been different in each case a common theme is emerging. The interest rate cycle that has dominated the global capital market landscape for 35 years and propelled asset prices higher has probably finished.

***Performance of hybrids versus equities***

We have written before about how, equities and hybrids, as denoted by the All Ordinaries Index and Elstree Hybrid Index respectively, have performed similarly in absolute terms for much of the period since the GFC. Remembering that this was a period when discount rates fell, which in theory should favour equity valuations over floating rate instruments like hybrids. The chart below shows the annual return (on the vertical scale) and volatility (Standard Deviation on the horizontal scale) of the All Ordinaries Accumulation Index and The Elstree Hybrid Index over 1, 3, 5 and 7 years. There is only one period (5 years) when equities produced a materially better return outcome, although at higher volatility or risk. Over the other time periods (1, 3 and 5 years) hybrids produced comparable or better returns and always at lower risk.



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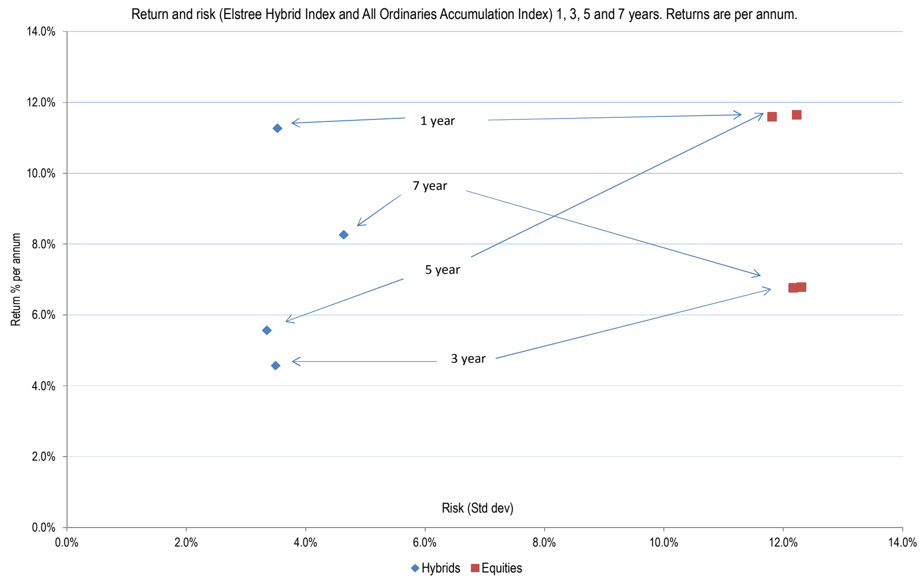


***Outlook: Hybrids will out-perform even if discount rates rise***

We can mount a strong case for hybrids to continue to perform well. The foundation for our thinking is a combination of factors including, the current spread margin, which is comparable with the long term ex-post equity excess return, relatively short credit term duration and rising discount rates. Should discount rates rise in response (say) to global inflationary concerns returns on fixed income, equities, property and infrastructure will range from bad to very bad. While hybrids may underperform cash due to spread margins widening (prices decline when spread margins widen), their higher income yield will afford them some protection enabling them to perform well compared with fixed income, equities, property and infrastructure.

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

| | December 2016 | January 2017 |
|---|---|---|
| Net Asset Value (NAV) | **$6.016#** | **$6.045** |
| Change in NAV month on previous month (mopm)* | **2.13%** | **0.49%** |
| Total investment return includes the value of franking (mopm) | **2.32%** | **0.49%** |
| Dividend (declared January 2016 and payable 16 January 2017) | **$0.0875** | **n/a** |
| Percent franked (*quarterly estimate @ 30% tax rate*) | **42%** | **n/a** |
| Cash yield per annum (basis NAV) | **5.80%** | **5.78%** |
| Grossed up yield basis NAV per annum (*estimated*) | **6.64%** | **6.62%** |
| Investment grade issuer (including cash) | **90%** | **90%** |
| Fund average term | **4.1 years** | **4.2 years** |
| Bank Tier 1 exposure | **52%** | **52%** |
| 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.