July 11, 2019

Australian Enhanced Income Fund - ASX Code "AYF"
June 2019 Investment Update and NAV

June 2019 NAV and Fund performance

The Fund's NAV of a unit at the close of business on June 28, 2019 was $**6.037** per unit. After the cash distribution of $0.08 cents per unit was paid to unit holders registered at the close of business on 28 June the Fund's ex-distribution NAV of a unit was $5.957. This compares with the Fund's NAV of a unit at the close of business on 31 May 2019 of $5.969. The change in NAV over the month of June represents a return of **1.14%.** The franking benefit for June 2019 was estimated to be **0.20%.** Including the value of franking the Fund returned 1.34% over the month.

Performance	1 month	3 months	12 months	3 Year p.a.
Australian Enhanced Income Fund*	1.14%	2.45%	6.51%	6.78%
UBS(A) Bank Bill Index	0.13%	0.49%	1.99%	1.86%

*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 the ASX listed hybrid market returned 1.75% for the month. This compares with the All Ordinaries Accumulation Index return of 3.43% and the UBSA Bank Bill Index return of 0.13%.

After fees but before the value of franking, the Fund underperformed the broader market this month. Over 3 years the Fund's rolling annual net return, which excludes the benefit of franking but is net of all fees, for the period ending 28 June 2019 was 6.78% p.a.

Liquidity – we take it seriously

Liquidity is a bit like the 'elephant in the room'. We are aware of its presence but are reticent to talk about it. We have been quantifying liquidity risk in our portfolios for some time now (more on that later). Our interest in liquidity was piqued recently by events transpiring in the UK with renowned fund manager, Neil Woodford. Woodford, who has had a remarkably successful career as a fund manager at Invesco, set up his own funds' management business a number of years ago. After an initial period of extraordinary return outcomes accompanied by simultaneous bonus payments to management, Woodford's stock picking fortunes took a turn for the worse. For the last 3 years returns have been woeful with the end result that investors have been redeeming their investments. From GBP 10 billion the fund faced redemptions of circa GBP 6 billion standing where it does now at about GBP 4 billion. While the redemptions were initially met by selling 'liquid' securities the assets that remain are deemed 'illiquid', meaning that they are difficult or virtually impossible to sell. As a consequence of the illiquidity in his portfolio, Woodford took the decision to 'gate' or suspend redemptions in his fund. As a manager of risk assets in a relatively illiquid market with our very own GFC experience as a backdrop, we understand that such a decision rarely ends well.

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Our very own GFC experience entails one of our immediate competitors, the Challenger High Yield Fund. Without going into minute detail, the Challenger High Yield Fund was the darling of the hybrid market in the run up to the GFC. At one point the Fund approximated to 10% of the market's capitalization. Events of the GFC saw the Challenger High Yield Fund struggle, because of liquidity restrictions (the Fund was simply too large a share of the market) to meet redemption requests. This led, in the end, to a scheme of arrangement being drawn up between the Challenger (the parent company) and remaining unit holders.

At the time of the GFC our Fund size was much smaller at c1% of the market's capitalization. While we had no difficulty meeting redemption requests during the GFC, the problem posed by illiquidity gave rise to us, trying to find a way to quantify and measure, liquidity risk. So, we came up with a method of measuring the liquidity 'cost' inherent in our portfolios. Without going into detail about how we calculate the cost, we use this method, not only at the total portfolio level, but we also use it to determine the liquidity cost of each and every security in which we invest. There are some securities for example, where the liquidity cost is so large, we refuse to buy them.

And our methodology seems to be reasonably accurate. A few years ago, we 'lost' a mandate of about $90 million. The portfolio, which was liquidated by a transition manager in the 3 weeks before Christmas, had a liquidity cost, we estimated, of around 0.35% (this means we calculated the 'cost' of liquidation to be around 0.35% of what the market returned over the liquidation period). We could see the securities being transacted in the marketplace and while the 3 week period prior to Christmas is not an ideal period in which to liquidate a portfolio of this size (when the market in aggregate only turns over c$150 million per week), the cost of doing so, we calculated, was not far removed from our 0.35% estimate - not at all bad under the circumstances.

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

	May 2019	June 2019
Net Asset Value (NAV)	$5.969	$5.957 (ex dist)
Change in NAV month on previous month (mopm)*	0.95%	1.14%
Total investment return includes the value of franking (mopm)	1.02%	1.34%
Dividend paid 15 July 2019	n/a	$0.08cpu
Percent franked (*quarterly estimate @ 30% tax rate*).	n/a	50.77%
Cash yield per annum (basis NAV). Dividend change announced 5 June.	5.36%#	5.37%
Grossed up yield basis NAV per annum (*estimated*)	6.19%#	6.20%
Investment grade issuer (including cash)	90.0%	90.0%
Fund average term	3.40 years	3.70 years
Major Bank Tier 1 exposure	55.0%	51.0%
Property exposure	1.90%	1.90%

* Returns do not include the benefit of franking. Past performance is not necessarily a guide to future performance. # Refer to change of dividend announcement 5 June 2019.

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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