

Australian Enhanced Income Fund - ASX Code "AYF"

May 2017 Investment Update and NAV

May 2017 NAV and Fund performance

The Fund's NAV of a unit at the close of business on May 31, 2017 was \$6.122 per unit. This compares with the NAV of a unit at the close of business on 28 April of \$6.056. The change in NAV over the month of May represents a return of 1.09%. The franking benefit for May was estimated to be 0.06%.

Performance	1 month	3 months	12 months	3 Year p.a.
Australian Enhanced Income Fund*	1.09%	2.65%	10.30%	4.12%
UBS(A) Bank Bill Index	0.15%	0.49%	1.84%	2.25%

*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 0.90% for the month. This compares with the All Ordinaries Accumulation Index return of (2.58%) and the UBSA Bank Bill Index return of 0.15%.

Fund performance

After fees but before the value of franking the Fund out-performed the 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 May 2017 was 10.30%.

Bank hybrid and ordinary relationship

We have written on numerous occasions about the relationship between equities and hybrids. This month we thought we would highlight the specific relationship between bank issued hybrids and bank equity. The drawdown chart overleaf is of the Elstree Bank Hybrid Index and the ASX 200 Bank Accumulation Index. The drawdown measures the magnitude (in percentage terms) of a decline from a previous all-time index high as well as the time taken for the Index to make a new all-time high. An ideal outcome is for a drawdown to be not long in duration and not deep.

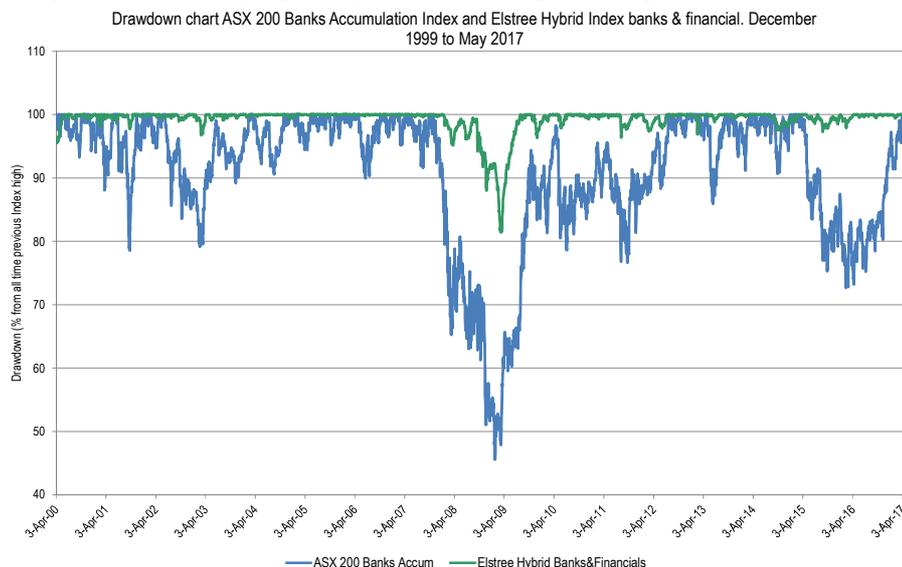
The correlation is weak but hybrids less volatile

The most recent bank ordinary equity drawdown, which ranks among the top 10 in the post GFC period, has not been mirrored by bank hybrids. The Elstree Bank Hybrid Index consistently made new all-time highs through May while the ASX 200 Bank Accumulation Index declined by as much as c12%. It is too much to expect this to continue because there is a relationship, but as the chart clearly shows, it is not strong. The key takeaway however, is that hybrids are significantly less volatile.

Fundamentals positive for hybrids – less so for ordinary equity

We believe that fundamentals are broadly now more supportive of Australian bank issued hybrid security pricing than ordinary equity. For the Australian banks to be "unquestionably strong" the banks will have to increase their common equity or CET1 to risk weighted asset (RWA) ratio. While the banks can achieve this objective in a number of ways, such as by reducing their RWA's or by raising additional common equity, the outcome comes at a cost which is not positive for equity holders. While such an outcome might not be positive for ordinary equity holders it is

unequivocally positive for investors in bank issued securities more senior to equity. With the listed subordinated debt and hybrid market set to embark on a period of negative net new security issuance amid a backdrop of yield starved investors the strength of the ordinary equity hybrid relationship will be questioned even further.



Sobering thoughts

While we continue to paint a rosy picture of Australian bank issued hybrids we were reminded last week with the collapse of Spanish bank, Banco Popular, what can happen should things go array. At its very epicentre Banco Popular's collapse lay in its' over reliance (in the end) on short term, expensive wholesale funding. The interesting takeaway is that Popular failed not because of deteriorating asset quality, because it could have muddled along, rather it failed, because it could not fund itself.

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

	April 2017	May 2017
Net Asset Value (NAV) - ex-distribution#.	\$6.056	\$6.122
Change in NAV month on previous month (mopm)*	0.67%	1.09%
Total investment return includes the value of franking (mopm)	0.67%	1.15%
Dividend (declared March 2017 and payable 18 May 2017)	n/a	n/a
Percent franked (quarterly estimate @ 30% tax rate)	n/a	n/a
Cash yield per annum (basis NAV)	5.78%	5.72%
Grossed up yield basis NAV per annum (estimated)	6.61%	6.53%
Investment grade issuer (including cash)	90%	90%
Fund average term	4.5 years	4.1 years
Bank Tier 1 exposure	53%	48%
Property exposure	4%	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.