June 14, 2019

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

May 2019 NAV and Fund performance

The Fund's NAV of a unit at the close of business on May 31, 2019 was $**5.969** per unit. This compares with the Fund's NAV of a unit at the close of business on 30 April 2019 of $5.913. The change in NAV over the month of May represents a return of **0.95%.** The franking benefit for May 2019 was estimated to be **0.07%.**

Performance	1 month	3 months	12 months	3 Year p.a.
Australian Enhanced Income Fund*	0.95%	2.39%	7.04%	6.51%
UBS(A) Bank Bill Index	0.15%	0.48%	1.99%	1.87%

*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 1.21% for the month. This compares with the All Ordinaries Accumulation Index return of 1.67% and the UBSA Bank Bill Index return of 0.15%.

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 31 May 2019 was 6.51% p.a.

Where do we go from here?

We have been around capital markets for a while now, since the early 1980's in fact and it had to happen - record low cash and bond rates. The 10year bond rate @c1.5% is telling us that the market thinks that the official cash rate will 'average' approximately 1.5% for the next 10 years. And still, there is little sign of wage and price pressures, and economic growth, while not as strong as it might otherwise be, is still moderate. With the cash rate, now (after the RBA cut of 4 June) at 1.25% where does monetary policy go from here?

It seems the rest of the world has solved that little problem. Japan has had zero rates, or thereabouts, for more than 20 years and Europe almost 10 years. But zero interest rates aren't the end of it. Both Japan and Europe (and indeed the US) have dabbled in so called 'unconventional' monetary policy methods or quantitative easing for a number of years. Without the deployment of these 'methods' these economies may have suffered. Japan has not been the train wreck it could have been as a sustained period of zero rates might imply. Both the economy and risk assets have done reasonably well. The Nikkei has done c5% per annum over the last 20 years or so – not bad when the risk-free rate is zero, while credit spreads on investment grade rated corporate bonds have narrowed and are in fact considerably narrower than investment grade rated investment

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bonds issued out of other geographies. Default loss rates are lower in Japan that in other geographies. This is a function of interest costs being so low that corporates rarely default.

So this is blank canvas that the RBA and Australia is confronted with. If it does play out like Japan, we'll most likley see reasonable levels of economic growth, low interest rates, low earnings per share (EPS) growth and subdued, but reasonable equity returns through price earnings (PE) expansion. And in-line with the Japanese experience, the spread margins on well rated credit assets, including hybrids, will narrow. Hybrid margins of around 3% over a risk free rate of less than 2% (soon to be less than 1% if some commentators are right in their predictions) are not sustainable. Equity market returns won't be much better than hybrids (i.e risk free plus 3%), however, in risk adjusted return terms (i.e returns adjusted for volatility), investors should rationally choose hybrids over equities.

But making predictions for 2025 is extremely difficult. Without doubt much will be written about the RBA and the methods it chooses to use other than interest rates, if indeed, it does go down the unconventional methods path. The outcome is clearly dependant upon a myriad of different things. We know one thing and that is, investors continually underestimate risk and the range of outcomes. As an investor in risk assets, we will focus on understanding the companies we invest in and the way the market behaves in so doing constructing portfolios that generate c5% income with understandable risk factors.

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

	April 2019	May 2019
Net Asset Value (NAV)	$5.913	$5.969
Change in NAV month on previous month (mopm)*	0.35%	0.95%
Total investment return includes the value of franking (mopm)	0.37%	1.02%
Dividend paid 15 April 2019	n/a	n/a
Percent franked (*quarterly estimate @ 30% tax rate*)	n/a	n/a
Cash yield per annum (basis NAV). Dividend change announced 5 June.	5.92%	5.36%#
Grossed up yield basis NAV per annum (*estimated*)	6.77%	6.19%#
Investment grade issuer (including cash)	91.0%	90.0%
Fund average term	3.50 years	3.40 years
Major Bank Tier 1 exposure	55.0%	55.0%
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.

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