March 13, 2019

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

February 2019 NAV and Fund performance

The Fund's NAV of a unit at the close of business on February 28, 2019 was $**5.916** per unit. This compares with the Fund's NAV of a unit at the close of business on 31 January 2019 of $5.891. The change in NAV over the month of February represents a return of **0.42%.** The franking benefit for February 2019 was estimated to be **0.02%.**

Performance	1 month	3 months	12 months	3 Year p.a.
Australian Enhanced Income Fund*	0.42%	1.64%	3.74%	6.75%
UBS(A) Bank Bill Index	0.17%	0.51%	1.99%	1.91%

*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 (0.23%) for the month. This compares with the All Ordinaries Accumulation Index return of 6.05% and the UBSA Bank Bill Index return of 0.17%.

After fees but before the value of franking, the Fund out-performed 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 February 2019 was 6.75% p.a.

The reasons for Fund's out-performance of the broader market this month can be traced directly to the performance of 2 securities the Fund has an overweight position in, the perpetual NABHA security and the Multiplex Sites security, MXUPA. Both performed well over the month, the former on news that the CBA proposed to redeem 2 of its New Zealand perpetual hybrids and the latter on news flagged by Brookfield that it is considering a possible redemption of its MXUPA note. This once again serves to highlight the benefit of outsourcing the management of a portfolio of hybrid securities to an active manager.

To call or not to call, that is the question.

As an investor in hybrid capital instruments the first question we ask ourselves is; what is the issuer of the security most likely to do at the call date? The issuer has the 'option' to either call or not to call the security on the call date. While there are a number of permeations and combinations surrounding exactly what the issuer can do, in essence, it comes down simply to calling or not calling. By not calling a security the issuer is at risk of sending a poor message to investors. While this is the general consensus, it is not always the case that the message is a poor one. There were some recent examples of European bank issuers where management chose not to call securities at the call date despite being robustly capitalised and in no danger whatsoever of breaching their capital ratios. And similarly, issuers can call when perhaps the market thinks they might otherwise not. There is a lot

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of skill in analysing bank issuer behavior and we, as a manager of hybrid capital, spend a considerable amount of time determining what we think motivates the issuer to call or not to call. After all, if a security is expected to be called at a certain date and it isn't for whatever reason it makes a material difference to the security's present value (PV) or price which is of course the sum of the cash flows discounted by an appropriate 'discount rate'.

Almost unbelievably investors don't always understand – and this goes for professional investors too if Europe is anything to go by - that the issuer has an option not to repay at the call date. Maybe, just maybe, it's because it doesn't happen all that frequently. Aside from the immediate GFC period we can only think of one that we were intimately involved with that occurred in 1996 in New Zealand. Since 2005 – including of course the GFC period - there have been no less than 8 issues where the option to extend was exercised by the issuer for economic reasons.

It is indeed confusing. We've always thought that if you give an issuer an option to do something with a security at a particular point in time in the future, you have to be able to price that option. And despite the securities appearing to be quite similar we know intuitively that individual issuers looks at their redemption/rollover options differently. At the same time, investors are often getting handsomely paid for these options, particularly when the issuers are well capitalised and investment grade rated - such as the big 4 Australian banks - where extension and indeed equity conversion risk are minimal. We think the analysis we undertake in valuing these options is one area where we will out-perform most investors. It is without doubt a consistent source of value add for our investors.

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

	January 2019	February 2019
Net Asset Value (NAV) # Ex-distribution.	$5.891	$5.916
Change in NAV month on previous month (mopm)*	0.28%	0.42%
Total investment return includes the value of franking (mopm)	0.28%	0.44%
Dividend paid 14 January 2019	n/a	n/a
Percent franked (*quarterly estimate @ 30% tax rate*)	n/a	n/a
Ex-distribution cash yield per annum (basis NAV)	5.94%	5.92%
Ex-distribution grossed up yield basis NAV per annum (*estimated*)	6.79%	6.76%
Investment grade issuer (including cash)	90.0%	90.0%
Fund average term	3.60 years	3.60 years
Major Bank Tier 1 exposure	57.2%	55.0%
Property exposure	1.9%	2.0%

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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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