February 13, 2020

Australian Enhanced Income Fund - ASX Code "AYF"
January 2020 Investment Update and NAV

January 2020 NAV and Fund performance

The Fund's NAV of a unit at the close of business on 31 January 2020 was $**5.927** per unit. This compares with the Fund's ex-distribution NAV of a unit at the close of business on 31 December 2019 of $5.881. The change in NAV over the month of January represents a return of **0.78%.** The franking benefit for January was estimated to be **0.01%.** Including the value of franking the Fund returned **0.79%** over January 2020.

Performance	1 month	3 months	12 months	3 Year p.a.
Australian Enhanced Income Fund*	0.78%	1.29%	6.12%	5.12%
UBS(A) Bank Bill Index	0.08%	0.24%	1.40%	1.70%

*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 0.58% for the month. This compares with the All Ordinaries Accumulation Index return of 4.69% and the UBSA Bank Bill Index return of 0.08%. After fees and before the value of franking, the Fund outperformed 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 January 2020 was 5.12%.

Bond yields and the impact on discount rates and asset valuations

Investors in equities, because they are riskier investments, expect to receive a higher rate of return, called the excess return, for investing in a riskier asset. While the excess return or margin applied to riskier investments is integral to the pricing of those investments what interests the writer more, is what effect falling bond yields has on the discount rates applied to risk assets. Clearly, the effect has been significant because bond yields have fallen in absolute terms from 15% to 1% in Australia since 1985. Irrespective of the expected excess return applied to equities, this represents a material difference. It is little wonder equity valuations have gone up over the period since 1985.

In one of his famous "essays' Warren Buffett wrote in 1999 about such a topic. In his essay which was written in conjunction with Fortune's Carol Loomis and delivered in a speech, Buffett mused about the relationship between nominal GDP growth and stock market valuations. In his speech he looked at the performance of the US stock market and gross national product (GNP) over two 17 years periods spanning 34 years. The first period was from calendar year (CY) end 1964 to CY end 1981, and the second period was from CY end 1981 to CY end 1998. In the first 17 year period the stock market, as measured by the Dow Jones Industrial Average (DJIA) rose by a meagre 0.1 of 1% while GNP rose a not inconsequential 373% or c22% per annum. In the second period, the DJIA rose from 875 to 9181 (a 950% increase) while GNP rose by comparison with the first period, by a relatively pedestrian177%. In nominal terms the US economy grew almost twice as fast in the first period yet the stock market remained unchanged. It was at this point in his speech that Buffett spoke about bond rates. Bond rates were 4.2% at the beginning of the first period in 1964 and

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13.65% at the end of it. Bond rates then fell from 13.65% at the beginning of the second period to 5.09% at the end - almost the complete reverse of what happened in the first period (the table below summarises this data). The interesting thing is of course was that despite GNP growing at a much slower pace during the second period, because the discount rate applied to future cash flows declined so dramatically, the present values applied to those cash flows rose equally dramatically.

Period	Dow Jones Industrial Average (DJIA) (Change)	Gross National Product (GNP) (Change)	Bond yield (Change)
1964 - 1981	0.10%	373%	9.45%
1981 - 1998	950%	177%	-8.56%

The other interesting thing is the sensitivity of changes in interest rates at different absolute levels. Without going into the mathematics, a bond at a yield of 2% is more than twice as volatile (read "risky") as it is at 10%. This means that bonds (and as a consequence discount rates) at current levels are more than twice as sensitive to movements in interest rates as they are at 10%.

Despite hybrids being short duration assets they have performed exceptionally well over almost any reasonable time over the last 20 years. While declining discount rates have contributed to a positive return outcome, periodic cash flows, which pay a fixed margin over a floating benchmark reference rate have fallen lock stock with the decline in floating short term interest rates have been a 'drag'. Interestingly, spread margins, which move in the opposite direction to price and present as either a discount or premium to a security's PAR value, in aggregate terms across the market are only fractionally below their post GFC average IPO issuance level. Aside from being a viable alternative to risk free bank term deposits, given the magnitude of the excess return vis-à-vis the risk free rate, an investment in hybrids also makes sense from the total portfolio perspective, particularly now that fixed rate bond and equity risk are at their highest point.

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

	Dec 2019	Jan 2020
Net Asset Value (NAV). # Ex distribution.	$5.881#	$5.927
Change in NAV month on previous month (mopm)*	0.34%	0.78%
Total investment return includes the value of franking (mopm)	0.50%	0.79%
Dividend paid 15 January 2020	$ 0.07	n/a
Percent franked (*quarterly estimate @ 30% tax rate*).	39.59%	n/a
Cash yield per annum (basis NAV).	4.80%	4.72%
Grossed up yield (basis NAV) per annum (*estimated*)	5.60%	5.57%
Investment grade issuer (including cash)	92.0%	92.3%
Fund average term	3.25 years	3.30 years
Major Bank Tier 1 exposure	48.5%	43.6%
Property exposure	0.00%	0.00%

* Returns do not include the benefit of franking. Past performance is not necessarily a guide to future performance. # Refer to change of dividend announcement 2 October 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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