July 13, 2020

Australian Enhanced Income Fund - ASX Code “AYF”
June 2020 Investment Update and NAV

June 2020 NAV and Fund performance

The Fund’s NAV of a unit at the close of business on 30 June 2020 was $**5.944** per unit. This compares with the Fund’s NAV of a unit at the close of business on 29 May 2020 of $5.841. After the cash payment of $0.055 cents per unit to unit holders registered at the close of business on 30 June the Fund’s ex-distribution NAV of a unit was **$5.889**. The change in NAV over the month of June represents a return of **1.76%.** The franking benefit was estimated to be **0.18%.** Including the value of franking the Fund returned **1.94%** over June 2020.

Performance	1 month	3 months	12 months	3 Year p.a.
Australian Enhanced Income Fund*	1.76%	10.09%	3.66%	4.52%
UBS(A) Bank Bill Index	0.008%	0.064%	0.85%	1.53%

*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 2.34% and the UBSA Bank Bill Index return of 0.008%. After fees and before the value of franking, the Fund performed in-line with the broader market this month returning 1.76%.

As investors in alternative tier 1 (AT1) and tier 2 (T2) capital instruments issued by banks, we are always interested in any event that might impact bank capital levels. While not professing to know what the economic impact will be should the recipients of “Job Keeper” and “Job Seeker” be weaned around the same time the moratorium on interest payments on home and busines loans ends, we thought the bank stress tests conducted by APRA in 2017 might provide useful guidance as to how the banks might fare. The reason we think the stress test outcomes might be a useful, and we acknowledge the limitations of modelling and testing, is that the macroeconomic inputs used in the stress tests, look, for all intense and purpose, like they could play out in a similar way in the real covid-19 affected world of today.

APRA’s scenario analysis of 2017, which was conducted on 13 ADI’s covering 90% of system loans, assumed a 4% decline in GDP accompanied by a rise in unemployment to more than 10% and a decline in national house prices over 3 years of approximately 35%. While the macroeconomic variables of 2017 seemed preposterous at the time, they appear less preposterous now. The table below summarises and compares the stress test inputs with a ‘best guess consensus’ of today.

	APRA stress tests 2017	Best guess consensus
GDP growth CY 2020	-4%	-4.50%
Peak unemployment rate	10.50%	c8.50%
House price declines – peak to trough	35%	c20%

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The aggregate dollar loss estimates of the stress test as determined by APRA for the 13 banks was material at A$144 billion. Despite representing far and away the greatest proportion of risk weighted assets (RWA), a little more than ¼ of projected losses were derived from residential mortgages. This is because "loss given default" (i.e the loss incurred after default) used to calculate loss rates for residential property is lower than it is (say) for SME and corporate loans. While the losses in absolute terms are material and certainly bank capital levels and profitability were severely impacted APRA reported that minimum capital levels were not breached.

One of the most limiting thing about the stress tests is the assumption that management and administrations fail to respond to the risks unfolding before them. In a real world scenario such as the one we are presented with today, we would reasonably expect management to manage the risks proactively, by (say) raising equity, or by cutting costs or reducing or eliminating dividends, or by tightening lending standards or by changing the funding composition. Similarly, we would reasonably expect administrations to be proactive as well. Indeed, these initiatives are being implemented right now before our very eyes.

While we understand the limitations of scenario analysis, APRA's stress tests of 2017 aren't a bad reference point. The takeaway from the tests of 2017 is that despite the assumption of 'non action' by management and administrations (which you would ordinarily expect in the real world) minimum bank capital levels were not breached. Indeed, we take a degree of comfort from the stress tests results and reasonably expect a better outcome in the 'real world' of today because of the pre-emptive actions undertaken by management and administrations. From the portfolio perspective we will remain vigilant closely monitoring bank capital levels and profitability, using, in particular, the drawdown of bank ordinary equity (both at the individual bank and collective levels) as a forward indicator of likely future hybrid and subordinated security performance.

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

	May 2020	June 2020
Net Asset Value (NAV). ** denotes "Ex distribution".	$5.841	**$5.889
Change in NAV month on previous month (mopm)*	1.09%	1.76%
Change in NAV including the value of franking (mopm)	1.11%	1.94%
Dividend payable 15 June 2020*. Next dividend due - 15 July 2020.	n/a	$0.055
Percent franked (*quarterly estimate @ 30% tax rate*).	n/a	56.02%
Cash yield per annum (basis NAV and annual cash dividend of $0.22cpu).#	3.76%	3.73%
Grossed up yield (basis NAV) per annum (*estimated*)	4.62%	4.58%
Investment grade issuer (including cash)	93.2%	92.3%
Fund average term	3.19 years	3.40 years
Major Bank Tier 1 exposure	55.6%	54.1%

* Returns do not include the benefit of franking. Past performance is not necessarily a guide to future performance. # Refer to change of dividend announcement 6 March 2020.

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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