Schroders Fixed Income

Quarterly Investment Option Update

31-March-2017

Availability

Product name	APIR
Flexible Super – Choice (Retirement)	AMP1376AU
Flexible Super – Choice (Super)	AMP1505AU
CustomSuper	AMP1288AU
Flexible Lifetime – Allocated Pension	AMP1295AU
Flexible Lifetime – Super	AMP1288AU
Signature Super	AMP1302AU
Signature Super – Allocated Pension	AMP1309AU

Investment Option Performance

Investment performances are subject to product fees and where relevant tax as outlined in the product PDS. Therefore investment performance may differ between products. In addition, activity on your account such as contributions and deductions will also impact the investment performance specific to you. To view the latest investment performances for each product, please visit **www.amp.com.au**. You can also view the last investment performance specific to you by visiting your My Portfolio account.

Contact Us

Web: www.amp.com.au

Email: askamp@amp.com.au

Phone: 131 267 (Mon. to Fri 8:30am to 6:00pm AEST)

Overview

Aim & Strategy: To obtain exposure to a diversified range of domestic and international fixed income securities with the principal aim of outperforming the Bloomberg AusBond Composite 0+Yr Index over the medium term. The objective is to provide a diversified portfolio delivering low capital volatility and competitive risk-adjusted returns with low correlation to equity markets by investing in a broad range of domestic and international fixed income assets. The investment adopts a "core-plus" approach whereby a core portfolio comprising of low risk Australian bonds is complemented by investments in a diverse range of low correlation, non-benchmark fixed income securities. International securities are hedged to the Australian dollar.

Investment category: Enhanced Fixed Interest

Suggested Investment Timeframe: 3 to 5 years

Relative Risk Rating: Low to medium

Investment Style: Active

Asset Allocation	Actual (%)	Range (%)
Government	65.2	20-80
Australian IG Credit	19.6	0-50
Global IG Credit	-0.1	0-50
Australian High Yield and Subordinated	0.3	0-20
Global High Yield and EMD	0.1	0-20
Cash	14.8	0-50

Holdings

Industry Exposure	%
Cash & Equivalents	14.8
Sovereign/Supra	16.6
Semis	18.0
Government	30.7
Collateralised	4.5
Corporates	12.3
Subordinated	3.2

Top Ten Securities	%
Australian Government Sr 128 5.75% 15/7/2022	5.1
Australian Government Sr 133 5.5% 21/4/2023	4.8
Australia Government Bond 4.75% 21/4/2027	3.4
Australian Government Sr 137 2.75% 21/4/2024	3.3
Australian Govt Sr 140 4.5% 21/4/2033	3.2
QLD Treasury Corp Sr Regs 4.25% 21/7/2023	2.9
Australia Govt Bond I/L 6.8226% 20/8/2020	2.5
WA Trsry Corp Govt Gtd 6% 16/10/2023	2.0
Intl Bk Recon & Develop Sr Mtn 2.8% 13/1/2021	2.0
Australian Government Sr 124 5.75% 15/5/2021	1.7

Market Commentary

Politics continues to be the main focus of markets. Post President Trump's inauguration in January, he was initially quick off the mark issuing several executive orders. However, difficulties set in relatively quickly, with his orders around immigration blocked by the courts. In March his first substantive policy, rewriting Obama's healthcare legislation, failed to pass Congress. The US Federal Reserve (Fed) continued on its path to normalising rates, raising its official cash rate in March. While markets expect a further two rises this year, the Fed was quick to indicate that it expects to be measured in its actions. In Australia, the housing market has been the key focus, with regulators announcing steps to limits banks' lending of interest only loans and loans on investment properties.

Global bond markets were mixed over the quarter, with yields diverging across the major markets. US 10 year Treasury yields fell by 0.06% over the quarter ending March at 2.39%. Japanese and German 10 year bond yields moved higher, by 0.02% and 0.12% respectively. Australian bonds followed the US lower, with 10 year yields falling by 0.06% to 2.70%. Credit markets posted a positive quarter with a narrowing of credit spreads.

Investment Option Commentary

2017 so far has seen a consolidation of the reflation theme that was enthusiastically embraced by markets late last year, with bond yields oscillating a little below their highs in a relatively tight range, while credit spreads have continued to edge tighter. In general, data has been supportive of these developments, with neither further Fed tightening nor political uncertainty in Europe significantly destabilising. Both Australian rates and Australian credit outperformed global peers over the quarter.

The Portfolio's performance was in-line with that of the benchmark over both the month and quarter. The yearly 2.82% (pre-fee) return of the Portfolio is well ahead of benchmark, due mostly to our positioning for rates to move higher – as occurred in the last quarter of 2016 - expressed through our short duration, yield curve steepening and long inflation-linked positions. We've reduced each of these, but are still biased for yields to move higher. Our credit exposures are moderate and concentrated in high-quality Australian issuers, though with spreads continuing to tighten into expensive territory we pared our exposures further over the quarter.

Outlook

An investment in fixed income is much more certain than most other investment types. Compared to an investment in a share, an investment in a single bond has, for most, a known time horizon (being the term to maturity) and a set of cashflows which are more predictable because coupon rates and frequency are specified in advance, and because debt is senior to equity in the capital structure. The value of the bond changes as investors discount the cashflows at different rates, at times demanding greater premium for perceived risk / higher uncertainty or simply greater opportunity cost versus other investments. This price volatility is, however, limited by the known (finite) timeframe and relative payment certainty compared to other investments.

This relative certainty drives many of the defensive features that we appreciate about fixed income – a smooth income profile, a high degree of capital stability, elevated liquidity and liability matching properties. It does, of course, also mean investors typically demand less return from fixed income than from other less-certain investments.

Cash's appeal differs from that of fixed income in several ways. Firstly, while returns from cash are highly certain in the short term, returns from cash are less certain than returns from bonds over the timeframe of most fixed income investments, because of uncertainty about the rates at which you need to repeatedly reinvest your cash (this is true although typically you are usually able to earn a 'term premium' by investing in bonds over cash). Secondly, cash can't provide portfolio insurance as effectively as fixed income can. The ability of fixed income to perform strongly when equities are performing badly (as has generally occurred over recent decades) - and hence diversify equity risk is a broader defensive feature of fixed income.

It's true low yields compromise some of these defensive features of fixed income, but they don't invalidate them altogether. At lower yields, and where durations are longer on benchmark portfolios, the ratio between income generation and capital price change worsens for a given yield move (i.e. there is a higher chance of losing money in the short term when yields go up). Fixed income becomes less an income investment (as income yields are low) and more a capital price investment in the short term. However, over the medium to longer term, so long as yields remain positive, the maths holds – fixed income will remain a consistent income-generator with a high degree of capital stability.

Additionally, it's not just fixed income that is trading at low yields, and portfolio diversification for an uncertain world remains as important as ever. While the ability of bonds to rally as strongly as in prior episodes of equity weakness is curtailed by the proximity of yields to zero (and assuming some reluctance on the part of rational investors to push them much below that level), fixed income will likely still do well in such an environment. With markets currently fixated on the cyclical reflation story, it's worth remembering that the long-run inflation versus deflation debate is far from settled, and nominal bonds remain the most effective hedge for the latter scenario.

Turning to our current outlook and portfolio positioning, our view remains that duration is expensive, though with other asset classes also looking stretched, the relative attractiveness of government bonds / duration has improved. Additionally, while the data has broadly validated the reflation theme, the large gap between hard and soft data and the peaking of year-on-year headline inflation as base effects roll through, puts significant onus on the data to continue to firm for markets in general to retain their optimism for the reflation theme. Accordingly we've trimmed a number of our interest rate positions, including buying duration so that we are now 0.75 years short versus benchmark. We also neutralised our curve steepening exposure in Australia and took partial profits on our long inflation position in the US. This leaves the portfolio still positioned for higher yields, but with position sizing of about 60% compared to the start of the year. Our short duration remains spread across Australia where cyclical prospects are improving and we're beginning to position for an eventual reversal of the RBA easing cycle, Germany where valuations are worst, and the US where the cycle is the strongest, though we have considerably reduced the size of our short in the US as Treasuries have underperformed.

Credit continues to enjoy the benefit of a stronger cyclical environment, but the narrowing of spreads has taken corporate bond valuations back into expensive territory. From here any excess returns from credit are likely to be generated through carry rather than capital appreciation. Having pared our exposures considerably in the June quarter of last year, we have been running a small, high quality, domestic-only absolute exposure, which represents only a very modest overweight exposure versus benchmark. However we used ongoing spread tightening in February to further trim our Australian credit exposure back to benchmark, and will likely reduce again should spreads continue to narrow. We've also slightly reduced our exposure to semi-government bonds, at tight spread levels to government bonds.

Cash remains reasonably elevated, and combined with our interest rate and credit positioning, leaves us defensively positioned and focused on protecting capital as markets adjust to developments.