Schroders Fixed Income

Quarterly Investment Option Update

31-December-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.

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Overview

Aim & Strategy: To obtain exposure to a diversified range of domestic and international fixed income securities with the principal aim of outperforming the UBS Composite Bond 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	67.9	20-80
Australian IG Credit	24.5	0-50
Global IG Credit	-0.2	0-50
Australian High Yield and Subordinated	0.7	0-20
Global High Yield and EMD	0.2	0-20
Cash	5.9	0-50

Holdings

Industry Exposure	%
Cash & Equivalents	5.9
Sovereign/Supra	16.7
Semis	19.8
Government	31.3
Collateralised	5.5
Corporates	18.5
Subordinated	2.2

Top Ten Securities	%
Australian Govt Sr 133 5.5% 21 Apr 2023	5.1
Australian Govt Sr 128 5.75% 15 Jul 2022	3.7
Australian Govt Sr 137 2.75% 21 Apr 2024	3.6
Australian Govt Sr 140 4.5% 21 Apr 2033	2.8
Australian Govt Sr Regs 3.75% 21 Apr 2037	2.7
QLD Treasury Corp Sr Regs 3.25% 21 Jul 2026	2.6
Australian I/L Sr 20Ci 6.6819% 20 Aug 2020	2.4
Intl Bk Recon & Dvlp Sr Mtn 2.8% 13 Jan 2021	2.2
Australian Govt Sr 152 2.75% 21 Nov 2028	2.1
QLD Treasury Corp Sr Regs 4.25% 21 Jul 2023	1.9

Market Commentary

President Donald Trump signed into law the biggest overhaul in the federal tax code in more than 30 years. It cuts the corporate tax rate from 35% to 21% beginning in 2018, while for individuals it keeps the seven income tax brackets but lowered six of them. It also sees changes in deductions and eliminates personal exemptions. The corporate tax cuts are permanent, while the individual taxes cuts are temporary, expiring at the end of 2025. The expected benefit of the tax cuts in 2018 is around $US200bn, or 1% of GDP. The European Central Bank (ECB) responded to the improving European economy by announcing in October that it will reduce its monthly bond purchases down to EUR 30 billion. This lower pace of purchases will start in January and last until at least September of 2018. The US Federal Reserve (Fed) raised its official cash rate by 0.25% in December, the third rise in 2017 and fourth since the low in the cash rate. President Trump also announced that Jerome Powell will become the new Fed chair once Janet Yellen's term expires in February.

Global bond yields generally rose over the month but were more mixed over the quarter. US 10 year Treasury yields ended December at 2.41%, unchanged over the month and 0.7% higher over the quarter. German and Japanese 10 year government bond yields rose in December but were slightly lower over the quarter. Australian 10 year bond yields ended December at 2.63%, a rise of 0.13% in December but 0.21% lower over the quarter. Credit spreads, in both investment grade and high yield, narrowed over both the month and quarter seeing corporate bonds outperform government bonds.

Investment Option Commentary

The portfolio remains positioned cautiously against a backdrop of low bond yields and narrow credit spreads. The Fund is holding about 3.90 years of duration, and a modest allocation to high quality credit. In the quarter the Fund added back a little to domestic investment grade credit, pared both Australian and US duration, and made changes to the US and Australian yield curve positioning.

Outlook

With markets pricing in a benign inflation environment, the fund manager believes both risk assets and bond yields will initially be negatively impacted by a change in the inflation regime. Higher US inflation will prompt the Fed to raise rates potentially more than implied market expectations. A faster pace of accommodation withdrawal by central banks would also pose further risks to bonds and risky assets – keeping upward pressure on bond yields and a widening of credit spreads.

From the Fund's perspective inflation is the most likely fundamental cause of a turn in sentiment and policy. The outlook for inflation and more generally the poor valuations for longer term bonds (implying pretty low returns going forward) keeps us defensively positioned across fixed income portfolios – with less interest rate risk vs the benchmark and modest exposure to credit risk. In rates, the Fund is holding about 1.25 years less duration than the benchmark. While Australia is clearly lagging the US cycle, if the global cyclical uplift continues to broaden as expected, Australia will likely be pulled along with it. In addition, the prospects for policy tightening is underpriced in Australia and the RBA has indicated that the next move is likely to be up. Given this outlook the Fund has continued to add exposure to inflation linked bonds and shifting the preference on the Australian yield curve from shorter to longer dated maturities. Both these positions should help protect against an upwards turn in the domestic cycle.

Credit markets continue to enjoy a sweet spot of improving cyclical growth prospects with little apparent fear of profitability or liquidity effects of central bank withdrawal. There is always risk with such a benign outlook, and these are now rising with spreads at post-GFC tights. Improving fundamentals are insufficient to justify such tight valuations when adjusting for lower quality and longer duration across most global credit indices. However, as yields generally remain low and central banks remain accommodative, it’s possible that risk assets will remain stretched and the reach for yield will continue to be a factor driving markets. That said, the Fund thinks that risks are becoming more skewed to the downside with much of the favourable business cycle story already reflected in asset prices. A pickup in inflation combined with central bank withdrawal could just be the catalyst for a shift in credit markets.

Given this outlook the Fund is holding a very modest absolute exposure to credit assets, a little above the benchmark weight, maintaining a strategy of accessing a small amount of ‘safe’ carry until better value is restored. During October the Fund added back a little to domestic investment grade credit, at present the preferred fixed income asset for its high quality and short duration. The Fund’s exposure to lower quality domestic and global credit remains limited. The Fund also recently marginally topped up exposures to longer-dated semis and to AAA rated Australian residential mortgages, which have lagged the spread tightening of other sectors. Altogether this positioning is defensive as the fund manager patiently await the triggers for market volatility that should provide the opportunity to position more constructively.