AMP

Schroder Fixed Income

Quarterly Investment Option Update

31 March 2023

Aim and Strategy

To obtain exposure to a range of domestic and international fixed income assets with the objective of outperforming the Bloomberg AusBond Composite 0+Yr Index, whilst delivering stable absolute returns over time. The option adopts a Core-Plus investment approach whereby a core portfolio comprising of Australian investment grade bonds (including government, semi-government, supranational and corporate bonds) is complemented by investments in a diverse range of global and domestic fixed income securities. The targeted result is a defensive strategy which is broadly diversified with low correlation to equity markets.

Investment Option Performance

To view the latest investment performances for each product please visit amp.com.au/performance

Investment Option Overview

Investment Category	Fixed Interest
Suggested Investment timeframe	3 years
Relative risk rating	5/ Medium to high
Investment style	Core
Manager style	Single Manager

Asset Allocation	Benchmark (%)	Actual (%)
Aust. Investment Grade	100%	91.9%
Cash & Equivalents	0%	15.7%
Global Investment Grade	0%	-6.0%
Australian High Yield	0%	1.8%
Global High Yield	0%	-3.3%

Sector Allocation	%
Government	17.6%
Semi-Government	26.0%
Supranational/Sovereigns	14.2%
Corporates	32.1%
Subordinated	2.4%
Collateralised	3.9%

Quality Allocation	%
AAA	34.8%
AA	29.7%
A	10.4%
BBB	18.0%
Below BBB	1.4%
Not Rated	1.4%

Top Holdings	%
AUSTRALIA (COMMONWEALTH OF) 2.75 21-NOV-2029 Reg-S	3.5%
NEW SOUTH WALES TREASURY CORPORATI GOVTGUAR 3.0 20-MAR-2028 Reg-S	2.7%
QUEENSLAND TREASURY CORPORATION NONDMUNI 1.75 21-AUG-2031 Dual 144a|Reg-S	2.5%
AUSTRALIA (COMMONWEALTH OF) 2.25 21-MAY-2028 Reg-S	2.3%
WESTERN AUSTRALIAN TREASURY CORP 1.75 22-OCT-2031	2.3%
AUSTRALIA (COMMONWEALTH OF) 3.25 21-JUN-2039 Reg-S	1.8%
AUSTRALIA (COMMONWEALTH OF) 3.0 20-SEP-2025 Reg-S	1.8%
TREASURY CORPORATION OF VICTORIA 1.5 10-SEP-2031	1.7%
QUEENSLAND TREASURY CORPORATION NONDMUNI 1.75 20-JUL-2034 Dual 144a|Reg-S	1.7%
KFW GOVTGUAR 3.2 11-SEP-2026 (SENIOR)	1.6%

Investment Option Commentary

Over the March quarter the portfolio returned 4.81% (after fees), outperforming the benchmark by 0.33% (after fees). Both Schroder's long interest rate exposure and their recent shift to improve the credit quality of corporate exposures added value.
Schroder made two key changes to positioning over the quarter. Firstly, they used the volatility of large intra-quarter yield moves to increase interest rate duration. They mainly added to US Treasury exposure in shorter dated maturities, to position for an end to policy tightening. Secondly, Schroder reduced their exposure to riskier fixed income assets, selling out of Asian credit and emerging market sovereign exposures, further reducing their US high yield position, and also reducing their global investment grade exposure. These assets had all performed strongly since October last year on expectation of a slowing pace of rate hikes; with valuations now unappealing and heightened risk of correction should the economic cycle sour further as we expect. Schroder used some of the proceeds to add to higher quality government linked sectors offering spreads over sovereigns, i.e. semi-government and supra-national issuers.

High-quality bonds, both government and corporate, are very appealing sources of low-risk income and diversification over medium-term investment horizons and are increasingly attractive in a cyclical sense relative to other assets. Schroder are positioned longer than benchmark in their interest rate exposure and hold mostly high-quality credit exposure.

Outlook

Coming into this year the manager firmly believed high-quality fixed income offered attractive relative and absolute value. Schroder also expected the economic cycle to turn in favour of bonds, albeit since late last year most data was indicating resilience in economic activity and persistence in core inflation. The banking stresses that emerged in March provided the first clear evidence that rate hikes are biting, and that the cycle is turning.

Markets are digesting one of the most rapid tightenings in monetary policy ever seen, at individual country levels and collectively across countries. Although monetary policy typically works with long and variable lags, the effect of policy tightening is beginning to show, in particular via stress within the financial system itself. It's been a very volatile quarter, but the key moves have been:

- A flight to quality, with government bonds outperforming other assets. Short-dated bond yields have plunged, driving strong returns from high-quality fixed income portfolios. In part this has been an unwind of short positioning in interest rate derivatives, but it also reflects a significant repricing of the expected path of rate hikes.
- A widening of credit spreads, but particularly in bank spreads and especially in subordinated bank issues, given the concern over the Credit Suisse AT1 bonds being written down to zero.
- Dislocated funding markets, in a scramble for liquidity. US banks usage of the central bank liquidity facilities has surged. Interestingly, however, the US dollar has traded sideways, as US rate expectations have repriced lower.

Three risks dominate markets: 1) banking system stability given the nervousness of depositors and counterparties, in spite of the swift Fed and Swiss regulator actions to stem the US regional and Credit Suisse situations, 2) the probability of a material contraction of credit availability to businesses, 3) inflation stickiness which potentially puts policymakers in a corner.

• The US bank failures and Credit Suisse takeover in March are significant developments that suggest the financial system is being extremely stressed by the rapid rise in rates. It is hard to ignore these as isolated or idiosyncratic situations.

• So far, the market is considering these risks to be relatively containable, but nervousness is clearly gathering momentum and banks survive on sentiment and depositor confidence. We expect to continue to see a flight to quality and higher-rated banks will gain additional market share as a result of these developments.

• Our view is that central banks cannot raise interest rates at the recent speed and magnitude without some level of creative destruction. Raising rates to fight inflation is by design aimed at restricting the supply of credit to the real economy, thereby crimping business and household demand. That the cracks are appearing first in the financial system is very concerning for central banks, as the financial system is inherently interconnected and counterparty risk exposures are not always well known. This can lead to contagion and a rapid loss in

confidence to selected financial institutions that central banks and regulators will look to limit as they wait for the real economy impacts to appear.

• To date, these events have largely been confined to the banking sector. Corporates, especially those with large fixed asset bases, will soon be feeling the impact of higher interest rates through negative mark to market adjustments and what is highly likely to be a period of credit rationing by the banks and debt capital markets. More generally, corporate models that were viable in periods of ultra-low rates and abundant capital will be stressed.

• The market dislocation may be contained by swift central bank and regulator responses, however Schroder expect the resulting restriction of credit to the economy will accelerate the anticipated slowdown in growth.

• Central banks are likely to be more cautious in tightening further from here. This may involve both a slower pace and lower peak cash rate.

• Rate cuts (at this stage) are unlikely to be delivered in 2023, as the fight against inflation remains the priority. However, all else being equal, the emergence of banking system stress and the likely credit tightening for the real economy are likely to help central banks in their fights against inflation.

• Together this leaves risky assets vulnerable while high-quality bonds looking increasingly appealing. Schroder do, however, expect volatility to remain high and expect to see sharp moves in both directions.

Positioning

• Schroder's portfolios have held moderate long duration positions and are positioned for yield curves to steepen, which have benefited performance. They are waiting for opportunities to further increase duration, particularly in US Treasuries. Treasuries are particularly appealing because of the high-rate structure in the US and their high quality.

• Schroder's credit allocations have been concentrated in high-quality Australian investment grade issuers, with small allocations to Australian mortgages, and Australian higher yielding credit. They are running net short positions in both US high-yield and US investment grade sectors. Although the market is likely to see some further widening of credit spreads as the cycle enters the downturn stage, investment grade spreads are already pricing a recession and therefore offer good medium-term value. However high-yield spreads appear vulnerable to a material repricing as downgrades/defaults pick up.

• Within Schroder's Australian credit allocations they have been rotating issuers to improve overall credit quality; buying banks from an underweight position, and de-risking by reducing lower rated credit issuers. Schroder are confident that Australian banks are well positioned, with simpler business models and high liquidity and high capital levels.

High-quality fixed income offers attractive income levels and improved diversification benefits as the cycle turns. The manager is positioned constructively in interest rate duration and high quality corporate debt, and expected to become even more constructively positioned through the year.

Availability

Product name	APIR
Flexible Lifetime Investment (Series 2)**	AMP2040AU

**Closed to new and existing investors

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