Schroder Fixed Income

Quarterly Investment Option Update

30 September 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	3/ Low to Medium
Investment style	Core
Manager style	Single Manager

Asset Allocation	Benchmark (%)	Actual (%)
Aust. Investment Grade	100%	89.2%
Cash & Equivalents	0%	9.4%
Global Investment Grade	0%	-2.1%
Australian High Yield	0%	3.4%
Global High Yield	0%	0.1%

Sector Allocation	%
Government	12.0%
Semi-Government	23.9%
Supranational/Sovereigns	13.1%
Corporates	35.2%
Subordinated	2.0%
Collateralised	4.7%

Quality Allocation	%
AAA	31.6%
AA	26.9%
A	10.4%
BBB	21.8%
Below BBB	2.3%
Cash & Equivalents	4.8%
Not Rated	2.1%

Top Holdings	%
AUSTRALIA (COMMONWEALTH OF) 2.75 21-NOV-2029 Reg-S	3.7%
TREASURY CORPORATION OF VICTORIA 1.5 10-SEP-2031	3.2%
QUEENSLAND TREASURY CORPORATION NONDMUNI 1.75 21-AUG-2031 Dual 144a|Reg-S	2.6%
AUSTRALIA (COMMONWEALTH OF) 2.25 21-MAY-2028 Reg-S	2.4%
AUSTRALIA (COMMONWEALTH OF) 3.0 20-SEP-2025 Reg-S	1.9%
AUSTRALIA (COMMONWEALTH OF) 3.25 21-JUN-2039 Reg-S	1.7%
QUEENSLAND TREASURY CORPORATION NONDMUNI 1.75 20-JUL-2034 Dual 144a|Reg-S	1.7%
SOUTH AUSTRALIAN GOVERNMENT FINANC NONDMUNI 2.75 24-MAY-2030 Reg-S	1.7%
INTERNATIONAL BANK FOR RECONSTRUCT 3.0 19-OCT-2026 (SENIOR)	1.7%
AUSTRALIA (COMMONWEALTH OF) 3.0 21-MAR-2047 Reg-S	1.5%

Investment Option Commentary

In the September quarter the portfolio returned -0.15%, ahead of the benchmark by 0.14%. This takes year-to-date portfolio returns to 1.55%, ahead of benchmark by 0.33%. Outperformance in the quarter was driven by the fund's overweight allocation to Australian corporates and government spread sectors. The fund's US yield curve steepening positions and overweight inflation exposure helped to offset its long duration exposure.

The key changes the manager made in the quarter were to shift duration from the US to Europe and move their yield curve exposures steeper (more overweight shorter dated bonds relative to longer). Schroder modestly adjusted their credit allocations, marginally trimming their Australian spread exposures and adding a small allocation to emerging market debt.

Schroder retain a modest long interest rate position, and constructive positions in Australian credit, particularly in investment grade. While delivering good income (the yield on the portfolio is 5.15%) these positions also potentially set the portfolio up for better returns ahead should the cycle turn weaker.

Outlook

Just as a US recession was the consensus expectation at the beginning of the year, a soft landing has become the current expectation. A soft landing is not a well-defined concept, and we find that the term has been loosely used to define everything from ongoing expansion to a mild recession. Schroder think it describes the scenario where inflation moderates nicely but high rates don't cause a recession. Soft landings are not common – tightening typically leads to a fall in interest rate sensitive spending, a contraction in corporate profit growth, job layoffs, and insolvencies – so Schroder are sceptical one can be achieved this time around. Notwithstanding this, the manager acknowledges that economies are resisting monetary tightening better than expected.

There is always uncertainty around cycle turning points, but there are considerable differences between this cycle and others – higher inflation initially supporting corporate profitability, savings patterns are changing (older cohorts are dis-saving), fiscal policy is more active, and supply disruptions have yet to fully normalise. This means, in our minds, that the range of possibilities from here is wide. Markets have narrowed in on the soft-landing scenario, but Schroder believe complacency around this view is a risk.

Fixed income remains attractive

Schroder's view on the cycle is that it remains favourable for fixed income. Cash rates are now at restrictive levels in most economies, and there is evidence they are beginning to bite. Households are under interest rate and cost of living pressure, forward indicators suggest labour markets will soften, and while inflation remains elevated, it is softening. The recent rise in US Treasury yields is likely to put pressure on exposed balance sheets, similar to what occurred earlier in the year. Patience is required, however, as this cyclical view may take some time to play out. While the Federal Reserve (Fed) has upgraded its growth and unemployment forecasts for 2024, it also increased its projections on where it believed the cash rate would be next year. Market participants have since reassessed what the impacts of a more restrictive for longer Fed policy would mean for the economy and asset prices.

A key positive about fixed income at current levels is that investors are typically rewarded for patience. Yields on high quality portfolios are above 5% and are attractive relative to cash yields and compressed equity dividend yields. The income represented by these yields can provide both the base for decent future returns, and a buffer against price weakness. Schroder have modelled a range of cyclical scenarios, which suggest a favourable skew towards outperformance of fixed income, given the limited downside to returns should rates continue to rise, and the material upside to returns should rates fall in a weaker environment.

Uncertainty will likely bear on risk premia

There is also the intersection of the cyclical and structural outlook to consider. More strategically, Schroder expect fixed income to offer a safe harbour as cycles potentially become more volatile. The manager expects inflation to run higher on average over the next decade than the preceding decades, resulting in higher yields on average. This will provide good ongoing income from fixed income. At the same time, higher macroeconomic volatility, and therefore uncertainty, should see market risk premias (term, credit, equity) rise – as we are currently witnessing with the rise in the US Treasury term premium – but underlying repayment probabilities on high quality debt should only shift marginally. The predictable cashflow profile which underpins debt investment should therefore remain and provide shelter for investors from volatility.

In summary, with bond yields at their highest level in 15 years and high-quality spread assets offering decent value, long term investors may expect improved future returns on offer in fixed income. Though patience is required for the turn of the economic cycle, relative to other assets, high quality fixed income is likely to offer decent yield, the ability to perform should the economic cycle turn down more meaningfully, and protection from higher volatility.

Positioning

Schroder are positioned for the end of the tightening cycle, but with short term interest rates likely to stay higher for longer, the manager acknowledges that rate cuts may take some time to be priced into markets. The portfolio holds modestly long interest rate positions, constructive positions in higher quality corporate debt and government spread sectors, and limited exposure to riskier debt.

Within these broad settings there is considerable dispersion between countries and sectors that are providing opportunities. In particular:

- Schroder prefer interest rate duration in Australia and Europe, where the cycle is slowing more quickly, and the manager is running small long duration positions in each.
- In the US, Schroder expect the yield curve to steepen from heavily inverted levels. This most likely occurs via the Fed cutting rates at some point next year, though a rise in longer-term yields could occur. Schroder are both overweight short-dated Treasury yields (yielding about 5.1%) and underweight long-dated yields (yielding about 4.5%). Schroder also continue to prefer inflation exposure in the US as markets seem optimistic about a return of inflation back to low levels.
- Schroder’s strongest conviction is in Australian investment grade corporates. Spreads are wide relative to the high quality/low risk of the underlying issuers. The manager also likes Australian Tier 2 bank sub-debt, in which issuance to meet regulatory capital requirements is keeping spreads wide relative to the low underlying risk, though T2 has performed well in recent months.
- This contrasts with the manager’s view on global credit where exposures are limited, and Schroder continue to run a small short position in US high yield. In September, Schroder lifted some credit protection across investment grade and high yield markets to further add to carry within the portfolio, positioning for a higher for longer environment. Schroder have considerable flexibility to add exposure as the opportunity arises.
- With the end of the policy tightening cycle in sight and the potential for the US dollar to stabilise, Schroder added a small exposure to emerging market debt (EMD). Despite the recovery experienced this year by EMD, these markets still offer attractive valuations and Schroder see continued macro-resilience exhibited by a number of member countries, with a select number starting to cut policy rates from restrictive levels as inflation pressures ease.
- Across higher quality spread product, Schroder favour the sub-sovereign (state government and supranational) issuers over government bonds. Aiding performance of these sectors is the likely ongoing compression of swap spreads.

As uncertainty persists in the global economy, high quality fixed income offers attractive income levels to asset allocators as we wait patiently for the end of the cycle, when once again, fixed income is likely to provide good cyclical diversification.

Availability

Product name	APIR
Flexible Lifetime Investment (Series 2)**	AMP2040AU
SignatureSuper*	AMP1302AU
SignatureSuper Allocated Pension*	AMP1309AU

*Closed to new investors
**Closed to new and existing investors

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