Schroder Fixed Income

Quarterly Investment Option Update

31 December 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	81.6
Cash & Equivalents	0	5.4
Global Investment Grade	0	2.6
Australian High Yield	0	7.5
Global High Yield	0	2.9

Sector Allocation (excluding cash)	%
Government	14.2
Semi-Government	22.8
Supranational/Sovereigns	12.8
Corporates	29.5
Subordinated	7.9
Collateralised	7.6

Quality Allocation	%
AAA	29.5
AA	27.3
A	11.3
BBB	22.0
Below BBB	3.1
Cash & Equivalents	4.5
Not Rated	2.2

Top Holdings	%
TREASURY CORPORATION OF VICTORIA 1.5 10-SEP-2031	2.5
AUSTRALIA (COMMONWEALTH OF) 2.75 21-NOV-2029 Reg-S	2.1
NEW SOUTH WALES TREASURY CORPORATI NONDMUNI 4.75 20-FEB-2035 Reg-S	2.0
NEW SOUTH WALES TREASURY CORPORATI 2.0 08-MAR-2033	2.0
AUSTRALIA (COMMONWEALTH OF) 3.0 20-SEP-2025 Reg-S	1.9
QUEENSLAND TREASURY CORPORATION NONDMUNI 1.75 20-JUL-2034 Dual 144a|Reg-S	1.8
AUSTRALIA (COMMONWEALTH OF) 3.25 21-JUN-2039 Reg-S	1.8
AUSTRALIA (COMMONWEALTH OF) 2.25 21-MAY-2028 Reg-S	1.7
AUSTRALIA (COMMONWEALTH OF) 3.0 21-MAR-2047 Reg-S	1.6
QUEENSLAND TREASURY CORPORATION NONDMUNI 1.5 20-AUG-2032 Dual 144a|Reg-S	1.4

Investment Option Commentary

In December the portfolio returned 3.08% (before fees), ahead of benchmark by 0.40%. This takes year-to-date portfolio returns to 6.03% (before fees), ahead of benchmark by 0.97%. Outperformance in the month was driven by the fund's long duration position and overweight allocation to credit spreads, primarily in Australia.

Schroder's key focus recently has been to make the most of elevated yields. In October, the fund added US High Yield, US inflation-linked (real) yields and some emerging market debt (EMD). In November, the fund added high quality US mortgages at attractive price levels, more real yields and more EMD. Across both months the fund also increased duration exposure, particularly in Europe. In December the fund took profit on some on its long duration positions.

At December end the portfolio is yielding 4.48% with an interest rate duration of 5.36 years. This leaves the portfolio well set up to generate robust income, and deliver an uplift to returns should rates be cut.

Outlook

Victory declared in December
Schroder has been flagging for several months the great opportunity for asset allocators to lock in attractive yields in fixed income (see Lock it in Eddie). Yields on high quality fixed income assets are attractive in absolute terms and relative to riskier assets, and form a great base for good returns over time.

Additionally, Schroder's inflation and policy rate models have been indicating that central bank policy rates are high for the expected future path of inflation. Schroder has therefore been confident that central banks are very close to finishing their tightening, and expecting an asymmetric – i.e. positively skewed – distribution of possible returns for 2024, with total returns significantly above current yields if central banks returned to cutting rates.

In December, the US Federal Reserve (Fed) emphatically agreed by declaring victory on inflation – flagging no more rate hikes, and cuts of 75bps in 2024. Forecasting inflation falling towards 2% by the end of 2024, Fed Chairman Powell indicated a switch in the policy focus from higher inflation, to potentially weaker growth. Markets had already performed well over November and early December, supported by encouragingly softer inflation prints in both the US and Europe, but this dovish pivot signalled a significant shift from the previous "higher for longer" narrative and buoyed markets further.

This change in stance by the Fed improves the chances of a "soft landing". If inflation continues to decline, as currently expected, interest rates will be cut and financial conditions will continue to ease which supports both business and consumers. If growth weakens as well, then there is significantly more scope to cut rates to support the economy. Equity markets have rallied and corporate credit spreads, particularly high yield, have narrowed reflecting the lower risk of a US recession with the Fed willing and able to provide a safety net. Other central banks are a little more cautious about the risks to inflation. The European Central Bank have pushed back on the prospect of rate cuts in the first half of 2024, despite the European economy being considerably weaker (with zero growth over the past two quarters). Their focus remains on domestic price pressures remaining elevated, primarily owing to strong growth in unit labour costs. In Australia, the RBA left policy unchanged at their December meeting, but maintained a bias to raise rates further to ensure inflation returns to target in a reasonable timeframe. As at the end of December, market pricing for official policy rates for the end of 2024 has the US Fed Funds Rate 1.5% lower, European deposit facility rate 1.6% lower and the Australian cash target 0.6% lower. While Schroder expect US rates to be eased next year, for short-dated bonds to outperform cash, official policy rates have to be cut by more than 1.5% over the course of 2024. While this is definitely more than possible in a recession, pre-emptive easing by the Fed may limit the amount of eventual easing required.

The surprises of 2023 – most expected the major economies to be in recession by now, and for asset prices to struggle – remind us of the dangers of confidence in forecasts, particularly over shorter periods. The unequivocally good news over the past few months is that inflation has slowed by more than expected globally. While this may provide a tailwind to further asset price gains, and lower volatility, it seems likely again that 2024 will prove an eventful year. The global economic picture remains complicated, and political risks are particularly high with elections taking place in more than 70 countries. Schroder's multi-dimensional approach, with a strong emphasis on valuations and strategic themes, helps to stay focused through some of the noise.

Schroder reiterate their view that high quality fixed income remains attractive, with still elevated yields of ~4.5%

forming a good base for returns over time, and the apparent turn in cyclical inflation dynamics suggesting a higher skew to return distributions over shorter periods.

Positioning

The manager's focus in October and November was to add attractively-priced yield to the portfolio. Schroder's asset additions were in US mortgages, US inflation-linked (real) yields and emerging market sovereign debt, which had all cheapened considerably driven by the US rate cycle and dollar strength. Schroder closed their high yield short to lock in attractive yields (albeit with spreads at about average levels). Schroder also added duration, especially in Europe, and moved their yield curve exposures shorter, particularly in the US.

With yields having shifted lower by 100bps since their peak in October, Schroder took some profit on their long duration positions, but broadly held their asset allocations steady in December. The portfolio is well set for the year ahead, and resilient over the longer term to a possible new regime of persistent inflation and greater macroeconomic volatility.

The fund's key positions are:

1. Overweight investment grade credit, particularly in Australia. This is a key way to access income from high quality assets at a reasonable price, and an attractive way to build inflation resilience via sectoral exposure to infrastructure, utilities etc. Schroder also like Australian bank sub-debt, which sits in a sweet spot for return versus risk in the capital structure given the strong Australian banking sector. Overall Schroder prefer investment grade over high yield credit based on cheaper valuations, and as a safer harbour should the cycle weaken more meaningfully.

2. Modestly overweight interest rate (duration) risk. It appears yields peaked for the cycle in October. For now Schroder has taken profit on some of their long positions, but will look to rebuild these on opportunity.

3. Overweight inflation-linked (ILBs) versus nominal bonds. ILBs are delivering higher income in the near term, given sticky inflation, and provide cheap longer-term protection against inflation. Schroder hold most of Their inflation exposure in the US, where pricing is more attractive than domestically.

4. A preference for shorter tenors. This is particularly the case in the US, Europe and the UK where short-dated yields are higher than those on longer maturities. This preference will help portfolios should central banks need to ease more rapidly than is priced, and also insulates them from higher volatility. In Australia, Schroder's preference is to be holding mid-curve exposure, in high quality spread product.

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

Contact Details

Web: www.amp.com.au
Email: askamp@amp.com.au
Phone: 131 267

INSIGHTS
IDEAS
RESULTS