

Aberdeen Australian Fixed Income Fund



Investment objective

To provide exposure to primarily Australian fixed income securities, to generate income with some growth potential over the medium to long term. The Fund aims to outperform the UBSA Composite Bond Index over the suggested investment time frame.

Investment strategy

The investment strategy of the Fund is to aim to actively add value through interest rate, credit and relative value strategies. The strategies involve both fundamental and model driven analysis that seeks to exploit as many return generating opportunities as possible, and are therefore well risk diversified.

The Fund may have a limited exposure to international fixed income securities.

Performance summary

	1 Month %	3 Months %	1 Year %	3 Years %pa	5 Years %pa	Since Inception [^] %pa
Australian Fixed Income Fund						
Net returns*	-0.11	1.85	7.18	6.59	5.84	7.24
Australian Fixed Income Fund						
Gross returns**	-0.07	1.98	7.72	7.07	6.24	7.59
UBSA Composite Bond Index						
returns	-0.38	1.03	1.72	6.55	5.71	7.31
Net returns* vs Index	0.27	0.82	5.46	0.04	0.13	-0.07
Gross returns** vs Index	0.31	0.95	6.00	0.52	0.53	0.28

* Net performance figures are calculated using end-of-month exit prices, post standard fees, reflect the annual reinvestment of distributions and make no allowance for tax. If investing through an IDPS Provider, the total after fees performance returns of your investment in the Fund may be different from the information we publish due to cash flows specific to your portfolio and any fees charged by the IDPS Provider.

** Gross Performance figures are calculated using end-of-month exit prices, pre-fees, reflect the annual reinvestment of distributions and make no allowance for tax. These returns are provided for the purpose of wholesale investors only. Retail investors should refer to net returns.

[^]This figure represents the annualised performance of the Fund from the first full month of operation in June 1993.

Please note: Prior to 1 May 2009 the Fund was known as the Credit Suisse Australian Fixed Interest Fund

Past performance is not a reliable indicator of future results.

Performance review

The Fund outperformed its index during December, primarily driven by our credit strategies. In credit we remain overweight high quality financials and mortgages, though we have been moderately trimming these positions. We also favour semi government bonds over supranationals even though supras have recently underperformed due to a widening in the basis swap.

Interest rate strategies had little net impact on the performance for the month, as value added via our short duration position was offset by value detracted through our curve flattening position. In early January we removed the short duration position and are currently neutral. The Australian yield curve has re-steepened too aggressively, in our view, considering both the cyclical influences (the domestic policy outlook as well as the prospect of global 'normalisation') and improved demand-supply dynamics.

Market review

Australian yields rose in December and as a result, the index returned -0.38%. Three-year yields rose by 5 basis points while 10-year yields rose by 40 basis points, as short end yields were anchored by comments from the RBA Deputy Governor that the effective cash rate (at least 4.75% now versus an official rate of 3.75%) was back in the normal range, perhaps implying a more moderate pace of tightening from here. Longer yields were, as usual, more influenced by global yield moves. Ongoing demand for Australian bonds due to APRA's proposed liquidity requirements (which remain unconfirmed) led to spread tightening to offshore equivalents.

Portfolio analytics

	Fund	B/mark
Modified Duration (years)	3.34	3.40
Yield to Maturity (% pa)	6.72	5.66

Sector holdings

	Fund %	B/mark %
Government	-	26.57
Semi Government	15.77	32.04
Corporate	59.72	41.40
Supra/Sovereign	2.63	21.32
Financials	34.59	16.75
Non-Financials	9.42	3.26
Asset-Backed	13.08	-
Bank Bills	4.25	-
Other	1.10	-
Cash*	19.16	-

Security type

	Fund %	B/mark %
Fixed	33.98	100.00
Floating	41.44	-
Inflation-Linked	0.04	-
Hybrid	-	-
Bank Bills	4.25	-
Other	1.13	-
Cash*	19.16	-

Credit rating profile

	Fund %	B/mark %
AAA	33.26	79.36
AA	18.50	13.65
A	17.10	5.19
BBB	7.73	1.79
<BBB	0.00	-
A-1+	4.25	-
A-1	-	-
A-2	-	-
A-3	-	-
Cash*	19.16	-

*As at 31 December 2009 our cash levels were unusually high. These are now within the expected 0-10% range

Further information

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Credit assets outperformed both swaps and Commonwealth bonds in December, making 2009 the best year for Australian credit returns on record. Spread tightening was more modest in December than in the earlier part of 2009 and market activity slowed during the second half of the month. The UBS Credit index tightened by 3 basis points relative to swaps, with some softness in spreads mid-month before a tightening move into the year end.

Financials performed well, with subordinated debt outperforming senior bonds. Spreads in senior debt for the four "majors" have been fairly weak due to ongoing concerns over supply volumes, comparably wide levels of non-Australian issuance and uncertainty around the new APRA proposals on liquidity requirements. Non-financial credit had a quiet month as spreads were either unchanged or slightly tighter.

Semi-government bonds tightened to swaps over the month and outperformed Commonwealth bonds by around 40 basis points, driven largely by tighter swap spreads and better carry. Supranational bonds performed in line with semis over the month, outperforming Commonwealth bonds. Although supranational spreads widened to swaps by around 2 basis points, the higher yield versus semis and swaps meant total performance was comparable.

Sovereign credit risk, rather than corporate credit, was a focus for December. Greece had its rating downgraded by Fitch from A- to BBB+ with a negative outlook and S&P changed the outlook on the A- rating from stable to negative watch. Markets remained cautious about the ratings outlook for countries such as Spain, Ireland, Portugal and Italy. Markets were surprised by Nakheel's repayment of its December 2009 bond, as the troubled Dubai World conglomerate (Nakheel's parent) is currently renegotiating much of its debt burden. In the US, banks including Bank of America, Wells Fargo and Citigroup agreed to repayments of Troubled Asset Relief Program (TARP) funding using cash and newly issued equity. Of the big US banks, only Citigroup now has any TARP assistance outstanding. Despite repaying US\$20 billion of preferences, Citigroup remains partially government owned. Late in the month Westpac announced it will be repaying its 6% LT2 bond at the February 2010 call date which, whilst not surprising, was a small positive for the market.

Outlook

We expect an ongoing recovery in markets, but the global financial crisis hangover means this is not a normal recovery. Recovery timing and eventual magnitude are dictated by countries' relative positioning in the structural globalisation / developing economy industrialisation process, and their flexibility of adjustment. 'Normalisation' will eventually be global and involve policy removal, higher yields and flatter curves - suggesting plenty of convergence opportunities between leaders and laggards - though we must also be careful to identify meaningful longer-term divergences. For most of the coming year this theme of normalisation will fight the attractions of holding bonds for carry (given liquidity, steep curves) and risk aversion recurrences, and longer term regulatory reform impacts.

Based on historical credit cycles, the speed of the 2009 recovery suggests a little over two thirds of the spread correction has occurred. Further spread tightening will be a more gradual affair, drawn out over many quarters, and likely to be punctuated with periods of spread weakness as macro data and company results fail to keep pace with market expectations.

We remain positive on the outlook for credit, due largely to fundamentals rather than valuations. In financials, the de-risking and de-levering imposed by governments and regulators is largely working to benefit bond investors, as capital levels have been increased in the sector globally. Funding without government guarantees is feasible for all but the weakest institutions. For non-financials, balance sheets are healthy with high cash levels and relatively low debt. Costs have been slashed aggressively, leaving companies positively exposed to rising revenue in 2010 as economies gradually recover. Earnings power will therefore be strong, which should be positive for credit. Senior RMBS assets are still very attractive given their wide spreads and very low credit risk, despite liquidity remaining impaired.

Maturity profile

	Fund %	B/mark %
0-1yrs	13.47	12.50
1-3yrs	27.72	30.56
3-5yrs	12.65	25.74
5-7yrs	5.51	10.91
7-10yrs	13.45	13.84
10+yrs	8.04	6.45
Cash*	19.16	-

*As at 31 December 2009 our cash levels were unusually high. These are now within the expected 0-10% range

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As a result of our positive outlook, we expect to remain overweight credit assets. However, given the strong spread recovery we have witnessed, it would be prudent to reduce credit exposure in those assets that have more limited potential for spread tightening in the short to medium term.

Key information

APIR Code	CRS0004AU
Benchmark	UBSA Composite Bond Index
Date of Launch	June 1993
Income Payable	31 March, 30 June, 30 September and 31 December
MER	0.51% pa
Buy/Sell spread	0.30%/0.30%
Fund Size	A\$465.4m
Redemption Unit Price	\$1.1172

Important information

This document has been prepared by Aberdeen Asset Management Limited ABN 59 002 123 364 AFSL No. 240263.

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