

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*	0.18	3.46	11.48	8.27	6.42	7.39
Australian Fixed Income Fund Gross returns**	0.23	3.60	12.05	8.77	6.86	7.75
UBSA Composite Bond Index returns	0.27	3.31	7.81	7.52	6.02	7.37
Net returns* vs Index	-0.09	0.15	3.67	0.75	0.40	0.02
Gross returns** vs Index	-0.04	0.29	4.24	1.25	0.84	0.38

* 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 portfolio underperformed the index during July. The defensive credit positioning of the portfolio during the month detracted slightly from performance. This was offset by the attractive running yield in the portfolio, and the solid performance in the financial and Australian AAA mortgage-backed sectors.

We were surprised by the strong recovery in risk sentiment following the European bank stress tests. As a result, the underweight positions to the Australian Itraxx credit index and European supranational issuers detracted from performance, as these sectors recovered from the weakness seen in May and June.

The small overweight position to state government debt also detracted marginally from performance as it was not the strongest sector in the month, although this was offset by security selection within the sector, as our largest overweight position to Queensland debt outperformed.

During the month, our rates positioning reflected the view that bond markets had become overvalued. This short duration position added value in the earlier part of the month. We trimmed the size of the position mid-month, which assisted in limiting downside in the second half, as bonds performed quite strongly following the benign inflation data. Our positioning for a flattening of the yield curve (longer maturity bonds outperformed shorter maturities during the month) had little impact on performance in July.

Market review

Australian yields rose slightly over July - three-year yields by 8 basis points to 4.64% and 10-year yields by 9 basis points to 5.195% - but finished the month some distance below their highs. July began with yields at one year lows, with rate cuts priced in. However, the probability of

Sector holdings

	Fund %	B/mark %
Cash & Cash Equivalents	19.59	0.07
Government	0.00	29.13
Semi Government	27.97	32.40
Corporate	52.44	38.40
Supra/Sovereign	7.16	22.67
Financials	24.91	12.91
Non-Financials	7.41	2.77
Asset-Backed	12.96	0.05

Sector holdings: credit duration (yrs)*

	Fund	B/mark
Cash & Cash Equivalents	0.00	0.00
Government	0.00	0.00
Semi Government	1.65	1.29
Corporate	1.28	1.08
Supra/Sovereign	0.36	0.73
Financials	0.49	0.27
Non-Financials	0.17	0.07
Asset-Backed	0.26	0.00

* Credit duration measures exposure to changes in credit spreads. It is a more realistic measure of credit positioning than % holding.

Security type

	Fund %	B/mark %
Fixed	45.50	100
Floating	34.87	-
Inflation-Linked	0.05	-
Hybrid	0.00	-
Cash & Cash Equivalents	19.59	-

Portfolio analytics

	Fund	B/mark
Modified Duration (years)	3.26	3.49
Yield to Maturity (% p.a.)	6.29	5.32

The Fund is positioned:

- short duration for a rise in overall yields
- long slope for a flattening yield curve.

Further information

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further RBA hikes increased with strong employment data for June, after which the market lacked direction for a few weeks while waiting for the July 28 CPI release. The market consensus prior to the release was for a high number, but analysts were generally surprised by a soft 0.6% headline increase and 0.5% underlying rise, which all but assured there would be no rate rise during the election campaign.

A calming of concerns over European sovereign risk, a generally positive reception to the European banking stress test results and a watering down of tough new bank capital proposals led to a rally in risk assets during the second half of the month. Despite this, global bond yields meandered sideways as bond market focus remained on the likelihood of sluggish growth in the core of the developed world. Chairman Bernanke's description of the US outlook as 'unusually uncertain' and the prospect of further US quantitative easing saw treasuries outperform, including against Australian bonds.

After the challenges for credit markets in May and June, July was a strong month. Credit outperformed both Commonwealth and semi-government bonds by around 60 basis points, as spreads tightened. Sovereign/supranational bonds also outperformed Commonwealth and semi-government bonds, though not to the extent of the financial and corporate sectors. The Itraxx Australia index of CDS spreads tightened by 23 basis points, mirroring the strong performance of the US and European markets, while the UBS Credit index spread tightened by 3 basis points to 133 basis points.

Although economic data releases were soft during the month, especially in the US, several developments helped credit market sentiment. Bond auctions from Spain, Greece and Portugal were viewed positively, despite relatively narrow placement, and the release of the European stress tests for the banking system proved to be a catalyst for all risk assets to rally. Although questions remain over the rigour of the tests, the lack of major surprises helped financial spreads in particular to contract from the wide levels reached at the end of June. A further positive driver for financials was the softening of Basel III reform language and extension of implementation timeframes. Quarterly earnings from the US were mixed, with major US financials reporting softer revenue from investment banking but also sharp reductions in credit costs. Management outlook statements expressed caution about the extent of the earnings impact from recent regulatory changes and this will remain a drag on equity performance. For non-financial corporates, balance sheets are healthy and should withstand the likely weakening in the US recovery, while outright funding costs are very low. Certainly, economic data released during the month confirmed the prevailing view of the Federal Reserve, that growth would remain subdued and therefore there was no reason to remove monetary stimulus.

After limited new issuance in May and June due to the volatility in spreads, July saw a reasonable amount of supply both locally and globally. The US market has now seen over \$500 billion of new investment grade issuance year-to-date. In terms of local issuance, new deals in July have come from the sovereign/supra sector (KFW, EIB, EDC, IFC), financials (ANZ, Westpac) and corporates (SPI Australia, APT, Sydney Airport) to bring total monthly new issuance to \$5.6 billion. The domestic banks have largely completed their funding task for the current year, but given the size of funding required for the next two to three years, it is likely any spread stability will be met with proactive new issuance.

Outlook

As we noted last month, rates markets have shifted lower in yield in recent months, initially in a somewhat disorderly response to the bad European news of May and more recently, in an orderly manner on expectations of a more stable but lower growth environment. The tone of European and British fiscal austerity is likely to be replicated elsewhere, suggesting cash rates will stay low for longer as the naturally dampening effect of fiscal tightening diminishes the need for monetary tightening. In future, lower public debt should also compress government-cash spreads (or similarly, reduce sovereign CDS spreads) although, given the obstacles to lower and sustainable debt levels, such compression will likely be volatile and lengthy. Cyclical normalisation and convergence opportunities will be delayed or reduced in magnitude due to the substitution of fiscal-for-monetary tightening. However, an increasingly compelling diversification argument and the strong fiscal story suggest Australian bonds should be reasonably well supported, in spite of likely cyclical outperformance of the domestic economy for some time.

Credit rating profile

	Fund %	B/mark %
AAA	43.89	81.12
AA	19.92	13.26
A	12.31	4.50
BBB	4.88	1.11
A-1+	15.72	0.00
Cash	3.29	0.00

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While credit performed well during July we retain our cautious stance in the medium term, believing there is scope for modest spread contraction in the longer term. Moreover, as credit spreads are relatively wide in an historical context, the high running yield is a significant driver of the overall returns expected from the allocation to credit.

Our caution stems more from macro-economic influences than the outlook for credit quality at the individual corporate level. The events of May were a clear signal to European governments of the need for increased fiscal austerity and budgetary repair. As a consequence, the greater focus on delevering will result in higher taxes, lower public spending and slower growth than was forecast earlier in 2010. This has knock-on effects for the banking system, which is already experiencing high levels of loan losses. A low growth environment, with the risks of another bank or even sovereign default scare, is not a strong environment for risk assets. Furthermore, the US seems to be continuing down the path of profligacy as growth slows, the housing market weakens and unemployment remains high. This could result in pressures on US credit worthiness in the years to come, although this has not eventuated to date. It is also worth mentioning that some strategists believe China is a bubble economy, especially the housing market. This is weighing on some investors' minds, although we do not subscribe to the bubble view.

In contrast to the gloomy macro picture, at the individual corporate level the environment is quite robust. In general, corporates have strong balance sheets with ample cash, strong margins and limited refinance pressure. Top-line sales have been slightly weak but credit quality is high. Default rates in non-investment grade markets have been falling sharply. This gives us confidence that credit fundamentals have support in the medium term. The key local influence for credit spreads is the banking sector, specifically funding issues and eventual regulatory reform. The four "majors" have significant amounts of wholesale funding to complete in coming years and as a result of proposals regarding banking liquidity regulations, they will no longer be able to help each other by investing in bank bonds as "liquid assets". The threat of sizable new issuance will keep a floor under local senior bank spreads and, by implication, the wider Australian credit market, given the relative lack of non-bank credit.

Our strategy in recent months has been to reduce our credit exposure to a smaller overweight, mostly through hedging with Itraxx CDS contracts and the swap market, but also by selling the cash credit which we viewed as overpriced. It is likely we will retain this cautious stance with current fund positioning providing a relatively small exposure to credit risk and giving us the flexibility to change fund positioning when the market outlook becomes clearer.

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	0.05%/0.10%
Fund Size	A\$400.602m
Redemption Unit Price	\$1.1381

Important information

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

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