

Aberdeen Balanced Fixed Income Fund



Investment objective

To provide exposure to a diversified portfolio of high quality fixed income investments. The Fund aims to outperform a benchmark based on the various sector market indices weighted according to the benchmark asset allocation over the suggested investment time frame.

Investment strategy

The investment strategy of the Fund is to obtain exposure to a range of predominantly domestic fixed income sectors including Australian fixed income, inflation linked bonds and cash with significant exposure to international fixed income investments.

The Fund primarily aims to gain diversification from industry/sector selection, security selection, credit quality and country selection. This results in a conservative, actively managed diverse fixed income portfolio.

Performance summary

	1 Month %	3 Months %	1 Year %	3 Years % pa	5 Years % pa	Since Inception ¹ % pa
Aberdeen Balanced Fixed Income Fund Net returns*	0.16	2.92	10.60	8.38	6.52	7.03
Aberdeen Balanced Fixed Income Fund Gross returns**	0.20	3.03	11.06	8.82	6.95	7.49
Blended benchmark	0.28	3.29	8.63	7.83	6.27	6.99
Net returns* vs Index	-0.12	-0.37	1.97	0.55	0.25	0.04
Gross returns** vs Index	-0.08	-0.26	2.43	0.99	0.68	0.50

* 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. Retail investors should refer to net returns.

¹ This figure represents the annualised performance of the Fund from the first full month of operation in January 1997.

Please note: Prior to 1 May 2009 the Fund was known as the Credit Suisse Balanced Fixed Income Fund.

Past performance is not a reliable indicator of future results.

Performance review

The Balanced Fixed Income Fund returned 0.20%, underperforming the benchmark return by 0.08% (both before fees). The underperformance was largely driven by the allocation to Australian Fixed Income which underperformed its benchmark in July. The Fund's allocation to Inflation Linked Bonds and International Fixed Income added to performance.

Market review

Australian Fixed Income - 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 5.20% - but finished the month some distance below their highs. July began with yields at one year lows, with rate cuts priced in. The probability of further RBA hikes increased with strong employment data for June, after which the market lacked direction for a few weeks while waiting for the 28 July 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.

Portfolio structure and investment parameters¹

	Fund %	Min %	Max %
Australian Fixed	57.17	30	90
International Fixed	20.32	10	60
Inflation Linked Bonds	17.47	0	30
Cash	5.04	0	40

¹ We will provide you with information about any changes to the Fund's benchmark asset allocation via our website www.aberdeenasset.com.au, where permitted by law

Further information

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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.

Global Fixed Income - In government bond markets, yields generally fell in July and curves steepened as fears of a double-dip recession re-emerged after a raft of disappointing economic data in the US. 2 year yields finished the month at their lows for the month at 0.54% - 8bps lower for the month. The 10 year yield spent the majority of the month below 3.00% as it finished the month at 2.90%, 4bps lower in yield. US economic data weakness continued with a weak Non-Farm Payrolls report and another poor retail sales print. Fed Chairman Bernanke was less than upbeat when describing the US economic situation as "unusually uncertain".

Peripheral European government bond markets recovered significantly over the month led by Spain, who benefited most from the announcement of the positive bank stress test results. German government bonds underperformed due to the stronger tone in peripherals.

Global credit markets retraced some of their recent weakness, as a calming of concerns over European sovereign risk, a generally positive reception to the European banking stress tests and a watering down of tough new bank capital proposals led to a rally in risk assets during the second half of the month.

In the currency markets, the US dollar was the worst performing major currency as improving sentiment towards Europe led to strength in higher risk currencies.

Inflation Linked Bond - The release of June quarter inflation data was the focus for the month of July, with a lower than expected increase in inflation hitting short breakevens hard (the entire market had been expecting a more markedly positive inflationary outcome). The 2015 bond breakeven fell 14 basis points over the month, in comparison to the 2020 bond break even which fell by only 1 basis point (although bigger falls were experienced intra-month). Breakeven inflation as measured by zero coupon swaps displayed similar performance, with shorter-dated inflation expectations falling by more than longer-dated inflation expectations. In fact, the inversion that was exhibited in this curve during May and June has largely, and justifiably, been priced out.

As always, any consideration of the market's expectation for future inflation, as measured by the break-even inflation rate, should not take place in isolation. This is because movements in nominal yields are almost always highly correlated to these changes in the market's inflation expectation, as has been seen in price action for most of 2009-10. July, however, represented a break in this relationship. With nominal yields rising 10 basis points, break even inflation would usually have been expected to rise by around 8 basis points. Yet break even inflation rates actually fell, and this significant underperformance underpins the marked effect that the weaker than expected inflation data had on the market.

The only supply for the month came in the form of a strong tender for 2020 maturity Government capital indexed bonds. This issue was well received, with almost \$1.2 billion of bids competing for \$200 million of stock. Only three bids were accepted, with Aberdeen funds among the successful bidders. The market is now focussed on the significant benchmark extensions which will take place on August 20 upon the maturity of the 2010 Government capital indexed bond. Following this, the market will focus on the new 2030 capital indexed bond that is expected to be issued by the Government, following a syndication process, in September or October.

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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.

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. 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 the APS210 proposals, they will no longer be able to help each other by investing in bank bonds as "liquid assets".

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 a more modest overweight allocation to credit compared to the mid 2009 environment, for example.

Key information

APIR Code	CSA0104AU
Benchmark	Weighted average of sector market indices
Date of Launch	January 1997
Income Payable	30 June and 31 December
MER	0.42% pa
Fund Size	A\$75.243m
Buy/sell Spread	0.05%/0.15%
Redemption Unit Price	\$0.9425

Important information

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

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