

## Fixed Income - performing when it matters most



In this edition of the Aviva Investors Quarterly Review, Nick Tribe, Senior Manager, Fixed Income, takes a look at the current climate and specifically the fixed income space and its outlook for 2009.

The year 2008 was certainly a remarkable year.

Fixed income markets were at the epicentre of what is now being referred to as the GFC – Global Financial Crisis, the causes of which were highlighted in the September edition of the Quarterly Review. But how has the fixed income market performed during this period? Well it depends where you were invested. The more of your fixed income allocation that was invested towards credit, the lower your returns would have been, as credit was not the place to be in 2008 from a fixed income perspective.

Let's have a look at the performance of the components of the UBS Composite Bond Index for the full year, remembering that this index is the fixed income market equivalent of the "All Ords". It is the most widely used benchmark in Australia for fixed income products.

The table below shows the major sector returns that comprise the UBS Composite Bond Index:

Sector	1 year	6 months	3 months
Government Bonds	19.1%	15.7%	8.5%
Semi-government Bonds	16.2%	12.7%	6.3%
Corporate Bonds	10.7%	8.7%	5.4%
Supra/Sovereign Bonds	15.3%	12.1%	5.5%
UBS Composite Bond Index	15.0%	12.0%	6.3%

**Table 1 - Major fixed income sector returns (2008)**

Source: UBS

Simplistically the return of a fixed income security is made up of the running yield, or the effective interest rate earned, and capital movements. When yields fall capital gains are generated, and the reverse is true when yields rise.

Some key observations from Table 1:

- Commonwealth Government bonds, often considered to be risk free, were the place to be in 2008 given they benefited from the flight to quality, pushing yields down more than the other sectors.
- Semi-government bonds were not far behind given they are highly rated, liquid and the next best thing to a Commonwealth Government bond.
- Corporate bonds still delivered a respectable return but lagged the returns of the government and semi-government bond markets as they did not fall as much in yield, so had less capital gains.
- Supra/sovereign bonds, holding similar characteristics, performed broadly in line with semi-government bonds.

The reason investors have fixed income in a diversified portfolio is to provide exactly that – diversification. As shown in Table 1, by having an allocation to fixed income – and we mean the more traditional type – a portfolio would have benefited from strong returns and offset some of the losses from sharemarket exposures. It is proof that fixed income provides "insurance"; performing when it counts. 2008 was a year when investors needed it to perform and it did – remaining true to label. In fact, the fixed income market delivered its second highest calendar year return since the end of 1994.

So in light of the exceptional returns of late, is the coming year the time to avoid fixed income in favour of cash options? For the following reasons we would say resoundingly "no":

- Fixed income is still likely to outperform cash given it has an average running yield of 4.9%, above the current cash rate of 4.25% which is highly likely to fall even further through monetary policy easing.
- Historically the fixed income market has outperformed cash in the two years following the last official cash rate hike – we are currently not even one year into this period.

- Credit markets – which struggled so much last year – are likely to deliver better returns than government bonds this year because they have a high starting yield, as well as offering the prospect of capital gains as market participants become less risk averse.
- In terms of government bonds, inflation is very much last year's news and is unlikely to be a factor this year and possibly into 2010. This should allow interest rates to be cut further and remain at lower levels for some time, providing the potential for capital gains, further boosting returns.

For some time now we have been talking about having a diversified fixed income allocation because it's better for you long term. Better in the sense that "through the cycle" by having a mix of traditional Australian fixed income, international fixed income, and the ability to have exposure to higher yielding securities, inflation linked bonds and cash will deliver a better risk return profile when compared solely to cash or Australian fixed income.

This is why our flagship offering is a diversified fixed income fund, the Aviva Investors Premier Fixed Income Fund. Importantly its foundation remains the Australian fixed income market, together with an allocation to the international fixed income market as well as an exposure to higher yielding securities. The characteristics of this fund provide diversification; ensuring your fixed income allocation will still perform when it counts, as well as providing the diversification benefits of fixed income when used as part of an overall portfolio.

Our Premier Fixed Income Fund delivered a very healthy gross return of 10.7% over the course of 2008. As we enter 2009 the fund is well placed to produce another year of strong returns – the average yield of the fund is attractive, currently at 6.1%, which is 1.6% above its benchmark yield, and well above the prevailing official cash rate of 4.25%, which is expected to fall even further throughout the year.

Falling inflation and a weak economy allow for even lower interest rates and the potential for further capital gains. Additionally the fund remains exposed to higher yielding securities via the fund's high yield component. These are largely better quality securities caught up in the current credit crisis and now offer very attractive yields in the order of 13.8%. As such, another year of possible double-digit returns remains in prospect.

## Market Review

The condition of the Australian equity market worsened in the December quarter, as sharemarkets around the world felt the full pain of the fallout from the sub-prime mortgage lending fiasco – most dramatically exemplified by the collapse of Lehman Brothers in the US. Global recession is upon us, with the US, Japan and Europe officially in recession. Corporates are having to deal with a sluggish or falling economy and the impact of the global credit crunch. The key for the broader markets is how much bad news has already been priced into the market. On a positive note global policy makers have reacted decisively to restart global activity.

Domestically, the S&P/ASX200 Index fell 19.1% over the quarter as the credit crisis spread into the real economy. There was a sharp deterioration in economic expectations and capital raisings were extensive, especially amongst the banks, as companies looked to shore up balance sheets and replace debt with equity. This balance sheet strength was a focus for investors throughout the quarter, as were prospects for 2009, as corporate earnings took a back seat. Merger activity was relatively quiet, with the most noteworthy possible unions being abandoned including BHP Billiton/Rio Tinto, Qantas/British Airways, and ABB Grain/AWB.

Despite the worsening global outlook, the Resources sector performed slightly better than the broader market (down 18.7%), assisted by a large fiscal stimulus package announced by China, and the encouraging performance of BHP Billiton

(down 1.8%) following its rejection of a takeover bid for Rio Tinto.

Driving the market's performance over the quarter was Newcrest Mining (up 22.7%), Sino Gold Mining (up 19.6%), and Tatts Group (up 17.2%). Detractors were Babcock & Brown (down 92.0%), HFA Holdings (down 91.4%), and ING Industrial Fund (up 91.0%).

As global central banks slashed their official lending rates, so did the Reserve Bank of Australia (RBA), with steep cuts in the December quarter. The official cash rate fell from 7.0% to 4.25% in the quarter, with a total of 3% cut in the last four months, effectively unwinding six years of rate hikes.

Fixed Income markets remained volatile but in a trend to lower yields and steeper yield curves. The key 3-year and 10-year Government bonds closed the quarter lower in yield by 1.78% and 1.4% respectively at 3.29% and 4.0%. The UBS Composite Bond Index delivered a positive return of 6.34%.

Below are short commentaries on each Aviva Investors fund, outlining their gross performance and the main contributors to performance.

**Australian Equities Fund** - the fund returned -16.5% for the December quarter, outperforming the Benchmark S&P/ASX 200 Accumulation Index return of -18.3% by 1.8%. The main contributors to performance for the portfolio over the quarter were an underweight position in Commonwealth Bank and an overweight position in Sonic Healthcare. Stocks detracting from performance were overweight positions in Rio Tinto and Asciano Group.

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**Dividend Builder** - the fund delivered a return of -18.9% for the quarter, underperforming the Benchmark S&P/ASX 200 Industrials Accumulation Index of -18.1% by 0.8%. Overweight positions in Foster's Group and Telstra Corporation positively contributed to performance, while stocks detracting from performance included an overweight position in Wesfarmers and a zero weighting in Woolworths.

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**Elite Opportunities Fund** - the fund returned -15.6% for the quarter, outperforming the Benchmark S&P/ASX 200 Accumulation Index return of -18.3% by 2.7%. The main contributors to performance for the portfolio were overweight positions in Newcrest Mining and Origin Energy. Being overweight Rio Tinto and Asciano Group detracted from performance over the quarter.

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**High Growth Shares Fund** - the fund returned -13.3% for the quarter, outperforming the Benchmark S&P/ASX 200 Accumulation Index of -18.3% by 5.0%. The main stocks to contribute to performance during the December quarter were overweight positions in Newcrest Mining and Queensland Gas Company. Main detractors from performance were an overweight position in Rio Tinto and an underweight position in Woolworths.

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**Small Companies Fund** - the fund delivered a return of -31.4% for the quarter, underperforming the Benchmark S&P/ASX Small Ordinaries Accumulation Index of -29.2% by 2.2%. The main contributors to performance for the portfolio were overweight positions in Queensland Gas Company and Invocare. Stocks detracting from performance over the December quarter were overweight positions in Nomad Buildings Solutions and NRW Holdings.

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**Sustainable Investment Fund** - the fund returned -14.7% for the quarter, outperforming the Benchmark S&P/ASX 200 Accumulation Index of -18.3% by 3.6%. The main contributors to performance for the portfolio during the December quarter were overweight positions in Sonic Healthcare and Origin Energy. Stocks detracting from performance were overweight positions in Asciano Group and WorleyParsons.

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**Listed Property Fund** - the fund returned -25.7% for the December quarter, outperforming the Benchmark S&P/ASX 200 A-REIT Accumulation Index of -32.9% by 7.2%. Positively contributing to performance during the quarter were zero weightings in ING Industrial Fund and Macquarie Office Trust. Stocks detracting from performance were underweight positions in CFS Retail Property Trust and Westfield Group.

**Premier Fixed Income Fund** - the fund delivered a positive return of 3.8% for the quarter, underperforming the Benchmark<sup>1</sup> return of 5.9% by 2.1%, but comfortably outperforming cash returns of 1.7%. Contributing positively to performance over the quarter was successful switching activity between Australian versus offshore bonds, a yield curve steepening bias, and positioning within the international fixed income allocation where a Government-related bias was maintained. The major detractors to performance were the fund's overweight exposure to high yield securities and semi-government bonds, and an overweight holding of Australian bank subordinated debt. High yield in particular underperformed strongly as credit-related spreads continued to widen.

1 Benchmark is 75% UBS Australian Composite Bond Index & 25% Barclays Capital Global Aggregate Bond Index (hedged in \$A)

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**High Yield Fund** - the fund delivered a return of -7.7% for the quarter, underperforming its Benchmark<sup>2</sup> by 12.7% over the same period. It should be remembered that there is no true benchmark for higher yield products available in Australia. The one used by this product contains a mixture of government, semi-government and high quality investment grade bonds, whereas the High Yield Fund invests in domestic hybrid securities, asset backed and higher yielding corporate bonds. The fund's exposure to financials and real estate were the biggest detractors from performance over the quarter.

2 Benchmark is UBS Australia Composite 0-5 Year Index

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**Income Plus Growth Fund** - the fund returned -8.2% for the quarter, underperforming the Benchmark<sup>3</sup> by 3.6%. The main detractor to performance came from the fund's credit investments, in particular the fund's exposure to financials and real estate. In terms of the fund's Australian equities holdings the main contributors to performance during the December quarter were overweight positions in Coca-Cola Amatil and Foster's Group. Stocks detracting from performance were an overweight position in Fairfax Media and a zero weighting in Woolworths.

3 Benchmark is 40% S&P/ASX200 Industrials Accumulation Index & 60% UBS Australia Composite 0-5 Year Index

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**Australian Shares Fund\*** - the fund delivered a return of -16.5% for the quarter, outperforming the Benchmark S&P/ASX 200 Accumulation Index of -18.3% by 1.8%. The main contributors to performance over the quarter were an underweight position in Commonwealth Bank and an overweight position in Sonic Healthcare. Stocks detracting from performance were overweight positions in Rio Tinto and Asciano Group.

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\*Closed to new investments

# Aviva Investors Investment Returns

## Performance to 31 December 2008 (net of fees)

		3 mths %	1 yr %	2 yrs % pa	3 yrs % pa	4 yrs % pa	5 yrs % pa	Since Inception % pa	Inception Date
<b>Australian Equities</b>									
<b>Aviva Investors Australian Equities Fund</b>	Distribution	1.2	5.6	7.5	9.8	8.8	7.7	9.4	03/07/1995
	Growth Return	-17.9	-40.0	-20.2	-11.8	-5.2	-0.7	-0.2	
	Total Return	-16.7	-34.4	-12.7	-2.0	3.6	7.0	9.2	
<b>Aviva Investors Dividend Builder</b>	Distribution	2.5	3.8	5.3	6.0			5.8	06/09/2005
	Growth Return	-21.5	-40.7	-23.9	-12.2			-10.1	
	Total Return	-19.0	-36.9	-18.6	-6.2			-4.3	
<b>Aviva Investors Elite Opportunities Fund</b>	Distribution	1.5	7.3	10.1	15.9	16.3	14.7	13.0	18/11/2002
	Growth Return	-17.2	-38.2	-21.3	-16.8	-11.8	-5.9	-1.8	
	Total Return	-15.7	-30.9	-11.2	-0.9	4.5	8.8	11.2	
<b>Aviva Investors High Growth Shares Fund</b>	Distribution	0.0	6.0	10.0	12.8	13.9	14.2	13.3	07/12/1999
	Growth Return	-13.7	-38.8	-18.8	-14.1	-9.2	-6.3	-2.4	
	Total Return	-13.7	-32.8	-8.8	-1.3	4.7	7.9	10.9	
<b>Aviva Investors Small Companies Fund</b>	Distribution	0.8	9.9	14.6	22.1	25.1	23.2	16.0	19/11/1999
	Growth Return	-32.3	-58.0	-34.5	-25.2	-23.6	-17.3	-8.3	
	Total Return	-31.5	-48.1	-19.9	-3.1	1.5	5.9	7.7	
<b>Aviva Investors Sustainable Investment Fund</b>	Distribution	1.0	12.8	29.4				24.6	16/02/2006
	Growth Return	-15.9	-44.8	-39.7				-28.1	
	Total Return	-14.9	-32.0	-10.3				-3.5	
<b>Aviva Investors Australian Shares Fund *</b>	Distribution	1.1	17.0	18.2	19.2	19.9	19.3	14.4	25/01/2000
	Growth Return	-17.8	-51.6	-30.8	-21.5	-16.5	-12.2	-7.7	
	Total Return	-16.7	-34.6	-12.6	-2.3	3.4	7.1	6.7	
<b>Listed Property</b>									
<b>Aviva Investors Listed Property Fund</b>	Distribution	0.2	2.5	4.3	6.2	9.5	10.4	9.3	28/02/1994
	Growth Return	-26.1	-51.2	-32.8	-18.3	-15.9	-9.9	-2.7	
	Total Return	-25.9	-48.7	-28.5	-12.1	-6.4	0.5	6.6	
<b>Fixed Income</b>									
<b>Aviva Investors Premier Fixed Income Fund</b>	Distribution	1.4	6.0	6.0	5.7	6.1	5.8	6.5	31/05/2000
	Growth Return	2.3	4.3	1.1	0.2	-0.1	0.6	0.2	
	Total Return	3.7	10.3	7.1	5.9	6.0	6.4	6.7	
<b>Aviva Investors High Yield Fund</b>	Distribution	1.7	5.7	5.8	5.9	6.2		5.7	21/01/2004
	Growth Return	-9.6	-15.8	-10.4	-7.1	-5.6		-3.8	
	Total Return	-7.9	-10.1	-4.6	-1.2	0.6		1.9	
<b>Aviva Investors Income Plus Growth Fund</b>	Distribution	1.9	6.9	7.0	6.9	6.7	6.5	6.6	31/03/1998
	Growth Return	-10.3	-22.5	-13.6	-7.8	-5.3	-2.8	-1.2	
	Total Return	-8.4	-15.6	-6.6	-0.9	1.4	3.7	5.4	

\*Closed to new investments

Disclaimer: All returns are based on exit to exit unit prices for Professional Selection units, are net of fees and assume the reinvestment of income. Past performance is not a guide to or indication of future performance. At Aviva Investors' discretion, the management and/or performance fee may be partly rebated to professional, sophisticated or wholesale investors. The above information is of a general nature and has been prepared without taking account of your individual investment objectives, financial situation or particular investment needs. It is not intended as financial advice to retail clients. Before making an investment decision, you should consider the appropriateness of the information, having regard to your objectives, financial situation and needs. We recommend you consult with your financial adviser, who can help you determine how best to achieve your financial goals and whether investing in a fund is appropriate for you. Investment in the Aviva Investors Investment Funds will only be made upon receipt of a completed application form from the current PDS, a copy of which can be obtained from Aviva Investors.

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