

UBS Diversified Fixed Income Fund

December 2021

Fund description

The Fund is an actively managed, diversified portfolio of Australian and global fixed income assets.

Investment strategy

The strategy is managed employing both top-down macroeconomic research and bottom-up security specific analysis to build a portfolio with the core defensive characteristics of the fixed interest asset class. Whilst the Fund seeks to be fully hedged to Australian dollars, we may invest in strategic foreign currency exposures that will not exceed 10% of the total portfolio.

Investment return objective

The Fund is actively managed, based on fundamental research that draws upon the investment insights of our fixed income teams. The approach employs both "top-down" research, including analysis of economic factors, market data and macro credit themes and "bottom-up" research in respect of particular securities including analysis of earnings and cash flow stability, balance sheet strength, industry and valuation.

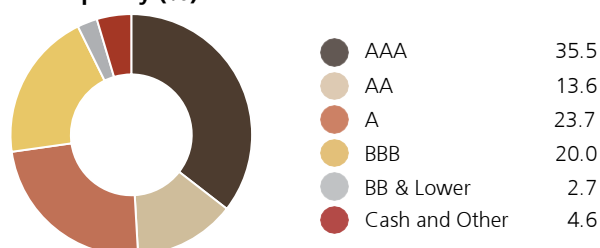
Key statistics	Fund	Benchmark ¹
Modified duration (yrs)	6.09	6.68
Spread duration ² (yrs)	4.34	3.27
Weighted avg maturity (yrs)	6.92	7.66
Average credit quality	A1	Aa2
Yield to maturity ³ (%)	1.79	1.34

¹ Benchmark statistics do not reflect month end rebalancing for new issues and reinvestment of coupons.

² Option adjusted spread duration ex Treasury.

³ Yield to Maturity (YTM) is the estimated annualised rate of return that would be received if the Fund's current securities were all held to maturity. Note that YTM does not account for fees or taxes. YTM is not a forecast, and is not a guarantee of the future return of the Fund.

Credit quality (%)



Note: Credit ratings for physical holdings only, 'cash and other' includes the effect of derivatives.

Fund information

Inception date	31 January 1997
Fund size	\$ 834.9 m
Management fee	0.55% pa
Minimum initial investment	\$50,000
Distribution frequency	Quarterly
Buy/sell spread	+ 0.05% / - 0.15%
APIR code	SBC0007AU

Fund positioning – modified duration contribution (yrs)

By sector	Fund	Benchmark
Government nominal ⁴	2.53	4.21
Government inflation-linked	0.22	0.00
Semi-government	0.90	0.94
Government related	0.83	0.51
Corporates	1.35	0.81
Financials	0.43	0.25
Industrial	0.73	0.47
Utility	0.19	0.09
Securitised	0.27	0.22

By Country

Australia	3.01	2.98
USA	0.80	1.45
Japan	0.49	0.61
Canada	-0.02	0.12
Euro area	0.82	0.86
UK	-0.05	0.28
New Zealand	0.41	0.00
China	0.59	0.22
Other	0.03	0.16

⁴Includes derivatives.

Investment performance

Fund	1 month %	3 months %	1 year %	3 years % pa	5 years % pa	Since inception* % pa
Total return	0.11	(0.97)	(2.47)	2.60	2.96	5.67
Benchmark**	(0.17)	(0.70)	(2.18)	3.20	3.27	6.11
Added value	0.28	(0.27)	(0.29)	(0.60)	(0.31)	(0.44)

*Inception date: 31 January 1997. **50% Bloomberg AusBond Composite 0+ Yr Index / 50% Bloomberg Global Aggregate (hedged to \$A). Performance figures are net of ongoing fees and expenses. The performance figures quoted are historical, calculated using end of month redemption prices, and do not allow for the effects of income tax or inflation. Total returns assume the reinvestment of all distributions. Performance can be volatile and future returns can vary from past returns.

Market highlights

- Australian Government bond yields traded in a tight range.
- Australian credit spreads were broadly stable.
- The RBA remained cautious with key decision on tapering to be made in Feb 2022.

Performance review

US government bond yields gradually rose throughout December, as volatility surrounding the omicron variant subsided and the market began focusing on the implications of the Fed's upsized tapering and the potential for swifter policy tightening. Credit spreads tightened in December, with high yield spreads tightening more than investment grade and retracing the omicron-induced widening from the previous month. Total returns were generally positive in the high-beta segments and negative in higher quality, rate sensitive segments of the fixed income market as rates rose during the month.

In the US, Congress was able to pass a bill that keeps the government funded for another few months and struck a deal to raise the debt ceiling. But the Build Back Better legislation - President Joe Biden's USD 1.75 trillion investment package in social and climate programs - suffered a setback after a key Democratic senator withdrew his support. On the economic front, inflation and supply chain issues remained in the spotlight as headline consumer price index rose 6.8% in November, its biggest annual increase since 1982. The Fed took a more hawkish turn at its December meeting, announcing an accelerated tapering of bond purchases at a pace of USD 30bn per month.

The Australian bond market delivered a slight positive return in December and domestic government bond yields traded in a tight range. The Australian 3-year Government bond yields rose 4bps to 0.91% while 10-year bonds yields fell 2bps to 1.67% over the month. The spread between Australian 10-year and US 10-year Government bond yields narrowed, ending the month at +16bps (from +25bps at the end of the prior month). Credit spreads were relatively unchanged while semi-government bond spreads tightened marginally over the month. The Bloomberg AusBond Composite 0+Yr Index returned 0.09% in December.

Our duration positioning delivered positive performance over December as the UK and US central banks moved to tighten policy settings, while others remained cautious, especially in light of the spread of the omicron variant of COVID-19. Our overweight duration positions in Australia, New Zealand and China contributed positively to relative performance while underweight positions in the UK and the US were also positive contributors, with both Gilt and Treasury yields rising over the month. Elsewhere, our overweight position in investment grade credit also made a positive contribution, with spreads recovering some of their widening in November. Spread contraction was more pronounced in the US and European markets and less so in Australia.

Outlook

We continue to expect the global economic expansion to proceed, albeit unevenly as the spread of COVID-19 (including new variants) impacts economies unequally and as policy support diminishes at different speeds. We remain confident that the Australian economy will continue to rebound strongly amid high vaccine coverage, stronger political will to avoid future lockdowns and a high household savings rate. Improving expectations for domestic growth has seen an increased sensitivity of Australian government bonds to global equivalents resulting in some cyclical upward pressure on yields. We are however conscious that there are limits to how far long-dated bond yields can get dragged higher, especially given longer-dated forward rates have not got far to travel before they start to look high in the context of an overleveraged global economy.

Another feature of the global recovery that we are tracking closely is the high incidence of supply bottlenecks and the impact on inflation. These disruptions have emerged in sectors such as lumber, shipping and now the energy sector. So far, Australia has avoided the worst of the inflationary pressures experienced by the likes of the UK, US and even the Eurozone but there is uncertainty as to whether this will remain the case as the larger states of New South Wales and Victoria re-open. We note that the Q3 inflation release surprised to the upside with the trimmed mean measure running at 2.1%. While this is still well below peers, underlying inflation is now within the RBA's 2-3% target band for the first time in six years and it is plausible that it could hit the mid-point sometime next year.

Higher domestic inflation as well as a global shift in a hawkish direction from other Anglo-Saxon central banks has caused a sharp jump in short-dated yields culminating in the RBA's Yield Curve Control formally being renounced in November. Some more volatility is expected as bonds try and find a more market-determined level, with the US Federal Reserve having increased the pace of its tapering and also as QE is being wound down here in Australia. However, at the time of writing, it appears that any future RBA tightening looks well-priced with 75bps of implied hikes factored in for 2022 and an implied terminal cash rate above 2% in five-years' time. The latter is above our central estimate of c.1.5%.

Meanwhile, credit spreads have been relatively resilient, despite some weakness in global equities. We expect investor demand to remain strong so long as official cash rates are at or close to zero and investors globally continue their reach for yield. The accumulated and still growing stock of bonds on global central banks' balance sheets will also underpin demand for high quality credit and is likely to help keep a ceiling on any spread widening episodes. Based on this backdrop, we expect the Australian corporate credit market will continue to perform reasonably well.

Client Services

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