

UBS Australian Bond Fund

March 2022

Fund description

The Fund is an actively managed, diversified portfolio of largely investment grade fixed income securities, cash equivalents and cash.

Target market

The Target Market Determination (TMD) for the Fund sets out the class of consumers for whom the product, including its key attributes, would likely be consistent with their likely objectives, financial situation and needs. To access to the TMD and other Fund documentation visit our [website](#).

Investment strategy

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.

The Fund’s investment strategy is to invest in a portfolio of largely investment grade fixed income securities, cash equivalents and cash.

Investment objective

The Fund aims to outperform (after management costs) the Bloomberg AusBond Composite 0+Yr Index over rolling three year periods.

Key statistics

	Fund	Benchmark ¹
Modified duration (yrs)	5.50	5.47
Spread duration ² (yrs)	3.67	2.09
Weighted avg maturity (yrs)	6.28	6.28
Average credit quality	AA	AA+
Yield to maturity (%)	3.11	1.88

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

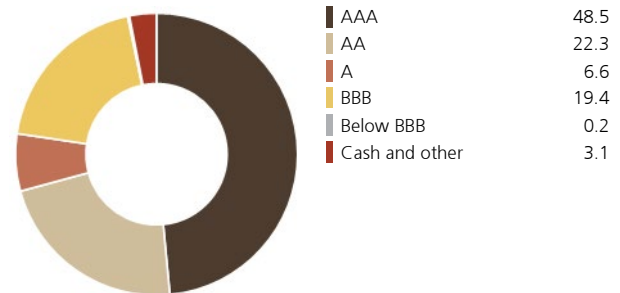
² Option adjusted spread duration ex Treasury.

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.

Fund information

Inception date	30 November 1989
Fund size	\$ 858.0 m
Management fee	0.45% pa
Minimum initial investment	\$50,000
Distribution frequency	Quarterly
Buy/sell spread	+ 0.025% / - 0.08%
APIR code	SBC0813AU

Credit quality (%)



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

Fund positioning – modified duration contribution (yrs)

By Sector	Fund	Benchmark
Government nominal ⁴	1.97	3.37
Government inflation-linked	0.00	0.00
Semi-government	1.73	1.49
Government related	0.67	0.36
Corporates	1.05	0.24
Financials	0.48	0.10
Industrial	0.40	0.11
Utility	0.17	0.03
Credit hedge ⁵	0.00	0.00
Securitised	0.08	0.01
Cash and cash equivalents	0.01	0.00

By Tenor	Fund	Benchmark
0–3 year	0.33	0.38
3–5 year	0.76	0.68
5–7 year	0.85	0.91
7–10 year	1.40	1.79
10+ years	2.16	1.70

⁴ Includes derivatives. ⁵ Spread duration contribution.

Investment performance

Fund	1 month %	3 months %	1 year % pa	3 year % pa	5 years % pa	Since inception* % pa
Total return	(3.90)	(6.16)	(5.90)	(0.55)	1.68	7.16
Benchmark**	(3.75)	(5.88)	(5.55)	(0.32)	1.86	7.16
Added Value	(0.15)	(0.28)	(0.35)	(0.23)	(0.18)	0.00

*Inception date: 30 November 1989. **Bloomberg AusBond Composite 0+ Yr Index.

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 rose across the term structure.
- Australian credit spreads widened over March.
- The RBA kept cash rate target at 0.10% in the March meeting and continued with their longstanding “patient” narrative.

Performance review

Yields rose in March, especially at the front end of the curve, as investors positioned for a faster pace of central bank policy tightening in response to elevated inflation. 10-year US Treasury yields climbed 51bps to 2.34%. The 2-year/10-year portion of the curve inverted briefly for the first time since August 2019. In Europe, yields on 10-year German Bunds climbed 39bps to 0.55%. Most major fixed income sectors generated negative returns driven by higher yields despite tighter credit spreads during the month.

The Australian bond market delivered negative return in March as domestic government yields rose strongly across the term structure with a larger impact on the front-end, and credit spreads widened. The Australian 3-year Government bond yields rose 80bps to 2.34% while 10-year bonds yields rose 70bps to 2.84% over the month. The spread between Australian 10-year and US 10-year Government bond yields widened, ending the month at +50bps (from +31bps at the end of the prior month). Domestic credit spreads referenced by the Bloomberg Ausbond Credit 0+Yr Index, widened 18bps from 90 to 108bps.

An emerging ESG theme in the REITs space is the differentiation of issuers by sustainability measures. Traditionally, buildings have been differentiated by quality, i.e., Prime vs A-Grade vs B-Grade, but we assert that in the future, buildings will increasingly be differentiated by NABERS ratings given the increasing focus by tenants and investors on low carbon emissions. NABERS is an energy rating system which assesses assets on a scale of 0 to 6 stars, 6 being the most energy efficient. Whilst there has been limited evidence so far that higher NABERS scores result in materially higher rents, we think landlords’ investment into greener buildings is an important future proofing strategy which could ultimately result in higher tenant demand, higher occupancy, lower outgoings and higher valuations. The flipside is landlords which have not invested in efficiency measures and have lower average NABERS ratings face lower demand and higher vacancies as well as large future capex requirements given the high construction or upgrade costs associated with building green assets. One such REIT we think will benefit from this theme, and is a core holding in the fund, is the Dexus

Wholesale Property Fund (DWPF). The REIT benefits from the wider Dexus Group’s leadership in ESG - it has a 5.2 NABERS Energy rating in its office portfolio (vs. national market average of 4 stars) and an aggressive net zero emissions target of 2022. The fund has also been named GRESB sector leader in the last quarter for the third consecutive year and Dexus Group achieved the top-ranking score amongst 237 real estate participants in the 2021 Dow Jones Sustainability Index (DJSI) assessment. For these reasons, we rate DWPF highly in our internal ESG scoring system. In an environment where more and more companies are becoming ESG-aware and looking to lower their carbon footprints, we think REITs such as DWPF will have a competitive advantage.

Australian Government bond yields rose strongly over the month. We took profit on our short duration position over the course of March. We ended the month with an overall neutral duration positioning.

On global rates exposures, our existing spread tightener position - short US duration against New Zealand interest rate swaps - contributed a slight positive to relative performance as this spread tightened slightly over the month. We also initiated another spread tightener position, short US duration against long Australian duration over the course of the month as spreads have widened to an attractive level where we think they will likely converge over time given the economic outlook expectation of both markets.

Australian credit spreads across all sectors widened over the month with the corporate sector being impacted the most. The portfolio’s overweight positions across Australian supranational and corporates contributed negatively as spreads widened. Over the month, we added positions in the supranational sector through purchasing a 10-year bond from National Housing Finance and Investment Corp, as well as in the corporate sector through participating in an attractively priced new 7-year bond issue from the University of Monash.

Conversely, spreads in the Australian semi-government sector remained relatively stable and our overweight position contributed a slight positive to relative performance.

Outlook

We wrote at the start of the year that bond yields were more likely to be biased higher in the months ahead particularly at the front-end of government yield curves as central bank tightening gathers pace. This turned out to be an understatement as continued upside surprises in inflation has seen an aggressive re-pricing of rate hike expectations across the globe and some of the largest quarterly losses on major bond indices on record, including the Ausbond Composite (-5.88%).

Having been a better seller of duration in Q1, we assess the outlook to be much more balanced in Q2. To be sure the near-term outlook for the Australian economy remains strong with most COVID restriction gone while pre-election fiscal handouts and a high savings rate should support nominal household spending. At the same time, we are observing an acceleration and broadening out of inflation. Higher energy and food prices should contribute to another strong inflation release in Q1 after a bumper 1.0% q/q increase in the RBA's preferred trimmed mean measure in Q4. All told, we expect the coming months to see the unemployment rate fall through 4% - the level thought to represent full employment – underlying inflation to comfortably breach the upside of the RBA's 2-3% target band and wages to also show stronger upside momentum.

As a result, it looks like a matter of time before the RBA drops its patient approach to the cash rate and follows in the footsteps of other Anglo-Saxon central banks in hiking, potentially as early as June. Yet we don't think this tightening will outpace the Federal Reserve, which is now openly entertaining moving in 50bps increments, nor reach the 3%-plus terminal rate that is currently baked into the forwards given the high sensitivity of households to mortgage rates. We also note that the 10-year yield is sitting close to 3%, a level that it hasn't breached since 2015. All told, ACGBs are beginning to look cheap, although high global rate volatility means we prefer to express this view in cross-market positions for now.

It is our view that this tightening of monetary conditions, including a drying up of the flow of central bank QE and higher real yields, as well as conflict in Ukraine provides a more challenging outlook for corporate credit than 2021. The recent moves wider in spreads to the 2018/19 wides restores some risk premium and puts spreads back closer to what we'd categorise as fair value. We continue to think the relatively low duration and high quality of Australian credit should see it outperform other markets such as the US.

Client Services

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