

# Perennial Australian Fixed Interest Trust

Monthly Report as at 31 July 2010

	Month %	Quarter %	FYTD %	1 Year %	2 Years % p.a.	3 Years % p.a.	5 Years % p.a.
Perennial Australian Fixed Interest Trust*	0.44	3.21	0.44	10.20	11.32	9.14	7.04
UBS Composite Bond Index (0+years)	0.27	3.31	0.27	7.81	8.51	7.53	6.02
Value Added (Detracted)	0.17	-0.10	0.17	2.39	2.81	1.61	1.02
Net Performance	0.41	3.12	0.41	9.84	10.91	8.74	6.66

\* Gross Performance Past performance is not a reliable indicator of future performance

- Mixed domestic economic data with strong labour market readings and a much softer than expected inflation number for Q2, 2010.
- Investor sentiment improves following the better than expected European Bank Stress tests.

## Performance

The Australian bond market produced modest returns in July, with some of the income being offset by a small amount of capital loss from higher yields. The key drivers included strong labour market numbers, which spooked investors initially pricing in prospects of higher cash rates only to be partially unwound later in the month by softer than expected inflation readings. This resulted in the UBS Composite Bond Index (0+years) (the Index) returning 0.27%.

Pleasingly, the Perennial Australian Fixed Interest Trust (the Trust) performed particularly well, outperforming the Index by 17 basis points, returning 0.44%. Performance over the past year also remains strong on both an absolute and relative basis.

Interest rate strategies, in the form of an underweight duration position, added value as bond yields rose. Perennial Fixed Interest (we) felt that bonds were in expensive territory and even at current pricing look for higher yields over the coming months. In addition, spread strategies were employed within the Trust, using long inflation-linked bonds hedged by government bond futures, which also added value in July. This was primarily due to the bond futures selling off more than the inflation-linked bonds.

Sector strategies, in the form of an overweight to investment corporate debt, also added value as credit spreads improved. This was partly due to investor confidence returning following the relatively benign results of European bank stress tests.

At the security level, strong relative performance was achieved in the areas of senior & subordinated financials, listed property trusts and infrastructure debt.

## Perennial Australian Fixed Interest Trust: Fund Facts

The Trust aims to provide a total return (after fees) greater than cash and inflation, and that exceeds the, UBS Composite Bond Index (0 + years), measured on a rolling three-year basis.

<b>Portfolio Manager:</b> Glenn Feben	<b>Risk Profile:</b> Moderate
<b>Trust FUM (as at 31/07/10):</b> AUD \$92.5 million	<b>Income Distribution Frequency:</b> Quarterly
<b>Team FUM (as at 31/07/10):</b> AUD \$5.0 billion	<b>Minimum Initial Investment:</b> \$100,000
<b>Trust Inception date:</b> August 2002	<b>APIR code:</b> IOF0113AU

## Did you know?

That the Perennial Fixed Interest Team has on average 22.5 years experience per Team member.

## Market Review

After several strong months, returns from the Australian bond market were more subdued in July. The month began with the Reserve Bank of Australia (RBA) leaving the cash rate unchanged at 4.5%. The RBA commentary suggests that they remain in 'wait and see mode' against a backdrop of lending rates at longer run average levels.

Data released over the month were mixed. Interest rate sensitive sectors like building approvals, housing finance and credit were soft. The labour market exceeded expectations again with a strong 45,900 gain in job vacancies. Business and consumer confidence also bounced, helping lift three and ten year government bonds to month highs of 4.73% and 5.27% prior to the release of the June quarter Consumer Price Index (CPI).

Markets were looking for a 1% gain and when the actual result came in at 0.6%, both three and ten year bonds rallied, as markets factored out any chance of a near term tightening. Despite the late month rally, three and ten year government bond yields still ended the month 13 and 11 basis points higher at 4.56% and 5.2% respectively. There was no discernable reaction to the announcement of an election, with both parties targeting a balanced budget.

Credit markets improved over July. Investor concerns over European debt markets abated, following the relative healthy results of the European banks' stress tests. Primary markets opened with a number of financial and infrastructure debt issuers tapping the markets, whilst secondary markets continued to be healthy. Senior debt of financials, prime 'AAA' rated RMBS, domestic REITs and infrastructure debt performed very well over the month. The Australian Itraxx finished the month 18 basis points lower at 116 basis points.

## Market Outlook

While the better than expected CPI number takes a near term tightening off the table, we still hold the view that markets are not properly pricing in the risk of further monetary tightening over the next 18 months. At the end of July, the December 2010 and November 2011 30 day interbank cash contracts were yielding 4.56% and 4.68%, against the current cash rate of 4.5%.

While the interest rate sensitive sectors of the economy are adjusting to a lift in lending rates back to long run levels, the longer term outlook remains for trend to above trends rate of growth. The pipeline of public and private sector investment and the recent boost to household income from a lift in employment, hours worked, tax cuts and wage rates should help underpin activity. A pause in the tightening cycle should help boost growth later this year and into next. Given that the RBA are projecting inflation at the upper end of its target band by June 2012 and there are signs of wages lifting,

the risks are tilted towards further tightening over the next 18 months. We view short to medium term yields as being on the expensive side, as markets are not recognising this risk.

Further out along the curve, we also view a ten year bond yield at around 5.2% as being on the expensive side, with investors receiving little compensation for medium term inflation risk. Offshore long bond yields remain extremely low and should provide a boost to world growth. Investors are getting little reward for the risk that global growth will turn out better than expected and push global yields up. Furthermore, significant increases in government bond supply should place upward pressure on offshore yields over the medium term. We are reflecting these views by holding moderate underweight duration positions.

Despite recent volatility, we remain constructive on investment grade corporate and asset backed debt. Margins remain at attractive levels and the yield advantage they enjoy relative to treasuries provides some protection against further bouts of risk aversion. Solid corporate fundamentals combined with a gradually improving macro-environment should allow this sector to continue to outperform treasuries over the medium term.

## Investment Strategy

The following is a summary of the key strategies in the Trust:

**Interest rates** – at the end of the month, the duration position of the Trust was as follows:

Modified Duration	Years
Trust	2.80
Index	3.49
Active Position	-0.69

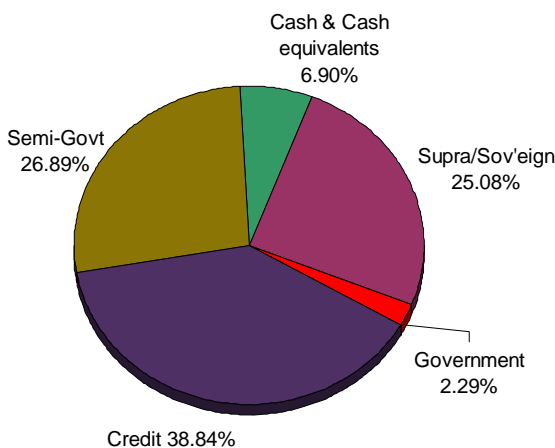
**Interest rates: Underweight duration** – we maintain a short duration position. We feel the current level of yields is at odds with a relatively positive outlook for the domestic economy over the next 12 to 18 months. Furthermore, with US and European bond markets now priced for a prolonged period of very weak growth, with little or no inflation, we feel they are vulnerable should the global economic recovery prove to be more enduring than current sentiment suggests.

**Overweight Corporate Debt** – we remain overweight corporate debt, with sound corporate fundamentals and a broadly supportive macro environment to provide the basis for this sector to outperform over the medium term. Valuations appear attractive and adequately compensate investors for default risk.

**Overweight Bank Guaranteed and Semi-Governments** - our government exposure is concentrated in semis and guaranteed bank securities, on the basis of the attractive yield advantage they offer relative to government bonds.

### Trust Snapshot

**Sector Allocation**



**Credit Rating Distribution**

