Fund Update

Australian Bond Fund

JUNE 2010

BLACKROCK

Market Update

- June proved to be another volatile month in risk assets which started the month weakly before a brief respite and then further weakness toward the end of the month. Reflecting those developments in risk assets government bond yields rallied strongly in the month.
- The issues which undermined risk assets in June were in large measure similar to those afflicting risk assets in May although their prominence was somewhat different.
- The fiscal issues in Europe, while no means less resolved, were less front and centre in June as markets grew more convinced that the magnitude of the response from the European authorities was sufficient to address some of the near-term funding issues in the most affected countries in the European periphery.
- Of relatively greater importance were heightened concerns about a slowdown in the Chinese economy coupled with an unexpected apparent slowdown in the US economy.
- Some of the risks that we have been monitoring have increased over the past month.
- Positive surprises for macro-economic growth and inflation data have generally weakened over the month. This softening has been led by the United States, where macro-economic surprise has turned negative.
- The weaker tone in leading indicators noted in May continued in June. Our leading indicators have fallen to flat, the weakest they have been in over a year. This weakness has been broad-based across all major regions and across both developed and emerging markets.
- While macro policy settings continue to be extremely supportive in general, fiscal policy has become less expansionary of late in Europe and potentially in the US. That said, we continue to expect a mid-cycle slowdown rather than a "double dip", as monetary policy globally remains extremely supportive, with the potential for further quantitative easing if required.
- In Australia, the Reserve Bank of Australia (RBA) left the policy rate unchanged at 4.50% following an increase in May. However, with the emergence of further uncertainties in the global economy and the fact that the RBA now considers interest rates to be close to their "average" levels, we expect that any future increases will need to at least await the release of the June quarter CPI figures in late July and will certainly be less frequent.
- Reflecting the renewed bout of risk aversion in global markets, Australian bond yields again fell sharply in June.

Performance Review as at 30/6/10

	Gross	Benchmark*	Out-performance^
1 Month	1.09%	1.37%	-0.28%
3 Month	3.35%	3.60%	-0.25%
6 Month	5.26%	4.90%	0.36%
1 Year	9.78%	7.86%	1.92%
2 Year (pa)	8.32%	9.33%	-1.01%
3 Year (pa)	6.29%	7.67%	-1.38%
5 Year (pa)	5.42%	6.06%	-0.64%
Since inception (pa)#	6.06%	6.16%	-0.10%

* Benchmark between inception (31/10/1997) and 30/3/2001 was UBSA Government Bond Index and from 31/3/2001 to 31/1/2005 the UBSA Fixed Interest Index, and from 01/2/2005 the UBSA Composite Bond Index.
# Gross – 31/10/97.

Past performance is not a reliable indicator of future performance.
The performance figures assume the reinvestment of all income and are calculated gross of fees and charges. Total net Fund returns shown are prepared on an exit-to-exit basis (ie. includes all ongoing fees and expenses). Rounding used in the presentation of returns may result in minor variations.

- Those same developments saw credit spreads on subordinated financial company bonds, to which the Fund retains an overweight exposure, increase which contributed to underperformance.
- Despite some uncertainties surrounding the outlook for global economic growth, the Reserve Bank of New Zealand (RBNZ) increased its policy rate (OCR) by 25 bps to 2.75% at its meeting on June 9th.

Market Outlook

- We still believe a flexible mindset is warranted in the current environment, notwithstanding some reasonable negative news flow for risk assets. The exit strategy from current extreme macro-economic policy settings was always going to be problematic.
- Although fiscal policy is yet to be tightened significantly (outside the distressed economies in peripheral Europe) the impact of fiscal policy on the global economy is transitioning from a major positive over the past year to neutral, and it will become a significant negative in 2011.
- Of course, the private sector could normally be expected to take up the slack at this stage of the cycle as labour markets and capital expenditure recover. Indeed, that process appeared to be underway prior to the recent market turbulence, although the recent softer tone of macroeconomic data has cast that in some doubt.
- The European sovereign debt situation stabilised somewhat in June. However, spreads of peripheral European Monetary Union (EMU) countries debt remains at historically extremely wide levels, indicating market scepticism that the very extensive liquidity support provisions put in place will be a permanent fix.
- While the European sovereign debt situation is by definition political, potential bearish triggers for renewed market concerns may include:
  - A situation where significant parts of the banking system in some EMU countries become distressed and require further government support. This would transfer the balance sheet liabilities of the banks from the private to the public sectors.
  - This could, in turn, stress even the very considerable support arrangements put in place by the EU.
- On the positive side, we think that recent months have demonstrated the depth of commitment by European political leaders to the Euro. Should further support be required, we have little doubt that it would be ultimately forthcoming. However, as events in May demonstrated, this process is unlikely to be immediate or smooth.

- As noted earlier, the US economy appeared to slow in June. There are a number of potential reasons for this.
- The expiration of some Federal Government measures to stimulate the housing market appears to have had a larger than expected impact on the housing market, at least in the short term. The prospect for tighter fiscal policy also appears to have increased.
- A number of tax cuts passed during the Bush administration are due to expire soon. The prospect of these tax cuts being extended appears to have receded recently, which may have possibly contributed to weaker consumer spending. There have been similar developments with regard to state governments, which require further support from the Federal government to avoid budget cutbacks.
- It is also possible that increased financial regulation flowing from the financial reform bill may have the unintended macro economic consequence of tightening credit. This of course is not confined to the US, as other national parliaments are also in process of increasing financial regulation and there is also the transnational rules of the Bank of International Settlements under Basel 3.
- Finally, the cyclical risk in China will remain a key focus in coming months as evidence builds that the economy is slowing. This should be a welcome development, but there will naturally be some concern that a slowdown in growth turns into a hard landing.
- We expect the slowdown in growth to be benign, but it will take some months to get some visibility on economic growth in 2011 in China.
- Nevertheless, we are still disposed to seeing a modest recovery in the global economy this year as central case, led by strong growth in the emerging economies.
- The recent trends in inflation and the travails of Europe and more recently the negative news flow out of the US will likely make central banks more comfortable with current extreme policy settings which could, in turn, provide a benign liquidity backdrop for risk assets for some months to come.
- In Australia our budget metrics remain superior to those elsewhere and Australian long-term interest rates may not be subject to upward pressure emanating from a challenging fiscal and public debt profile. However, the better activity picture domestically, combined with "sticky" inflation may mean that short-term rates are not as well anchored as in the large developed countries.
- The Australian economy has continued to perform much better than anticipated by both markets and the authorities, and there is a prospect that the RBA will increase official interest rates again in 2010.
- While the strong increases in Australia's terms of trade, which have been the main element supporting activity growth over recent times, are off their peaks, they are at what are historically high levels (and are forecast by the authorities to remain so) and have ameliorated any softening in activity.
- The better activity performance has been motivated by continuing strength in the Chinese economy combined with policy stimulus. As mentioned, however, the risk around some slowdown in China is a notion which came under some scrutiny in June. Nevertheless recent indications (particularly from the labour market) suggest grounds for some optimism around Australia's growth prospects.
- The flipside of that better activity performance, however, has been "stickier" inflation with the RBA's favoured measure of underlying inflation still well above the 2-3% target band at a time when the worst, in terms of subdued activity growth, is behind us.
- Such an environment means that in general we still have a bias toward "risk-seeking" themes in the portfolio. As was the case through June, however, it may be necessary to temper the extent of that bias from time to time.

Performance Review as at 30/6/10

- The BlackRock Australian Bond Fund underperformed its benchmark in June.
- Short duration positions made a negative contribution largely reflecting short positions in Australian and UK markets.
- Our overweight position in spread product (credit securities) was the biggest contributor to underperformance in the month.
- Other strategies only had a minor impact on performance.

Strategy Attribution as at 30/6/10

	1 month	3 months	1 year
Duration	-0.08%	-0.37%	-0.71%
Curve	-0.03%	-0.03%	-0.04%
Currency	0.01%	0.18%	0.36%
Credit/Sector	-0.12%	0.03%	2.36%
Total	**-0.23%**	**-0.20%**	**1.97%**

About the Fund

Investment objective

The objective of the Fund is to outperform the UBS Australia Composite Bond Index (All Maturities) by 100 basis points p.a. over a rolling three year period (before fees).

Fund strategy

The Fund is actively managed within a rigorous risk management framework and the portfolio is continually monitored and adjusted as necessary to suit changing economic and market conditions.

The investment process focuses on accessing the best ideas of our local and global fixed income teams. The teams seek to add value by managing duration, yield curve, credit, individual security, country and currency exposures against the Fund's benchmark. In seeking to access a broad array of value enhancing strategies, the team uses proprietary research-based knowledge and fundamental macro-economic and credit analysis.

Designed for investors who...

- Seek returns superior to the benchmark by accessing a range of value-enhancing strategies in a portfolio of domestic and international debt securities.

If you have any queries relating to any of this information or to obtain a copy of the Product Disclosure Statement (PDS) for the Fund, please contact your relationship manager. Alternatively, if you have a query relating to the wholesale funds, please contact Distribution Services on 1300 658 766, or please call Adviser Services on 1300 366 101 if you have a query relating to our retail fund range.

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