



**Fund Manager  
Commentary**

**March quarter 2010**

 **BT** Investment  
Management

# Table of contents

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<b>Australian Shares .....</b>	<b>3</b>
<b>Small Caps.....</b>	<b>6</b>
<b>International Shares .....</b>	<b>8</b>
<b>Australian Fixed Income .....</b>	<b>10</b>
<b>Cash .....</b>	<b>13</b>
<b>Credit.....</b>	<b>16</b>
<b>International Fixed Income .....</b>	<b>18</b>
<b>Australian Property.....</b>	<b>21</b>
<b>Active Balanced .....</b>	<b>22</b>
<b>Performance as at 31 March 2010.....</b>	<b>24</b>

# Australian Shares

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## Market review

The strong momentum of late 2009 continued at the start of the year taking the ASX200 index close to 5000 in early January before pulling back towards 4500 then returning almost to the January high by the end of March, for a gain of just 1.3% over the quarter.

December earnings reports saw positive surprises outweighing negative ones, but guidance and outlook statements were frequently guarded. In major company news, BHP announced that it had agreed with customers to shift from annual benchmark pricing for iron ore to a quarterly. M&A activity picked up through the quarter with Arrow Energy, Macarthur Coal and Lihir Gold receiving offers.

Banks were one of the best performing sectors (+5.8%) boosted by good results, and updates which underlined that the loan loss cycle is proving milder than previously expected. IT was the top sector for the quarter, up +7.1%.

Telcos and Energy were the worst performing sectors in Q1. The fall in Telecom stocks (-12.8%), reflected regulatory concerns, with Telstra down -8.8% over the quarter, while Energy was down -1.3%, despite the rise in oil prices.

Resources (+0.3%) mirrored the fortunes of the broader market: a tough January, marked by concerns about China's need to tighten monetary policy, was followed by a recovery to the end of the quarter which reflected very strong bulk commodity pricing and a shift by the major producers to a quarterly-based pricing system for iron ore.

In economic news, the Reserve Bank of Australia surprised many forecasters by leaving the cash rate target unchanged at its February meeting but resumed the tightening cycle in March with a 25 basis point hike to 4.0% while the Australian dollar gained 2.2% against the USD over the quarter. Base metals were mostly firmer, particularly copper, despite concerns over whether China's credit policy might be tightened.

## Fund performance

The portfolio underperformed its benchmark over the March quarter.

The main detractor to returns was the portfolio's overweight position in QBE. The insurer lost ground following its result as its insurance margins came in below what the market was expecting. The company chose to take extra reserves against some longer term industrial claims and in our view this reflects prudence rather than any fundamental problem with the business. There is no doubt that in the short term the company is impacted by the strong Australian dollar and the very low level of global interest rates.

However these factors are likely to ameliorate at some point which will lead to a significant pick up in earnings. It is effectively a cyclical stock trading at low multiples and we believe it remains good value.

Our overweight in WorleyParsons also detracted over the quarter as the Energy sector underperformed the market despite the rise in oil prices – this reflected the weight of new equity supply that has impacted the sector in the short term. Worley had downgraded its profit forecast in January partly as a result of reduced investment spend in the US power sector due to increased legislative uncertainty and ongoing funding issues, and a lag in the recovery in investment in the energy sector as industry players wait to gauge the sustainability of the recovery in oil prices. Towards the end of the quarter we saw a number of new contracts awarded to Worley, notably from the oil sands sector, which is a good lead indicator that confidence is returning and we do expect investment spend to begin to pick up.

In terms of contributors to returns over the quarter, the portfolio's overweight holding in Westpac performed well as the company raised its outlook for profits as a result of the improvement in provisions for bad and doubtful debts. In addition Asciano continued to perform well on the back of a strong first half result, with the first signs of economic recovery beginning to come through.

## Strategy & outlook

The rally in equity markets off their recent lows has reinforced our view that we remain in a consolidation phase. We are now 12 months on from the turn in the markets as the potential financial crisis was averted and the domestic economy started its recovery. The market has re-rated back to its long-term valuation, contingent on a recovery in earnings of 20% in the 2011 financial year. It is the confidence in this earnings recovery which will drive the markets from here.

The key swing factors relate to the US and Chinese economies. During March there were favourable developments on both these fronts. In the US the signs are beginning to emerge that employment is improving, following a lull over the northern winter. We believe that we will see a short term step up in US activity, however we are concerned that this will be relatively short lived given the continued structural issues relating to debt in both households and at the government level.

In China we got a clear message from policy makers that they will not aggressively tighten policy, reflecting their concerns about the uncertainty of the global economic environment. Our recent trip to China highlighted that underlying infrastructure investment is continuing, with the projects started last year providing plenty of work to continue growth through this year. In addition, we anticipate a pick up in property investment as the government seeks to increase supply to deal with the rise in prices. The economy will start to slow later in the year, but the policy mistakes of 2008, when the Chinese over tightened are fresh in their mind, and will lead them to err towards growth.

The domestic economy is transitioning from being driven by government stimulus and the consumer towards growth coming from investment, particularly relating to the resource sector. The terms of trade shock will generate substantial growth in the second half and in addition continued strong population growth will underpin the economy.

The February reporting season provided a direct insight into corporate performance. The sharp reactions to announcements, in both directions, highlight that at the current time the market is close to fair value and relying on a strong earnings recovery. Any signs of a delay in this are dealt with harshly by the market, however this is providing opportunities to buy into good longer-term stories that the market has lost patience with. Reporting season confirmed that the recovery in the domestic economy is flowing through, with the banks in particular benefiting from a drop off in loan losses. Overall the continued improvement in balance sheets helps to reduce the risks from any future economic shocks and would suggest that M&A activity will become a bigger theme in months to come.

In this environment, the portfolio's key exposures are to the resource sector, but rather than concentrate that solely in mining stocks it is spread across a number of themes being bulks, energy and engineering services, covering companies such as Rio, Oil Search, Worley and United Group. In addition we are exposed to the 'back end' of the domestic economy, i.e. companies exposed to greater corporate spend in the supply chain such as Qantas and Asciano. Finally, we are cautious for the near term on consumer-sensitive stocks as we see the effects of rising interest rates kick in.

# Small Caps

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## Market review

The Small Ordinaries benchmark fell -1.6% for the quarter as the market traded in a wide range over March as the global economy recovery came into question. The Small Ords had declined by approximately 15% from early January to mid February over concerns surrounding sovereign debt issues in the eurozone and around the Chinese economy overheating. Though the market has recovered strongly since focusing on the February earnings season.

Both the small resources and industrials sectors traded largely in line, declining 2.0% and 1.3% respectively. The resource sector had quite divergent performance during the quarter. With strength in iron ore and coal prices and forecast contract pricing, small iron ore and coal companies performed strongly over the quarter. The Energy sector (oil, gas and uranium) performed relatively poorly over the March quarter as Karoon Gas, Carnarvon Petroleum and Beach Petroleum all fell 20% in this period.

In the domestic economy we continue to see signs of strengthening in employment, housing and consumer spending. This along with a significantly improved resources sector saw the RBA raise interest rates in both March and April by 25 basis points each time. Over the last seven months the RBA has lifted rates by 125bps.

## Fund performance

The portfolio outperformed its benchmark over the quarter.

The major contributors to outperformance included overweight positions in REA Group, Bradken, MacArthur Coal and Hills Industries along with underweight positions in Sigma Pharmaceutical and Gunns.

REA Group, Bradken and Hills Industries all performed strongly over the period after reporting better earnings than expected results.

MacArthur Coal rallied 25% following a takeover bid from US-based coal company Peabody. The company is now in play with other mining houses bidding including London-based diversified miner Xstrata, Asian-based commodity trading firm Nobel Group and Australian-based coal company New Hope Coal.

The portfolio also benefited from underweight positions in Sigma Pharmaceuticals and Gunns which had negative earnings announcements.

Underweight positions in Ramsay Health Care, Ten Holdings and Riversdale Mining and overweight positions in Alesco Corp and Programmed Maintenance Services detracted from performance as sentiment towards resources improved during the quarter.

## Strategy & outlook

We continue to focus on valuation-based bottom up stock selection, with a focus on earnings, clearly aligned cashflow delivery, market/pricing power, strong balance sheets and better quality management/franchises. In addition, we have positions in companies we expect to benefit from ongoing industry consolidation and structural growth opportunities.

While optimistic on the continuing global recovery and its implications for resources demand, we are conscious of the potential for a correction given relatively full valuations in the small resource industry. We continue to see strong signs of a broader ongoing improvement in the domestic economy, albeit recognise the risk of a pullback in the consumer and housing sectors in particular if the Reserve Bank tightens too aggressively. We remain watchful for the impact of a strong Australian dollar on the earnings of import-driven sectors like retail and conversely on those sectors exposed to import competition.

We continue to selectively participate in the solid pipeline of corporate opportunities. We expect this year to see a high proportion of secondary issues being used for merger and acquisition related activities. We also expect this year will see a steady stream of initial offerings.

From a portfolio positioning point of view, we will continue to:

- increase exposure to stocks with attractive valuations and superior management
- decrease exposure to companies with weaker earnings profiles
- remain conscious of the potential earnings impact to companies exposed to cyclical drivers and adjust positions where required
- seek out undervalued and under-researched opportunities.

# International Shares

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## Market review

Macro news flow during the quarter focused on possible monetary policy tightening in China, sovereign debt issues and stimulus withdrawal, unemployment in the US and a possible currency war between the US and the China. A better-than-expected US reporting season and the Fed's commitment to keep the Fed funds rate low supported the market. With the US economy showing signs of stabilisation, the Fed increased the discount rate and discussed other possible tools available to reduce its balance sheet to pre-crisis levels. Despite struggling during the first part of the quarter, equity markets finished positively.

In Australian dollar terms, the MSCI World (Ex-Australia) Index (Net) was up +1.1% for the quarter though a strengthening Australian dollar meant that global equity returns in local dollar terms were +4.8%.

In the US, the S&P 500 posted a gain for the fourth quarter in a row (+4.9%) and at its end-March level had gained 73% from the closing low of 9th March 2009. Volatility continued to slide: the VIX index of implied volatility saw out March at the lowest monthly close (17.6) since June 2007. Q4 earnings beat expectations on average and in particular helped the Financials sector (+10.8%) overcome regulatory concerns. Cyclical stocks generally fared well with Industrials (+12.5%) and Consumer Discretionary (+10%) outperforming while defensives like Healthcare (+2.9%), Utilities (-4.6%) and Telcos (-5.7%) lagged.

Oil gained ground in Q1 (+5.5%) while gold was broadly flat (+0.4%) over the quarter. Base metals were mostly firmer, particularly copper, despite concerns over whether China's credit policy might be tightened.

The US dollar was volatile during the quarter. Initially, the USD appreciated against most major currencies with investors looking for the relative safety of the greenback. A deteriorating macro environment and the risk of a hung parliament in the UK saw the EUR and the GBP weaken most against the USD. Meanwhile Chinese authorities shrugged off US pressure on China to revalue the renminbi, sparking fears of a trade war between the two countries.

## Fund performance

The portfolio outperformed the benchmark for the March quarter.

The result was driven by positive performance in the US and Continental Europe strategies while the UK and Japan strategies were flat for the period. The outperformance in the US was mainly due to a positive period in our valuation and management signalling factors outweighing a weak period in our momentum signals. In Continental Europe, the positive performance was driven by a good quarter in our valuation and momentum factors outweighing negative performance in our industry valuation signals.

The flat performance in the UK was due to positive performance in our valuation factors balancing negative performance in our industry valuation and industry momentum signals. In Japan, the flat performance was mainly due to positive performance in our valuation signals offsetting negative performance in our momentum signals.

Positive performance in stock selection within the Materials and Consumer Discretionary sectors outweighed negative performance in stock selection within the Information Technology sector. In terms of sector positioning, we are currently overweight Consumer Discretionary and Industrials while being underweight Information Technology.

Within the global asset allocation overlay, the BTIM currency overlay strategy was positive for the March quarter. During the period we were long Australian dollar and Japanese yen while we were short the euro, Canadian dollar (on average) and UK sterling. The largest contributors to performance were the short euro and the short UK sterling positions. The Canadian dollar position detracted.

## Strategy & outlook

Tactically, we now are underweight Value in the US, UK and Continental Europe. Our Japan strategy is currently at long-term strategic weight.

# Australian Fixed Income

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## Market review

### International

After a chaotic 2009 that saw markets reach a low point in early March only to bounce back strongly investors could be forgiven for wanting a quieter 2010. January indicated that they would not get their wish. Despite better economic news, worries about China and proposed changes to US bank regulations drove equity markets down approximately -4%, investors snapped up government debt and the US\$ continued to appreciate against most major currencies. February was also tough going, the economic news was broadly negative as most of the developed world economies struggled to keep the recovery momentum going.

Worries about the difficult fiscal situation in Greece, soon followed by similar concerns about Portugal and Spain, led to much wider credit spreads in both bond and CDS markets for these sovereign borrowers. The credit spreads for some other euro area sovereign borrowers also rose. The more pronounced spread widening for Greece and, to a lesser degree, Portugal clearly reflected more imminent investor concerns. In contrast, Irish, UK and US spreads have changed little over recent months.

The economic news out of the US continued to be something of a mixed bag but with some signs of a recovery. The unemployment rate remained stubbornly high for the quarter at approx 9.7% and existing home sales were tepid. On the positive side the annualised Q4 GDP estimate came in 5.6% while house prices were fairly steady. The FOMC continued to stress that rates were on hold for the foreseeable future but demand at the US bond auctions waxed and waned. Most companies reported better-than-expected earnings at the start of the quarter but the markets also took a huge hit as US President Obama unveiled plans to limit risk taking by US. March saw fresh risk taking as the markets shrugged off the bad news and the S&P500 finished up over 5% for the quarter. The US\$ continued to appreciate through Q1 rising over +4% against the major currencies while Treasuries were largely unchanged.

After officially coming out of recession in Q3 Europe's recovery was thrown into some doubt as Q4 GDP came in at 0.1% QoQ – much less than the 0.3% expected. The chief culprits were a lacklustre Germany - whose economy stalled in the fourth quarter – and Italy whose 4Q GDP fell -0.2% QoQ. Beyond the dismal economic picture Greece dominated investors thinking as the EU appeared to dither over whether to bail-out Greece or not and what form the bail out would take. In the ensuing confusion the Euro was hammered as investors shunned the currency causing it to fall approx -6% over the first three month of 2010. Most European equity markets fell through the quarter with Spain, Greece and Italy bearing the brunt of investor fears. The ECB left interest rates unchanged at 1% and Bunds were a source of safety in all the turmoil with yields ending down -30bps for the quarter.

Japan continued to struggle as the economy limped into 2010 without showing many signs of life. Machine orders began to recover bolstering the idea that capital spending in Japan was back on track. Retail sales also increased MoM in Q1 indicating that the Japanese consumer may finally be beginning to spend again. However Japanese inflation was negative through the quarter fanning deflation worries. As usual the BoJ left rates on hold at 0.1% and the equity market followed the US up posting over +8% gain for the quarter. The Japanese bond market sold off a little with 10Yr yields rising approx. +10bps for the quarter.

The recovery in the UK gathered pace in Q1 and the 4Q GDP was revised upwards to 0.3% QoQ from a previous 0.1%. However the UK also posted its first budget deficit for January since the survey began in 1993 – this was an unpleasant surprise since traditionally January is the biggest tax collection month of the year and may imply that the UK's spending needs to be trimmed back. The BoE left rates unchanged for the quarter and declined to extend the QE program. Unlike most of Europe the UK equity market followed the US upwards rising +5.8% for the quarter while 10Yr Gilt yields fell by just over -7bps.

### **Australia**

With no RBA meeting in January 2010 market expectations were for a +25bps rise in the base rate in February. The following month the RBA surprised the market by deciding not to raise the base rate from 3.75%. The central bank cited both global financial uncertainty regarding some sovereigns and also the actions of local banks in passing on larger rate rises to consumers as the main reasons why it paused. By the end of the quarter the RBA went back to its rate-raising ways and increased the base rate by 25bps to 4.0% in early March. Citing surging Asian growth and an overheating housing market the RBA also appeared to signal that more rate rises were on the way in the coming months.

Australia continued to deserve its reputation as the lucky country with economic data in the first quarter underlining the strength of the economy. Building approvals and retail sales mostly beat expectations while the unemployment rate actually declined to only 5.3% - far lower than in Europe or the US.

On the back of the increase in the base rate and a brightening economic climate the Australian dollar continued its good run and stayed comfortably above 0.85 for the quarter. By the end of March it was heading north again and closed the quarter just a touch below 0.92.

## Fund performance

The portfolio outperformed its benchmark for the March quarter. Both the macro strategies and credit strategies components contributed to returns.

## Strategy & outlook

The Bank remains very optimistic about the domestic and global growth outlook and more than likely will continue to tighten policy at the April meeting. Bond yields have risen substantially and offer better value at current levels relative to cash rates.

However, we continue to believe that the RBA will continue to tighten monetary policy throughout 2010 and 3 and 10-year bond yields at 5.28% and 5.78% respectively do not offer great value.

Bond issues with an explicit government guarantee continued to outperform its respective commonwealth government bonds. In the macro portfolio, we remain aggressively overweight this sector and we expect this sector to continue performing well as the government has withdrawn its guarantee to the banks and states. The lack of supply should cause spreads to continue to narrow relative to commonwealth government bonds.

In credit, we remain overweight in corporate bonds and underweight in supranationals. We maintain our overweight in bank subordinated debt over bank senior debt. Finally, we maintain our overweight in credit duration over the benchmark.

## Market review

There was no Reserve Bank meeting in January. The Reserve Bank surprised the market in early February when it decided to leave the cash rate unchanged at 3.75%, following on from consecutive rate hikes at its previous three meetings. The Reserve Bank remained positive on the economic outlook however believed that it was appropriate to hold steady the setting of monetary policy for the time being as information about the effect that previous policy tightening has had was still limited.

Data released post the February meeting confirmed the strength of the labour market in the Australian economy. Data for January revealed a much stronger than expected employment growth of 52,700 for the month and the employment rate falling from 5.5% to 5.3%. Other data released over the month was mixed with January retail sales posting a decline of 0.7% for the month and fourth quarter capital expenditure stronger than expected at 5.5%.

The Reserve Bank of Australia raised the cash rate by 25 basis points to 4.00% at its March meeting. Continuing its theme from previous statements, the Reserve Bank continued to note that global economic growth is expected to rise to trend pace in 2010 and 2011, despite the expansion being hesitant in some developed countries as a result of the global financial crisis. The Reserve Bank also noted that in Asia, where financial sectors are not impaired, growth has continued to be quite strong.

Unemployment in Australia peaked at a much lower level than the Reserve Bank expected. Inflationary pressures declined from their peak in 2008, helped by the fall in commodity prices, the rise in the exchange rate and the previous period of slower growth in demand. More recently, inflationary pressures are re-emerging as commodity prices increase, credit for housing expands at a solid pace and domestic demand rebounds.

With the risk of economic contraction having passed, the Reserve Bank viewed it as prudent to lessen the degree of monetary stimulus that had been put in place when the outlook appeared to be much weaker and raise the cash rate.

Data released after the Reserve Bank increased the cash rate supported the decision. Fourth quarter GDP was as expected at 0.9%, with upward revisions to previous GDP data reflecting stronger performance from the Australian economy. Labour data was also strong, with the hours worked component picking up.

90 day bank bills moved higher over the quarter following monetary policy tightening, ending 21 basis points higher at 4.49%. 3 and 10 year bond yields also ended the quarter higher, rising by 62 and 14 basis points to end at 5.28% and 5.78% respectively.

## Fund performance

### Managed Cash

The portfolio performed in line with its benchmark and portfolio weights remained consistent over the quarter, with commercial paper exposure remaining concentrated in shorter dated maturities providing additional yield pick up relative to the cash rate. Intra-month moves over the quarter provided opportunities for relative value trades that assisted performance. Late in the quarter yields again rose as the prospect of monetary policy tightening at the RBA's April meeting increased. These elevated yields will assist performance in the coming months.

### Enhanced Cash

The portfolio outperformed its benchmark and was active over the quarter as primary market issuance started to pick up. Whilst activity was typically quiet in January, February saw an increase in primary market activity which we participated in. ANZ printed a 4-year deal priced at 90 over swap and Harvey Trust priced a Mortgage Backed deal at 135 over swap. March was again an active month, participating in new issuance in the financial, infrastructure, diversified financials and asset backed securities sectors. Primary issuance is expected to increase further in the coming months, with the fund well positioned to take advantage of this. These deals offer significantly higher margins than where they were issued prior to the global financial crisis and will assist the portfolio in outperforming its benchmark.

## Strategy & outlook

At the time of writing the Reserve Bank increased the cash rate by a further 25 basis points to 4.25%. With interest rates remaining below average to most borrowers it is clear that further near term policy tightening will occur unless there is a significant event to destabilise the global economy. Whilst sovereign concerns have increased, particularly more recently in relation to Greece, the Australian economy has been well served by strong growth in the Asian region. The improving terms of trade will also continue to provide Australia with a significant income boost.

Moves by financial institutions in lending rates will also be closely monitored. Bank funding costs have increased more recently with the rise in underlying bond yields. Offsetting this has been the move by some institutions to lower the rate on term deposits. Should lending rates increase by more than moves in the official cash rate, the Reserve Bank may have more time to observe economic data and the effect that monetary policy has had before tightening policy. Should this not occur, it is likely the Reserve Bank will have to increase the cash rate more aggressively to get lending rates back to a normal level more quickly.

The current stage of the business and credit cycles remains constructive for asset markets. Liquidity conditions in the form of ultra-low short rates and continued private sector de-leveraging provide additional, albeit temporary, support across asset classes especially credit.

Overall economic conditions appear to be favourable for most asset classes, with the mild exception of government bonds. On an aggregate global basis, economic growth is above trend and set to stay that way through 2011. Inflation remains below trend in most countries, reflecting the economic slack generated during the financial crisis.

An economic environment characterised by above trend growth and below-trend inflation is historically associated with strong returns from financial assets.

## Market review

In the first two months of 2010, the rise in risky asset prices ran out of steam. After 10 months of substantial increases, equity prices in both advanced and emerging economies started falling from mid-January, while credit spreads widened. With volatility and risk aversion rising, increased demand for government bonds pushed benchmark bond yields downwards. Towards the end of the quarter however, markets stabilised and reversed.

Concerns about the market implications of large fiscal deficits came to the fore in early 2010. Investors' attention was first drawn to the issue of sovereign risk by the financial difficulties encountered by the government-owned Dubai World in late November. More recently, the focus has shifted to the euro area, where large budget deficits led to the prospect of rapidly increasing government debt/GDP levels in several countries.

Worries about the difficult fiscal situation in Greece, soon followed by similar concerns about Portugal and Spain, led to much wider credit spreads in both bond and CDS markets for these sovereign borrowers. The credit spreads for some other euro area sovereign borrowers also rose. The more pronounced spread widening for Greece and, to a lesser degree, Portugal clearly reflected more imminent investor concerns. In contrast, Irish, UK and US spreads have changed little over recent months.

Investor concerns about sovereign exposures weighed on banks' equity prices in late 2009 and early 2010, particularly in Europe. That said, bank credit spreads and equity prices also reflected financial statements posted in January and February that continued to report positive, albeit moderate, profits.

A speech given by the US President on 21 January clearly affected financial markets. The proposals put forward – quickly labelled the “Volcker rule” – envisaged that commercial banks with a large deposit base should face limits to their proprietary trading and similar activities. The proposals also provide for limits on the size of individual firms relative to the overall system. The shares of large banks with significant earnings from US financial market activities, whether or not they were headquartered in the United States, tended to weaken. In contrast, equity prices for US regional banks – which rely less on earnings from financial market activities – were less affected.

Data and news flow were clearly more positive in March 2010. The US economy seems to be on the path of recovery. While this is not a housing-led recovery nor a consumer-led recovery, it is arguably a corporate profits and business spending led recovery.

## Performance

The portfolio outperformed the benchmark in the March quarter. Positive performance came from an overweight to Bank sub debt and insurance.

## Market outlook

The current stage of the business and credit cycles remains constructive for asset markets. Liquidity conditions in the form of ultra-low short rates and continued private sector de-leveraging provide additional, albeit temporary, support across asset classes especially credit.

Overall economic conditions appear to be favourable for most asset classes, with the mild exception of government bonds. On an aggregate global basis, economic growth is above trend and set to stay that way through 2011. Inflation remains below trend in most countries, reflecting the economic slack generated during the financial crisis.

An economic environment characterised by above trend growth and below-trend inflation is historically associated with strong returns from financial assets.

In the credit component we remain overweight in corporate bonds and underweight in supra-nationals. We maintain our overweight in bank subordinated debt over bank senior debt and maintain our overweight in credit duration over the benchmark.

# International Fixed Income

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*(Commentary provided by BlackRock)*

## Market review

During the first quarter, investors endured a recurrence of threats that have plagued risk assets in the past, including deteriorating public finances in Greece, California, and the US Treasury. However, the combination of continued accommodative monetary policy from the Federal Reserve and improved economic fundamentals has kept market volatility low and demand for higher yielding assets robust.

Within the Barclays Capital US Aggregate Index, the Treasury Index quarterly return (1.1%) was outpaced by that of CMBS, Corporate, ABS, and MBS Indices (9.1%, 2.3%, 2.2%, and 1.5%, respectively). Other barometers of risk appetite, including the S&P 500 Index (5.4%) and the Barclays Capital Corporate High Yield Index (4.6%), also displayed strong returns.

While conservative management of corporate finances has positioned many companies to weather the economic downturn, poor management of public finances has resulted in deterioration of fiscal imbalances, and in some cases, heightened risk of default. Greece dominated headlines during the first quarter as it negotiated a financial aid package with other European Union governments and the International Monetary Fund. Greek 5-year bond yield spreads widened 170 basis points in January, and there was talk of dissolving the European Monetary Union. Attention was also drawn to precarious fiscal situations in Spain and Portugal. However, these peripheral European markets rallied significantly once a rescue package for Greece was successfully negotiated and Greece was able to bring a bond issue to market. Greece continues to have long-term, structural fiscal problems, but the quick-fix elicited impressive investor support.

In the US, California's fundamental credit problems seemed to be largely forgotten in the wake of a successful \$3.4 billion taxable bond issue. Interestingly, given the context of elevated sovereign credit risk around the world, 30% of investors in this deal were foreign buyers. Overall, the taxable municipal bond sector returned 3.7% for the quarter, outperforming investment grade corporate indices.

While California may be building a foreign investor base, a number of poorly executed auctions during the quarter called into question the ability of the US Treasury to attract buyers. Notwithstanding the deficit-friendly scoring by the Congressional Budget Office, the successful passage of healthcare reform raises the spectre of further long-term pressure on federal finances from entitlement programs. While 10-year Treasury yields were little changed on the quarter at 3.83%, investor caution manifested itself in a steeper yield curve: the 2-year to 30-year spread increased from 3.5% to 3.7%.

The FOMC's zero interest rate policy continues to be a powerful inducement for investors to reach for yield, particularly given the Committee's message that rates will be "exceptionally low" for "an extended period". The consistency of this message has helped to drive volatility lower and with it the perception of risk. The shrinking mortgage portfolios of FNMA and FHLMC have also contributed to the decline in volatility. The Fed, through its Mortgage Purchase Program, has removed a significant portion of the recent supply of mortgages from the market, therefore reducing the demand for hedging prepayment and convexity risk. This program expired at the end of the first quarter, but this stock of mortgages remains out of the market. Long-term structural issues, including over-leveraged commercial and residential real estate and sovereign and municipal fiscal imbalances, remain. For the moment, however, these issues are trumped by short-term cyclical improvements in economic activity along with a Fed determined to counteract headwinds with accommodative monetary policy.

## Fund performance

The portfolio outperformed its benchmark over the March quarter.

The quarter was marked by further signs of global economic impetus and by a number of central banks phasing out exceptional liquidity and credit support mechanisms. However, low levels of policy rates and an element of 'flight to quality' related to Greece's financial woes, combined with some supply indigestion to take the major global yield curves lower, and steeper, over the quarter. In general, our portfolios were well positioned for the Greek financial crisis:

- i) our overweight duration in the eurozone performed well, especially our preference of core German government bonds again peripheral markets;
- ii) our small exposure to Greek government bonds was established at attractive levels in January and contributed positively;
- iii) moreover, the portfolio benefitted from short positions in euro vs. US dollar and Japanese yen as the common currency came under attack. The portfolio's positions in the CMBS and corporate credit markets also contributed positively to performance, helped by our preference for financial credits, and the addition of high yield names on market weakness. CMBS was driven by investor demand for higher yielding assets and declining risk premia. A similar demand for yield allowed the High Yield sector to outperform. Conversely, the portfolio suffered minor setbacks from our flattening position in USD rates markets, our overweight duration position in AUD rates, and our underweight position in the US agency MBS sector. For the Mortgage sector, with the Fed officially stepping aside as the backstop bid for mortgages, the sector now finds itself in an uncertain position from a relative value as well as demand/supply perspective.

## Outlook

**US Rates.** The FOMC recognises the economic recovery is fragile. It is committed to provide continuing accommodation to offset drag from over-leverage and increasing regulation. Current economic momentum should promote improving asset quality and balance sheet repair without raising resource utilisation, inflation, or inflationary expectations to uncomfortable levels. While the Fed will no longer be the dominant bid in the Agency MBS market, we expect that valuations will be well-supported by healthy investor appetite for yield and anaemic supply.

**Securitised Assets.** While real estate and other collateral markets have shown signs of stabilisation, there is still an extraordinary amount of distress. Loan modifications may ultimately serve only to delay and disperse defaults rather than prevent them. Even following a strong first quarter rally, significant opportunities remain.

**Investment Grade Corporates.** Credit fundamentals continue to compare favourably to other fixed income sectors, including such traditional high quality havens such as sovereigns and municipals. Further spread compression is probably limited, but interest rate risk is likely less than that of equivalent duration Treasuries.

**Leveraged Finance.** Conservative liability management over this cycle has companies placing less supply pressure on the market, while a healthy investor appetite for yield should continue to produce steady demand.

**Non-Dollar.** Performance dispersion across non-dollar markets is expected to continue, with some central banks already hiking rates, and others in the early stages of liquidity withdrawal. The return of credit risk in sovereign curves will create significant relative value opportunities.

# Australian Property

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## Market review

The Listed Property Trust sector fell -1.6% in the March quarter. On a total return basis, the sector underperformed the broader share market by 3.0%. Over the past year the sector is up by 42%.

Over the quarter we saw continued consolidation in the Australian market with Charter Hall buying management rights to Macquarie Office and Macquarie Countrywide. In addition Mirvac raised \$500m for the acquisition of the Westpac Office Trust. We expect this trend to consolidation will gather pace as credit conditions improve.

Property asset markets are improving globally. In Australia, Charter Hall sold a half share in their Brisbane office tower at a firm price (6.5% yield) while in the US, the ongoing tussle for mall owner General Growth (there are now four bidders) highlights the re-emergence of global appetite for property assets

Earnings growth for the sector may be only 2% for the near term FY10-FY11, but thereafter earnings momentum should improve.

Returns from the various LPT sub-sectors were mixed. Industrial (+1.0%) was the strongest sub-sector mostly driven by Goodman Group (investors now forecasting a return to better development and leasing activity) Office was the worst performing subsector (-2.1%) dragged down by CPA (-5.0%) and ING Office (-1.8%).

## Fund performance

The portfolio outperformed the benchmark for the March quarter. An underweight in Ardent Leisure Group was the main contributor to returns while the key detractor was an underweight in Westfield.

## Strategy & outlook

At current prices, the sector is delivering a 6.2% distribution yield and 0–2% p.a. medium term growth. Earnings and balance sheets are stable. We look to improving direct property and equity markets for the next leg up in the sector.

# Active Balanced

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## Market review

January and February were challenging for markets as the economic news was broadly negative. There were concerns about possible monetary policy tightening in China, sovereign debt issues and stimulus withdrawal, unemployment in the US and continuing bad news out of Greece.

This news flow unsettled equity and currency markets while bolstering bonds though equity markets recovered at the end of February and continued the positive momentum into March. The quarter ended with equity markets rising over +4% on average while bond markets remained largely unchanged.

The Australian sharemarket gained just +1.3% over the quarter. The reporting season saw positive surprises outweighing negative ones, though guidance and outlook statements were frequently guarded. Banks were one of the best performing sectors, up nearly 6%, boosted by good results, and updates which underlined that the loan loss cycle is proving milder than previously expected.

Australian economic data in the first quarter underlined the strength of the local economy. Building approvals and retail sales mostly beat expectations while the unemployment rate declined to only 5.3% – far lower than in Europe or the US. The Reserve Bank of Australia surprised many forecasters by leaving the cash rate target unchanged at its February meeting but resumed the tightening cycle in March with a 25 basis point hike to 4.0%. Meanwhile the Australian dollar gained 2.2% against the USD.

## Performance

The portfolio outperformed the benchmark over the March quarter. Global equities outperformed over the period, driven by positive performance in the US and Continental Europe strategies while the UK and Japan strategies were flat for the quarter. The BTIM currency overlay strategy also contributed to the outperformance.

Australian equities underperformed with the main detractor being the portfolio's overweight position in QBE. The insurer lost ground following its result as its insurance margins came in below what the market was expecting. The company is also being impacted in the short term by the strong Australian dollar and the very low level of global interest rates.

The portfolio's Australian listed property trusts and international fixed interest component contributed to outperformance while our holdings in global property and alternative assets detracted from returns. For credit, an overweight to Bank sub debt and insurance drove outperformance.

We returned closer to our benchmark weightings in December, and made no material changes to the asset class positioning over the March quarter. We currently maintain a slight underweight position in domestic listed property and slight overweight in Australian fixed interest via credit securities.

## Outlook

Asset allocation remains similar to the benchmark aside from a small overweight to credit securities and underweight to Australian property. In essence, investment grade credit has performed well and still looks reasonably attractive though the valuation argument is less compelling than last year. Government bond yields are likely to rise further from here, as long as the economic recovery remains intact. Inflation is not yet a concern, but needs to be monitored. Currency market volatility is generally subsiding however the Euro continues to suffer from sovereign debt issues, and Sterling faces the prospect of a hung parliament in the May elections.

The global imbalances will be rectified in time but since shares are now above fair value by some metrics, and with limited prospects in the near term for dividend growth and a need for more equity raising, we prefer owning the paper higher up the capital structure, i.e. corporate bonds.

We are neutral in equities having removed the bias to the US dollar bloc at end 2009. We are currently overweight credit and underweight sovereign bonds.

The main risk to global economic growth and the performance of risk assets is the sovereign debt problem of some European countries and the lack of real consumer spending. Until we see real measures to fix the overhang of government debt and see some sustained pick-up in consumer demand we believe that any recovery will be anaemic at best.

# Performance as at 31 March 2010

(%)	1 Month	3 Months	6 Months	FYTD	1 year (pa)	2 Years (pa)	3 Years (pa)	5 Years (pa)	Since Incp. (pa)
<b>Australian Shares - All Cap</b>									
<b>BT Wholesale Core Australian Share Fund</b>									APIR - RFA0818AU
Total Return (post-fee, pre-tax)	5.96	0.33	4.59	25.65	38.91	2.11	-0.30	9.72	11.19
Total Return (pre-fee, pre-tax)	6.03	0.52	5.00	26.40	40.01	2.92	0.49	10.61	12.26
Benchmark	5.74	1.25	4.66	27.31	41.94	-0.18	-2.58	8.00	11.24
<b>BT Wholesale Imputation Fund</b>									APIR - RFA0103AU
Total Return (post-fee, pre-tax)	6.21	0.31	4.20	25.51	38.40	0.37	-1.57	10.16	12.12
Total Return (pre-fee, pre-tax)	6.29	0.53	4.67	26.36	39.65	1.27	-0.70	11.11	13.18
Benchmark	5.74	1.25	4.66	27.31	41.94	-0.18	-2.58	8.00	9.89
<b>BT Wholesale Focus Australian Share Fund</b>									APIR - RFA0059AU
Total Return (post-fee, pre-tax)	6.35	1.05	5.15	27.98	43.87	0.86	-1.91	10.94	10.95
Total Return (pre-fee, pre-tax)	6.45	1.17	5.61	28.79	45.30	1.74	-1.10	12.27	12.28
Benchmark	5.74	1.25	4.66	27.31	41.94	-0.18	-2.58	8.00	8.00
<b>BT Wholesale Ethical Share Fund</b>									APIR - RFA0025AU
Total Return (post-fee, pre-tax)	6.30	0.21	3.90	24.56	37.18	-0.91	-2.47	9.54	9.96
Total Return (pre-fee, pre-tax)	6.39	0.45	4.39	25.45	38.49	0.04	-1.56	10.55	11.06
Benchmark	5.74	1.25	4.66	27.31	41.94	-0.18	-2.58	8.00	8.88
<b>Australian Shares - Mid Cap</b>									
<b>BT Wholesale MidCap Fund</b>									APIR - BTA0313AU
Total Return (post-fee, pre-tax)	5.80	0.06	5.81	32.37	55.61	N/A	N/A	N/A	6.56
Total Return (pre-fee, pre-tax)	5.86	0.59	7.03	34.88	59.02	N/A	N/A	N/A	10.72
Benchmark	5.93	-1.51	2.62	25.94	47.65	N/A	N/A	N/A	-6.10
<b>Australian Shares - Small Cap</b>									
<b>BT Wholesale Smaller Companies Fund</b>									APIR - RFA0819AU
Total Return (post-fee, pre-tax)	6.86	1.24	9.53	37.43	65.13	-0.01	-1.89	10.22	14.57
Total Return (pre-fee, pre-tax)	6.97	1.50	10.12	38.56	66.95	1.09	-0.82	11.43	15.84
Benchmark	6.84	-1.57	3.23	25.76	58.06	-7.42	-7.48	5.84	9.70
<b>International Shares</b>									
<b>BT Wholesale Core Global Share Fund</b>									APIR - RFA0821AU
Total Return (post-fee, pre-tax)	3.37	2.19	3.43	11.46	18.02	-5.06	-10.96	-1.57	3.07
Total Return (pre-fee, pre-tax)	3.46	2.43	3.93	12.22	18.96	-4.31	-10.21	-0.67	4.28
Benchmark	3.52	1.12	3.24	10.54	14.47	-7.02	-9.61	-0.83	5.20
<b>Property</b>									
<b>BT Wholesale Property Investment Fund</b>									APIR - RFA0817AU
Total Return (post-fee, pre-tax)	0.09	-1.47	-6.47	22.02	42.09	-18.35	-18.83	-4.23	7.03
Total Return (pre-fee, pre-tax)	0.15	-1.32	-6.17	22.62	43.02	-17.82	-18.30	-3.60	7.80
Benchmark	-0.03	-1.63	-6.54	22.23	42.00	-22.82	-23.27	-7.20	6.31
<b>BT Wholesale Global Property Securities Fund</b>									APIR - RFA0051AU
Total Return (post-fee, pre-tax)	7.63	6.42	13.85	46.39	82.79	-11.07	-14.16	3.42	6.32
Total Return (pre-fee, pre-tax)	7.73	6.67	14.40	47.45	84.49	-10.27	-13.36	4.38	7.25
Benchmark	8.13	7.71	15.06	50.36	86.28	-11.65	-15.13	2.26	5.23
<b>Fixed Interest</b>									
<b>BT Wholesale Fixed Interest Fund</b>									APIR - RFA0813AU
Total Return (post-fee, pre-tax)	-0.28	1.59	3.01	5.88	6.10	7.92	6.21	5.63	6.93
Total Return (pre-fee, pre-tax)	-0.24	1.68	3.22	6.19	6.52	8.35	6.63	6.06	7.51
Benchmark	-0.58	1.26	2.30	4.11	2.73	7.63	6.51	5.99	7.09
<b>BT Wholesale Global Fixed Interest Fund</b>									APIR - RFA0032AU
Total Return (post-fee, pre-tax)	0.83	3.34	4.53	9.53	12.73	6.94	6.32	5.89	6.78
Total Return (pre-fee, pre-tax)	0.88	3.48	4.81	9.96	13.31	7.48	6.86	6.44	7.41
Benchmark	0.56	2.69	3.84	7.90	10.24	8.62	8.41	7.28	7.73
<b>BT Wholesale Enhanced Credit Fund</b>									APIR - RFA0100AU
Total Return (post-fee, pre-tax)	0.16	2.08	4.42	8.32	10.29	8.40	5.50	5.41	5.67
Total Return (pre-fee, pre-tax)	0.20	2.19	4.66	8.69	10.80	8.90	5.98	5.89	6.23
Benchmark	-0.20	1.55	3.01	5.15	5.33	8.25	6.54	6.10	5.87
<b>Cash &amp; Income</b>									
<b>BT Institutional Enhanced Cash Fund</b>									APIR - WFS0377AU
Total Return (post-fee, pre-tax)	0.48	1.49	3.29	5.45	7.41	5.48	5.03	5.41	5.38
Total Return (pre-fee, pre-tax)	0.51	1.55	3.42	5.65	7.68	5.74	5.30	5.68	5.76
Benchmark	0.33	1.02	1.92	2.73	3.54	5.11	5.73	5.84	5.79
<b>BT Institutional Managed Cash Fund</b>									APIR - WFS0245AU
Total Return (post-fee, pre-tax)	0.35	0.99	1.86	2.66	3.44	5.03	5.62	5.70	7.64
Total Return (pre-fee, pre-tax)	0.37	1.05	1.97	2.83	3.67	5.26	5.85	5.93	7.97
Benchmark	0.33	1.02	1.92	2.73	3.54	5.11	5.73	5.84	7.73
<b>Diversified</b>									
<b>BT Wholesale Active Balanced Fund</b>									APIR - RFA0815AU
Total Return (post-fee, pre-tax)	3.29	1.29	4.11	16.24	24.98	-0.42	-2.89	4.77	7.77
Total Return (pre-fee, pre-tax)	3.38	1.53	4.61	17.08	26.17	0.53	-1.97	5.77	8.87
Benchmark	3.06	1.41	3.54	16.40	24.10	0.96	-1.02	5.74	7.46

All returns calculated by BT Investment Management (RE) Limited. No part of this Fund Manager Commentary (**Commentary**) is to be circulated without this page attached.

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- BT Wholesale Focus Australian Share Fund
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- BT Wholesale Smaller Companies Fund
- BT Wholesale MidCap Fund
- BT Wholesale Core Global Share Fund<sup>#</sup>
- BT Wholesale Global Fixed Interest Fund<sup>##</sup>
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