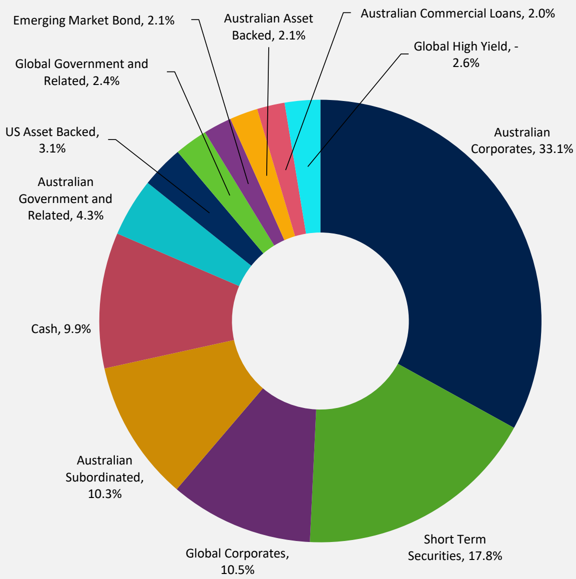
Schroder Absolute Return Income (Managed Fund) (Ticker: PAYS)

Quarterly Report - March 2023

For more information about the Fund visit www.schroders.com.au/pays

Total return %	1 mth	3 mths	6 mths	1 yr	3 yrs p.a.	Inception p.a.
Schroder Absolute Return Income (Managed Fund) (post-fee)	0.27	1.40	2.34	1.51	1.93	1.08
RBA Cash Rate	0.30	0.83	1.54	2.11	0.80	0.78
Relative performance (post-fee)	**-0.10**	**0.57**	**0.80**	**-0.60**	**1.13**	**0.30**

Portfolio inception 19/11/2019, 3 years and 4 months



Portfolio statistics

Duration	1.01 yrs
Yield to maturity	4.57%
Average credit rating	A
Number of securities	3,455

*Please note numbers may not total 100 due to rounding

*The Portfolio may have a sizeable exposure to securities, including cash instruments, issued by each of the four major Australian banks.

*Unless otherwise stated figures are as at the end of Mar 2023

*Benchmark is the RBA Cash Rate

Market review

Risk assets rebounded in the second half of the month and rallied over the course of the quarter, despite the banking turmoil caused by the collapse of Silicon Valley Bank and Signature Bank, along with the buyout of Credit Suisse. This is due to the change in expectations that the US Federal Reserve (Fed) will likely have to pause rate hikes and consider cutting sooner than expected, along with providing liquidity to banks via their new Bank Term Funding Program. The uncertainty in the banking sector resulted in a significantly rally in bond yields, particularly in the front end of the US curve, which also resulted in bond volatility (as measured by the MOVE Index), reach its highest level since the GFC. Financial markets are now pricing in multiple rate cuts for the second half of this year, despite the relative stickiness of US core inflation to date. Domestically, the RBA changed its stance as moderating levels of monthly inflation and a greater focus on the potential impact of fixed rate mortgages beginning to roll off saw the RBA release a more dovish statement in March, followed by a pause (at least for now) to rate hikes in April.

Portfolio review

Over the quarter, the Schroder Absolute Return Income (Managed Fund) returned 1.40% (after fees), or 0.58% (after fees) above the RBA Cash Rate.

Largest contributors

Our allocation to credit assets contributed to returns, despite a widening of spreads following the turbulence in the global banking sector, via higher coupon income (carry). Duration also added to performance as yields declined in response to a potential unwinding of tight monetary policy and fears of a banking crisis contagion.

Largest detractors

Curve positioning was the main detractor to performance as short term yields fell more than long term yields in response to the banking sector stress.

Outlook and strategy

March has been another challenging month in markets. We continue to believe we are in a transition phase, during which the central banks are adjusting monetary policy settings from excessively loose to settings which are more appropriate for the level of inflation. The size and pace of monetary tightening has resulted in stress in the financial system, particularly the banking system, wherein banks are more susceptible to failure as potential asset/liability mismatches arise. This was the case as we witnessed a run on deposits with Silicon Valley Bank (SVB) and Credit Suisse, which then required regulators to step in to prevent contagion across the entire banking system.

The response from regulators was swift, providing liquidity to offset deposit losses to deal with SVB and Credit Suisse and avert a GFC mark 2.0. Our base case is that the current stresses in the banking sector do not morph into a full blown banking crisis. The rapid rise in rates has, in our view, resulted in a liquidity crisis for the banks but not a systemic solvency crisis. That said, a material deterioration in the asset side of bank balance sheets (i.e. loan quality deterioration) would be highly concerning.

With the banking system crisis seemingly averted, at least in the near term, the market's focus has reverted to the tension between inflation and growth and the reaction function of the central banks. With the reemergence of inflation for the first time in decades, the playbook of central banks has arguably changed as their flexibility to respond to crisis is constrained. No longer able to aggressively cut rates at the first sign of stress they are forced to navigate a more difficult environment, balancing off inflation and growth. This is likely to see a stop-start approach to interest rate policy as we witnessed with the Reserve Bank of Australia in early April, where policy was unchanged but they also warned that this did not mean the tightening cycle was over.

Schroders

Post-fee performance of the underlying Schroder Absolute Return Income Fund, offered by Schroders as a Unit Trust

	1 mth	3 mths	6 mths	1 yr	3 yrs p.a.	mFund Code
Schroder Absolute Return Income Fund - Wholesale Class^	0.27	1.40	2.35	1.51	1.92	SCH55

^The fund on offer is unlisted. An application into this fund may be made through an application form attached with the PDS, which is available on our website at www.schroders.com.au. The management fee for the Schroder Absolute Return Income Fund (Wholesale Class) is 0.54%.

Outlook and strategy continued

A new investment regime

We believe we are heading into a different investment regime than we have been facing over the previous decade. The past 10 years have been marked by very low inflation, very low interest rates and low macro-economic volatility. Central banks flooded markets with liquidity by buying both sovereign and lower risk credit assets, a policy known as quantitative easing. This resulted in very low credit risk premia as investors were forced to chase higher yields with less regard for credit risk; those credit managers that invested at the higher risk end of the spectrum were rewarded with very strong relative returns.

High inflation in 2022 and the central bank response has resulted in a new investment environment, where economic risks have increased and there is higher risk of recession (with higher default risk) and higher uncertainty over growth and inflation outcomes, resulting in higher market volatility. In this environment it pays to build robust, liquid and defensive portfolios that diversify across multiple risk premia. As such, investors should be favouring income strategies that are: 1) diversified across risk premia (primarily interest rates and credit); 2) diversified across region, industry sector and asset type; 3) invested in liquid assets with transparent pricing; and 4) actively managed to enable shifting of portfolio allocations as valuations and risk change.

We believe that the Schroder Absolute Return Income Fund is well placed to manage through this change in regime. Firstly, with a duration range of -2 to +4 years we have significant flexibility to manage the level of interest rate risk in the portfolio and avoid structurally long duration settings. We expect much higher inflation volatility and it will pay to be active and flexible in managing interest rate risk by varying the total portfolio duration exposure. The recent experience in 2022 of very negative returns in government bonds as yields increased reinforces this.

Quality always matters

Investment grade credit will remain a key exposure for income funds, but managers will need to discriminate between issuers. The yield premium over government bonds will provide income, however individual issuer selection and sector selection will be increasingly important, particularly in periods where lending standards are being tightened. Identifying businesses that have high-quality cash flows and a business model that benefits from higher inflation will be important. Tighter credit standards will see some businesses face refinancing difficulty and hence default risk will rise; the importance of picking the winners and avoiding the losers in a market with asymmetric payoffs will rise. Investing in high yield (lower quality) credit will require even higher levels of valuation support (i.e. higher credit spreads) to provide an additional return to compensate investors for default risk, particularly as recession risks increase. This suggests tactical exposures to high yield credit – when valuations provide a high level of support – are the most appropriate way to manage exposures to this asset class. A structural exposure or buy and hold approach is, in our view, not advisable.

Foreign currency exposures will continue to be an important component of the portfolio. The Schroder Absolute Return Income Fund is atypical among its peer group, with the flexibility to hold up to 10% currency exposure. This is important as it provides an additional lever to add diversification and help manage and insulate the portfolio from downside risk in credit exposures, but can also be a source of return. For example with the rising risk of recession, the US dollar and the Japanese yen typically perform well against the Australian dollar. Furthermore as we move from the coordinated global easing cycle of the past decade to more divergence in policy from central banks, cross currency opportunities are expect to emerge as a source of return.

Overall we remain defensively positioned and our globally diversified and active approach will allow us to be flexible and take advantage of opportunities as we navigate the period ahead. Over the quarter we have deployed cash into high quality credit while also adding duration risk. Our liquid and high-quality credit bias should continue to protect capital and provide a defensive income stream with a current distribution rate of 4.5%pa, paid monthly.

Schroder Absolute Return Income (Managed Fund)

Quarterly Report
March 2023

Fund Objective

To outperform the RBA Cash Rate after fees over the medium term while aiming to avoid negative returns over any rolling 12-month period.

Key Features

– **Reliable monthly income:** Predictable and stable monthly income assists investors with planning their retirement income needs.
– **Global diversification:** Provides diversification across broad global fixed income markets with flexibility to respond to changing market conditions.
– **Strong risk management:** Actively managed to provide strong risk management, helping to avoid losses and preserve capital, should markets fall.
– **Competitively priced:** Competitive management fee of 0.54% p.a.
– **Easily accessed via one trade:** Contact your broker, financial planner or invest via your online trading account using the Cboe code: **PAYS**.
– **Brought to you by Schroders:** A leader in fixed income, with an experienced local team backed by specialists in 12 locations around the world.

Fund details

Cboe Code:	PAYS
Fund size (AUD)	$57,725,338
Redemption unit price	$9.2906
Fund inception date	November-2019
Management costs	0.54%
Distribution frequency	Monthly

Top ten holdings %

	Portfolio
TREASURY NOTE 2.0 30-JUN-2024	5.4%
AUSTRALIA (COMMONWEALTH OF) 2.75 21-APR-2024 Reg-S	2.9%
COMMONWEALTH BANK OF AUSTRALIA 5.0 13-JAN-2028 Reg-S (SENIOR)	1.3%
AUSNET SERVICES HOLDINGS PTY LTD 6.739 06-OCT-2080 Reg-S (SUB)	1.3%
TREASURY NOTE 2.625 15-FEB-2029	1.3%
AUSTRALIA (COMMONWEALTH OF) 1.25 21-MAY-2032	1.2%
TREASURY NOTE 1.75 15-NOV-2029	1.2%
AMPOL LTD 7.2361 09-DEC-2080 Reg-S (SUB)	1.0%
WESTPAC BANKING CORP 5.3 11-NOV-2027 Reg-S (SENIOR)	1.0%
SCENTRE GROUP TRUST 2 5.125 24-SEP-2080 Reg-S (SUB)	1.0%
Total	**17.6%**

Maturity Profile %

	Portfolio
0-3 Years	53.2
3-5 Years	19.8
5-7 Years	9.1
7-10 Years	9.1
10-15 Years	1.9
15+ Years	6.9

Security profile %

	Portfolio
Fixed rate	64.3
Floating rate	36.8
Other	-1.1

Regional exposure %

	Portfolio
Australia	66.2
USA	25.4
Europe ex UK	6.1
UK	1.2
Asia inc Japan ex EM	0.0
Emerging Markets	1.1

Holdings by composite broad credit rating %

	Portfolio
AAA	8.3
AA	12.5
A	16.2
BBB	41.0
Below BBB	4.6
Cash and Equivalents	15.1
Not Rated	2.3

Credit ratings are scales by which the future relative creditworthiness of a security is measured and express an opinion about the vulnerability of default. Credit ratings may be issued by an independent credit rating agency, or represent internal ratings prepared by Schroders. A change in a published credit rating can impact the price and liquidity of the security(ies) being re-rated.

Investors should not rely on credit ratings in making investment decisions or view them as assurances of credit quality or the likelihood of default. The ratings issued included in the monthly report are intended to be used by wholesale investors as a guide only and should not be relied on by retail investors when making a decision to buy, hold or sell any securities or make any other investment decisions.

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Figures may not total 100 due to rounding

Regional exposure is expressed by currency pre-hedging

Contact www.schroders.com.au
E-mail: web.queries@computershare.com.au

Schroder Investment Management Australia Limited ABN 22 000 443 274 Australian Financial Services Licence 226473 Level 20 Angel Place, 123 Pitt Street, Sydney NSW 2000 Phone: 1300 136 471 Fax: (02) 9231 1119