

Schroder Australian High Yielding Credit Fund - Active ETF (Cboe: HIGH)

Portfolio Review

In October, the Fund returned 0.5% (after fees), ahead of the benchmark by 0.2%. The underlying strategy has delivered a one-year return of 7.4% (before fees), ahead of the benchmark by 3.4%.

At October end, the portfolio is yielding 5.4% with an interest rate duration of 0.4 years.

Market Review

Markets moved largely sideways this month, with the steepness of the Australian yield curve continuing to see longer-dated credit outperform the mid-curve. Credit spreads were slightly more volatile, with higher -beta issuance widening materially, driving their attractiveness and creating opportunity.

The UBS AT1 security, notably, had an underwhelming month, primarily due to regulatory developments in Switzerland. Our dedicated European bank analyst notes that Swiss authorities are signalling the introduction of a new four-quarter profit test, which could automatically suspend all AT1 interest payments if a bank records four consecutive quarters of losses. This would differentiate Swiss AT1 securities from their US and European peers, which remain governed solely by capitalisation levels. Why does this matter? Based on this proposal alone, it could signal downgrade risk to these securities. However, in addition to the new profit test, the Swiss regulator is proposing a significant increase in required capital levels for Swiss banks - a material positive for credit investors. On balance, we believe a good argument can be made to suggest the credit rating will remain unchanged. Let's remember the Australian banks received a rating upgrade when it was legislated that they were required to hold more capital. We remain comfortable with our exposure to UBS, with spreads more than compensating for the evaluated risk.

The S&P downgrade to France's sovereign credit rating sent a few jitters through credit markets, especially impacting French Kanga Tier 2 bank paper, which detracted from returns. Despite this, we remain confident in the fundamentals of these institutions. Australian major bank Tier 2 has become exceptionally tight and overcrowded due to the launch of ETFs dedicated to this segment. It does highlight the concentrated nature of T2-focused ETFs at a time when these securities are now trading at a 1.7x sub-to-senior ratio - priced to perfection and offering little buffer. In the Schroder Australian High Yielding Credit Fund, we have been rotating our exposure away from expensive major bank Tier 2 securities into high-quality senior Australian corporates.

Meanwhile in the US, investors' nerves were rattled by concerns over exposures to the non-bank financial institutions, and allegations of fraud resulting in defaults of Tricolor and First Brands. Although subsequent disclosures showed exposures were small, the headlines put a dark cloud over what had been a relatively solid reporting season for the US banks. However, we are not discounting the potential for these types of events to have a more pronounced impact on financial markets, particularly as the problem lies in the opacity of the exposures and the quality of the underlying collateral. It highlights the importance of a sound investment process as risk assets remain highly priced, leaving little room for error.

Deal Focus

The primary landscape has seen mixed performance among corporates with some mild indigestion in select lines contributing to marginal spread widening. Most lines tightened on average 15-20 basis points (bp) from initial guidance, with investors spoilt for choice from a broad selection of new issues - from Stockland and Port of Melbourne and two inaugural deals from Patrick Terminal and German Utilities E.ON. Patience proved to be virtuous, as initial softness subsequently provided attractive entry levels. This was particularly pertinent with the US regional bank volatility and broader swap spread widening. Pleasingly, we saw a longer-dated corporate hybrid (Ampol) come with a NC8.25Y callable bond, which was 5x oversubscribed, highlighting robust demand for wholesale corporate hybrids.

The 'interesting' news this month was the issuance of a different type of hybrid. We saw the return of a franked hybrid from Lendlease. Compared to that of a retail bank hybrid, where the franking is included in the coupon, this particular hybrid applies franking post the calculation of the margin above cash.

Lendlease, despite its large but decreasing global presence, is emerging from an extended period of poor performance with a construction business historically recording poor margins, continued exposure to long-dated capital-intensive projects, revenue volatility, balance sheet strain and a history of project write-downs. Whilst it has recently been successful in fending off competitor Mirvac from taking a significant slice of its funds management business, Lendlease remains exposed to change, and we are very happy to watch from the sidelines.

Regardless of the underlying assessment, the franking arrangement proved to be an attractive selling point to mid-market and saw the issuer tighten from a very large initial range of +220-270 bps to +170-220bps, a tightening of 100 bp from the extreme ranges of the initial price talk.

The pricing certainly raised my eyebrows (a Botox refresh is required), especially given our proprietary valuation model suggested a fair value of well over 300bps at a very minimum, given the level of risk. It was obvious through the deal statistics, and the comparable deal participation from asset managers and institutions in Australian issuance, that there was broad agreement that investors are in no way being compensated for the risk here.

We saw opportunities elsewhere that were able to provide slight extension of duration e.g. inaugural UK mining issuer Weir, which is an issuer favoured by our global credit desk.

Sector focus

This year, the A-REIT sector has continued to demonstrate resilience amid ongoing macroeconomic uncertainty and evolving market dynamics. Following a challenging FY2024, characterised by flat interest rates and persistent inflationary pressures, the sector witnessed renewed investor interest, supported by stabilising bond yields and a brighter outlook for high-quality commercial property fundamentals. This positive momentum was driven by a rebound in rental growth, the stabilisation of capitalisation rates, and improving occupancy rates in select segments.

The retail sector saw incremental improvements, with discretionary consumer spending holding firmer than expected and regional shopping centre foot traffic rebounding. While discretionary retailers remain exposed to broader cost-of-living pressures, overall rental income has been underpinned by resilient essential retail and healthcare tenants.

Office A-REITs, however, continued to face headwinds from persistent hybrid working patterns and elevated vacancies. Some stability in capital values emerged in premium-grade assets, assisted by a

dearth of new supply due to high construction costs. However, non-premium and secondary office properties continued to experience high vacancy levels and weak tenant demand, a trend we don't see abating any time soon.

Finally, REITs focused on industrial and logistics assets continue to benefit from ongoing e-commerce expansion and supply chain modernisation, with strong tenant demand supporting high occupancy and robust rental income. Significant capital continues to be deployed into data centre infrastructure, reflecting an increasing digitalisation theme.

Market Outlook

We maintain the view that markets are currently pricing in an excessive number of interest rate cuts. As the outlook for these cuts becomes increasingly uncertain, the risk of a sell-off in risk assets correspondingly rises. While the underlying fundamentals of public credit remain robust, broader macroeconomic sentiment continues to influence market direction. In response, we have increased our allocation to higher-quality credit, positioning the portfolio more defensively as credit spreads gradually tighten.

Nevertheless, we continue to identify selective opportunities, particularly in periods of market dislocation - such as the small widening triggered by US private credit concerns earlier in the month. This environment reinforces the importance of an active approach, remaining anchored to valuations and maintaining a high level of vigilance in security selection.

Portfolio

This month, we focussed on improving the quality of the portfolio by down weighting our subordinated financial exposure and rotating into high quality Australian corporates within the infrastructure, utilities and metals and mining sectors.

Our exposure remains broadly skewed to Australian credit with over 90% denominated in local currency. With the recent supply indigestion in US investment grade (e.g. Meta's \$30bn jumbo deal) and growing concerns around regional bank credit quality, we held almost no USD credit exposure. We are looking to reengage in this segment as more underperformance has been priced in and offering better value against equities and attractive carry.

We currently hold around 40% in senior securities and continue to diversify our issuer exposure across over 60 individual companies.

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