Schroders

Schroder Sustainable Growth Fund (Wholesale Class)

Portfolio Review

The Schroder Sustainable Growth Fund returned 1.1% (post-fees) in April taking the one-year return to 1.7%. The portfolio has underperformed its Strategic Asset Allocation (SAA) benchmark for the month, as well as over one year.

Largest Contributors

Equities was the primary contributor to absolute returns during April, adding 0.8% to returns, primarily driven by Australian equities which added 0.7%. Foreign currency added a further 0.2%, driven by a stronger US dollar (USD) , while duration and credit added a further 0.1% to returns in aggregate. On a benchmark relative basis, active credit and duration added to returns, as did stock selection within Australian equities.

Largest Detractors

Over the month, there were no major detractors in absolute terms, while in benchmark relative terms, the fund's underweight to global equities, as well as stock selection within global equities and active foreign currency exposures were the negative contributors.

Market Review and portfolio update

Despite ongoing concerns around the banking sector, equity markets rallied through April on the back of resilient macroeconomic data and better than expected earnings in US and Europe. We are 70% of the way through the first quarter earnings season, and despite absolute levels of earnings falling compared to last year in both US and Europe, they have surprised to the upside against benign expectations. Within fixed income, bond yields moved higher in the first half of the month, before rallying in the latter stages to end the month broadly unchanged. On the inflation front, data was mixed, with US headline CPI falling to 5% on a headline basis, while core inflation continues to remain resilient, actually moving moderately higher to 5.6%, though leading indicators for the shelter component (which has a relatively large weighting within core CPI) continue to suggest a moderation in core inflation going forward. In Australia, both the headline and trimmed mean measures of inflation moderated over the first quarter, coming in at 7.0% and 6.6% respectively on an annual basis, with the latter measure being below market expectations. Towards the latter stages of the month, the ongoing issues surrounding the US debt ceiling began to make news headlines once again, though so far market reaction has been relatively muted.

Global equities gained 1.6% over the month in local currency terms, while Australian equities rallied by 1.8%. Emerging market equities underperformed, delivering -1.1% in US dollar terms for the month. Equity market volatility also continued to fall, with the VIX Index dropping to 15.8, the lowest month end level in almost 2 years. Australian 10 year bond yields moved 0.04% higher over the month to finish at 3.34%, while in the US 10 year bond yields rallied by 0.05% to finish the month at 3.42%. German and Japanese bond yields also moved higher by 0.02% and 0.04% respectively during April. Credit spreads tightened marginally across investment grade and high yield in developed markets, while emerging market debt spreads were flat over the month. The Australian dollar (AUD) weakened against most major currencies as a result of the market mostly pricing out RBA rate hikes (which later proved to be incorrect in May), as well as weakness in industrial commodity prices, notably iron ore, which dropped by over 12% during April.

Portfolio Sustainability

The portfolio's emissions intensity (scope 1 and 2) remains over 60% lower than that of the benchmark. The portfolio's SustainEx score remains positive on both an absolute (+2.3%), and benchmark relative basis (+4.9%), indicating a positive societal impact on both people and the planet using our proprietary ESG measure.

*Schroders uses SustainEx™ to estimate the net impact of an investment portfolio having regard to certain sustainability measures in comparison to a product's benchmark where relevant. SustainEx scientifically combines measures of both the harm companies can do and the good they can bring to arrive at an aggregate measure of each firm's social and environmental impact, allowing investors to target their ESG investments effectively. It quantifies the extent to which companies are in credit or deficit with the societies to which they belong, and the risks they face if the costs they externalise are pushed into companies' own costs. It does this using third party data as well as Schroders own estimates and assumptions and the outcome may differ from other sustainability tools and measures.

Portfolio Changes

Over the past few months, our strategy has been shifting to increasing duration risk and reducing equity and credit risk as the balance of probabilities shifts towards a recession in the US and potentially Australia as well. We have been reducing exposure to credit, particularly higher risk credit, as we believe the riskiest borrowers will struggle to refinance their debt as lending standards tighten. This is an intentional consequence of tighter monetary policy. Credit availability (at any price) will be restricted for both households and corporates that have high debt loads and reduced capacity to pay. The credit binge honeymoon is over! Current credit spreads for non-investment grade issuers are insufficient to compensate investors for the level of defaults that typically occur in a recession, so we have cut all exposure to high yield credit and have implemented hedges via credit derivatives in high yield to reduce overall portfolio credit risk.

We have been increasing duration exposure whenever yields backup. Through April we added an addition 0.2 years to portfolio duration, taking it to 2.0 years (0.6 years overweight), from 1.1 years at the end of last year and we expect to increase further as opportunities present. We have favoured longer dated maturities to gain duration exposure in both the US and Australia, as shorter maturities are still exposed to further policy tightening. Again patience is required, but we expect yields to eventually decline as central banks succeed in further moderating inflation and growth starts to contract.

Our foreign currency exposures remains skewed to defensive currencies, mainly the USD and the Japanese Yen (JPY). Historically the yen has performed well during cyclical declines, particularly against the Australian dollar, and together with our US dollar (USD) exposure, provides a downside risk hedge (alongside our duration exposure) against further weakness in credit spreads. In addition, the Yen remains very cheap historically and we patiently wait for the new Governor of the Bank of Japan to begin the process of dismantling their yield curve control policy, which should lift bond yields and the Yen.

Our equity position is key in terms of downside portfolio protection. During the month, we trimmed our equity allocation at the margin, but maintain some long call options to ensure that we can still participate in a rally, should risk assets continue to bounce. At month end we had 57% equities in option adjusted terms (54% excluding options), we remain defensively positioned, and 10% underweight our SAA benchmark. We are predominately underweight the US market, which has the most stretched valuations amongst the major equity markets. Interestingly, returns from US stocks this year have been driven almost exclusively by a handful of large tech stocks on the back of optimistic rate expectations, which we don't think will be sustained.

The flip side of this is that our cash weight remains high, with around 19% (22% excluding the impact from options). Fortunately, cash now pays us a decent nominal return as well as being a good short-term store of value). It's important to note here, though, that we have increased activity in the portfolio over the last 18 months, as both economic and market volatility have increased. We see this as being more consistent with the broader environment where liquidity is less abundant and assets need to compete for capital. This means

fundamentals matter again, as opposed to abundant liquidity driving prices, and we expect this heightened level of portfolio activity to continue and to be reflected in both asset allocation and implementation decisions.

Individual Equity Holdings

The Fund holds securities in the following companies that breach our negative revenue screens. We hold these securities in our "transition" allocation by exception and provide the rationale below. In aggregate, these holdings have a 3.7% weight in the portfolio.

Equinor

A Norwegian based oil and gas company which is remains 2/3rd state owned. They have a group-wide operational target to reduce emissions by 90% by 2030 (vs 2015 levels). Included in this target is more than 50% of their annual capital expenditures to renewables and low carbon solutions by 2030.

NextEra Energy

Largest developer of renewable assets in the US who are also in the business of buying up bigger polluting utilities and improving their emissions by transitioning them to renewable sources. Its 2020 CO2 emissions were 47% lower than the average US power sector with a target to reduce emissions by 67% by 2025 (2005 baseline). Do not currently have a Science Based Target Initiative (SBTI) endorsement but they do use science-based targets. The company has set ambitious Real Zero emissions reductions targets, aiming to reduce emissions by over 80% through 2030, and to be Real Zero by 2045.

Clearway Energy

Clearway is the 6th largest owner and operator of renewable energy in the USA. Through its wind, solar and energy storage business they estimate they account for 10m metric tons of CO2 annually. In 2021, 91% of their produced electricity came from carbon-free sources with additional major renewable developments already in the pipeline (4x current capacity). Clearway aims to have 95% of the electricity it generates to be carbon free by 2035, and to achieve net zero emissions by 2050.

Iberdrola

Iberdrola is Spanish based utility who are also the world's second biggest producer of wind power by market cap. The company increased its renewable capacity by 9.1% over the past 12 months including an increase of 60% in its photovoltaic capacity and a 135% increase in its installed battery capacity, combining so that the group's installed emission-free capacity now stands a 81%. Iberdrola has set a target of being carbon neutral for scope 1 and 2 emissions by 2030 and to achieve net zero prior to 2040 (including scope 3 emissions). Iberdrola's emissions targets have been ratified by SBTI as 1.5˚C aligned.

Pioneer Natural Resource

Pioneer Natural Resource is a US based Energy company. It has set net zero targets by 2050, and also has significant shorter term greenhouse gas (50% reduction) and methane reduction (75% reduction) targets by 2030 relative to 2019 levels. Additionally, it has also set a significant 80% fresh water used reduction target by 2026 relative to a 2015 baseline, while it is also involved in a number of landscape restoration and conservation efforts in its region of operation.

Asahi Group

A Japanese beverage company that has 1.5°C SBTI climate targets, and are also early signatories of the new SBTI Net Zero category, which sets very clear and strong guidelines for achieving a high quality net zero trajectory. These targets commit Asahi to reduce scope 1+2 emissions by 50% by 2030, and 100% by 2050. These are strong targets in a global context, and is seen as a climate leader within Asian equities.

BHP

An Australian mining company with a resource mix that is important for the world's decarbonisation needs, with material such as nickel used for electric vehicles and battery storage, copper used in renewable energy generation and iron ore for infrastructure projects. Its 2030 emissions intensity reduction targets are expected to be 80% lower than the current regional sector average, and it aims to achieve net zero emissions (inclusive of scope 3) by 2050. Over a shorter time horizon, it has been divesting from its coal mines, and aims to continue do so going forward.

Market Outlook

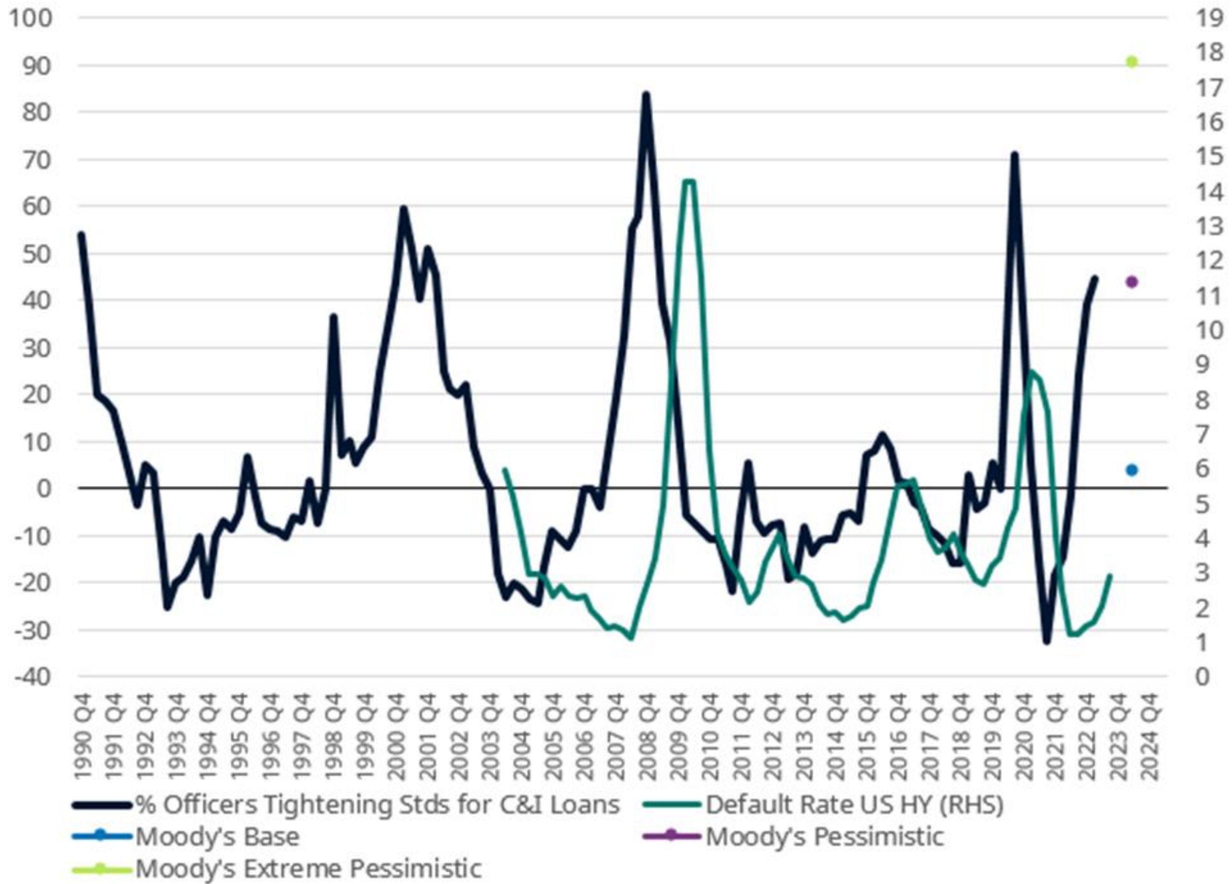
April drew to a close with recession still an expectation, not the reality. Economic data generally continues to moderate, but is not yet dire, while inflation, the key focus of policy maker attention, is also starting to soften but remains uncomfortably and stubbornly high. While bond markets are reflecting the ongoing tussle between these factors, equities in April (at a headline level at least) seemed to reflect a more positive interpretation of events.

We remain of the view that recession is the most likely outcome for key economies, given the accumulated policy tightening and the eventual outworking of Covid stimulus, and remain very defensively positioned. Unfortunately, the confluence of current economic outcomes is uncomfortable for central banks and rates are more likely to rise than fall in the near term. Outside of a recession, any potential for rates cuts seems remote and in our opinion is not a 2023 scenario.

Our conviction in looming recession (both in Australia and in key global economies), is reflected in our recession indicator which has been flashing red for 12 months now, with 65% of the indicators signalling recession. US employment, a lagging indicator, is starting to show some cracks. Although the headline unemployment rate remains at historical lows at 3.5%, initial jobless claims are now starting to rise. This means that they are finally correlating with other negative labour market signals and we expect the unemployment rate to increase over the remainder of the year. We are also cognisant that monetary policy acts with a lag and while rates have been rising steadily for 12 months now, starting rates were low and the pass-through to household and business cash-flows more muted.

If proof that higher rates are having a negative impact is required, then we need to look no further than the unfolding crisis in US small/regional banks, where the Federal Reserve's policy actions have exposed the accumulated risks of the free money era on bank balance sheets, as well as a flawed regulatory framework and poor management in some of these banks themselves. The pressures here will likely lead to a further tightening in lending standards by US banks, which will restrict access to credit to the riskiest borrowers, both household and corporate. Bank lending standards have already increased and are consistent with levels prior to past recessions. The chart below shows a Federal Reserve survey of the percentage of senior loan officers tightening lending standards and the US high yield default rate. The latest survey was conducted prior to Silicon Valley Bank being closed by US regulators, but shows a significant tightening in lending standards was well underway and consistent with a significant increase in the default rates of the most risky corporate borrowers. The next senior loan officers survey is due out in early May and we expect confirmation of a further tightening of lending standards.

Chart 1: US Federal Reserve Senior Loan Office Survey vs Moody's High Yield Defaults



Source: US Federal Reserve, Moody's Investors Service.

The Reserve Bank of Australia is well aware of the long and variable lags of the impact of previous monetary policy decisions and while political pressure on the RBA has been intense, a pause in April after a cumulative 3.5% lift in official rates since May last year was justifiable. However, slowing down the pace of tightening is sensible. Inflation, while moderating, remains way too high for policy maker comfort. This unease was reflected in the RBA's decision to lift rates in early May to 3.85%, despite market expectation for an extended pause. The Fed also raised rates again in early May, with a clear message that while there are positives in the global inflation fight, the fight isn't over and inflation remains uncomfortably high.

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