Schroders

May 2025

Schroder Sustainable Growth Fund (Wholesale Class)

Portfolio Review

The Schroder Sustainable Growth Fund returned 3.4% (post-fees) in May, taking the one-year return to 10.3%. The portfolio outperformed its Strategic Asset Allocation (SAA) benchmark for the month, but has underperformed over one year. Over the medium to longer term, the fund has returned 7.8% p.a. and 7.5% p.a. over three and five years respectively.

Largest Contributors
With equity markets rallying through May, equities was the largest positive contributor over the month, adding 3.5% to returns, with 2.4% from global equities and 1.1% from Australian equities. As credit spreads tightened, the Fund's allocation to higher yielding credit was a more marginal contributor to absolute returns through May. On a benchmark-relative basis, stock selection in global equities was the biggest contributor to positive active returns, while the Fund's call options on US equities also added to active returns.

Largest Detractors
With bond yields moving higher through the month, duration was the largest detractor in May, having a -0.3% impact on portfolio returns, while FX also detracted by 0.2%. On a benchmark-relative basis, stock selection within our Australian equity biodiversity strategy was the largest detractor of active fund returns. The Fund's active hedges such as its gold exposure, its moderate overweight exposure to duration and its currency tilt towards the yen also detracted from active returns.

Market Review

Equity markets performed strongly in May, primarily driven by an easing of trade tensions between the US and China, with both countries significantly lowering their tariff rates for imports from each other, while a trade deal was also negotiated between the US and the UK. On the economic side, data remains resilient in the US, with solid jobs growth and Q2 GDP indicators suggesting a rebound from the negative Q1 GDP figure. Survey data in the US remains mixed, with the University of Michigan consumer sentiment and US CEO confidence both still at relatively low levels, while the Conference Board consumer confidence indicator has partially rebounded. In the second half of the month, the Moody's credit rating downgrade of US sovereign debt, sparked concerns about the sustainability of the US government's fiscal policy. Global trade uncertainty also fluctuated towards the latter stages of the month, with President Trump initially raising the tariff rate against the European Union to 50%, before delaying this increase until July 9. Locally, the Reserve Bank of Australia (RBA) cut its policy rate by 0.25% in May and implied a more dovish outlook, with financial markets currently pricing in 3 to 4 additional 0.25% rate cuts over the next year.

Global developed market equities delivered a strong return of 6.0% in local currency terms during May, while Australian Equities returned 4.2%. Emerging market equities also produced a solid return of 4.3% in US dollar terms during the month. At a sector level, the Tech sector was the standout performer both in Australia and globally. In fixed income, bond yields moved higher, particularly in the US with the 10-year bond yield increasing by 0.24% to finish at 4.4%, while in Australia the 10 year bond increased by 0.1% to finish at 4.26%. 10-year bond yields also moved higher in Germany and Japan by 0.06% and 0.18% respectively. Credit spreads tightened across sectors, most notably in US high yield where spreads moved almost 70 basis points tighter. Within currency, the US dollar index was broadly flat for the month, while a number of Asian currencies were the standout performers, most notably the Taiwanese dollar which appreciated by 7.0% in May relative to the US dollar. The Bloomberg commodity index fell by 0.6% in May, however oil rebounded from its lows, with the Brent oil benchmark rallying by 3.5%.

Portfolio Sustainability

The portfolio's weighted average carbon intensity (scope 1 and 2) remains approximately 50% lower than that of the benchmark. The portfolio's SustainEx score remains positive on both an absolute (+2.3%), and benchmark relative basis (+4.3%), indicating a net positive societal impact 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.

Individual equity holdings

The application of the Negative Screens is only limited to directly held company-issued public securities that can be reasonably screened, such as listed Australian and International equities as well as corporate bonds. *Our definition of directly held or direct investment means securities held either by Schroder Investment Management Australia Limited (SIMAL) or other Schroders Group managed funds that apply SIMAL's exclusions and where SIMAL has discretion over security selection.* ***These Negative Screens do not apply to Indirect Investments, including other Schroders Group managed funds that do not apply the Fund's exclusions****. This includes those investments in securities where SIMAL does not have discretion over security selection such as those managed by third-party investment firms, such as joint venture partners, market indices and externally managed investments such as ETFs, as well as Sustainable Finance Disclosure Regulation (SFDR) Article 8 and 9 funds that are managed by Schroders Group. The Fund's total exposure to these Article 8 and 9 funds could be approximately 20-40% of the NAV of the Fund. Unless otherwise stated, the thresholds apply only to a company's direct involvement in the excluded activities. More information on the application of Negative Screens can be found in the Additional Information to the PDS' booklet (which forms part of this PDS). You can download a copy of the PDS and the 'Additional Information to the PDS' from Schroders' website at www.schroders.com.au*

The Fund holds securities in the following companies that do not meet our negative revenue screens. We hold these securities by exception and provide the rationale below. In aggregate, these holdings have a 0.2% weight in the portfolio. The list of securities below includes direct holdings, as well as positions in Sustainable Finance Disclosure Regulation (SFDR) Article 8 and 9 funds that are managed by Schroders Group that are held indirectly, but does not include derivatives (such as index futures and index options) and ETF positions used for tactical implementation and/or portfolio hedging.

<u>Contact Energy</u>
Contact Energy is a New Zealand energy generator and retailor, that is working towards having its power generation operations being net zero by 2035. It currently operates a number of low carbon geothermal power stations, as well as hydroelectric power plants. It is also working on the development of various solar and wind farm projects, as well as partnering with Tesla on the development of large scale battery infrastructure. It's climate targets and ambitions have been independently certified through the Science Based Target initiative (SBTi) as being aligned to 1.5 degrees of warming. Contact Energy is held directly through our allocation to investment grade credit.

<u>Heineken</u>

Heineken is a Dutch brewing company, that produces a wide range of beers and ciders globally. Heineken has committed to reach net zero emissions across its value chain by 2040, while also committing to reduce Scope 1 and 2 emissions by 90% by 2030 (relative to a 2022 base year), along with targets on circularity and water usage. The company has been involved in a significant number of renewable energy projects worldwide to help Heineken achieve its climate targets, with management compensation also tied to climate KPIs. Heineken is held indirectly through one of underlying our Global Equity managers.

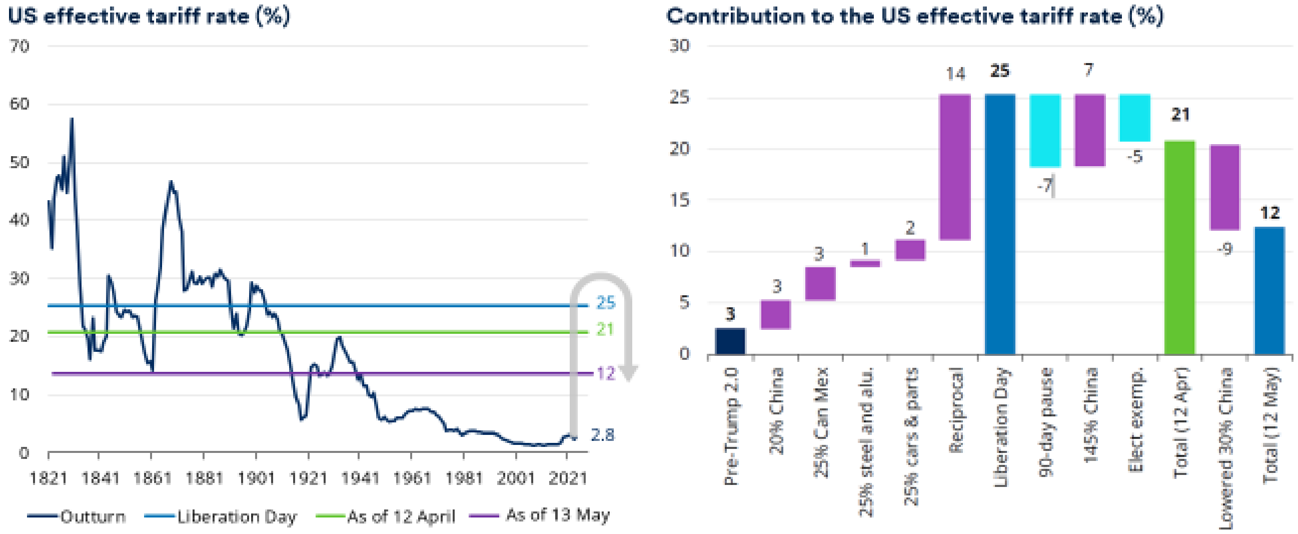
NextEra Energy
The largest clean energy company in the US, who are also in the business of buying up bigger polluting utilities and improving their emissions by transitioning them to renewable sources. Its historical CO2 emissions have continuously been lower than the US power sector average with a target to reduce emissions by 70% by 2025 (against a 2005 baseline). 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. NextEra Energy is held indirectly through one of underlying our Global Equity managers.

Market Outlook

Another month and another policy reversal. On April 2nd, Liberation Day, Trump unveiled sweeping tariffs across all trading partners, which resulted in a tit-for-tat tariff escalation between the US and China. The total effective tariff rate on US goods rose to a peak of 30%, which, if left for long, would have set the course for a US recession. In early May, the US and China lowered tariffs on each other from 145% and 125%, respectively, down to 30% and 10% for 90 days, causing the current effective tariff rate to settle somewhere around 12%, effectively removing the economic pain while the US negotiates with its trading partners. Thankfully, I don't even have to write about the brief escalation of EU tariffs to 50%, or the US trade court ruling that tariffs were unlawful, as these were both resolved within days. While we could easily see Trump ratchet tariffs higher again if he believes this will increase his negotiating power, we believe peak tariff fear is behind us and the market will instead turn its attention now to fiscal policy.

The rest of the year will likely entail more volatility as the market narrative oscillates between Trump's growth policies and his protectionist policies. Even if the market is starting to move on from tariffs, Liberation Day did more than liberate us from our money – it also dented the US economy. Uncertainty has caused consumption to slow and for businesses to pull back from hiring and capital expenditure plans. Corporates are unlikely to lift a finger until Trump shows his hand. Only once the trade war is over can they start to make long-term investment plans. This has caused our global economics team to downgrade their US growth forecast from an above-trend 2.5% to slightly below-trend 1.7% real GDP growth for 2025. This assumes the trade war ends with 10% universal tariffs globally and 30% on China, resulting in an effective tariff rate around 12%, which is where we've currently settled.

Chart 1: Easing of US-China trade tensions brings the US effective tariff rate to 12%



145% on China represents the additional 91% imposed since Liberation Day on 2 April.
Source: Schroders Economics Group. 12 May 2025

We are monitoring the job market and domestic consumption to see if the hit to growth was worse than expected. Recent weak first quarter GDP was muddied by large swings in net trade and inventories as companies tried to front-run tariffs, while underlying domestic demand so far seems weaker but not broken. Higher tariff rates will likely lift US inflation to above 3% both this year and potentially next year as well, which would hinder the US Federal Reserve (Fed) from cutting rates as aggressively as the market desires. The likely worsening of the fiscal deficit from Trump's 'One Big Beautiful Bill' Act will also put upward pressure on long-end bond yields, which could ultimately hurt both the economy and the equity market. However, fiscal stimulus and deregulation should keep growth afloat in 2025, even though there will be bumps along the way.

Recession is no longer a given in the US but still remains a risk. If there is a larger slowdown below trend growth or recession, the US will be in a difficult spot. Tariffs lead to higher inflation, which would prevent the Fed from cutting rates to defend growth. The US fiscal position is already dire, which would only get worse if economic activity rolls over. This would limit the usual stimulus from monetary and fiscal policy. This is not true in other parts of the world, as any slowdown would most likely be disinflationary. Central banks globally have already started to cut rates and increase fiscal stimulus, and have the capacity to do more if growth weakens further. Europe is also undergoing more economic intervention. After a decade of austerity, Germany has announced plans to spend up to an extra 3.5% of GDP on fiscal stimulus, focusing on defence spending, infrastructure and tax cuts. Combined with further progress on inflation, our economics team anticipates the European Central Bank (ECB) will reduce the deposit rate to 2%. This should see Eurozone growth increase from 1% this year to 2% by 2026.

In Australia, the Reserve Bank of Australia (RBA) is set to deliver a soft landing as inflation has continued to gradually moderate and the labour market remains resilient. Activity indicators point to the risk that growth may not be rebounding as quickly as expected. The RBA will need to return the cash rate to a neutral stance over the coming months. Australian growth is likely to return to trend at around 1.5% assuming the RBA cuts rates to 3%. The most obvious risk to the downside remains the global backdrop and its uncertain transmission to the local economy, particularly any damage to China through the trade war. Despite the fiscal position of both the federal and state governments deteriorating, this will help support growth and we remain in good fiscal standing compared to other countries. If we did experience a more significant slowdown, the government could stimulate to support growth. A larger fallout could see the need for the RBA to take policy into stimulatory territory, taking the cash rate below 3% to defend growth. This means we view the likelihood of an Australian recession as low.

Portfolio changes

We increased our equity allocation from 65% at the end of April to 69% in May (inclusive of our equity call options), predominantly through increasing our exposure to US equities. This was a mix of closing our short US futures position and our S&P 500 call options delta increasing. US equity positioning is still very light at almost -1 standard deviation based on the indicators that we are observing, where systematic traders could reallocate given strong momentum and falling volatility. On a benchmark-relative basis, our total equity exposure is neutral based on our underlying allocations, but after taking into account the exposure from our call options, this takes us to 2% overweight. On a regional basis, we still prefer global equities over Australian equities, where we remain 2% underweight, given the more expensive valuation and benign growth outlook locally.

Our credit exposure also increased by over 3% in May, split across investment grade, high yield and securitised credit. Although spreads have tightened from their April wides, there were still opportunities to take advantage of spreads in early May. Whilst we are not out of the woods, the reduction of recession risk and potential for volatility in equities over the next few months on wild policy swings makes earning carry attractive. The addition to equities and credit saw our cash allocation drop from over 11% (6% overweight) down to 4% (1% underweight) by the end of May.

In currencies, we remain defensively tilted, with our largest active position being in the Japanese yen, where the portfolio is about 3.5% overweight at the end of May. With trade tensions between the US and China easing over the shorter term, we have closed our small short position in the Chinese yuan (CNY), as the prospect of any currency devaluation from the People's Bank of China is now very limited. Our overall foreign currency exposure is about 23% (2% overweight).

Finally, we reduced our portfolio duration from 1.8 years down to 1.6 years (0.3 years overweight). Compared to early April, we have reduced overall portfolio duration in the fund by over 0.7 years. We maintain a relative preference towards Australian government bonds, and to a smaller extent Europe and the UK, over the US and Japan, where we believe the longer end remains more vulnerable to a further sell-off.

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