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

Quarterly Report - December 2023

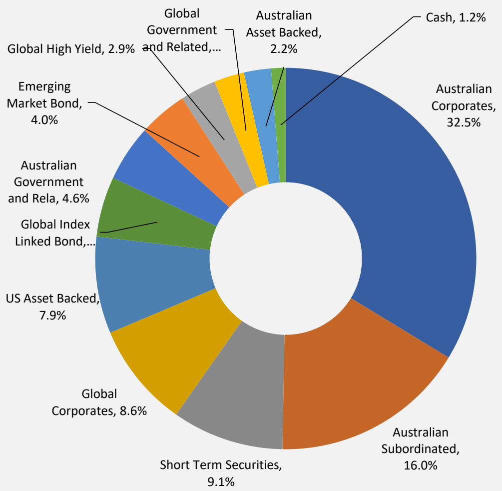
For more information about the Fund visit www.schroders.com.au/pays

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)	1.39	2.73	3.91	5.80	1.56	1.93
RBA Cash Rate	0.36	1.05	2.07	3.89	1.75	1.37
Relative performance (post-fee)	**1.03**	**1.68**	**1.84**	**1.91**	**-0.19**	**0.56**

Past performance is not a reliable indicator of future performance. Returns over 12 months are annualised.

Portfolio inception 19/11/2019, 4 years and 1 months

Asset allocation %



Portfolio statistics

Duration	1.28 yrs
Yield to maturity	5.15%
Average credit rating	A
Number of securities	2460

*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 Dec 2023

*Benchmark is the RBA Cash Rate

Market review

Global equity and bond markets posted strongly positive returns in December, as the US Federal Reserve signalled a shift in policy, with rate cuts now expected in the first half of 2024.

Equities

With US core inflation continuing to weaken and growth slowing, markets have quickly shifted towards a cycle of rate cuts in 2024. This was reinforced by Fed chair Jerome Powell, who indicated that the central bank was aware of the risk of keeping rates at restrictive levels for too long. Policymakers now expect rates to end 2024 at 4.5%-4.75%, down from the current 5.25%-5.5% range. Global equities rallied strongly in response, with the S&P500 up 4.5% over the month and European equities up 3%. Australian equities outperformed gaining 5%. Emerging market equities marginally underperformed, held back by Chinese equities which were down 2% amid ongoing worries over the real estate sector.

Fixed Income

Government bond yields fell sharply, and credit spreads contracted, with corporate bonds outperforming government bonds in response to the Fed's policy shift. Other major central banks appear more cautious on the inflation outlook and have pushed back against market expectations for a large rate cutting cycle in 2024. As markets priced in easing conditions, government bond yields fell across the board. The US 10-year Treasury yield fell from 4.35% at the end of Q3 to 3.87%, the German 10-year Bund yield ended the month 0.42% lower at 2.03%, while the Japanese 10-year bond yield fell 0.04% to 0.63%.

Despite more evidence of a slowing in growth, the corporate bond market staged an impressive rally on hopes that a recession could be averted as financial conditions eased. High yield markets outperformed investment grade in both the US and Europe, with a tightening of spreads also marking significant outperformance over government bonds.

Foreign Currency and Commodities

The S&P GSCI Index declined in the fourth quarter, with price gains for precious metals and industrial metals failing to offset weaker prices for agriculture, energy, and livestock. Energy was the worst performing component, with sharply lower prices for natural gas, crude oil, and gas oil. Oil prices fell despite output cuts from OPEC and continuing conflict in the Middle East.
The US dollar (USD) weakened sharply in response to the expected change in policy from the Fed, weakening by 5% against the Japanese yen and 1.5% against the Euro. Emerging market currencies outperformed, particularly the higher yielders, notably the Thai Baht, South African Rand and Mexican peso. The Australian dollar also gained 3.5% against the USD.

Portfolio review

The Schroder Absolute Return Income (Managed) Fund delivered a return of 1.4% (net of fees) for the month of December and 5.8% (net) over 12 months, which is 1.9% over the RBA cash rate for the past year. Over 3 years the fund has returned, net of fees, 1.6% p.a. which is 0.2% p.a. below the RBA cash rate.

Largest contributors

All fixed income allocations added value over the month. Australian investment grade corporate allocations added the largest positive contribution, followed by global investment grade corporates. Higher yield Australian corporates, predominantly subordinated bank debt and BBB corporates, were also strong contributors. Foreign currency exposures added marginally.

Largest detractors

The Fund's interest rate overlays, which are used to partially hedge duration exposures, detracted from returns.

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^	1.39	2.73	3.92	5.81	1.56	SCH55

Outlook and strategy

Equity and bond markets continued to perform well over December. While the market correctly predicted that the US Federal Reserve (Fed) would leave policy rates unchanged at their December meeting, the collective wisdom (us included) was that Chairman Powell would push back against the recent sharp falls in bond yields and the general easing in financial conditions to dampen down expectations of early rate cuts in 2024. Instead the Fed has effectively declared victory over inflation, with a big shift in the quarterly update of their economic and Federal Funds Rate projections. The previous projections in September showed the majority of members expected one more rate increase by the end of 2023. Now the committee expects to cut rates by 75 basis points in 2024, with inflation falling to 2.1% by year end whilst avoiding a recession. Chairman Powell's press conference following the meeting delivered further confirmation that the Fed was now focused on the potential for weaker growth, not higher inflation, as policy was now "well into restrictive territory" and the Fed would need to start cutting rates well before inflation reached their 2% target as failing to do so would risk slowing activity too much. As this was a significant shift from the previous "higher for longer" narrative, the market reaction was swift and over the course of the press conference 2-year and 10-year US treasury yields fell by 30 and 20 basis points, respectively and the US dollar (USD) weakened by 2%.

This change in stance by the Federal Reserve is a particularly good outcome for investors in equities and bonds. If inflation continues to decline, as currently expected, interest rates will be cut and financial conditions will continue to ease which supports both business and consumers. If growth weakens as well then there is significantly more scope to cut rates to support the economy. Equity markets have rallied and corporate credit spreads, particularly high yield, have narrowed reflecting the lower risk of a US recession with the Fed willing and able to provide a safety net. Other central banks are a little more cautious about the risks to inflation. The European Central Bank has pushed back on the prospect of rate cuts in the first half of 2024, despite the European economy being considerably weaker (with zero growth over the past two quarters). Their focus remains on domestic price pressures remaining elevated, primarily owing to strong growth in unit labour costs. In Australia, the RBA left policy unchanged at their December meeting, but maintained a bias to raise rates further to ensure inflation returns to target in a reasonable timeframe. As at the end of December, market pricing for official policy rates for the end of 2024 has the US Fed Funds Rate 1.5% lower, European deposit facility rate 1.6% lower and the Australian cash target 0.6% lower. While we expect US rates to be eased next year, for short dated bonds to outperform cash, official policy rates have to be cut by more than 1.5% over the course of 2024. While this is definitely more than possible in a recession, this is no longer our base case, particularly if the Fed is pre-emptive as suggested by Powell.

Reflecting this higher hurdle for duration risk, within the Schroder Absolute Return Fund, we reduced our duration exposure by 0.8 years across all three of our main exposures in Australian, European and US rates throughout the month. In Australia, with rate cuts priced, we also shifted exposure further along the yield curve as we expect the RBA to be on hold for a considerable time due to their current trajectory for core inflation only just reaching the top of its target band by the end of 2025. In addition, the Federal Government's stage 3 tax cuts are due to come into effect in July. We have seen projections that the tax cuts are the equivalent of a 50 basis point easing for higher income earners. With this loosening in fiscal policy on the horizon, unless the economy is in recession, we expect the RBA will want to assess the impact on third quarter inflation and growth data, before cutting rates.

Within foreign currency exposures we have maintained the total net exposure to an absolute minimum as we have been expecting the Australian dollar to perform well given the RBA's continued tightening bias. Instead, we have increased exposure to the Japanese yen, which we expect to perform well given its historical cheapness and the prospect of declining interest rate differentials to other currencies. We hold the long yen position (currently 2.5%) against a mix of USD, euros and Swiss francs. Additionally we have increased exposure to emerging market currencies (also currently 2.5%) held against the USD, as we expect higher yielding EM currencies (such as the Brazilian real and Mexican peso) to perform well against the USD as the Fed cuts rates. We gain exposure to a selection of EM currencies via an allocation to the Schroder Emerging Market Debt Absolute Return Fund, managed by our team in London.

With the Fed pivot to providing a safety net, the outlook for credit risk remains favourable and we have broadly maintained the Fund's exposures over the month. Cash levels remain historically low at around 13% and we have the majority of our credit exposures diversified across Australian and Global investment grade corporates. In addition, we have been building up our position in securitised credit, which is cheap relative to equivalent rated corporate securities. In higher risk credit, we took profits on some of our Australian subordinated bank debt, which have outperformed strongly, and saw an attractive entry point to rotate into US high yield. High yield spreads have rallied considerably since and now look expensive so we expect to close out our position in January.

With the near-term inflationary problem seemingly tamed and central banks biased to ease monetary policy, the outlook for returns from fixed income has improved. However, the market has moved quickly to price significant rate cuts into global bond yields, which makes us more cautious on duration risk in the shorter term. We have reduced our duration exposure, but expect to increase duration if yields back up over strong growth or disappointing inflation data. We have increased risk in foreign currency exposures, but avoided being short the Australian dollar, which we expect to continue to do well. Instead we prefer being short the USD, particularly against the Japanese yen and higher yielding emerging market currencies. Credit exposures should continue to perform well, but if recession risk increases we will look to reduce exposures.

Schroder Absolute Return Income (Managed Fund)

Quarterly Report
December 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 Chi-X 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)	$53,190,070
Redemption unit price	$9.3655
Fund inception date	November-2019
Management costs	0.54%
Distribution frequency	Monthly

Top ten holdings %

	Portfolio
AUSTRALIA (COMMONWEALTH OF) 2.75 21-APR-2024 Reg-S	3.1
TREASURY (CPI) NOTE 0.5 15-JAN-2028	2.0
TREASURY (CPI) NOTE 1.25 15-APR-2028	2.0
COMMONWEALTH BANK OF AUSTRALIA 5.0 13-JAN-2028 Reg-S (SENIOR)	1.5
TREASURY NOTE 1.75 15-NOV-2029	1.2
AUSTRALIA (COMMONWEALTH OF) 1.25 21-MAY-2032	1.2
TREASURY NOTE 2.625 15-FEB-2029	1.2
AUSTRALIA AND NEW ZEALAND BANKING 5.5472 04-NOV-2027 Reg-S (SENIOR)	1.2
WESTPAC BANKING CORP 5.6486 11-NOV-2027 (SENIOR)	1.2
SUNCORP METWAY LTD 5.0229 25-JAN-2027 (SENIOR)	1.2
Total	**15.8**

Maturity Profile %

	Portfolio
0-3 Years	41.6
3-5 Years	25.2
5-7 Years	12.8
7-10 Years	8.6
10-15 Years	3.6
15+ Years	8.2

Security profile %

	Portfolio
Fixed rate	67.0
Floating rate	30.8
Other	2.2

Regional exposure %

	Portfolio
Australia	58.5
USA	31.3
Europe ex UK	5.3
UK	1.9
Asia inc Japan ex EM	-0.4
Emerging Markets	2.1

Holdings by composite broad credit rating %

	Portfolio
AAA	10.6
AA	13.4
A	19.6
BBB	33.2
Below BBB	7.4
Cash and Equivalents	13.6
Not Rated	2.2

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.

Unless otherwise stated figures are as at the end of December 2023

Figures may not total 100 due to rounding

Regional exposure is expressed by currency pre-hedging

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