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

Monthly Report - May 2024

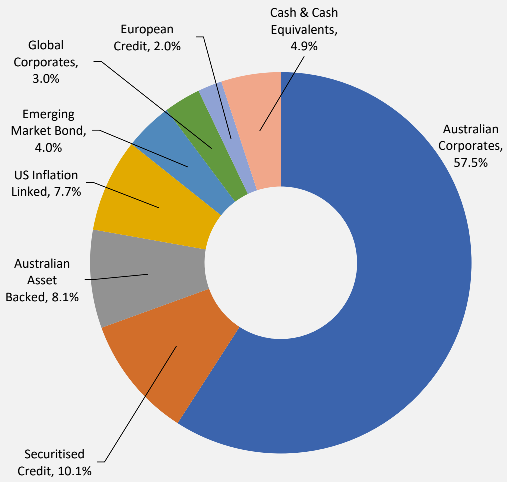
For more information about the Fund visit www.schroders.com.au/pays

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)	0.53	1.41	3.35	5.79	2.09	2.18
RBA Cash Rate	0.36	1.07	2.15	4.25	2.34	1.64
Relative performance (post-fee)	**0.17**	**0.34**	**1.20**	**1.54**	**-0.25**	**0.54**

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

Portfolio inception 19/11/2019, 4 years and 6 months

Asset allocation %



Portfolio statistics

Duration	1.92 yrs
Yield to maturity	5.36%
Average credit rating	A
Number of securities	1690

*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 May 2024

*Benchmark is the RBA Cash Rate

Market review

Global equities rallied in May with developed markets outperforming emerging markets. US shares, outperformed posting strong gains in May, supported by some strong corporate earnings and hopes that interest rate cuts are still on the way later this year as the latest inflation data met expectations and was greeted by relief from investors. The equity market advance was led by the information technology, utilities, and communication services sectors. Energy was the main laggard amid weaker oil prices. Some of the "Magnificent-7" stocks performed strongly in the month amid strong earnings and high demand for AI-related technologies. Eurozone stocks advanced with the real estate and utilities sectors among the top gainers. These sectors drew support as investors looked ahead to the European Central Bank (ECB) meeting in June where a rate cut is widely anticipated. Data showed that eurozone annual inflation, as measured by the consumer price index, increased to 2.6% in May from 2.4% in April. Nevertheless, investors continued to expect a 25 basis point rate cut when the ECB meets on 6 June. However, the timing of further rate cuts remains uncertain. The Japanese equity market experienced a rebound in May, with the TOPIX generating a total return of 1.2%. Japanese companies continue to benefit from a weak currency and the market is rewarding companies focusing on the cost of capital the share price, with a record high amount of share buybacks announced. Emerging market (EM) equities rose in US dollar terms although they lagged developed market peers. Softer US macroeconomic data helped ease concerns about the timing of US interest rate hikes while better performance from China also supported EM returns. Lower energy prices weighed on some of the Middle Eastern markets.

Government bond markets diverged in May. US Treasury yields fell from their year-to-date highs, outperforming European markets where yields crept higher. Positive inflation data, signs of weaker growth, and softer labour market indicators supported US bonds. US Federal Reserve (Fed) chair Jerome Powell maintained an easing bias, hinting that rate hikes remained unlikely. Renewed confidence in the Fed lowering interest rates later this year supported credit markets. Australian government bonds yields had a volatile month trading in a 30 basis point range, falling sharply following weak employment data, then rising after inflation disappointed. Overall Australian 10 year bond yields fell by 5bps. US investment grade (IG) corporates outperformed European markets on a total return basis, although positive excess returns over governments were similar across regions as spreads tightened.

The US dollar weakened against all G10 currencies due to softer rate expectations, with the Australian dollar gaining the most, following the disappointing inflation data. In commodities, the Bloomberg Commodity Index fell in May. Energy and livestock were the weakest components of the index, while agriculture, industrial metals, and precious metals achieved modest gains. In energy, the price of unleaded gasoline recorded a significant decline, while crude oil, Brent crude, heating oil, and gasoil also fell in the month. Conversely, the price of natural gas rose sharply in the month.

Portfolio review

The Schroder Absolute Return Income (Managed) Fund delivered a return of 0.53% (net of fees) for the month and 5.79% (net) over the 12 months to May, which is 1.54% over the RBA cash rate for the past year. Over 3 years the Fund has returned, net of fees, 2.09%pa which is 0.25%pa below the RBA cash rate.

Largest contributors

The largest contributor was the Fund's allocation to Australian corporates; together Australian investment grade credit and subordinated bank debt added 0.40%. Allocations to US inflation linked securities, which benefit from a fall in real yields, and global securitised credit both added 0.1%.

Largest detractors

The main detractor was interest rate overlays which detracted 0.15%, where our interest rate hedges detracted as yields fell over the month.

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^	0.55	1.44	3.38	5.83	2.11	SCH55

Outlook and strategy

The combination of weak growth and stalling progress on inflation leaves the RBA in a difficult situation, with a further interest rate hike clearly the risk in the months ahead. The RBA has been very cautious in raising rates, trying to maintain the gains on employment while bring inflation back to target. As we wrote last month, the last mile is proving difficult. The current level of interest rates is clearly restrictive, with Australia one of the most rate sensitive economies, with high levels of floating rate mortgage debt. However, services inflation remains too high, and if progress on goods inflation has stalled, the RBA may be forced to implement another 'insurance' hike as they contemplated in their last meeting. A further rate hike may just be the tipping point for the mortgage sector. The corporate sector thus far has been coping with higher rates, with pricing power enabling them to maintain margins. However, cracks are starting to appear and the equity market is getting prepared for disappointment on earnings.

In the US, the latest inflation readings have been a welcome relief and brings the prospect of a pre-election rate cut back on the table. US growth remains solid, supported by real wage gains fuelling consumption gains. The US labour market does look to have taken a step down in the pace of hiring, and weaker payroll growth is the key to allowing the US Federal Reserve to cut rates in September. At the time of writing, the European Central Bank is expected to cut rates in June, with further rate cuts in a quarterly cycle. Although the latest European inflation reading was a hiccup and growth looks to have bottomed, inflation is expected to be closer to 2% by the end of the year allowing an easing of policy towards 3% by the middle of 2025.

For the Schroder Absolute Return Income Fund, we continue to be cautious with our interest rate exposures. After cutting exposure over March and April, we have used the recent increase in yields to add duration, particularly in Australian rates as the pricing of rate cuts moves from 2024 to late 2025. There is no doubt the economy is very weak and that the RBA would be preferring to cut rates, but with inflation not reading the script, the RBA is most likely to be on hold for a considerable period, locking yields into a range. We have also added to exposure in 2-year US rates as yields approached 5%. With inflation more well behaved and a clear bias from the Fed to ease restrictive policy, we have added US duration. Total portfolio duration is at 2 years, up from 1 year at the end of last month.

Within credit we continue to add exposure to Residential Mortgage Backed Securities (RMBS) increasing exposure to 8% (from 7%) over the month via the new issue market, with cash holdings declining to 5%. High quality RMBS with AAA ratings and strong credit support are yielding 1% over cash providing a low-risk yield enhancement to the portfolio. Most of our credit exposure remains with Australian investment grade corporates where spreads are providing 1.5% over Australian government bonds, and, in recent months, we have sold down global investment grade exposure to 5%, maintaining a bias to European corporates where spreads are also attractive relative to its US counterparts. In the US we have maintained a 10% exposure to our securitised asset strategy which is predominantly US mortgage-backed securities, with a significant allocation to AAA Agency mortgages. This strategy is providing a credit spread of 1.85% over US government bonds with an average credit rating of AA. With the US consumer capturing real wage gains and mostly insensitive to higher rates through long term fixed rate mortgages, we remain positive for the continued strong performance from this credit sector.

We added 2% in foreign currency exposure over the month taking total exposure to 3.5%. Having reduced exposure by 2% in April when the Australian dollar weakened sharply as Iran launched rockets and drones over Israel in response to the bombing of the Iranian embassy in Syria, we added foreign currency back in May as the Australian dollar rallied to over USD0.66, benefiting from the pushing out of rate cuts by the RBA. Within foreign currency, we continue to prefer holding mostly US dollars (USD) against short positions in European currencies which we expect to weaken as interest rate differentials favour the USD.

In summary our strategy remains unchanged. We continue to prefer high quality credit risk and manage our interest rate risk cautiously. With the recent backup in yields, we have extended duration as yields represent improved value as rate cuts are pushed further into the future. With elevated inflation and wages data in Australia, the risk is official cash rates stay elevated for longer. Despite weakness in domestic consumption in Australia, the RBA may be forced to raise rates again increasing the risk of recession. In credit, we have exited the most expensive sectors of the market, US investment grade and high yield corporates, and continue to prefer sectors offering better value; floating rate exposures in securitised assets (particularly US and Australian mortgage-backed securities), Australian investment grade corporates and sub-ordinated Australian bank debt.

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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)	$51,194,738
Redemption unit price	$9.3962
Fund inception date	November-2019
Management costs	0.54%
Distribution frequency	Monthly

Top ten holdings %

	Portfolio
TREASURY (CPI) NOTE 0.875 15-JAN-2029	3.6
TREASURY (CPI) NOTE 1.75 15-JAN-2034	2.1
MACQUARIE BANK LTD AT1-P 6.125 31-DEC-2079 Reg-S (CAPSEC (BTP))	2.1
TREASURY (CPI) NOTE 1.25 15-APR-2028	2.0
WESTPAC BANKING CORP. (NEW ZEALAND AT1-P 5.0 31-DEC-2079 (CAPSEC (BTP))	1.4
COMMONWEALTH BANK OF AUSTRALIA 5.0 13-JAN-2028 Reg-S (SENIOR)	1.3
AUSTRALIA AND NEW ZEALAND BANKING 5.6117 04-NOV-2027 Reg-S (SENIOR)	1.2
WESTPAC BANKING CORP 5.6004 11-NOV-2027 (SENIOR)	1.2
SUNCORP METWAY LTD 5.1922 25-JAN-2027 (SENIOR)	1.2
WESTPAC BANKING CORP T2 7.199 15-NOV-2038 (SUB)	1.2
Total	**17.2**

Maturity Profile %

	Portfolio
0-3 Years	32.5
3-5 Years	26.3
5-7 Years	11.6
7-10 Years	13.1
10-15 Years	6.2
15+ Years	10.3

Security profile %

	Portfolio
Fixed rate	63.7
Floating rate	35.9
Derivatives	0.2
Others	0.2

Regional exposure %

	Portfolio
Australia	62.5
USA	28.9
Europe ex UK	5.1
UK	1.2
Asia inc Japan ex EM	0.1
Emerging Markets	2.2

Holdings by composite broad credit rating %

	Portfolio
AAA	11.9
AA	22.8
A	17.6
BBB	34.8
Below BBB	3.3
Cash and Equivalents	8.1
Not Rated	1.5

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

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