Schroder Absolute Return Income (Managed Fund)

An active ETF designed to boost income while preserving capital
Chi-X code: PAYS

Quarterly Report - December 2021

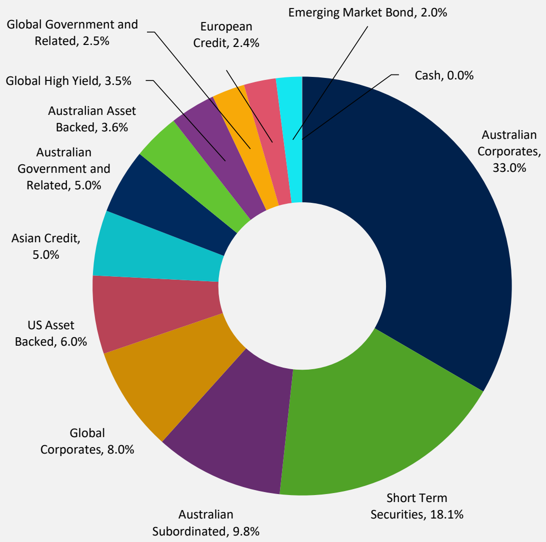
For more information about the Fund visit www.schroders.com.au/pays

Total return %	1 mth	3 mths	6 mths	1 yr	Inception p.a.
Schroder Absolute Return Income (Managed Fund) (post-fee)	0.16	-0.39	-0.30	0.32	1.70
RBA Cash Rate	0.01	0.03	0.05	0.10	0.23
Relative performance (post-fee)	**0.15**	**-0.41**	**-0.35**	**0.22**	**1.46**

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

Portfolio inception 19/11/2019, 2 years and 1 months

Asset allocation %



Portfolio statistics

Duration	0.27 yrs
Yield to maturity	1.58%
Average credit rating	A-
Number of securities	2752

*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 2021

*Benchmark is the RBA Cash Rate

Market review

Equity markets moved sideways on uncertainty around the Omicron variant and a more hawkish shift from the US Federal Reserve (Fed), before rallying in the latter stages of the month as markets began to look through the shorter-term risks and focus on expected growth over the coming year, which at this stage is still expected to be quite healthy. Developed market central banks shifted towards a more hawkish outlook, with the Fed signalling a faster pace of tapering. This could see tapering end in March, rather than June, and as a result markets priced in a potential for an official rate increase earlier than it had previously anticipated. Meanwhile the Bank of England lifted its policy rate to 0.25%, owing to inflationary pressures. Ultimately, the monetary policy decisions going forward will be heavily dependent on the inflation data, which could ease to some extent if the current supply bottlenecks become more manageable. In China, it's a different story, as the People's Bank of China has been easing monetary policy through a 0.5% cut to the reserve requirement ratio. This easing bias could continue in to 2022.

Developed market equities rallied by 4.0% in December, while the Australian market underperformed, but still delivered a return of 2.7% for the month. This was also the case over the fourth quarter, where developed market equities rose by 8.3% in local currency terms, while the Australian marked only rose by 2.1%. Emerging markets fell by -1.3% over the quarter in US dollar terms. Australian 10 year yields were broadly flat, ending the month at 1.67%, while US 10 year yields moved up by 0.07% to close at 1.51%. 10 year government bond yields were also generally unchanged in Japan, but moved higher by 0.17% in Germany. Over the quarter, the biggest moves were in short dated maturities in Australia and the US, where Australian 3 year yields jumped by 0.60%, while in the US 2 year yields increased by 0.45% as both markets began to price in more official rate increases. In credit, global spreads moved tighter over month, however in Australia they remained flat. While over the quarter, credit spreads were generally moderately wider, with the exception of US high yield which saw a small degree of tightening.

Portfolio review

Over the December quarter, the Schroder Absolute Return Income (Managed Fund) returned -0.39% (post fees) bringing the 12 month performance to 0.32% (post fees) or 0.22% (post fees) above the RBA cash rate.

Recent returns have been subdued given starting valuations and volatility in markets. Over the quarter credit exposure detracted from performance. Markets are fully priced and any weakness in risk assets has meant credit spreads have moved wider. The carry from the coupons was exceeded by the spread widening, the majority of which came from weakness in Australian credit assets.

Duration was a moderated contributor over the quarter. Whilst we hold minimal exposure to duration-based assets, we did benefit from holding some duration in Australia where we did see yields move broadly lower having retraced some of the selloff in the prior quarter. A short duration position in the US also assisted given the selloff in the front part of the US curve.

Foreign currency exposures were a small detractor over the month as the Australian dollar (AUD) was broadly stronger against both the US dollar (USD) and the Japanese yen (JPY).

Outlook and strategy

As we close out 2021, COVID continues to dominate the news headlines. Case numbers are rising quickly with the Omicron strain, however it looks at this stage that the risk of overwhelming hospital systems is low. High vaccination rates and the roll out of booster shots appear to be working to reduce the risk of becoming seriously ill. That said the situation remains fluid as we continue to adjust to living in a world with COVID.

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^	0.16	-0.37	-0.29	0.33	2.87	SCH55

^The fund on offer is unlisted. An application into this fund may be made through an application form attached with the PDS, which is available on our website at www.schroders.com.au. The management fee for the Schroder Absolute Return Income Fund (Wholesale Class) is 0.54%.

Outlook and strategy continued

Key risks to markets continue to be the outlook around inflation and growth. Growth appears to have peaked from elevated levels and whilst slowing still appears to be above trend. Inflation is expected to peak in the first half of 2022. Against this backdrop there is concern that the fiscal pulse will be weaker going forward and that monetary policy settings remain extremely accommodative and will need to be adjusted. Markets are pricing in official rate increases, hence the recent volatility in sovereign bond yields, however the transition to more appropriate monetary policy setting has only just begun. The reaction function for the central banks around the actual timing and pace of the adjustment remains tied to the data which as we know can surprise and lead to spikes in volatility.

In terms of portfolio changes we have made a few adjustments over the quarter. We have been reducing overall credit risk and adjusting the mix of exposures. The reduction in global high yield was driven by expensive valuations. Whilst earnings continue to be strong, we do think there is some complacency creeping into this market. We also reduced exposure to emerging market sovereign debt based on the view that a stronger USD combined with challenges around lower vaccination rates in the developing world would be negative for emerging markets.

We did increase our exposure to Asian credit via our Schroder ISF Asian Credit Opportunities Fund. On a valuation basis this asset segment is the one that has the most valuation support. The risks, particularly around the Chinese property sector, do demand a higher risk premium which is arguably in the price. The Evergrande restructuring process looks to be orderly and the systemic risks from this asset class remains manageable. That said we are watching this space closely.

We also increased exposure to US securitised credit on the view this would continue to benefit from a strong US consumer. This combined with the fact it is a floating rate asset class means it should benefit from the current environment. Domestic hybrids also continue to offer a reasonable yield via a subordination risk premium and hence we have retained our holdings at this stage.

In terms of duration, we continue to hold low levels of outright duration given the views around bond valuations and the risk of more hawkish central banks. Over the quarter we have continued to reduce interest rate sensitivity in the portfolio and are currently at 0.25 years of duration. This reflects the view that the adjustment in interest rate expectations means duration-based assets are likely to remain under pressure. Compared to December 2020 where we were carrying closer to 1.7 years of duration, the significant reduction over the last 12 months has been a deliberate strategy to insulate the portfolio from expected moves higher in bond yields.

We do have cross market positions in which we are long duration in Australia against a short duration position in the US. The short in the US is where we believe the risks around inflation are most prevalent and the likelihood that the Fed will be forced to act sooner. In the US we also have exposure to yield curve flattening to reflect the expectation that expectations for official rate increases will cause shorter dated yields to sell off more than longer maturities. The small long in Australia reflects the view that inflation is more contained than in the US and the RBA's reaction function will be more measured. It also does provide some downside risk protection if risk assets come under pressure.

In terms of foreign currency exposures, we have also made adjustments to the mix. We did take some profit on the long USD position. We added to the long JPY position on the view that the yen tends to provide the best downside risk hedge.

Cash and short term security holdings are elevated, reflecting the desire for liquidity in the portfolio but also as a result of reducing credit risk but not adding to duration risk. We currently prefer cash equivalents over sovereign bonds, even at the low cash rates, given the desire to protect capital and the view that negative returns on sovereign bonds remain a possibility as we witnessed last quarter.

Looking forward into 2022 we are once again in a period where markets are uncertain given the Omicron variant overlayed with the risk around inflation and the growth outlook. The risk of rising inflation appears to be fading into 2022 but central banks will still need to wind back liquidity support and lift official interest rates. This transition will be a delicate balance between adjusting policy settings and the economic uncertainty that will likely feed into market volatility. This policy adjustment is against a moderating growth profile. Whilst we do not foresee a recession, a slowdown is underway which the risk of the Fed entering into tightening cycle as growth is rolling over which can exacerbate the downside risk in markets.

Against this backdrop we remain defensive and liquid. The repositioning of the portfolio has been to focus on capital preservation at this stage of the cycle. With credit spreads fully valued, capital growth is less likely and we find ourselves in a carry phase. The uncertainly around the profile of normalization of interest rates also means we do not favour adding duration risk. The adjustment process can hit capital values as we have seen in the past and hence, we hold little exposure. Cash and highly liquid short term securities are elevated and ready to deploy as market re-pricing provides better opportunities.

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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

Chi-X Code:	PAYS
Fund size (AUD)	$61,145,745
Redemption unit price	$9.6912
Fund inception date	November-2019
Management costs	0.54%
Distribution frequency	Monthly

Top ten holdings %

	Portfolio
AUSNET SERVICES HOLDINGS PTY LTD 3.1693 06-OCT-2080 Reg-S (SUB)	1.5%
TREASURY NOTE 2.625 15-FEB-2029	1.3%
SCENTRE GROUP TRUST 2 5.125 24-SEP-2080 Reg-S (SUB)	1.3%
TREASURY NOTE 1.75 15-NOV-2029	1.2%
AUSTRALIA (COMMONWEALTH OF) 1.75 21-JUN-2051 Reg-S	1.2%
SANTOS FINANCE LTD. 4.125 14-SEP-2027 Reg-S (SENIOR)	1.1%
BRISBANE AIRPORT CORPORATION PTY L 3.9 24-APR-2025 Reg-S (SECURED)	1.0%
WCX M4 FINCO PTY LTD 3.15 31-MAR-2031 Reg-S (SECURED)	0.8%
AMPOL LTD 3.6607 09-DEC-2080 Reg-S (SUB)	0.8%
QPH FINANCE CO PTY LTD 2.85 29-JAN-2031 (SECURED)	0.8%
Total	**11.1%**

Maturity Profile %

	Portfolio
0-3 Years	39.2
3-5 Years	19.2
5-7 Years	12.2
7-10 Years	17.0
10-15 Years	1.7
15+ Years	10.7

Security profile %

	Portfolio
Fixed rate	61.8
Floating rate	35.4
Other	2.8

Regional exposure %

	Portfolio
Australia	61.5
USA	28.7
Europe ex UK	6.0
UK	2.4
Asia inc Japan ex EM	0.1
Emerging Markets	1.3

Holdings by composite broad credit rating %

	Portfolio
AAA	9.7
AA	5.9
A	12.1
BBB	45.4
Below BBB	8.5
Cash and Equivalents	17.2
Not Rated	1.2

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 2021

Figures may not total 100 due to rounding

Regional exposure is expressed by currency pre-hedging

Contact www.schroders.com.au
E-mail: web.queries@computershare.com.au

Schroder Investment Management Australia Limited ABN 22 000 443 274 Australian Financial Services Licence 226473 Level 20 Angel Place, 123 Pitt Street, Sydney NSW 2000 Phone: 1300 136 471 Fax: (02) 9231 1119

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