Schroder Absolute Return Income (Managed Fund)

An active ETF designed to boost income while preserving capital

Chi-X code: PAYS

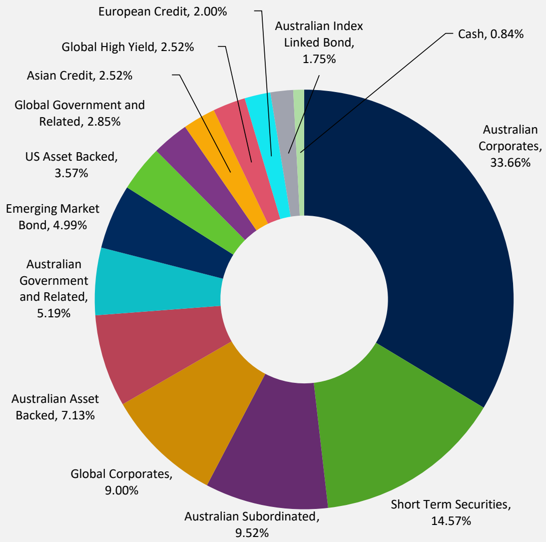
Quarterly Report - September 2020

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

Total return %	1 mth	3 mths	6 mths	Inception p.a.
Schroder Absolute Return Income (Managed Fund) (post-fee)	0.18	0.96	3.87	1.71
RBA Cash Rate	0.02	0.06	0.12	0.36
Relative performance (post-fee)	**0.16**	**0.90**	**3.74**	**1.35**

Portfolio inception 19/11/2019, 0 years and 10 months

Asset allocation %



Portfolio statistics

Duration	2.00 yrs
Yield to maturity	1.80%
Average credit rating	A
Number of securities	2602

*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 Sep 2020

*Benchmark is the RBA Cash Rate

Market review

A resurgence of COVID-19 cases in Europe and the inability of Democrats and Republicans in the US to come to an agreement on a fiscal package resulted in weaker equity market performance during September. With monetary policy expected to remain accommodative for the foreseeable future, markets shifted their focus to fiscal policy. There was hope that a fiscal support package would be agreed upon prior to the US election, but that now seems increasingly uncertain with the Democrats and Republicans still at odds regarding the size of the package. On the political front, Joe Biden's likelihood of winning the election has increased in recent weeks according to betting markets, following the first presidential debate and Trump's contraction of COVID-19. In Europe, an uplift in COVID-19 cases resulted in weaker than expected manufacturing data as countries consider reintroducing social distancing restrictions. Domestically, unemployment figures were stronger than expected, though there is greater uncertainty heading forward as JobKeeper starts to unwind. Meanwhile, local bond markets priced in the possibility of another rate cut to 10 bps and further quantitative easing.

Global equities returned -2.9% in local currency terms in September, with most major markets outside of Japan posting negative returns. Over the quarter, global equities still had a strong return of 6.9%, while the Australian market underperformed over the quarter with a return of -0.4%. Australian Government bond yields fell by 0.08% over the quarter to end at 0.79%. In the US, bond yields rose slightly to end the quarter at 0.68%. Bond yields decreased in Germany and Japan during the quarter by 0.07% and 0.01% respectively. Spreads in investment grade and high yield credit, as well as emerging market debt widened moderately during September in conjunction with the sell-off in risk assets, but remain tighter over the quarter. Similarly in FX, the USD strengthened during September as investors shifted to safer currencies, but remains weaker over the quarter.

Portfolio review

The Schroder Absolute Return Income (Managed Fund) delivered 0.96% (post-fees) over the quarter, or 0.90% (post-fees) above the RBA Cash Rate.

Credit was a key contributor over the quarter as spread compression continued to be driven by liquidity injected into the system by central banks. This continues to support risk assets in the face of poor fundamentals. The coupons paid by the bonds, also known as "carry", supported returns and is a key source of income for the portfolio.

Duration was also a contributor to the portfolio. Sovereign bond yields fluctuated over the quarter. Australian bond yields finished generally lower across the curve. This was partially offset with US yields moving higher particularly in the longer end of the yield curve. Inflation positioning was a mild contributor from the Australian exposures as market expectations around inflation began to shift modestly.

The currency positioning was also a moderate contributor. The AUD/Yen largely went sideways over the quarter and whilst the AUD continued to strengthen against the USD. Emerging market currencies were the key positive.

Outlook and strategy

As we round out the third quarter of 2020, to say it has been a somewhat strange year so far is a gross understatement. The exogenous shock resulting from COVID-19, the massive stimulus injections from central banks, and the challenging economic environment make navigating investment markets a challenge. The disconnect between fundamentals and risk assets is stark and, in the absence of continued liquidity and support from central banks, risk asset valuations would arguably be lower.

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^	0.17	0.94	3.84	1.91	3.16	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

Currently, risk assets appear to simply shrug off any concerns. There are bouts of volatility, but they don't appear to last, and markets continue to march forward. The challenges, however, are real. Default rates in corporate bonds are rising as the high level of leverage and falling revenues hurt many companies. That said, the current default rates appear manageable by the market and hence credit risk premium has not sold off.

The economic data and the delay of additional fiscal stimulus in the US, given the two parties cannot agree, is also largely ignored by the market, at least to date. Uncertainty around the US election and the possibility of a contested outcome, not to mention potential social unrest, are once again largely ignored at this stage, as is the apparently deteriorating relationship between the US and China. That said, any one of these issues or something out of left field could cause markets to question current levels and valuations. Can liquidity continue to paper over the cracks?

The challenge for investors in this climate of uncertainty is to build a portfolio of assets that generates a defensive income stream. There are two important parts to this challenge.

The first part is to generate income. As many are acutely aware, the low level of cash rates naturally makes allocating capital to this asset class less attractive as an income source, creating a need to find alternatives. Cash is an important part of any portfolio, as it delivers a highly liquid, low volatility and essentially capital stable exposure. However, the current environment raises two questions: how much cash should investors hold, and what opportunities are there to deploy capital into other income-producing assets?

The second part of the challenge is to be defensive. The issue from an investment perspective is that the divergence between market fundamentals and market pricing appears quite stark and makes taking large amounts of risk somewhat dangerous to capital preservation.

Our investment approach is based on our value, cycle and liquidity framework, taking an active approach to both bottom-up stock selection and top-down asset allocation. This looks to build a diversified portfolio of assets across credit, rates and currency markets to meet the fund's objective while maintaining liquidity.

In light of this and the current market dynamics over the last quarter, we have been adjusting our portfolio position to take advantage of some of the areas where we see opportunity. First, we continue to invest some cash holdings. As we mentioned earlier, cash is liquid and capital stable, but the expected returns from cash are miniscule. In recognition of this, we have deployed some cash into income-producing credit assets. Adjustments to credit exposure in the portfolio were both in the total holdings and the mix across different assets and geographies.

We have also reduced our allocation to higher yielding Australian credit on the view that prices had rallied strongly and there may be some price weakness, given the pressure on asset values coming through bank balance sheets. We have also moved our global high yield short position to a more constructive stance. This is largely a tactical tilt designed to increase yield in the portfolio in an environment where liquidity-driven price momentum looks likely to continue over the short-term. We are mindful of valuations and potential volatility, hence the limited size of the position at 2.5% of the total portfolio.

We have also increased our US securitised credit exposures. These exposures continue to be defensive in nature, are highly rated, and are typically senior in the capital structure. As such, they have the advantage of subordination to help protect capital while also delivering income.

We have topped up our Asian credit exposure to access the additional yield and diversification available in this segment. We also added the Schroder ISF Global Income Short Duration Fund to our portfolio, giving us exposure to predominantly European credit. This provides diversification and supplements our US holdings, but importantly is shorter in duration and hence expected to be less variable should we get a spike in volatility.

Outlook and strategy continued

In terms of rates exposure, we retain a long duration position of close to 1.9 years. This is predominantly split between Australia and the US. In the US we are positioned in the long end of the curve, which has benefited the portfolio during the recent sell-off. In Australia, the positioning is more in the shorter end, which has continued to rally. We do believe duration still has a role to play in portfolios, although we also think the effectiveness of duration is challenged in an environment of low rates and yield curve control. As such, we currently hold duration positions mainly to provide some downside risk protection in a more extreme risk off phase, as well as for some moderate carry.

In currencies, we have reduced our USD position and added to our JPY position. We believe currencies can continue to provide downside risk management benefits to the portfolio. We also think that combining duration and currency positions is an effective method of maintaining downside risk protection, despite sometimes detracting from performance at the portfolio level. In the current environment where credit has continued to perform well, despite the occasional wobble, we still believe it is important to have some 'insurance' against a reversal, which the currency positioning can help provide.

Looking forward, we retain our defensive portfolio positioning. The liquidity-driven rally we have seen in risk assets looks to be disconnected from the fundamentals in many companies and businesses. We retain elevated levels of cash for the purposes of portfolio liquidity and we maintain our defensive bias with exposure to predominantly investment-grade credit. We continue to seek diversification through European credit, Asian credit exposures, US securitised exposures, and our emerging market debt absolute return focused portfolio. This supports the allocation in Australia which we continue to see as a low risk market. This higher quality focus, along with our currency and duration positions rounds out our active, defensive and liquid posture.

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Quarterly Report
September 2020

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

The benefits of investing in the Fund include the following:

– **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)	$28,841,877
Redemption unit price	$9.8763
Fund inception date	November-2019
Management costs	0.54%
Distribution frequency	Monthly

Top ten holdings %*

	Portfolio
AUSTRALIA COMMONWEALTH OF (GOVERN	1.8%
TREASURY NOTE	1.5%
AUSGRID FINANCE PTY LTD	1.4%
TREASURY NOTE	1.3%
SYDNEY AIRPORT FINANCE COMPANY PTY LTD	1.0%
MACQUARIE BANK LTD	1.0%
BBI (DBCT) FINANCE PTY LTD	0.9%
BRISBANE AIRPORT CORPORATION PTY LTD	0.9%
SANTOS FINANCE LTD.	0.9%
IDOLT_19-1	0.8%
Total	**11.4%**

Maturity Profile %

	Portfolio
0-3 Years	36.6
3-5 Years	18.9
5-7 Years	15.3
7-10 Years	13.2
10-15 Years	5.0
15+ Years	11.0

Security profile %

	Portfolio
Fixed rate	63.5
Floating rate	34.9
Other	1.6

Regional exposure %

	Portfolio
Australia	57.9
USA	32.5
Europe ex UK	5.4
UK	1.7
Asia inc Japan ex EM	0.0
Emerging Markets	2.4

Holdings by composite broad credit rating %

	Portfolio
AAA	13.9
AA	5.3
A	23.6
BBB	42.2
Below BBB	7.1
Cash and Equivalents	5.5
Not Rated	2.5

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.

Unless otherwise stated figures are as at the end of September 2020

Figures may not total 100 due to rounding

Regional exposure is expressed by currency pre-hedging

*Please note security descriptions are abbreviated due to an external data issue. We are working to rectify the problem. Please contact us directly if you need further details.

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