Schroder Real Return Fund
ASX: GROW

A smarter way to invest. An easier way to grow your wealth.

Quarterly Report - December 2018

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

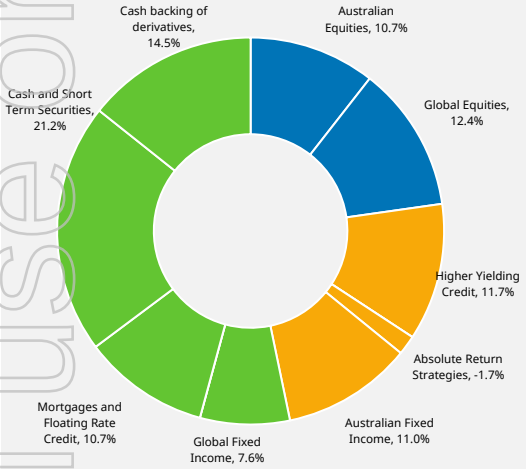
Total return %

	1 mth	3 mths	1 yr	3 yrs p.a.	5 yrs p.a.	Inception p.a.
Schroder Real Return Fund (Managed Fund) (pre-fee)	-0.07	-2.42	0.97			3.91
Schroder Real Return Fund (Managed Fund) (post-fee)*	-0.15	-2.64	0.07			2.98

Portfolio inception 09/08/2016, 2 years and 4 months

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

Asset allocation



* Includes floating rate notes, term deposits, negotiable certificate of deposits, cash and other cash equivalents.

Fund objective

To deliver an investment return of 5.0% p.a. before fees above Australian inflation over rolling 3 year periods. Inflation is defined as the RBA's Trimmed Mean, as published by the Australian Bureau of Statistics.

RBA CPI Trimmed Mean* as at 30 September 2018

3 months	0.37%
1 year	1.82%
3 years. p.a.	1.77%
5 years. p.a.	1.98%

*The RBA CPI Trimmed mean returns are published quarterly by the ABS. Historical returns may be subject to revisions.

Portfolio refers to investment in the Schroder Real Return Fund (Managed Fund)
Unless otherwise stated figures are as at the end of December 2018

Portfolio overview

The Schroder Real Return Fund (ASX:GROW) returned -0.1% (pre-fee) in December, seeing the 1 year return at +1.0% (pre-fee). December was a difficult month for markets with equity markets down sharply and credit spreads widening. Traditional diversifiers saw gains over the month. While the recent sharp pick up in volatility has impacted the strategy, our defensive positioning has mitigated the size of this impact.

Market review

Global equity markets fell sharply in December as concerns over the global growth outlook and the US Federal Reserve (Fed) again raising short-term rates both weighed on market confidence. The Fed's decision to increase short-term rates by 0.25% in December drew the ire of President Trump, who discussed the possibility of firing the Fed chair Jerome Powell. Globally, oil prices continued their decline in December, with WTI oil falling by an additional 11% in the month, further dampening the shorter-term outlook for inflation. The trade war between the US and China resulted in weaker Chinese manufacturing activity as well as weaker US factory activity. In the UK, Brexit continues to loom as an issue as Theresa May pushed back a vote on a Brexit deal within the UK parliament, while May also survived a vote of no confidence on her own leadership. Domestically, the Q3 GDP was relatively weak, growing by only 0.3% over the quarter, while property prices continued their downward trend, being led by weakness in the Sydney and Melbourne markets.

Global equities fell by approximately 8% in December and 13.3% over the quarter in local currency terms, with the US and Japan experiencing the sharpest declines over both the month and the quarter. The Australian market, which underperformed in November, fared better through December and was only down by -0.1%; however over the quarter it still dropped 8%. Government bond yields also fell globally amidst the volatility, with US 2 and 10-year yields both moving lower during the month by 0.3%, to end it at 2.49% and 2.68% respectively. Australian 10-year yields moved 0.27% lower to end the month at 2.32%, while German and Japanese yields also fell by 0.07% and 0.09% respectively. Credit markets continued to weaken as spreads widened across the board, with the weakest sector being High Yield where spreads widened by roughly 100bps during the month, and 200bps over the quarter.

Largest contributors

Currency positions were notable contributors to performance in December. The strategy's holdings of US dollars and Japanese Yen significantly added value due to the fall in the Australian dollar. Foreign currency is seen as cheap (AUD expensive) and it generally provides diversification to risk off events like we saw in December. The more traditional diversifier, bonds, also provided a positive contribution; with the strategy's duration at 1.4 years, the fall in bond yields added to performance.

Largest detractors

Global equities were a drag to performance in December, due to their sharp fall in the month. While the strategy's exposure to global equities is low at 13%, the size of the fall in equities resulted in a relatively large detraction. Another detraction came from our US breakeven position, which uses US TIPS, or inflation bonds, and futures to capture the market's inflation expectations. We are positioned for higher inflation expectations, however they fell over the month.

Portfolio Activity and key themes

Our view has been that the market was underestimating the political momentum around the trade war and its economic impact. The run to the mid-term elections, and the need for President Trump to get his base out to vote, meant that the dynamic for 2018 was a continued escalation. On top of that, we believed that the economic impact would be greater than expected. We have noted that while the economic modelling suggested a modest impact, this did not consider the acute nature of the shock. The uncertainty that the trade war would create and the potential need to adjust supply lines would see a greater short-term effect on the corporate sector. In July, we also noted that the market may need to riot to short-circuit the political momentum. So far so good, as we have seen an acceleration in the trade dispute, and tentative signs that we may be right around the economic impact (investment has stalled and surveys show manufacturing activity falling sharply), while equity markets have suffered large falls.

At the time, we also stated that markets rioting would be a buying opportunity, and while we did add to equities at the end of December, it was only by a small amount — an extra 2.5%. A key risk to buying equities at this point of time is if a US recession is on the cards. Given the elevated corporate debt levels and stretched valuations, a US recession could see US equities fall by circa 50% — still a significant decline from current levels. However, our analysis still suggests that the risk of recession is more likely in 2020 than 2019.

Post-fee performance of other Real Return products offered by Schroders

Schroders

	1 mth	3 mths	6 mths	1 yr	3 yrs p.a.	mFund Code
Schroder Real Return CPI Plus 3.5% Fund Wholesale*	-0.05	-1.49	-0.35	0.41	N/A	SCH12
Schroder Real Return CPI Plus 5% Fund Wholesale*	-0.19	-2.77	-1.32	-0.49	3.56	SCH11

*Both funds on offer are unlisted. An application into these funds 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 Real Return CPI Plus 3.5 % Fund (Wholesale Class) is 0.60% and for the Schroder Real Return CPI Plus 5% Fund (Wholesale Class) is 0.90%.

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Portfolio activity and key themes continued

Another positive is that not only have markets helped to force negotiations around the trade war, but also the political momentum has shifted. With the mid-term elections over, the focus will move to the 2020 presidential election. For President Trump to be re-elected he will need a positive economic environment given post-war presidents that have faced rising unemployment in their election year have all become one-term presidents. A continued ramp-up in the trade war would weigh on the economy and damage his chances of re-election.

So why are we still relatively cautious? Low risk entry points are generally seen in environments of market or policy capitulation. While markets have fallen sharply, and surveys of investor bullishness saw a significant drop in the Christmas week, one indicator we monitor didn't suggest panic. The VIX, aka the 'fear' index, did spike but not to a level usual for capitulation. While this does mean the Christmas week was not the capitulation we were expecting, it does create some uncertainty in our mind. Also, given the global economic environment is still difficult — the impact of the trade war has yet to show up to its full extent, oil prices suggest global growth is weak, and leading indicators of Chinese activity suggest a further slowdown — we believe the volatility is therefore likely to continue, and there will be more opportunities to add to our equity exposure.

On policy capitulation, while we have seen the Fed begin to back away from further rises in the cash rate, given the market had been sceptical of its stated path, we are not sure of the extent of the boost this offers. One risk we see is that in the shrinking liquidity environment, global real money growth has been falling most of the last year causing to something break, which may require an emergency easing by the Fed.

The other obvious policy capitulation is China. While authorities have been easing policy, it has been very modest, especially given the crackdown on the shadow banking system has seen a slowdown in credit growth, and a weaker economy. A further significant easing of policy would be needed.

Market Outlook

Equity

Equity markets fell sharply in December. The falls were also reflected in a very poor December quarter and a weak 2018. 2018 was a year of falls in most equity markets with only a couple of emerging markets rising in local currency terms. A concoction of factors have played on the market over the year, but a major problem has been the trade war between the US and China and the uncertainty it has created.

We adopted a very defensive stance towards equities in July and have generally held this position through the recent volatility. At the end of December, we added a small amount to our equity position, but still remain defensive. We continue to look to increase our exposure to equities, however we do see this as a tactical buying opportunity only, as we see recession risk in 2020. While the US is setting the current tone, it remains our least preferred equity market in the medium-term context given its structural overvaluation and overheating economy. Our preferred markets remain Australia and Japan given their relative cheapness. Emerging markets are starting to look a little more interesting, but we would prefer to see more evidence of capitulation (and more attractive valuations) and/or a peak in the USD before buying.

Fixed Income

Sovereign yields fell throughout December. The key US Treasury market saw yields fall back to levels last seen at the start of the year. Worries around the growth impact from the trade war, flight to quality flows into US Treasuries, and weak oil prices all conspired to push global yields lower. This was also reflected at the Fed, and although it raised the official cash rate in December, it laid the groundwork for a pause in the tightening cycle.

Sovereign yields in Australia also fell over the month, on the back of global trends as well as weaker growth that suggests the RBA is firmly on hold.

Credit spreads widened in December with credit continuing to catch up to equities. While investment grade spreads rose somewhat, high yielding credit saw greater volatility as a sharp decline in equities weighed on the market.

Currency

In December, currencies were mostly a mirror of the price action in November. A stronger USD saw the AUD fall, and the risk-off environment also led to a rise in the JPY. We continue to view a short AUD and long JPY position as good risk hedges. We continue to like the GBP on valuation grounds, although hard Brexit concerns are weighing on the currency. We generally see this as largely priced in, although some more weakness will occur in the event of a hard Brexit.

Fund details

ASX Code	GROW
Fund size (AUD)	$54,964,062
ASX Quoted Price	$3.5163
Fund inception date	August-2016
Management costs	0.90%
Distribution frequency	Normally twice yearly - June and December

Unless otherwise stated figures are as at the end of December 2018

Investment style

Our approach to inflation plus (or real return) investing is to choose the portfolio that has the highest probability of achieving the required return objective over the investment horizon with the least expected variability around this objective. The Fund employs an objective based asset allocation framework in which both asset market risk premium, and consequently, the asset allocation of the portfolio are constantly reviewed. The portfolio will reflect those assets that in combination are most closely aligned to the delivery of the objective.

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