Schroder Real Return Fund
ASX: GROW

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

Monthly Report - July 2019

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

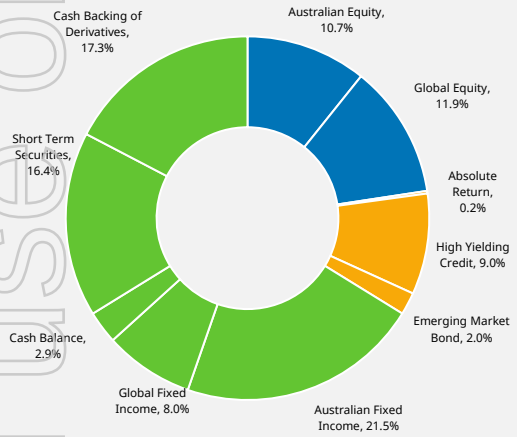
Total return %

	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)	0.69	1.86	5.82			5.60
Schroder Real Return Fund (Managed Fund) (post-fee)*	0.61	1.63	4.88			4.66

Portfolio inception 09/08/2016, 2 years and 11 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 June 2019

3 months	0.42%
1 year	1.61%
3 years. p.a.	1.70%
5 years. p.a.	1.80%

*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 July 2019

Portfolio overview

The Schroder Real Return Fund (ASX: GROW) returned 0.6% (post fees) in July, taking the calendar year to date return to 6.7% (post fee). Over the 1 year to July 2019 the strategy delivered a 4.4 (post fee) return. In real terms this equates to 4.0% real, below our real 5% objective. Notwithstanding a pick-up in market volatility, the volatility of the strategy remained low.

Largest contributors

Asset classes added across the board. Australian and global equities added the most over the month, followed by credit, sovereign bonds, emerging market debt and RMBS. Equities gained on continued optimism for rate cuts and potential trade war truce and debt instruments were supported by both lower yields and tighter spreads.

Largest detractors

The main detractor was from some dry powder we've raised through our equity and bond futures positioning where we have positioned the fund cautiously. Stock selection in large cap Australian equities also detracted over the month.

Market Outlook

I've been struck down with a bug and have spent the last few days at home. Daytime TV is a bit of a new experience and what I didn't know is how many forms of funeral insurance there are and how important it is for me. No – I didn't buy any – but I am thinking about it. I also got to see the news bulletins and accompanying dramatic music as "billions was lost from YOUR superannuation" as markets declined on the back of, among other things the escalating US/China trade tensions.

There were several things that struck me about this. Firstly, that these headlines failed to put the early August market declines into any context. The sky may have started to fall in August, but this was following a 23% gain in the seven months prior; and in any case, the decline only really took the market back to where it was in May. I'd hardly call this time to panic.

Secondly, it reminded me of the asymmetry in the generalised attitude of investors to risk. We want the upside, and not the downside – even if we think we have a more symmetric risk tolerance.

Thirdly, it highlighted to me how unprepared most people are to a major shake out in markets. We've bought the idea that the re-engagement of central banks will save the day, and this has progressively squeezed out most of the risk premium we would typically require to hold risky assets – there is no risk, right, if the Fed and other central banks continue to inject liquidity?

Consistent with this latter point is the idea that the giant Ponzi scheme that central banks are creating is becoming so systemically important that it can't seemingly be allowed to fail. Any market weakness is met with policy response, so markets are increasingly driving policy – and so the circle continues.

Last month I wrote about the "recency effect". A few clients did tell me they had to look it up and yes, it is a documented phenomenon. A practical illustration of this is the "pull to peer" trend among the institutional market. The bull market in "everything" has rewarded investors in typical SAA/equity heavy strategies, opening up a gap between funds that have adopted more objective-based approaches and those that have structurally ridden the central bank-induced bull market. While the latter have done well against their long-run objectives, the pressure to be at the top of the peer group is strong. Being different is a risk.

The realities of the current political, regulatory, and business environment make this easy to understand. It's less easy to rationalise from an investment standpoint. This model holds together while markets do. However, as 2018 reminded us (even if it has since been quickly forgotten), environments do change. While it can be costly to bet against central banks, it is an equally big call to buy the idea that central banks are infallible. If the template that has worked so well in recent years does come under pressure, the news headlines on the "billions lost" will make for hard listening. There will come a time when being different will be very important.
The Real Return strategy was not designed as a peer-relative strategy, albeit ex post, peer comparisons can and will be made. It was designed to target a particular rate of return and to do so in as consistent a manner possible. It is not designed to track equity markets but rather participate in the upside as a source of return, but to minimise the downside (consistent with a belief in the asymmetry of investor risk tolerances) and the fact that sequencing risk is important.

In the current context, we hold a moderate amount of equity exposure – similar to the level we held in the middle of 2018 – meaning we are reasonably defensively positioned in terms of overall exposure to risk assets.

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*	0.61	1.62	4.45	4.60	3.93	SCH12
Schroder Real Return CPI Plus 5% Fund Wholesale*	0.70	1.72	5.43	4.68	4.66	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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Market Outlook continued

The biggest change to positioning in July was to close the Short A-Reit/Long ASX 200 trade in the portfolio. This was a trade that we have held for some time. It was based on the idea that A-Reits were expensive relative to the broader market (a view we still hold) and that, given the sensitivity of A-Reits to inflation and bond yields, should inflation surprise on the upside then this trade would provide a good hedge. However, with cyclical risks to growth intensifying and central banks globally (including the RBA) now back on an easing track, the likelihood of A-Reits underperforming the broader market would seem to have lessened. In cutting this position we have also effectively increased portfolio duration. We also pared back the risk on our cross market Long Japan/Short US equity trade on the basis that with the Fed re-engaging it was harder to make the case for Japan to outperform the US (notwithstanding valuations still support a small position).

Equity

Equity markets continued to strengthen in July, albeit at a slower pace than June. Optimism over the US Federal Reserve cutting rates for the first time since the GFC and the re-engagement of the US-China trade negotiations continued to guide markets higher. Unfortunately, optimism was doused with reality on the last day of the month. While the Fed delivered the widely anticipated 25bps cut, Chairman Powell failed to deliver convincing market guidance when he mentioned this was only a mid-cycle adjustment, causing the S&P 500 to fall almost 2% intraday. The market clawed back 1% when he changed tack, saying that he doesn't mean one and done, but the market remained down 1% at the close. On the same day, talks in Shanghai came to a close. While being labelled productive, it was apparent that a deal was unlikely any time soon. While technically a story for August, Trump then proceeded with 10% tariffs on the remaining $300bn of Chinese goods.

The market rally in 2019 was supported by four main pillars – global growth was slowing but still robust, corporate earnings were still delivering, the US-China détente, and expectations for central bank support. Three of those four pillars now look questionable. The resurgence of trade hostility not only increases market volatility but has caused many to downgrade their growth expectations. Earnings have so far beaten low expectations, but forward guidance continues to be more sombre and 2020 analyst forecasts are at risk of downgrades. Central bank liquidity now remains the main driver for continued equity gains. While lower rates support higher multiples, this typically only lasts until earnings eventually turn negative. This then causes equities to re-rate lower towards economic fundamentals. Central banks therefore need to tread a fine line between delivering market expectations while keeping guidance supportive. In the meantime we will be monitoring earnings closely. Currently our global profit model points towards further deterioration.

Fixed Income

US sovereign bonds took a breather in July after a very strong quarter. US Treasury yields widened 5bps over the month. In June, the market was pricing in the potential for the Federal Reserve to cut by 50bps. Powell pushed back on these expectations along with Bullard suggesting 25bps would be more realistic. The market repriced to these levels after the strong US payrolls released in July showed 224,000 jobs were added in June, the strongest gain since January. Australia saw the RBA cut rates again in July, but gains came when economists increased their outlook for two more cuts before February 2020. European sovereigns continued to rally after Draghi's Sintra speech in June followed through into July. Italian 10-year bond yields tightened by over 50bps in July as tensions eased over Italy's fiscal policies and the expectation for continued ECB purchases.

Credit performed strongly as spreads continued to tighten. Investment grade credit spreads tightened around 10bps over the month with high yield tightening around 15bps. European credit performed the best thanks to spread tightening and lower sovereign yields, with similar returns for Australian credit.

Similar to equities, we continue to watch corporate profitability for any signs of deterioration for any signs that the carry play may be under threat.

Currency

The trade-weighted US Dollar rallied significantly in July as the EUR and GBP sold off. The pound sold off after Boris Johnson assumed control of the UK Conservative party, increasing the likelihood of a no deal Brexit outcome. While volatility will likely remain until the UK leaves the union, we continue to have a medium-term positive view on the currency due to attractive valuations.

The AUD slid steadily through the month, with the fall accelerating in early August to record its lowest level since the GFC. The JPY weakened modestly against the USD, but rallied over 1.5% relative to the AUD. We continue to favour the USD and JPY to the AUD given our views of slowing growth and the need for quality hedges within the portfolio.

Fund details

ASX Code	GROW
Fund size (AUD)	$54,587,444
ASX Quoted Price	$3.6893
Fund inception date	August-2016
Management costs	0.90%
Distribution frequency	Normally twice yearly - June and December

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.

Unless otherwise stated figures are as at the end of July 2019

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