Schroder Real Return Fund
ASX: GROW

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

Monthly Report - July 2020

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

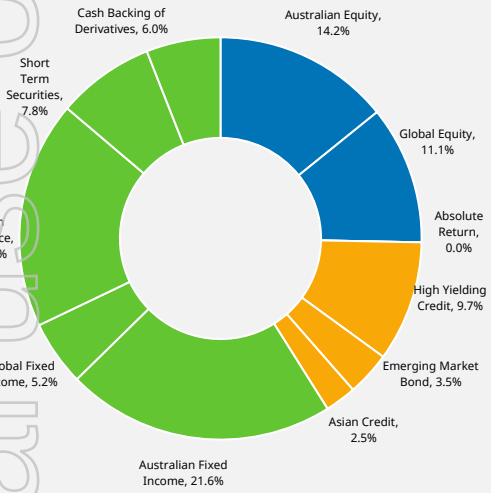
Total return %

	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)	0.56	2.66	2.12	4.53		4.71
Schroder Real Return Fund (Managed Fund) (post-fee)*	0.48	2.43	1.20	3.60		3.78

Portfolio inception 09/08/2016

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

Asset allocation



Fund objective

To achieve a return of CPI plus 5% p.a. before fees over rolling 3 year periods while minimising the incidence and size of negative returns in doing so. CPI is defined as the RBA's Trimmed Mean, as published by the Australian Bureau of Statistics.

RBA CPI Trimmed Mean* as at 30 June 2020

3 months	-0.15%
6 months	0.33%
1 year	1.22%
3 years. p.a.	1.48%

*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 2020

Portfolio overview

The Schroder Real Return Fund (Managed Fund) (ASX: GROW) returned 0.5% (post-fees) in July, taking the rolling one-year return to 1.2% (post-fees). While the 1-year return is below our target of real 5%, this compares to a fall of 8.9% in the ASX 200 over the same period. The Fund was well positioned and managed to absorb a lot of the volatility experienced so far in 2020. Volatility and downside risk remain low and consistent with the Fund's objectives.

Largest contributors

All major asset classes produced contributions through July. The primary positive contribution to returns in the month came from credit, which added roughly 0.34% to overall portfolio returns, as both the duration and spread component of returns did well. Equities also contributed positively in July, adding 0.1% to returns, mainly through international markets. Sovereign bonds rounded out the positive contributors.

Largest detractors

The main detractor to returns in July was FX as a weak US dollar weighed down the FX returns within our portfolio. Our S&P 500 put option position (before it was rolled) was another more moderate detractor, as the market rallied and moved further away from our strike price and time decay also weighed in. Lastly, the outperformance of growth stocks continued to hurt stock selection within our Australian and global equity exposures.

Market Outlook

At the end of July, global equities are a hair's breadth away from being flat for the year and US equities are now positive for 2020. This is during a time when US GDP experienced the biggest drop since World War 2 (down 32.9% last quarter), effectively wiping out five years of economic growth. Perhaps even more remarkable is that the NASDAQ is up over 20% and the NYSE FANGS+ index is up over 53% this year. This has led many to question whether tech stocks have disconnected from reality or are accurately reflecting investors' limited options for visible earnings growth.

We have often written about how we believe valuations are stretched in the US, but a lot of those metrics are being driven by the mega-cap tech stocks. While the market-cap-weighted S&P 500 has rallied 2.4% in 2020, an equal-weighted version of the same benchmark would have delivered –6.5%. By shifting the same index to equal weight, the S&P 500 tech exposure is cut in half from 28% to 15% and results in the cyclically adjusted price to earnings ratio drop from a stretched 28 down to a more reasonable 19.

In fact, an equally weighted basket of the FAANGM stocks (Facebook, Apple, Amazon, Netflix, Google and Microsoft) has a current PE ratio of 54.6 (versus 25.3 for the S&P 500), a price to sales ratio of 8.0 times (versus 2.4) and a cyclically-adjusted price-to-earnings (CAPE) ratio of an eye-watering 163 (versus 27.7). Apple now has the highest weight of any stock in the S&P 500 over the past 40 years, with a market cap almost as large as the entire Russell 2000 index. With metrics like this, there is no wonder people are starting to question if we're entering bubble territory.

On the flipside, mega-cap tech stocks beat analysts' earnings expectations by a massive 14% this quarter. Tech companies saw their earnings drop a measly 0.6% year-on-year (relative to a 36.4% drop for the S&P 500) and saw sales grow 3% (versus –9.8%). Unlike the tech bubble of the 2000s, tech companies these days are cash rich, have strong balance sheets and deliver consistent earnings growth.

Ironically, the COVID-19 crisis has made these companies even more integral to daily life than before. Our devices and their apps are our way to connect with work and friends, we shop almost completely online, and we spend more time at home watching 'TV'. Other tailwinds include ultra-low rates and abundant liquidity. Even though tech and communication companies comprise a larger portion of the S&P 500 than during the dot com bubble, the S&P 500 divided by US M2 money supply looks around fair value, and half the level reached in 1999. Given rates close to zero, the real equity risk premia of the S&P 500 (equity earnings yield minus the risk-free return, minus inflation) is close to all-time highs (since 1965) at 5%. On that metric, there really is no alternative!

We tend to believe that valuations do matter, especially over the longer term. Arguably, these are large and mature companies (in some cases), and the law of diminishing returns suggests it will be difficult to maintain their current growth rate in perpetuity (not to mention the impact of increasing regulatory scrutiny).

Global growth is currently stalling and labour markets are starting to roll over. As the V-shape recovery falters, both businesses and employees who thought their business or job would only be temporarily shuttered are slowly discovering this shift may be permanent. According to Yelp (an online business review website), in April 79% of closed businesses expected their closure to be temporary and 21% permanent – but as of July, permanent closures accounted for over 55%. As companies fold and staff find themselves without a pay-cheque, we expect expenditure to drop and earnings to come under pressure.

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*	0.65	2.58	-0.67	1.23	3.05	SCH12
Schroder Real Return CPI Plus 5% Fund Wholesale*	0.60	2.48	-1.66	0.57	3.29	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

Another non-conventional way to judge the value of US equities is to compare the Wilshire 5000 to nominal GDP, the so-called Buffet Yardstick. Given strong market performance and deteriorating GDP, this ratio stands at its highest reading ever at 1.7, well above the 1.4 seen during the dot com bubble.

Against stretched valuations and our pessimistic outlook on the economy, we remain cautious on equities. At the end of June into the beginning of July, we cut equities by 3.5% to target 25%. Despite all our talk of big tech and bubbles, most of this reduction came from the Russell 2000 (US small companies), as we believe these firms have a higher beta to the domestic US economy and that reducing our exposure helps reduce some of our mid-cap value bias. While we believe the S&P 500 (and more specifically mega-cap tech) remains overvalued, valuations can continue to inflate for far longer than seems rational. If this is a tech bubble, it can continue to inflate until the last investor capitulates and buys.

While we have seen retail capitulation and some institutional FOMO, we have yet to see a big whale shift course. It took Stanley Druckenmiller (George Soros' right hand man) numerous attempts to short the tech bubble in the 90s, eventually capitulating in March 2000, buying $6bn worth of tech hours before the top. After losing $3bn in six weeks, the bubble officially popped.

Given current positioning, we may be some way from that, with many still underweight or at best neutral. For these reasons, rather than cutting equities back to 20%, we have instead bought a 5% notional December S&P 500 put option (with a strike price of US$3000) . This will allow us to continue to participate in the upside but protect against any significant retracement from here. We continue to hold long positions in USD and JPY to protect the portfolio from any risk-off move and maintain higher than average duration at two years.

Equity

Equities continued to produce positive returns through July, with emerging markets leading the way on the back of a weaker US dollar and stronger commodity prices. Australia was a laggard as the emergence of a second wave in Victoria and the resulting lockdown weighed on sentiment and the economic outlook. We are now about two thirds through the Q2 reporting season in the US – so far over 80% of reported results have produced a positive earnings surprise. Having said that, earnings are still down over 30% year on year for the quarter. We think the greater risk to earnings is in the second half of the year, where the analyst consensus is for a relatively linear path of recovery, which we think is overly optimistic.

At a factor level, the thematic of growth stocks outperforming value stocks continued through July. Year to date, global growth stocks have now outperformed global value stocks by almost 30%, based on MSCI indices.

We have started to become more cautious in our positioning. Where we do hold equities, our preferences are still to Australia, Europe and arguably emerging markets, with the US our least preferred market.

Fixed Income

Global bond yields moved lower in July, while credit spreads continued to compress. Central banks are still providing the market with liquidity and support through asset purchases, although the rate of their purchases has slowed significantly compared to the levels we saw in March and April.

We made some tweaks at the margin of our fixed income positions through the month, but maintained our aggregate duration positioning. We closed a US break-even position after a strong rebound in performance over last few months. While we still hold a relatively positive view of break-evens over the longer term due to valuations, over the shorter term it is a position that has traded like a risk-on asset and would likely add to portfolio volatility and drawdowns in the case of another market downturn. We also switched a small amount of our exposure from Australian hybrids and sub debt into global high yield credit, based on the higher yields in global markets as well as the tactical views of our Credit Strategy Group.

Currency

The main theme in FX markets through July was USD weakness, which resulted in most major currencies, including the AUD, rallying against the USD. The Euro was one of the standout performers, as traders were encouraged by news around the European Recovery Fund, which raised the prospect of potential fiscal unity going forward.
Our long USD position in the portfolio has hurt us in recent months, however we are maintaining our exposure as a defensive play – particularly with yields at such low levels, potentially reducing the efficacy of bonds as a diversifier.

Discontinuation of the London Interbank Offered Rate

This notification is to inform you of the changes that will arise due to the discontinuation of the London Interbank Offered Rate (and other similar rates) by the end of December 2021 and its impact on our funds. For more details, please refer to our policies & notices page on our website www.schroders.com.au

Fund details

ASX Code	GROW
Fund size (AUD)	$38,277,016
ASX Quoted Price	$3.6079
Fund inception date	August-2016
Management costs	0.98%
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.

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