In a global environment of low interest rates, narrow credit spreads and demanding equity valuations, we ask the question “Is a 5% real return achievable without undue risk?” This paper suggests that while the re-engagement of the Fed has been a big driver of recent returns, this is unlikely to continue at the same pace. Managing beta actively will be paramount, as will be extracting alpha from a broad array of sources including interest rates, currencies, style biases (value v growth) and active stock selection. It concludes that while there are risks to both the upside and the downside “real 5%” remains an achievable, but nonetheless challenging objective over the next 3 years.

1. Executive Summary

- We last formally documented our views on achieving a “5% real” return in June 2016. At the time, there was growing debate about the challenges of achieving this target given low nominal bond yields and elevated equity valuations.

- Our conclusion was that achieving “5% real” would be “tough” but achievable on a 3-year horizon. We doubted “beta” in core assets alone would be enough. We also argued that it would require an episodic bias to equities over bonds, active asset allocation and active management at a strategy level for additional alpha contributions. We also argued that avoiding drawdowns (like 2018) would be important.

- Returns to “beta” over this period have exceeded expectations (both ours and the markets). The Real Return strategy has achieved a return of 4.3% real before fees over the 3 years to June 2019, admittedly below its return objective, but not miles away as was the prevailing concern at the time. From a risk perspective, volatility has remained exceptionally low (2.6%) with a maximum drawdown of -2.6% (vs -9.4% for the ASX 200).

- Despite clear headwinds and ongoing questions about the achievability of “5% real”, this return was achievable. For the Real Return strategy, more equities in 2017 and less in 2018 would have made the difference needed. Slightly better timing and we would have hit our return target. Certainly traditional “balanced” type funds with a more structural equity exposure have done well.

- Today, the outlook is more problematic. Cash rates and bond yields are low, including now in Australia where they are around 0.5% lower than 3 years ago, credit spreads are narrow (in Australian investment grade credit almost half the level they were 3 years ago), and equity valuations, especially in the US are still demanding. Base yields for bonds and equities alone won’t get to 5% real, meaning, from a core asset beta perspective capital appreciation will be required.

- Achieving “real 5%” will also likely require more than “beta” alone can deliver. While there is no silver bullet, managing increased volatility through more active and potentially aggressive asset allocation will be paramount. In addition, extracting alpha from adjustments to interest rates, currencies and style biases (value v growth for example) will need to contribute, as will active stock selection in key areas. Passive beta could be problematic in this context. The risks here are bifurcated suggesting problems for fixed SAA

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1 Achieving Real Returns in a Low Return World
structures (just because they've worked well recently doesn't mean they will going-forward). Increased turbulence will likely be a feature with a US led recession within a 3-year window our base case.

- Our conclusion is that “real 5%” remains an achievable albeit challenging return target over the next 3 years. It is not “pie in the sky”. While there are risks to both the upside and the downside, the arguments laid out in this paper suggest they are more skewed to the downside. With a US recession a likely scenario within this timeframe, managing downside risk will be paramount and more important than it ultimately proved to be in recent years.

**PART A: ASSESSING RECENT PERFORMANCE**

2. Recap of our performance track record relative to objectives

Unlike most pooled investment strategies that bury their objective deep in the PDS, we've highlighted our return objective in plain sight. This has given our investors clarity as to what we are seeking to achieve from a return perspective over time, but also a clear reference point as to how we are tracking against this (this clearly has its pros and cons).

Equally important to us, but less visible to our clients is how we think about risk in delivering on this objective. With 5% real a relatively aggressive objective over a full and normal investment cycle, we need to take risk and accordingly through time, our actual outcomes will vary from this target. After all, there is no “risk free” or “neutral” portfolio that will deliver our 5% real objective, especially on what is a relatively short (3 year) investment horizon.

To manage this risk, we aim to mitigate (including avoid where possible) drawdowns (both in extent and duration) and to keep volatility relatively low (circa <5%). We have always viewed the risk and return objectives as intertwined as we expect that minimising drawdowns and smoothing returns is an important component of delivering consistent returns commensurate with our objective to clients. This has proven to be the case over a long period of time.

An assessment of our performance over time should rightly view the returns delivered against the target, and the market context in which they were delivered, especially as to whether we were successful in achieving risk targets (such as low volatility and minimising drawdowns through difficult market environments) in a manner commensurate with client expectations.

Figure 1 below highlights the absolute outcomes for the Schroder Real Return CPI+5% strategy before fees for the 3 years to June 2019. Figures 2 & 3 compare the risk outcomes for the strategy against the competitor universe, firstly in the risk adjusted space (Sharpe Ratio) against competitor managed funds and secondly, against other “alternative” investments in drawdown terms. Figure 4 compares the strategies equity beta and downside risk capture metrics to major “alternative” reference indices.

The key points to highlight are that:

- The strategy’s “real” return of 4.3% pa before fees for the 3-year period was slightly (-0.7%) below the 5% “real” target (before fees);
- Against competitor funds and other “alternatives” this is a competitive return. Clearly though against some single assets and traditional balanced structures (and those funds with significant long duration illiquid investments) returns are lagging – as we would expect them to in the recent environment;
- On all major risk metrics, the strategy's results are also very solid, especially against the difficult conditions of 2018.
- As a broader risk diversifier, the strategy's performance characteristics (beta, upside/downside capture etc) compare favourably to these alternatives (with better return outcomes).
Return expectations: Is 5% Real "pie in the sky"?

Figure 1: Real Return CPI+5% Strategy Return & Risk Outcomes (pre-fees)

<table>
<thead>
<tr>
<th></th>
<th>Real Return CPI+5% Strategy² 3yrs to June 2019</th>
<th>RBA Trimmed Mean 3yrs to June 2019 (%pa)</th>
<th>Excess Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return (% pa)</td>
<td>6.0%</td>
<td>1.7%</td>
<td>4.3%</td>
</tr>
<tr>
<td>Volatility (%)</td>
<td>2.6%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sharp ratio (%)</td>
<td>1.6%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Max Drawdown</td>
<td>-2.6%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Figure 2: Rolling 3 Year Sharpe Ratio³ v Competitors

Source: Morningstar Direct. Performance since inception of the Schroder Real Return CPI+5% Professional Class net of fees versus all funds in the Morningstar Global Broad Allocation Category.

Figure 3: Drawdowns v Alternatives

² Performance statistics are shown before fees
³ The Sharpe ratio is calculated by dividing a fund's annualised excess returns over the risk-free rate by it's annualised standard deviation.
### Figure 4: Returns, beta and asymmetry of returns since inception of the Real Return Strategy to 30 June 2019

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Return %pa</th>
<th>Std Dev</th>
<th>Sharpe Ratio</th>
<th>Beta</th>
<th>Up Capture Ratio</th>
<th>Down Capture Ratio</th>
<th>Up - Down Capture</th>
<th>Beta</th>
<th>Up Capture Ratio</th>
<th>Down Capture Ratio</th>
<th>Up - Down Capture</th>
</tr>
</thead>
<tbody>
<tr>
<td>Schroder Real Return CPI+5% - Professional Class</td>
<td>7.09%</td>
<td>3.80%</td>
<td>1.08</td>
<td>0.24</td>
<td>35.62</td>
<td>8.67</td>
<td>26.96</td>
<td>0.15</td>
<td>29.79</td>
<td>0.43</td>
<td>29.36</td>
</tr>
<tr>
<td>Credit Suisse Global Macro USD</td>
<td>5.14%</td>
<td>4.03%</td>
<td>0.42</td>
<td>0.05</td>
<td>13.64</td>
<td>-2.40</td>
<td>16.05</td>
<td>0.09</td>
<td>21.26</td>
<td>3.57</td>
<td>17.71</td>
</tr>
<tr>
<td>Credit Suisse Hedge Fund USD</td>
<td>4.81%</td>
<td>4.48%</td>
<td>0.30</td>
<td>0.14</td>
<td>20.01</td>
<td>8.28</td>
<td>11.73</td>
<td>0.24</td>
<td>30.56</td>
<td>23.85</td>
<td>6.72</td>
</tr>
<tr>
<td>Credit Suisse Long/Short Equity TR USD</td>
<td>5.91%</td>
<td>6.51%</td>
<td>0.38</td>
<td>0.22</td>
<td>26.87</td>
<td>13.58</td>
<td>13.29</td>
<td>0.39</td>
<td>43.28</td>
<td>40.34</td>
<td>2.93</td>
</tr>
<tr>
<td>S&amp;P Risk parity 10% Target Volatility TR USD</td>
<td>6.62%</td>
<td>6.01%</td>
<td>0.53</td>
<td>0.20</td>
<td>27.31</td>
<td>11.27</td>
<td>16.04</td>
<td>0.29</td>
<td>37.48</td>
<td>24.30</td>
<td>13.17</td>
</tr>
</tbody>
</table>

Figure 4 also highlights:

- Relative to the other “diversifying” strategies shown, the Real Return strategy has generated competitive returns, at low volatility with the most favourable sharp ratio;
- The equity beta of the strategy is not out of line with the equity beta of other alternatives more typically viewed as diversifiers (some are a bit higher, some a bit lower);
- Importantly, and to the extent that diversification matters most in falling markets (this is where hedges count), the downside capture of the strategy has been relatively low (consistently) and certainly much lower than the Hedge Fund metrics highlighted in the table.
- On the flip side, while downside capture is low the strategy's upside capture is in line with other alternatives and illustrates the key asymmetry we are trying to produce, which is to minimise downside risk while ensuring a greater degree of participation to market upswings.

3. **The interaction between the primary return objective and the path of returns, including managing drawdown risk**

A key premise behind the Real Return strategy is to disconnect investment returns and the risk around them from the equity cycle. That's not to say we don't want to take equity risk, but rather that we don't want to be beholden to the equity cycle to determine the absolute quantum of returns. Our primary considerations are breadth of opportunity, structural flexibility, and the willingness to reflect the conclusions of our investment

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4 Inception date 1 October 2008
process in the portfolio with a focus on delivering a “5% real” target, as consistently as possible through time. It’s important to also remember that there is no benchmark or risk-free portfolio we can own to achieve our objectives, either on the return side or the risk side. This means that all investment decisions need to be framed against the trade-off between achieving the targeted rate of return, while ensuring our risk objectives aren't compromised, without an anchor.

Our investment process has been developed to attempt to balance these objectives.

We purposely chose valuation as a principal anchor as, in the medium to long run, it tells us a lot about potential returns and it tells us a lot about risk, especially the risk of loss. Valuations though have their limitations, which we recognise and have over time become more expert in. Firstly, there is no unique concept of valuation. It’s somewhat subjective and dependent on a wide range of assumptions. Secondly, the shorter your investment horizon, the less effective valuation is. To overcome these issues, we incorporate factors such as the business cycle, liquidity and to some extent momentum into our framework. These too have their limitations, such as the difficulty in assessing the business cycle, the increasing impact of central banks on investor behaviour and in the suppression of volatility etc., but nonetheless help us deal with the inevitable challenge that comes with attempting to position correctly for an uncertain future.

The point of the above comments is that the investment decisions we make will inevitably involve us trading off these factors, but we do need to anchor to something. For us this is the valuation concept and how this is reflected in returns. As valuations become stretched, future returns decline and the risk of a pull back to fair value (or beyond as is typically the case) increases. Our investment response is to reduce risk, even if other factors (albeit with more tenuous relationships to future returns and risk) aren’t signalling to the same extent. While this may dampen potential returns if markets continue to run on (because of liquidity or policy stimulus), it makes us more likely to deliver on the risk side (i.e. we’re less vulnerable to shocks). Tapping the brakes to slow down a bit is better than slamming them on to avoid a major accident and dealing with police, ambulances, hospitals and even funeral parlours if we’re not successful.

This trade-off has been a feature of our return and risk outcomes over recent years.

**Figure 5: Real Return CPI+5% Strategy v Return Objective since inception**

![Figure 5: Real Return CPI+5% Strategy v Return Objective since inception](image)

Source: Schroders

Figure 5 shows the long run performance of the Real Return CPI +5% Strategy compared to its return objective (expressed linearly as CPI+5%) and the Australian share market for context. The key points to take away from this are:
• Since inception, the Strategy has exceeded its target CPI+5% return (pa on a rolling 3-year basis) on 55% of occasions, with over 90% of outcomes above CPI+3%, and 100% of outcomes above CPI+2%;

• While up until 2017, returns have generally aligned with the objective, the trend in returns has dropped below target over the last couple of years. This has generally reflected more defensive positioning driven by deteriorating valuations and declining nominal return expectations (not to mention poor returns from markets across the board in 2018).

• In hindsight this was premature as markets rallied strongly in 2017, but this did set us up well for a more difficult 2018 where arguably we had more risk than we should have, albeit achieving our target return in 2018 would have been difficult no matter what the allocation (100% bonds maybe?).

• While there have been some wobbles along the way, where we have fallen a bit below target these have generally coincided with periods in which equity markets have been weakening, and we've tended to move sideways temporarily as a result (consistent with our risk objective of mitigating drawdowns).

• More recent performance outcomes in 2019 have again closed the gap from the targeted return.

• The bottom-line though is that we do not have the luxury of owning a portfolio that will replicate the CPI+5% return outcome. We will always be trading off return potential with risk assessments to balance out how best to position to achieve returns commensurate with our expectations (and those of clients) but to achieve these against appropriate risk outcomes.
PART B: RETURN OUTLOOK

4. The expected distributions of returns for major asset classes

a) Yields as a starting point

In thinking about likely returns going forward, a good place to start is the underlying yield currently available on each asset. Yields are also important as they are embedded within our own return forecasting framework.

From a bond perspective this is relatively clear, for equities the earnings yield is a better proxy than the dividend yield given it reflects the effective return to the equity holder as opposed to simply the cash distribution. Accordingly, in a steady state (i.e. no capital movements), and assuming no re-investment), this is effectively the return to investors from owning these assets.

Figure 6: Market Yields have continued to fall

![Market Yields Chart]

Source: Datastream, Local Currency as at end June 2019

The key observations we’d make from this are:

- Yields, particularly in bond markets are low to very low, and in most cases there is a big gap between the market yield (Yield To Maturity for bonds or “Earnings Yield” in the case of equities) and a threshold 5% real target. Here we are assuming 2% inflation (RBA Trimmed Mean) and therefore a 7% nominal hurdle. Core inflation for the 3 years to June has been 1.7% pa;

- Within equities, only a handful of the riskier equity markets have earnings yields at or near a 5% real threshold;

- If seeking 5% real from this group of assets, significant capital appreciation is required to augment the shortfall between the yield and the target return. This is possible in both equity and bond markets but how likely is hard to judge. Materially lower bond yields presumably require a weakening in growth as a catalyst which at some point would be damaging for earnings. In current markets where bad data is clearly good, it raises hopes of further central bank support although there is inevitably an inflexion point (see Figure 10).
b) How feasible is capital appreciation from here?

As a pragmatic observer of market behaviour, it would be foolish to dismiss the possibility of across the board price appreciation across these assets. 2019 to date is a good example where sovereign yields have lurched lower and equity markets higher.

Figure 7 examines the potential symmetry in returns for US sovereign bonds and Australian sovereign bonds. For sovereign yields we are assuming bond yields move to the noted yield over the next 12 months.

**Figure 7: Return Scenarios for Australian and US Sovereign Bonds**

<table>
<thead>
<tr>
<th></th>
<th>Lower Yields</th>
<th>Current⁵</th>
<th>Higher Yields</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>US 10-Year Bond Yield</strong></td>
<td>0.0%</td>
<td>0.5%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Return (% pa)⁶</td>
<td>19.4%</td>
<td>15.1%</td>
<td>10.7%</td>
</tr>
<tr>
<td><strong>AU 10-Year Bond Yield</strong></td>
<td>-0.5%</td>
<td>0.0%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Return (% pa)⁷</td>
<td>18.4%</td>
<td>14.2%</td>
<td>9.9%</td>
</tr>
</tbody>
</table>

What this shows is that while yields are low, significant returns are possible should the “Japanification” of global monetary policy continue and yields compress to 0%. In fact, given that currently $12 trillion US dollars of global debt are currently trading on negative yields (including almost 50% of bonds in Europe) assuming a 0% lower bound may be somewhat “pessimistic”. In fact, in a deflation / recession scenario long dated sovereign bonds would be the portfolio of choice.

It is a similar story for equity markets. However, as Figures 8 and 9 show, further growth in returns requires either an acceleration in earnings growth from an already robust 8% expectation, or further multiple expansion. If multiples stay flat (based on a current historic PE of circa 17x), and earnings growth in line with current 8% expectations is delivered, equity returns will be barely positive. Any softening in earnings growth must be accompanied by multiple expansion to see gains. It is a very similar story in Australia.

**Figure 8: 12-mth price return scenarios for US equities under different earnings growth and PE assumptions**

<table>
<thead>
<tr>
<th>US (% pa)</th>
<th>-16</th>
<th>-12</th>
<th>-8</th>
<th>-4</th>
<th>0</th>
<th>4</th>
<th>8</th>
<th>12</th>
</tr>
</thead>
<tbody>
<tr>
<td>PE June 2020</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>-2</td>
<td>3</td>
<td>7</td>
<td>12</td>
<td>17</td>
<td>21</td>
<td>26</td>
<td>31</td>
</tr>
<tr>
<td>20</td>
<td>-7</td>
<td>-2</td>
<td>2</td>
<td>7</td>
<td>11</td>
<td>15</td>
<td>20</td>
<td>24</td>
</tr>
<tr>
<td>19</td>
<td>-11</td>
<td>-7</td>
<td>-3</td>
<td>1</td>
<td>5</td>
<td>10</td>
<td>14</td>
<td>18</td>
</tr>
<tr>
<td>18</td>
<td>-16</td>
<td>-12</td>
<td>-8</td>
<td>-4</td>
<td>0</td>
<td>4</td>
<td>8</td>
<td>12</td>
</tr>
<tr>
<td>17</td>
<td>-21</td>
<td>-17</td>
<td>-13</td>
<td>-9</td>
<td>-6</td>
<td>-2</td>
<td>2</td>
<td>6</td>
</tr>
<tr>
<td>16</td>
<td>-25</td>
<td>-22</td>
<td>-18</td>
<td>-15</td>
<td>-11</td>
<td>-8</td>
<td>-4</td>
<td>-1</td>
</tr>
<tr>
<td>15</td>
<td>-30</td>
<td>-27</td>
<td>-23</td>
<td>-20</td>
<td>-17</td>
<td>-13</td>
<td>-10</td>
<td>-7</td>
</tr>
<tr>
<td>14</td>
<td>-35</td>
<td>-32</td>
<td>-29</td>
<td>-25</td>
<td>-22</td>
<td>-19</td>
<td>-16</td>
<td>-13</td>
</tr>
</tbody>
</table>

⁵ This is closest yield to current prevailing 10 year bond yields at the time of estimation.

⁶ US 10-Year Treasury Bond duration of 8.7 years

⁷ Australian 10-Year Government Bond duration of 8.4 years
Figure 9: 12mth price return scenarios for Australian equities under different earnings growth and PE assumptions

<table>
<thead>
<tr>
<th>Australia (% pa)</th>
<th>Earnings Growth %</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-16</td>
</tr>
<tr>
<td>20</td>
<td>-4</td>
</tr>
<tr>
<td>19</td>
<td>-9</td>
</tr>
<tr>
<td>18</td>
<td>-13</td>
</tr>
<tr>
<td>17</td>
<td>-18</td>
</tr>
<tr>
<td>16</td>
<td>-23</td>
</tr>
<tr>
<td>15</td>
<td>-28</td>
</tr>
<tr>
<td>14</td>
<td>-33</td>
</tr>
<tr>
<td>13</td>
<td>-38</td>
</tr>
<tr>
<td>12</td>
<td>-42</td>
</tr>
</tbody>
</table>

Based on this, to be “bullish” on equities, earnings must accelerate (and/or) the market continue to re-rate on the back of lower interest rates. While this is possible in a positive growth / positive profit growth environment where interest rates are falling, there will likely be a point where the nexus between lower rates and re-rating markets breaks down (i.e. PE frown).

Figure 10 shows the relationship between PE’s (or P/Cash Earnings in the case of Japan) and official policy rates. It demonstrates that as official interest rates approach zero, the re-rating effect starts to dissipate, in all cases, a moderate, but noticeable de-rating of the market the closer policy rates get to zero – the “PE frown” as noted above. Arguably this is caused by deteriorating underlying economic conditions (and therefore profits) that are motivating the extreme monetary policy conditions. This effect will be critical as rates re-test these levels.

Figure 10: The relationship between PE’s and interest rates is non-linear (US, Japan, Germany)

Source: Schroders / Datastream

c) Valuations do matter (especially in the medium term)

The relationship between valuations and subsequent medium to long run equity returns is strong and this is well demonstrated by the relationship between the Cyclically Adjusted PE Ratio (or CAPE) and subsequent 10-year real returns for US equities.
The current CAPE is just over 30x, implying low single digit real returns from US equities over the next decade. While the CAPE has been above current levels, it should be noted that these periods were generally associated with the last year or so of the "tech boom" which was subsequently followed by a decade of negative real rates of return, including the Global Financial Crisis. The equivalent metric for most other major markets is less negative, but nonetheless indicative of equity returns below trend for an extended period.

d) Schroders 3-Year Return Forecasts

Clearly, while CAPE is important in terms of helping to define the structural trend in returns it tells us very little about the path returns might take, and consequently how different say 3-year returns might look against this. Our own return methodology aims to incorporate structural drivers of return (like yields, long run earnings growth) and likely structural valuation adjustments, with cyclical over or undervaluation.

Figure 12 breaks down our 3-year US and Australian equities forecasts by component factor, highlighting the interplay between both structural and cyclical drivers, and the differences in these assumptions between these two major equity markets.

In Figure 13 we present our 3-year return forecast across asset classes that has been derived from this methodology as well as comparing our 3-year forecasts made 3-years ago (June 2016) with the subsequent 3-year return outcomes. It is important to note that these forecasts do not incorporate all elements of our methodological approach.
process. They (hopefully) give us a guide to the future as opposed to pin-point accuracy. Figure 14 shows these forecasts against their (non-normal) distribution forecasts, highlighting the range of possible outcomes.

**Figure 13: Schroders 3-Year Return Forecasts for major asset classes**

<table>
<thead>
<tr>
<th>Asset</th>
<th>Currency</th>
<th>3-Year Return Forecasts (June 2016)</th>
<th>3-Year Return (to June 2019)</th>
<th>Difference between forecast &amp; actual</th>
<th>3 Year Return Forecast (June 2019)</th>
<th>Forecast versus Prev 3 yr return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aust. Equities</td>
<td>AUD</td>
<td>9.8%</td>
<td>12.9%</td>
<td>+3.1%</td>
<td>6.5%</td>
<td>-6.4%</td>
</tr>
<tr>
<td>US Equities</td>
<td>USD</td>
<td>4.2%</td>
<td>14.2%</td>
<td>+10.0%</td>
<td>1.2%</td>
<td>-13%</td>
</tr>
<tr>
<td>Euro Equities</td>
<td>Euro</td>
<td>7.0%</td>
<td>10.5%</td>
<td>+3.5%</td>
<td>2.1%</td>
<td>-8.4%</td>
</tr>
<tr>
<td>UK Equities</td>
<td>GBP</td>
<td>7.9%</td>
<td>8.9%</td>
<td>+1.0%</td>
<td>4.1%</td>
<td>-4.8%</td>
</tr>
<tr>
<td>Japan Equities</td>
<td>JPY</td>
<td>10.5%</td>
<td>10.0%</td>
<td>-0.5%</td>
<td>10.0%</td>
<td>0%</td>
</tr>
<tr>
<td>EM Equities</td>
<td>H-AUD</td>
<td>11.3%</td>
<td>10.9%</td>
<td>-0.4%</td>
<td>8.1%</td>
<td>-2.8%</td>
</tr>
<tr>
<td>A-Reit’s</td>
<td>AUD</td>
<td>-3.6%</td>
<td>8.1%</td>
<td>+11.7%</td>
<td>-1.6%</td>
<td>-9.7%</td>
</tr>
<tr>
<td>Global HY Credit</td>
<td>H-AUD</td>
<td>6.4%</td>
<td>7.2%</td>
<td>+0.8%</td>
<td>2.3%</td>
<td>-4.9%</td>
</tr>
<tr>
<td>Australian Hybrids</td>
<td>AUD</td>
<td>4.6%</td>
<td>5.0%</td>
<td>+0.4%</td>
<td>2.5%</td>
<td>-2.5%</td>
</tr>
<tr>
<td>EMD</td>
<td>H-AUD</td>
<td>4.8%</td>
<td>5.5%</td>
<td>+0.7%</td>
<td>3.9%</td>
<td>--1.6%</td>
</tr>
<tr>
<td>Aust. Govt Bonds</td>
<td>AUD</td>
<td>-0.1%</td>
<td>4.3%</td>
<td>+4.4%</td>
<td>-0.8%</td>
<td>-5.1%</td>
</tr>
<tr>
<td>US Govt Bonds</td>
<td>USD</td>
<td>-1.8%</td>
<td>1.3%</td>
<td>+3.1%</td>
<td>-0.1%</td>
<td>-1.4%</td>
</tr>
<tr>
<td>Global Agg. Comp</td>
<td>H-AUD</td>
<td>-2.8%</td>
<td>3.1%</td>
<td>+5.9%</td>
<td>-1.6%</td>
<td>-4.7%</td>
</tr>
<tr>
<td>Global Agg. Corp</td>
<td>H-AUD</td>
<td>0.9%</td>
<td>4.4%</td>
<td>+5.3%</td>
<td>0.2%</td>
<td>-4.2%</td>
</tr>
</tbody>
</table>

**Figure 14: Schroders 3-Year return forecasts & expected distribution of returns**

*Source: Schroder Investment Management  Data as at: 30 Jun 2019*

9 Including Franking 7.6%
There are some important things to highlight here:

- Market returns almost universally exceeded our forecasts for the 3-years to June 2019. The biggest differences related to bond returns, which universally exceeded our expectations, notably the returns of “bond proxies” like A-Reit’s, and US equities. Clearly the ongoing active role of global central banks has been very important;
- Looking forward, our return forecasts are materially lower than forecasts 3-years ago, and clearly lower than returns delivered over the last 3-years. It’s important here to distinguish our return forecasts at a beta level for some key assets and the return objective;
- It is entirely possible that the impact of central banks will remain pervasive and that our return forecasts again undershoot. However, as we have outlined above, the likely breaking of the nexus between declining rates and market re-rating suggests there is an equally likely risk, that risk assets surprise to the downside, especially if, as we argue below, structural and cyclical pressures continue to build.

5. Alternative Assets

The analysis and views presented above focuses on traditional as opposed to alternative assets. Alternatives as an investment category is broad and we do not intend to consider the potential for all alternative asset classes from here. That said, there are a few general observations that can be made:

- Long duration alternative assets or unlisted assets have been major beneficiaries from ongoing low (and lower) rates and central banks. Like equities, their ability to continue to re-rate on lower interest rates will be limited by the extent to which the underlying cash flows support them. We do not expect these assets to continue to deliver the almost universally strong returns they have in recent years;
- If the investment environment becomes more problematic and there is more differentiation between genuine high-quality infrastructure assets with sustainable cash-flows, the resultant mispricing of assets in this space may present opportunities;
- Alternative Risk Premia (ARP)\textsuperscript{10} strategies have delivered underwhelming results to investors (particularly in 2018) and while they do offer some diversification benefits aren't good risk hedges. They are also unlikely to fill the gap left by the challenging return environment for traditional assets. That said, this space may episodically present us with opportunities, but these are more likely to be opportunistic rather than systematic;
- ARP have embedded complexity (model risk, assumption risk, leverage risk and execution risk). While complexity has historically been a feature of late cycle investment environment as expected returns from beta decline, history suggests this rarely ends well (e.g. CDO’s);
- As a general point, we don’t believe hedge funds are the solution to the return challenge. That said, the segment is broad and targeted strategies (and managers) in this space may help.

6. The structural and cyclical environment and their impact on returns

While the business cycle has evolved and faces significant challenges (e.g. trade wars, geo-politics etc), the structural environment remains just as problematic, if not more so, than it was 3 years ago.

The list of structural challenges to the global economy includes:

- High and growing debt levels, particularly government debt;
- In Australia’s case, high levels of household debt (127% GDP and 190% Household Income);
- Challenging demographics including aging populations, rising dependency ratios and increasing health care costs;
- Rising income inequality (in part a consequence of the various QE programs) and the associated rise of populism, which adversely impacts the ability of governments to undertake structural reforms as well as leading to increased social and political instability;

\textsuperscript{10} See Making Sense of Alternative Risk Premia (ARP), Schroders, Roland Winn, 2019
Globalisation is giving way to increased protectionism and a reversal of the free trade agenda;

Geo-political power shift with the rise of China challenging the US's global dominance, with the likelihood of ongoing and escalating tensions (Cold or Hot wars);

Climate change.

On the positive side of the structural ledger:

- Technology and automation are boosting productivity;
- Climate change is fast tracking innovation around renewable energy with associated positive impacts of other industries;
- Emerging economies (particularly in Asia) continue to grow and evolve.

As the balance of these two lists suggests, the structural environment has on balance been a solid headwind for global growth. That said, these structural challenges have also had some other implications:

- Inflation has remained low (stubbornly so, but low nonetheless) which has allowed Central Banks to suppress interest rates and continue to enact QE programs to support asset prices, risk taking, activity and confidence; and
- While government debt levels have been high and rising for some time, governments have increasingly viewed budget deficits and rising debt as the lesser evil, particularly in an environment of very low interest rates) and have looked to increasingly support growth through fiscal stimulus (e.g. recent US tax cuts).

There is clearly a circularity to this latter point. Global indebtedness has increasingly constrained central bankers and reduced the effectiveness of monetary policy as a demand management tool. However, low interest rates have encouraged governments to borrow which has fuelled this vicious cycle and further crimped the effectiveness of monetary policy as a demand management tool.

The net result has been an extended business cycle, but also a relatively muted and vulnerable one. The determination of central bankers and governments to avoid a cataclysmic end to this increasingly vulnerable and vicious cycle is without question. However, many good central bankers have been wrongfooted before. In this regard we think there are two key vulnerabilities.

- The re-emergence of inflation especially as the absence of inflation has provided central banks with the latitude to push the boundaries on monetary policy.
- A recession in the key US economy (with broader implications for global growth). This has been an area of increasing focus for us particularly given the downward pressure on the business cycle due to US/China trade. As Figure 15 highlights, recessions and bear markets typically come “hand-in-hand”.

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11 “The Federal Reserve is not currently forecasting a recession”. Ben Bernanke January 10, 2008.
A question therefore is how likely a recession is and when might we reasonably expect it to occur. While forecasting recessions is well known to be a difficult exercise, there are some ways to assess the risks (high or low, rising or falling) and the timing (imminent or outside our investment horizon).

Figure 16 highlights two different models. The NY Fed’s model, which is largely a function of the US yield curve, and, our own proprietary model “SIMAL Recession Probability Model” which combines US profit margins and US interest rates. The NY Fed Model suggests elevated recession risk (reflecting the flattening of the US yield curve) while our model is less negative reflecting ongoing resilience in profit margins.

One important observation to make here is with respect to profits, which is the key differentiator in these approaches. More broadly, markets, particularly the US, has re-rated on the basis of lower rates, but also supported by the resilience of profits. Our modelling on profits though suggests both significant weakness ahead, and, a big mismatch between current profits / bottom-up expectations and the outlook based on top-down factors. If our modelling proves correct, then both our recession model would likely spike and market forecasts for earnings would be revised down, potentially significantly. This would clearly be bad news for markets and the potential catalyst for a major re-pricing.
Our "best guess" on timing for recession is within a 1 to 2-year horizon and is based on our "Receiver Operating Curve" analysis which essentially looks at the relationship between a range of real economy and financial indicators and recession risk. The longer lead indicators in this analysis are elevated, consistent with elevated recession risk on a 1 to 2-year horizon.

Figure 18: “ROC” Longer term Indicators v US Recession

Outside the US, Chinese growth has moderated, and stimulus has been tepid compared to past cyclical slowdowns. Europe remains problematic and the UK is clearly at risk of a poor BREXIT outcome.

In Australia, after 28 years of continuous growth, the risks of recession have risen amid declining housing prices, digestion of new housing supply, a tightening in credit conditions, and exposure to moderating global

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12 Schroders Global Profit Model includes: Credit spreads, Global PMI’s, Commodity prices (industrial v precious metals), equity prices, cycicals/defensives.
trade. Lower rates, tax cuts and the potential for more monetary and fiscal stimulus should help moderate the slowdown and support growth based on domestic considerations, but the swing factor is global growth and a broader slowdown / recession in the US would be difficult for Australia to withstand.

7. CONCLUSIONS

- The structural pressures at play on the global economy are acute. They are being mitigated by extreme policy measures (both on the monetary and fiscal side) which are providing temporary, albeit extended, support;
- Markets are enjoying the support of policy makers who are collectively attempting to underwrite and encourage risk seeking behaviour and this is driving a wedge between the inherent and deep-seated risks in markets and economies, and investor behaviour;
- This “moral hazard” has the potential to unravel quickly – hence we see asymmetric risk to market returns, especially risk assets – credit and equities. Our asset class return forecasts (which are building blocks in the investment process) that are conditioned on valuations imply lower returns over the next 3-years than over the last 3 years, where returns in most asset classes have exceeded expectations.
- Recession, no matter how induced, is a key risk, as it would quickly remove the earnings support that markets have enjoyed. Our earnings model suggests growing downside risk to earnings which is not reflected in market expectations. This may well be good for sovereign bond investors, but very bad for risk asset holders.
- Alternatives will face some similar challenges, particularly those that have been the beneficiary of central bank largess - directly and indirectly. More complex alternatives (like ARP) may help manage volatility but are not good hedges against declines in risk assets.
- The environment we describe will likely see increased volatility meaning active asset allocation will become more important. A largely long dated US treasury portfolio would more than deliver on the target if the US goes into recession during this timeframe. Likewise, exploiting opportunities in areas including currency markets, interest rates and factor normalisation (growth vs value) will also likely contribute. We are also actively evaluating sources of differentiated risk premium, including in private markets.
- We would expect that the more pervasive underperformers in recent years (value and active management) will also make a comeback as more discrimination around the allocation of investment capital assets.
- Consistent with this, fixed SAA structures (balanced funds) that have benefitted from both rising equity markets and low yields would reasonably be expected to struggle in the 3-year environment we describe in this paper.
- With US recession a likely scenario within this timeframe, managing downside risk will be paramount.
- There are risks on both the upside and the downside over the next 3 years and, on balance, we think they are skewed to the downside over this timeframe. However, we hold to the view that a 5% real return is achievable on a 3-year horizon and that this is not “pie in the sky”.

Return expectations: Is 5% Real "pie in the sky"?
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