Schroders

Schroder Strategic Beta

Strategy Overview

Investment objective

The objective of our strategy is to harvest risk premia in the most efficient way possible. Based on our fundamental understanding of risk premia and our approach to building a highly diversified portfolio our long-term expectations for our strategy is approximately a 0.6 Sharpe ratio over a market cycle. This translates to an expected return of 7% for the 12% volatility we target for the strategy.[1]

[1]There can be no guarantee that any investor objective or outcome will be achieved.

Summary

Schroder Strategic Beta is invested across a broad range of risk premia using a risk-based asset allocation process that aims to deliver stable performance over the medium term in a variety of market environments. The strategy focuses on making asset allocation decisions in risk rather than capital space, using long-term risk relationships to diversify its risk across a wide range of different risk premia.

Strategic Beta is implemented predominantly using the most liquid types of derivative contracts to ensure low transaction costs and a high level of liquidity. It can use financial derivative instruments such as interest rate swaps, credit default swaps, total return swaps, futures, options, warrants, forwards and contracts for difference.

Moreover the strategy is subject to a number of investment guidelines which are monitored on a daily basis by Schroders risk and compliance teams. No single risk premia group can comprise more than 50% of the strategy's risk and 80-90% of performance is expected to be driven by the initial risk-balanced portfolio with the remaining returns driven by the strategy's valuation overlay.

Key features

- **Seeks stable performance**
  Strategic Beta is invested in a broad range of risk premia with the objective of seeking to deliver stable returns in a variety of market environments.

  We focus on investing in risk premia rather than asset classes. This is a more granular approach to investing and can help to improve the portfolio's diversification compared to approaches based on investing in asset classes.

  We group risk premia into one of four categories – three are driven by a single systematic risk factor, while the fourth covers investor behavior. We then construct an initial portfolio where the risk is equally distributed across the four categories.
- **Improved diversification**
  Strategic Beta benefits from being diversified across and within each risk premia category.
- **Targets downside protection**
  Downside protection is a key element in our approach and is based on a two tier approach of (i) efficient portfolio construction and (ii) downside risk management. Our downside risk overlay is designed to protect against tail risk events, both in individual risk premia groups and systemic events that can affect all risk premia.
- **High level of liquidity**
  The strategy is predominantly invested in the most liquid types of derivative contracts to ensure low transaction costs and a high level of liquidity.
- **Risk based asset allocation approach**
  All asset allocation and portfolio construction decisions are implemented in risk space. This means that there is a strong focus on monitoring and managing the portfolio's risks and on ensuring that risk is broadly distributed across the portfolio's investments.

Investment philosophy

Our investment philosophy is very simple. We believe that:

1. Asset class returns and consequently portfolio returns are best understood by considering the underlying drivers of asset returns: economic growth risk, interest rate risk, inflation risk, and investor behavior.
2. Diversification is about balancing risk allocations.
3. Diversification is a powerful risk control tool but it has two weaknesses. First, it is blind to the cost of acquiring a diversifying asset, which means diversification is susceptible to valuation risk. Second, diversification cannot protect one against systemic shocks.

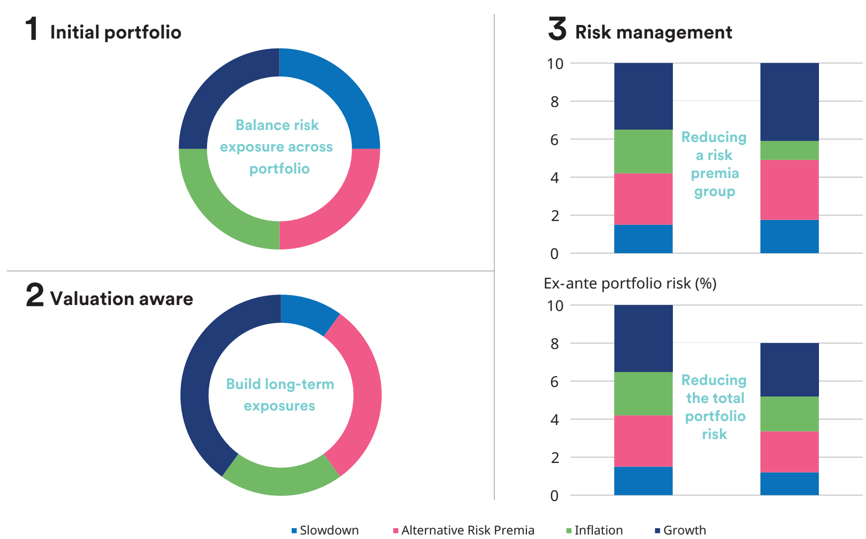
Taken together this leads us to build well-diversified portfolios that start with equal risk allocations, not to asset classes, but to the four key return drivers. This heavy reliance on diversification compels us to address the weaknesses of diversification by:

A tilting the risk allocations to reflect valuations. This occurs both at the level of the four drivers of returns and at the level of the assets that we believe are best positioned to capture these return drivers, and

B scale exposure back as necessary to reflect heightened systemic weakness

Investment process

Our investment process is based on a fundamental commitment to understanding the nature of risk premia and what drives their returns. More than 40 investment professionals collaborate in our risk premia research process which we believe gives us an advantage over our competitors and enables us to have unique insights into the nature of risk premia and the ability to design strategies to harvest them. The three-step process is illustrated below:



Source: Schroders. For illustrative purposes only.

Investment process (continued)

Constructing the initial risk-balanced portfolio

The portfolio managers leverage these risk premia insights to classify each identified risk premia into one of four groups, corresponding to the four key drivers of asset returns: growth, slowdown, inflation and investor behavior. We believe the fourth driver of return, investor behavior, explains the returns of alternative risk premia.

Given that our investment foresight is imperfect and economic and market conditions can change unexpectedly, sometimes severely, we look to build an initial portfolio that is as diversified across the return drivers as possible. Therefore, our starting point is to assign an equal amount of risk to each of the four groups as well as equally across the constituent risk premia.

We expect the majority of the overall return objective (approximately 80-90%) to be driven by harvesting the various risk premia through our initial risk-balanced portfolio.

Accounting for valuation risk

From this initial risk-balanced portfolio we allow for incremental deviations to reflect the valuation views from our risk premia research teams. Each risk premia research group assigns a score to their respective universe based on an evaluation of risk premia along three dimensions: valuations, the market environment and investor sentiment.

The investment team use these scores to tilt the portfolio away from those risk premia with the greatest valuation risk and towards those with the least risk. We do this within a defined risk budget of approximately +/- 2% of volatility for a portfolio target 12% volatility to ensure that these tilts don't undermine the starting, risk balanced core portfolio. We expect 10-20% of the overall returns to come from this step.

Accounting for systemic shocks

The final stage of the investment process is designed to provide additional dampening of volatility and increased downside protection against unexpected shifts in market conditions. This can be achieved through de-risking the entire portfolio or through the hedging of individual risk premia. For example, if the portfolio managers foresaw a number of potential risk events in subsequent months, they may reduce the portfolio's ex-ante volatility from 12% to 10%. Alternatively, should there be a potential risk event centred on a series of specific risk premia, they may elect to hedge correlated risk premia and reallocate the risk elsewhere. It is important to note that the portfolio managers cannot increase risk through this mechanism but can only reduce exposures to manage downside risk. As with our approach to managing valuation risk, we define a risk budget for managing the risk of systemic shocks. For a portfolio targeting 12% volatility, we allow this step to reduce portfolio volatility as much as 2%.

When building portfolios, our focus is on making allocations to the different risk premia in terms of their contribution to risk and to let capital allocations fall naturally out of these risk allocations.

Risk management

We devote considerable resources to analyzing how the portfolio would perform in unfavorable environments and developing strategies to reduce the uncertainties in the returns by better understanding and managing their associated risks. We do this through constructing portfolios with more stable diversification characteristics and through a risk management process that seeks to identify and mitigate the impact of extreme price distortions, which is often when diversification can fail.

We look to reduce potential losses by actively reducing exposure to any or all of the risk premia in a particular category where we expect poor performance.

In addition to actively managing the asset allocation, we may also implement downside risk overlay strategies designed to protect the portfolio against tail risks (we define tail risks as those where market falls exceed 10%). In the event of a large fall in a single risk premium (for example the US equity risk premium) we expect the portfolio to be protected by the diversification of risk across multiple premia. If, however, all growth premia fall sharply at the same time (for example all equities fell and credit spreads widened), then the portfolio would suffer, but positive performance in other categories (for example the duration risk premium) should offset these losses.

Risk management (continued)

In order to balance risk across the portfolio, the strategy makes use of leverage. We, therefore, also need to manage the particular risks that can emerge as a result of the strategy utilizing leverage. When a portfolio is leveraged particular attention has to be paid to the amount of cash available to ensure that increases in variation and initial margin can be accommodated from available cash. We mitigate this risk by ensuring that a suitable level of cash is held on the portfolio for the level of market exposure.

Leverage also magnifies market moves which can cause larger moves in portfolio exposure than in an unlevered portfolio. This can result in a change in the risk of the portfolio. We seek to mitigate this risk by monitoring the risk of the portfolio and taking action if the risk in the portfolio breaches a pre defined tolerance level. We also monitor the drift in capital weights to ensure the strategy does not become distorted.

Risk disclosures

The strategy will be affected by the investment decisions, techniques, and risk analyses of the investment team, and there is no guarantee that the portfolio will achieve its investment objective. The market value of the portfolio may decline as a result of a number of factors, including adverse economic and market conditions, prospects of stocks in the portfolio, changing interest rates, and real or perceived adverse competitive industry conditions. Investing overseas involves special risks including among others, risks related to political or economic instability, foreign currency (such as exchange, valuation and fluctuation) risk, market entry or exit restrictions, illiquidity and taxation.These risks exist to a greater extent in emerging markets than in developed markets. Bond and fixed income instruments are subject to a number of risk factors, including interest rate risk, credit risk, inflation/deflation risk, leverage risk and liquidity risk. The use of derivatives involves risks different from, or possibly greater than, the risks associated with investing directly in the underlying assets. The use of leverage may magnify gains and losses. No investment strategy or risk management technique can guarantee future returns or eliminate risk in any market environment

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