Schroders

June 2020

Schroder Real Return CPI Plus 3.5% Fund Wholesale Class

Quarterly Report

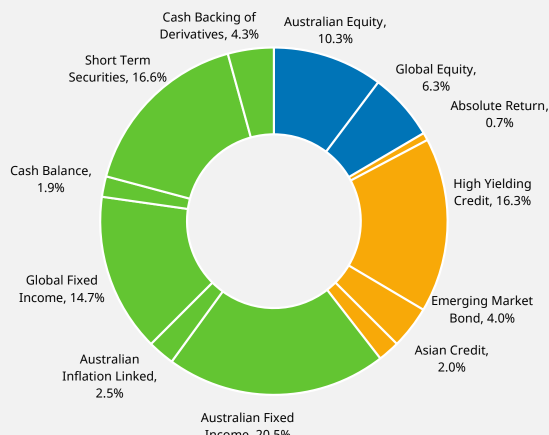
Total return %	1 mth	3 mths	1 yr	3 yrs p.a.	5 yrs p.a.	Inception p.a.
Schroder Real Return CPI+3.5% Fund (pre-fee)*	0.69	3.99	1.80	3.42	3.71	3.56
Schroder Real Return CPI+3.5% Fund (post-fee)*	0.64	3.84	1.20	2.81	3.09	2.94
Distribution^	0.76	0.78	3.01	3.05	3.29	3.69
Growth^^	-0.11	3.06	-1.82	-0.25	-0.20	-0.74

Portfolio inception 19/05/2015

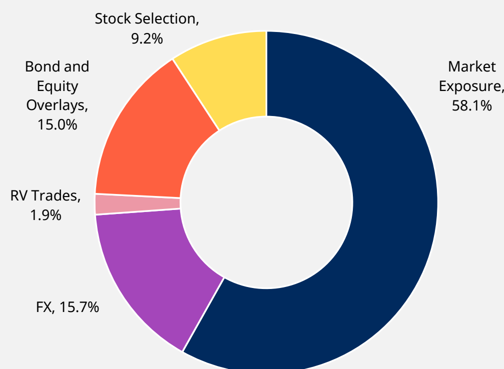
*Returns include impact from spread adjustments in March 2020.

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

Asset allocation - Capital Weights



Asset allocation - Risk Weights



RBA CPI Trimmed Mean* as at 31 March 2020

3 months	0.47%
6 months	0.93%
1 year	1.79%
3 years. p.a.	1.70%

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

^ Represents distributions as a proportion of total net return

^^ Price to price return excluding distribution reinvestments

Portfolio refers to the Schroder Real Return CPI Plus 3.5% Fund - Wholesale Class

Unless otherwise stated figures are as at the end of June 2020

Numbers may not total to 100 due to rounding

Fund objective

To deliver an investment return of 3.5% 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.

Portfolio review

The Schroder Real Return CPI + 3.5% Fund returned 0.6% (post-fee) in June, leading to a gain for the June quarter of 3.8% (post-fee). For the financial year (12 months to June) the strategy returned 1.2% (post-fee). The return over the last 12 months is below our target and is framed against an environment of heightened market volatility, significant falls in many asset prices (including big declines in equities), challenging liquidity conditions, and very low (close to 0%) cash rates and bond yields in the face of the COVID-19 environment.

While our return objectives weren't met, our risk objectives were met (and arguably exceeded). While strategy volatility has picked up, reflecting the exceptional volatility of the last 6 months, it remains broadly in line with our expectations as does the drawdown experience amidst this exponential shift in volatility.

Largest Contributors

The main positive contribution to returns in June came from credit with spreads generally drifting lower over the month, contributing 0.45% to returns in June. Equities also contributed roughly 0.42% to overall portfolio returns, with about half of that contribution from Australia. Likewise, sovereign yields were also flat to lower over the month ensuring a positive contribution from duration. The trends were consistent over the quarter. The rebound in equity and credit markets together with the stabilisation in sovereign yields all added 4.5% to returns in aggregate over the second quarter.

Largest Detractors

With equities and credit performing well (both in June and during the quarter), clearly returns would have been higher had we held more equity (or risk generally in the portfolio). That said, in terms of overall returns, the biggest detractor to returns in the month of June was the FX positioning. With the USD moderating as COVID-19 concerns eased, the AUD continued to recover much of the ground lost during the March quarter. Sterling also weakened as Brexit concerns elevated in June. The trends were similar over the quarter. After performing very strongly in the first quarter, FX detracted -0.43% from returns in the month, and -1.4% from returns over the last quarter. Stock selection in Australian and Global equities continued to drag down performance.

Market Outlook:

There are plenty of investors questioning the veracity and sustainability of the rally in equity markets through the June quarter (particularly in the US), in the face of deep global recession and a still unfolding health crisis. We'd put ourselves into that camp.

In looking for explanations we can rattle off a long list including:

- the improvement in valuations that resulted from the voracity of the sell-off on the back of the pandemic and the economic shutdowns;
- the apparent stabilisation in COVID-19 infection rates and the episodic progress in vaccines and treatments;
- the re-opening of the US and other economies and the shift in expectations from economic Armageddon to a V-shaped recovery; and
- more fundamentally, the fact that big US tech companies have to some extent been winners from the crisis, given the boost to technology and the online economy.

The more significant reason, though, is simply liquidity. Central banks globally have rapidly and substantially flooded the world with money, and with real economic activity depressed, this has found its way into financial markets, suppressing yields and in turn boosting equity prices independent of underlying earnings. The central bank playbook was refined in the post-GFC environment of financial repression but was quickly dusted off and put on steroids in the COVID-19 response. Furthermore, the US Federal Reserve has broadened its reach into the purchase of corporate bonds (both investment grade and high yield) on the argument of ensuring availability of capital and liquidity to underlying corporates (irrespective of underlying corporate quality). This has buoyed investor confidence, and with exceptionally low yields accessible on cash and sovereign bonds (globally), investors have been happy to follow the Fed into corporate assets, suppressing corporate bond spreads and boosting equity prices. Happy days!

It certainly seems unlikely that the taps will be turned off any time soon in light of the experience with QE withdrawal, which was not well received.

In the short run, the durability of the rally will likely depend on whether central banks can paper over significant fundamental problems for long enough for enduring underlying recovery to occur. On this point, the market's scenario gear shift from economic Armageddon to a V-shaped recovery seems highly optimistic (a U or a W would be more reflective of our central case). Likewise, the trajectory of COVID-19 infection in the US is worrying and the likelihood of further lockdowns is high (even if it's driven by states, corporates and individuals rather than the US federal government). Furthermore, from a valuation perspective, the US market is now trading on multiples about pre-crisis levels with considerable ambiguity around future earnings and their trajectory – the next couple of months will provide more clarity. On this basis we'd be loath to chase the market up. The liquidity story is real, but it is stretching the connection between the real economy and the market.

A broader factor to consider is what the increased penetration of central banks into asset markets means. How stable is a system where central bank actions extend beyond liquidity and proper market function to outright support for market levels (beyond the federal funds and treasury markets), which increasingly distorts the pricing of risk? This process represents the effective partial nationalisation of financial markets where prices are underwritten by the bottomless pockets of central banks (and the taxpayer). Arguably, a key role of financial markets is price discovery and the effective pricing of risk, such that capital is allocated to entities that will earn a return commensurate with the underlying risk of the investment. In theory at least, investors commit capital to companies (and markets) and in return demand a risk premium commensurate with this risk. This is ultimately what investing (as opposed to speculating) means.

Market Outlook continued

This tension between fundamentals and liquidity make it difficult to make a strong case for any core asset class today. For example:

- Cash rates are very low and short dated sovereign debt yields are similar. Longer dated sovereign debt offers some yield but is hardly cheap, and is also at risk, given fiscal expansion and explosive money supply growth.

- Corporate bonds are in the Fed's sights, compressing spreads to margins below levels commensurate with the fundamental risks associated with relatively highly leveraged corporates in a recessionary environment.

- While equity markets (particularly in the US) have rebounded solidly since March, prices have decoupled from earnings, stretching valuations. The positive for equities is that the central banks won't turn the liquidity taps off any time soon, so there remains upside should the economic damage be contained. Within equities, we prefer Australia where policy still has room to move and where the pandemic is seemingly under relative control.

Our approach has been to average back into equities (mainly in Australia) but also raising cash at the expense of investment grade credit. This barbell approach has let us cautiously participate in the upside, while giving us both protection and liquidity should risk assets start to reconnect the macro-environment with pricing. We expect more volatility, and this will bring opportunity (both to the upside and the downside).

On this point, in late June we tactically reduced equity exposure from just over 18%% to 16.5% on the basis that valuations were becoming stretched again and disconnecting from the economy, and that the risks of another shutdown in the US was rising as COVID-19 cases flared up. To reflect this, we sold both Australian equities (where we'd been accumulating exposure) and the US Russell 2000 futures index, which we felt was more likely to reflect the challenges in the US economy than the broader S&P 500 index. We also maintained some put option protection should the downside risks re-appear. Our equity exposure has moved roughly within a 7% range through the first half of 2020.

With treasury yields having moderated we trimmed portfolio duration to around 1.90 years (about 0.7 years lower than the peak in March).

Equity

In broad terms equities are again expensive. For example, the S&P 500 index is trading on a 12 month forward PE ratio of 22 times earnings, with considerable uncertainty with respect to the future path of earnings. The Australian market looks more reasonable, but still elevated, at 19 times. For the tech heavy Nasdaq, the equivalent ratio is 38 times, suggesting investors are prepared to pay a significant premium for growth, well supported by abundant central bank liquidity.

We are again becoming cautious and have both added downside option protection and most recently trimmed our exposure by selling Australian SPI futures, Euro Stoxx futures and US Russell 2000 futures, given the likelihood that small companies in the US will be more heavily impacted by further shutdowns and COVID-19 dislocations.

Where we do hold equities, our preferences are for Australia, Europe and arguably emerging markets, with the US our least preferred market. Interestingly, the US was an underperformer in June, which we haven't seen in some time.

Fixed Income

Global bond yields remain anchored to low levels, on the back of near-term deflationary forces and central bank QE programs. Government bond yields in Australia and the US drifted slightly lower over the month, but with central banks firmly targeting very low yields and underlying economies weak, the near term pressure on yields remains down.

There was some moderate volatility in credit markets in June, but the broader market remains well bid. Active Fed participation in the US credit market is keeping spreads well supported against a less favourable fundamental backdrop. This is spilling out across the credit market, with lower quality credit benefitting from both implicit and explicit central bank support.

We remain sceptical, but the liquidity injection from central banks is hard to fight. We prefer equity to credit in this environment because of the potential upside for equities, which is significantly more limited in the credit space. We have been generally reducing our investment grade exposure to build liquidity in the portfolio to better manage volatility and deploy on pull backs.

Currency

The Australian dollar continued to rebound strongly during June, largely on the back of a weakening in the USD as worst case economic fears subsided.

While we still favour the USD as a defensive play, we switched some of this exposure to Yen in both April and May, seeing the Yen exposure rise to 3.0%. USD remains our largest currency exposure, and we think shorter term support remains strong, particularly in an environment of global uncertainty, but we do think that the upside over the longer term is limited by the lack of valuation support.

Fund details

APIR code	SCH0096AU
Fund size (AUD)	$59,286,215
Redemption unit price	$0.9607
Fund inception date	May-2015
Buy / sell spread	0.18%/0.18%
Management costs	0.60%
Minimum Investment	$20,000
Distribution frequency	Normally quarterly - March, June, September and December

*Unless otherwise stated figures are as at the end of June 2020

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.

Please refer to the Product Disclosure Statement for more information.

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