Schroders

For Financial Intermediary, Institutional and Consultant Use Only.
Not for redistribution under any circumstances.

Schroders Strategic Beta 2018 Review

January 2019

Strategic Beta Year End Review

2018 was a difficult year for the Schroders Strategic Beta strategy. The Fund returned -8.4%, gross of fees, with headwinds stemming predominantly from declining equity markets and inflation sensitive assets.

From the perspective of global capital markets, 2018 could be summarized by two complementary tales. The first nine months of 2018 pivoted around a meaningful growth divergence between the United States and the rest of the world. Accompanying this divergence, the US dollar remained well supported and tighter monetary policy implemented by the Federal Reserve aggravated the financial stresses in overseas markets, affecting developing economies in particular.

The latter part of the year developed instead around a narrative of descent into synchronized deceleration. At the same time, the capital markets began to discount a scenario of policy error, with the monetary stance pursued by the US authorities being perceived as excessively tight relative to a weakening momentum in the economic expansion. The sudden repricing of growth risk saw all cyclical assets fall quite dramatically alongside the renewal of flight to quality flows directed towards core government bonds.

Our strategy has been built around the foundation of global diversification, however it struggled in an environment characterized by a narrow market leadership that suddenly experienced meaningful shifts in short-term expectations.

A regime shift in volatility is a classic feature of late phases of expansionary cycles which has likely been exacerbated by monetary tightening. While we expect this regime to continue for the years ahead we equally question the depth of future policy normalization against a backdrop of highly leveraged economies already facing major tailwinds to their growth outlook.

Despite the disappointing results for the year, we take stock of the fact that our strategy has historically delivered strong results since inception (on both, an absolute as well as a risk-adjusted basis) and has maintained low beta to global equity markets, a feature that highlights the complementary nature of our investment approach to more cyclically-oriented vehicles.

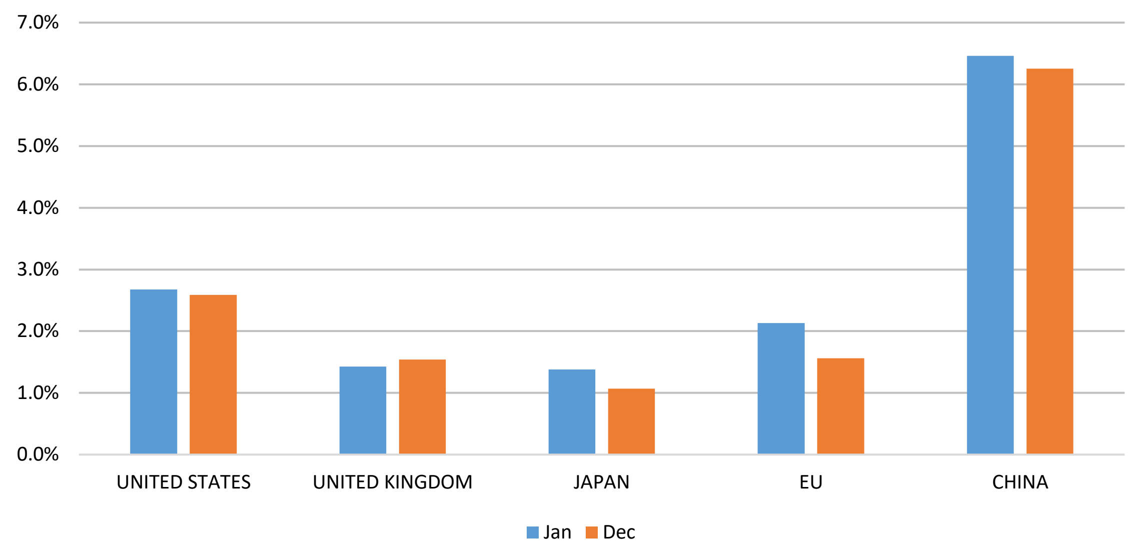
In this brief note, we will firstly take a retrospective look at the global economic backdrop during 2018 and then assess our results in absolute and relative terms versus mainstream risk parity indices. We will conclude by sharing our brief outlook for the year ahead.

Global Economic Backdrop in 2018

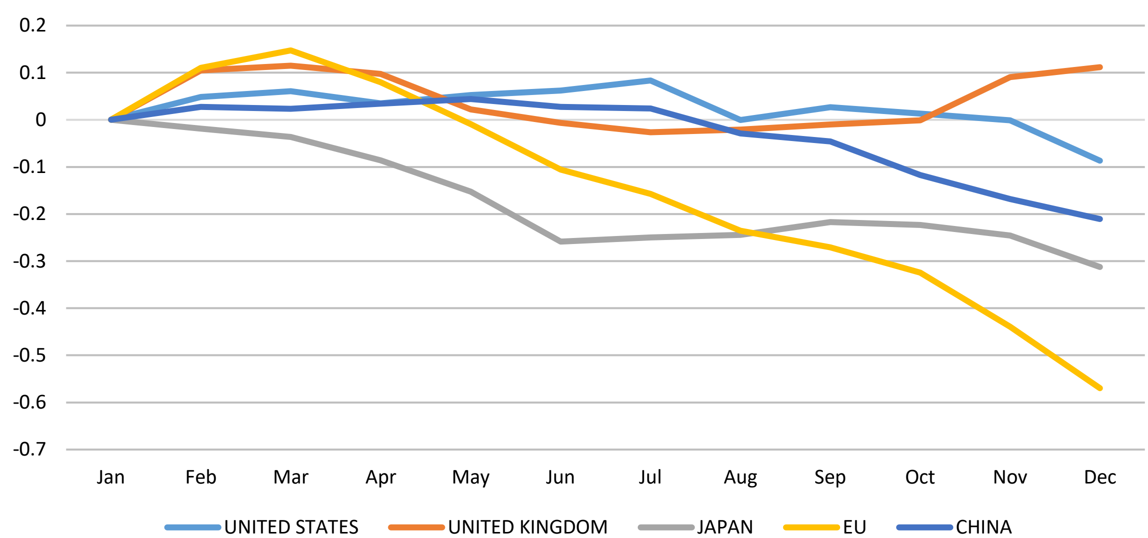
There was optimism for the global economy at the start of 2018 with hope that fiscal stimulus from the US and Europe's emergence from its prolonged slow growth phase would propel global growth. Therefore, many market participants worried that the big risk for global markets in 2018 would come from inflation. This had changed radically by the last quarter of 2018 with fears of a policy mistake by the US Federal Reserve, ongoing global trade tensions and uncertainty from events such as the UK withdrawal from the European Union driving a less positive outlook for GDP growth and a more benign backdrop for inflationary pressures.

The charts below show one-year Consensus Economics GDP growth forecasts in January and December 2018, and a chart which shows the path of revisions to GDP growth forecasts for the year.

One year GDP Growth Forecasts in 2018:



Consensus one year GDP Growth Forecast Revisions in 2018:



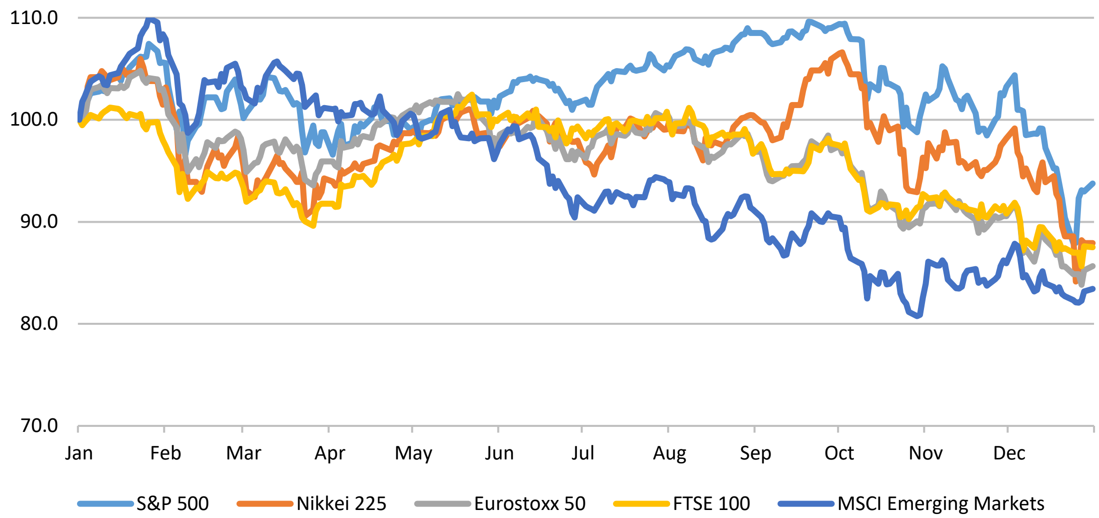
Source: Consensus Economics, December 2018.

While the downward revisions to GDP growth forecasts in the bottom chart look ominous as we enter 2019, the levels of forecast GDP growth are less discouraging; we have yet to see evidence which would signal a recession in the United States during 2019 a central scenario, but have this on our 2019 risk scenario watch list.

Equities

In line with the scenarios for the global economy, global equity markets started 2018 strongly and finished it poorly. In the chart below we plot the S&P 500, Nikkei 225, Eurostoxx 50, FTSE 100 and MSCI Emerging Indices (rebased to January 2018). Despite some visible dispersion in performance results (particularly during the earlier part of the year) all markets finished 2018 in negative territory. Our growth bucket performed correspondingly poorly during the year (-3.0%), with all its subcomponents failing to provide positive contribution.

The chart below shows cumulative performance of equity market indices in local terms during 2018 rebased to 100 on 31 December 2017:



Source: Bloomberg, 31 December 2018. Cumulative total return in local terms over 2018, rebased at 100 on 31 December 2017. Past performance in no guarantee of future results.

The high dispersion between different international markets in part reflected worries about the strength of the US Dollar and decreased global trade. Trade tensions escalated throughout the year with tariffs on an increasingly large set of goods, before subsiding a little towards year-end when the US and China agreed to continue their negotiation during the first months of 2019. In more positive news on global trade, at the end of Q3 2018 the new United States-Mexico-Canada Agreement (USMCA) revised the former North American Free Trade Agreement, showing some sign of resolve of the US administration to conduct successful negotiations.

From a sector standpoint, US technology performed particularly strongly in spite of increasing scrutiny from politicians on data privacy and a number of high profile companies such as Facebook having data breaches, which led to accounts being hacked. The momentum behind this sector was very strong during the first few months of the year, continuing a trend that dominated 2017. This was very much a US Technology story, as there was high dispersion between US and overseas technology companies. The strong results were reversed during the last quarter, which saw defensive sectors outperforming more cyclical industries and value trumping growth as an investment style. The worst performing sector over the year was energy, which reflected the performance of the underlying commodities. In our alternatives bucket, our multi factor equity market neutral strategy added 1.0%.

Commodities

Our inflation bucket, comprised of raw materials and inflation breakeven lost -3.5% in 2018, with all components contributing negatively to performance with the exception of gold, which rallied as inflation fell. This was more a response to softening pressure on the US Dollar than stabilizing pressures on prices. Industrial metals, agricultural commodities and energy all posted negative returns.

The energy sector was one of the best performing assets during the first nine months of the year, but sharply reversed in Q4, losing c.38% from peak to trough (as measured by WTI futures). Crude oil prices declined amid ongoing oversupply concerns as well as potential deterioration in the demand outlook as reflected by downward revisions in GDP growth forecasts for 2019.

Fixed Income

With the positive view on the global economy coming into 2018 and an environment in which central banks were expected to tighten[1], many commentators forecasted negative returns for government bonds. To paraphrase Samuel Langhorne Clemens, the reports of the demise of government bond markets were greatly exaggerated. Our slowdown bucket contributed 1.3% to the strategy return, through price appreciation in some markets as well as carry and rolldown.

---

[1] Either through interest rate increases or other forms of quantitative tightening

The US Federal Reserve increased rates four times in 2018, raising the cost of borrowing by 25bp each time. The US economy has been running above long-term average GDP growth, and unemployment remains low. Worries about inflation in the economy at the start of the year have gradually changed to worries about a policy mistake from the US monetary authorities in terms of interest rates being too high at year-end.

Growth momentum in the US, the announcement of fiscal stimulus as well as the disappearance of negative base effects[2] led many commentators to start the year with a growing worry on inflationary pressures during 2018, and a consequent rise in bond yields. US Treasury yields were up on the year, starting at 247bp and ending the year at 268bp after hitting a high of 324bp. The gyrations of the bond markets through the year meant that our fixed income relative value strategy in our Alternatives bucket has performed 0.4% over the year, the mean reversion component being the strongest performer in the overall strategy.

The Federal Reserve may be approaching the end of the tightening cycle for the United States, but other central banks are only just beginning to tighten liquidity. The European Central Bank decided in September to wind down its program of quantitative easing which has been in place since 2014.

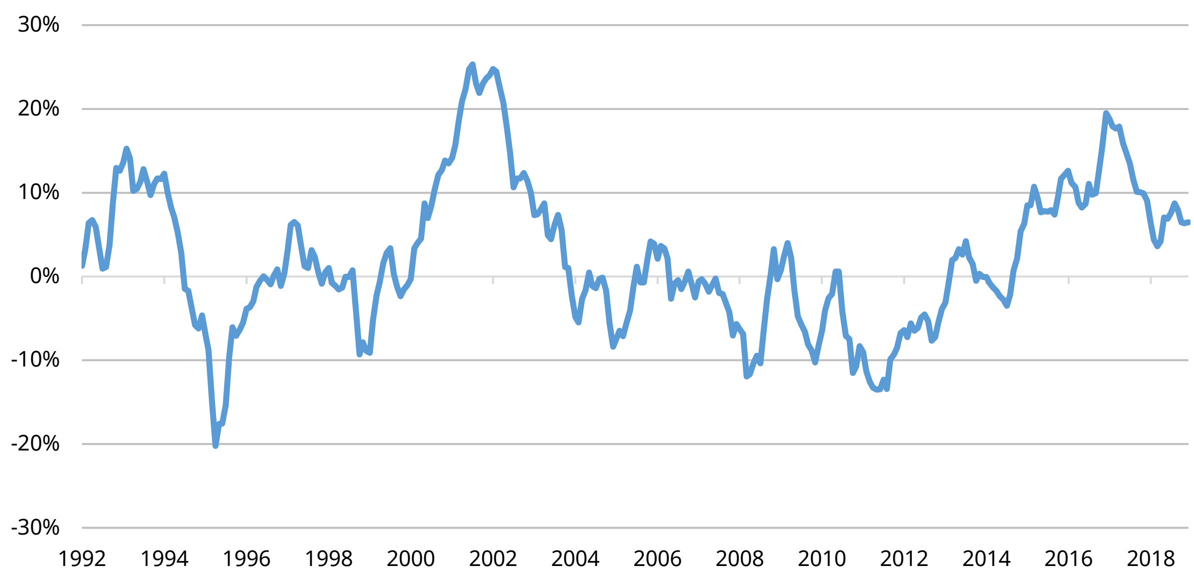
German Bunds started the year at 47bp, peaked at 77bp and ended up at 24bp by year-end, without any lasting sign of inflation. Bunds were also supported by worries about the Eurozone economy and a prolonged budget negotiation between Italy and the EU fuelled some worries about Europe's sovereign debt crisis returning.

Foreign Exchange

The increases in US interest rates had a major impact on the US Dollar, with the greenback generally appreciating against other currencies. The US Dollar tends to act as a safe haven during times of global uncertainty and tight liquidity, but the main driver of its performance during the past year could instead be found in the differential growth regime that characterized the US versus the rest of the world.

Notwithstanding the support from interest rate differentials, the US dollar currently appears overvalued on several metrics including our own modified Behavioural Equilibrium Exchange Rate (BEER) approach.

The chart below shows that average (mean) mis-valuation of the USD relative to the Euro, Japanese yen and UK sterling:



Source: Schroders, Bloomberg, as of December 31, 2018.

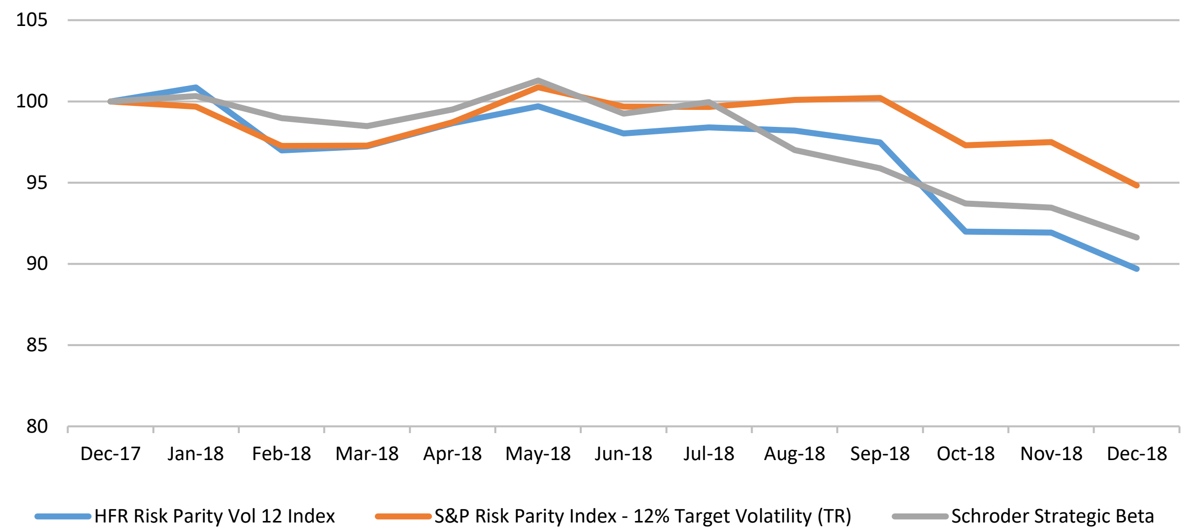
Our foreign exchange strategies in our Alternatives bucket had mixed performance over the year. The carry strategies had positive performance, and our valuation strategy was the strongest performer of all of our contributors to return; in total, our FX contributed -

[2] From a strengthening dollar to a stabilization of energy prices

0.1%. However, our growth momentum strategy was the worst performer, largely driven by emerging market currency performance (in particular the Turkish lira) from August through year end.

Comparative Performance

In the last 2 years 'risk parity' indices[3] from Hedge Fund Research (HFR) and Standard & Poors (S&P) have been introduced. These indices are intrinsically different in nature, with HFR building an index which reflects the performance of a universe of risk parity managers and S&P tracking a theoretical portfolio built using its own set of systematic rules, investment universe and risk management tools. We firstly show the performance of those indices and Strategic Beta over 2018 in USD terms:



Source: Schroders, HFR, Standard & Poors 31 December 2018. Cumulative total return in USD terms over 2018, rebased at 100 on 31 December 2017. Performance show is gross of fees. Past performance is not a guarantee of future results.

While there are strong commonalities in the universe composition underlying risk parity portfolios, we believe that risk parity is ultimately an inherently active strategy. That is not to say that we argue that fund managers following this investment philosophy should deviate substantially from their strategic definition of 'risk parity', but rather than the definitions of investment universe, systematic and risk management tools can drive substantial differences between risk parity portfolios.

To illustrate this point more clearly, the table below contains the tracking error of Strategic Beta, HFR index and S&P index to each other for 12% target volatility strategies since 30 June 2012, the inception of Schroders Strategic Beta strategy:

HFR vs S&P	HFR vs Schroders	S&P vs Schroders
4.1	5.5	5.7

Source: Schroders, HFR, Standard & Poors 31 December 2018. Tracking errors calculated on monthly total returns in USD terms over the period 30 June 2012 to 31 December 2018 for the following: HFR Risk Parity Vol 12 Institutional Index, S&P Risk Parity Index - 12% Target Volatility (TR) and Schroder Strategic Beta. Figures shown are historical and subject to change based on future fund performance.

Note that both 'indices' have a tracking error of over 4% to each other. This would equate a tracking error of the S&P 500 equity index with the Dow Jones Industrial Average of ~3.0% over the same period.

Besides the performance dispersion recorded above, Schroders Strategic Beta delivered a better risk-adjusted return to the HFR and lower than the S&P index. Realised Beta to global equities was lower than both indices while maximum drawdown follows the pattern seen in total return space, showing an improvement over HFR while lagging the S&P index. Given the realised volatility of the S&P Risk

[3] HFR launched their indices in August 2017, S&P in August 2018.

Parity Index is less than half the 12% target, materially lower than both the HFR risk parity index and Schroder Strategic Beta, this last result is perhaps to be expected.

S&P Risk Parity Index is less than half the 12% target, materially lower than both the HFR risk parity index and Schroder Strategic Beta, this last result is perhaps to be expected.

	HFR	S&P	Schroders
Total Return p.a.	3.9	3.5	3.5
Volatility p.a.	8.6	5.7	7.4
Risk-adjusted Return	0.4	0.6	0.5
Beta to Global Equities	0.5	0.3	0.2
Maximum Drawdown	-14.4	-8.8	-11.8

Source: Schroders, as of December 31, 2018. Performance is shown for the Schroder Strategic Beta composite, in US dollar and gross of fees. Inception date of composite: June 30, 2012. Performance for periods greater than 1 year is annualized. Past performance is not a guarantee of future results.

Outlook for 2019

2017 and 2018 showed that in periods of rising interest rates, duration assets (government bonds) have a place in a multi-asset portfolio by providing diversification, and the potential to enhance returns. We believe the same will prove to be true for 2019. Whilst there may be some uncertainty around the short-term environment for growth sensitive assets, the diversified return streams that underpin a risk parity portfolio should provide some insulation from equity market shocks.

The US dollar has gone through a long cycle of being strong relative to other currencies, and whilst there is no certainty that the valuation for the US dollar has topped out, slower global growth should limit the tightening cycle for the US Federal Reserve, which can reduce upward pressure on the currency. We believe this can help growth sensitive assets or assets that tend to respond better to environment of looser policy implemented by the US monetary authorities, in particular emerging market assets.

However, we remain firm believers of diversification and careful risk management in our portfolios. In a simplified framework, our investment approach underwrites different risks that we expect to be compensated for over the long-term. At times, market pricing of those risks may be complacent (a scenario where risk premia are excessively compressed), in other cases some of the risks may instead be excessively high (e.g. insurance premia after the onset of a tail event).

While there are several tailwinds still affecting the global economy it is also fair to say that risk premia have already meaningfully repriced, which is to say that the compensation for running those underlying risks is more favourable today than what it was at the end of Q3 2018. We continue to believe that a sensible blend of those components coupled with prudent risk management represents the most appropriate approach to produce strong risk-adjusted returns over an economic cycle.

Concluding Thoughts

2018 was a poor year for risk parity strategies and, in general, it was also a difficult year for growth-sensitive assets; longer-term performance for our risk parity strategy has been nevertheless robust. The allocation to interest rate-sensitive assets in our portfolio has proved beneficial, despite pre-conceived fears of tightening monetary policies.

The slowdown in forecast global growth we have seen towards the end of 2018 may well presage the end of a long running business cycle[4], but as we enter 2019 there is considerable uncertainty about how long this will take to fully play out.

As such, we think risk balanced portfolios have the ability to provide attractive risk-adjusted investors willing to withstand what may appear to be short-term headwinds.

[4] Looking at the US in isolation, the present expansionary cycle will be the longest on records should a recession not occur prior to Q419

Performance: as of December 31, 2018

In USD terms

	1 Month%	3 Month%	YTD%	1 Year%	3 Year%	5 Year%	Since Inc.*%
Composite (gross)	-1.96	-4.45	-8.38	-8.38	4.92	4.37	3.49
Composite (net)	-1.99	-4.54	-8.74	-8.74	4.50	3.96	3.08

Performance shown is past performance which is no guarantee of future results. The value of an investment can go down as well as up and is not guaranteed. Performance for periods greater than 1 year is annualized. Please see performance notes at the end of document for important composite disclosures. * Inception date of composite: June 30, 2012.

Important Information

The views and opinions contained herein are those of the Multi-Asset Investments team, and do not necessarily represent Schroder Investment Management North America Inc.'s house views. These views are subject to change.

Issuers/sectors/indices/countries mentioned are for illustrative purposes only and should not be viewed as a recommendation to buy/sell. Portfolio holdings may change at any time. This information is intended to be for information purposes only and it is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument mentioned in this commentary. The material is not intended to provide, and should not be relied on for accounting, legal or tax advice, or investment recommendations. Information herein has been obtained from sources we believe to be reliable but Schroder Investment Management North America Inc. (SIMNA) does not warrant its completeness or accuracy. No responsibility can be accepted for errors of facts obtained from third parties. Reliance should not be placed on the views and information in the document when taking individual investment and/or strategic decisions. The information and opinions contained in this document have been obtained from sources we consider reliable. The opinions stated in this document include some forecasted views. We believe that we are basing our expectations and beliefs on reasonable assumptions within the bounds of what we currently know. However, there is no guarantee that any forecasts or opinions will be realized.

The simulated and/or hypothetical results shown must be considered as no more than an approximate representation of the portfolio's performance, not as indicative of how it would have performed in the past. It is the result of statistical modeling, with the benefit of hindsight, and there are a number of material limitations on the retrospective reconstruction of any performance results from performance records. For example, it may not take into account any dealing costs or liquidity issues which would have affected the strategy's performance. This data is provided for information purposes only as at today's date and should not be relied on to predict possible future performance.

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. Market-neutral and long/short strategies in general may not fully participate in broader equity market increases. 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.

Schroder Investment Management North America Inc. ("SIMNA") is an indirect wholly owned subsidiary of Schroders plc, a UK public company with shares listed on the London Stock Exchange, and is an SEC registered investment adviser providing asset management products and services to clients in the US and Canada. Schroder Investment Management North America Inc. is a SEC registered investment adviser and registered in Canada in the capacity of Portfolio Manager with the Securities Commission in Alberta, British Columbia, Manitoba, Nova Scotia, Ontario, Quebec, and Saskatchewan providing asset management products and services to clients in Canada. This document does not purport to provide investment advice and the information contained in this newsletter is for informational purposes and not to engage in a trading activities. It does not purport to describe the business or affairs of any issuer and is not being provided for delivery to or review by any prospective purchaser so as to assist the prospective purchaser to make an investment decision in respect of securities being sold in a distribution.

Past performance is no guarantee of future results. Further information about Schroders can be found at www.schroders.com/us and www.schroders.com/ca.