Schroders

October 2019

Schroder Real Return CPI Plus 5% Fund Professional Class

Monthly Report

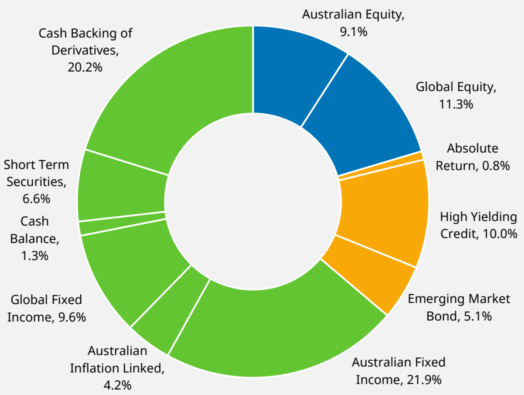
Total return %

	1 mth	3 mths	1 yr	3 yrs p.a.	5 yrs p.a.	Inception p.a.
Schroder Real Return CPI Plus 5% Fund (pre-fee)	0.19	0.66	7.03	5.56	5.19	6.75
Schroder Real Return CPI Plus 5% Fund (post-fee)	0.13	0.51	6.39	4.94	4.56	6.11
Distribution^	0.00	0.00	3.91	4.35	4.40	4.50
Growth^^	0.13	0.51	2.48	0.58	0.16	1.61

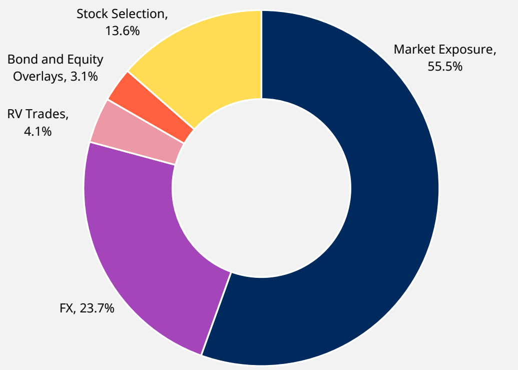
Portfolio inception 01/10/2008

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 30 September 2019

3 months	0.38%
1 year	1.55%
3 years. p.a.	1.68%
5 years. p.a.	1.77%
Since Inception	2.19%

*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 5% Fund Professional Class

Unless otherwise stated figures are as at the end of October 2019
Numbers may not total to 100 due to rounding
* Inception date of the Schroder Real Return CPI Plus 5% Strategy is 1 October 2008, as represented by the Schroder Real Return CPI Plus 5% Fund - Professional Class

Fund objective

To deliver an investment return of 5.0% 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 Plus 5% strategy returned 0.19% (pre-fees) in October, taking the return for the year to October to slightly over 7% (pre-fees). While the one year return is now back above our target of real 5%, the three year return is still lagging its objective. Volatility and downside risk remain low and consistent with the strategy's objectives.

Largest contributors

October was a mixed month for markets. Making positive contributions to returns in October were global equities, with the strategy's bias to Japan performing well, given the strong relative performance of Japan over the month (especially compared to the US). The positive tone in risk assets was reflected in narrower credit spreads, which also contributed positively. The rally in GBP amid Brexit optimism also made a positive contribution, given the strategy's modest long GBP position.

Largest detractors

Australian equities were dragged lower, due in large part to the banks, and as our largest equity exposure detracted from performance. Higher Australian government bond yields and a stronger $A also impacted negatively on performance.

Market Review

With the US Federal Reserve lowering the Federal Funds rate again in late October and Australian inflation printing on the low side of the RBA's target for the September quarter, pressure on interest rates in Australia remains down. From an interest rate perspective, we are again reminded that the investment landscape, particularly expectations around interest rates, has shifted, seemingly irrevocably.

On the basis that "hope is not a strategy", we need to rethink how we generate income from relatively safe sources. In other words, bunkering down on the basis that this decline in interest rates locally is temporary and will reverse within a manageable timeframe is not a viable strategy. We are going to be in this environment for the long haul and it will get much harder should recession unfold over the next couple of years.

In thinking about how to respond to this challenge, it's important to understand the big picture, as it better frames the policy response (particularly on the monetary side) and the starting point from an asset price perspective. The key idea here is that since the Asian crisis in the late 1990s, central banks (particularly the Fed) have failed to allow imbalances to properly correct, bailing out markets and investors, fuelling strong credit growth and boosting asset prices across the investment spectrum in the process.

This strategy of "kicking the can down the road" successfully averted major economic catastrophe in the aftermath of the "tech bubble", September 11 and the GFC, but the consequence has been rising debt and rising asset prices across the risk curve. It is manifested now in very low to negative real and nominal interest rates, as policy makers struggle with the debt burden created. To date, this has meant that borrowers have been bailed out and asset owners have been big beneficiaries of rising asset prices and rising wealth.

This is important in the context of the current challenge we face in seeking high-quality, low-risk income. While economists (and policy makers) argue that lowering official rates and lowering borrowing costs (especially mortgage rates) is net stimulatory for the economy overall, given the higher propensity for borrowers to consume, the flip side is the significant reduction in income for depositors and savers more generally. As rates fall, the reduction in cash flow becomes proportionally greater.

From a personal perspective, I've recently rolled a term deposit from 2.4% to 1.75% for 3 months. While the basis point reduction in the cash flow is 0.65%, the actual income on the investment has fallen by around 27%. Fortunately, I'm not yet relying on this income, but if I was (as many readers of this note or their underlying clients will be), this is a problem.

Whether this seems right or fair will depend on which side of the issue you sit. But from a bigger picture perspective it is generally the savers who have benefitted most from the decline in interest rates to current levels and the asset price appreciation (property, infrastructure, equities, bonds) that has resulted from a revaluation to a low interest rate environment. In other words, the income being generated from their investments (especially cash) may have declined but the value of the underlying asset base for many will likely have increased, in many cases significantly over this period.

I'm clearly generalising here, but hopefully the broader point is clear. While cutting rates at these levels for many may seem like a cross-subsidy from savers to borrowers, for many borrowers the assets they've borrowed to acquire were at relatively high prices from the savers.

All that said, the practical challenge for all of us, is "what do we do now"?

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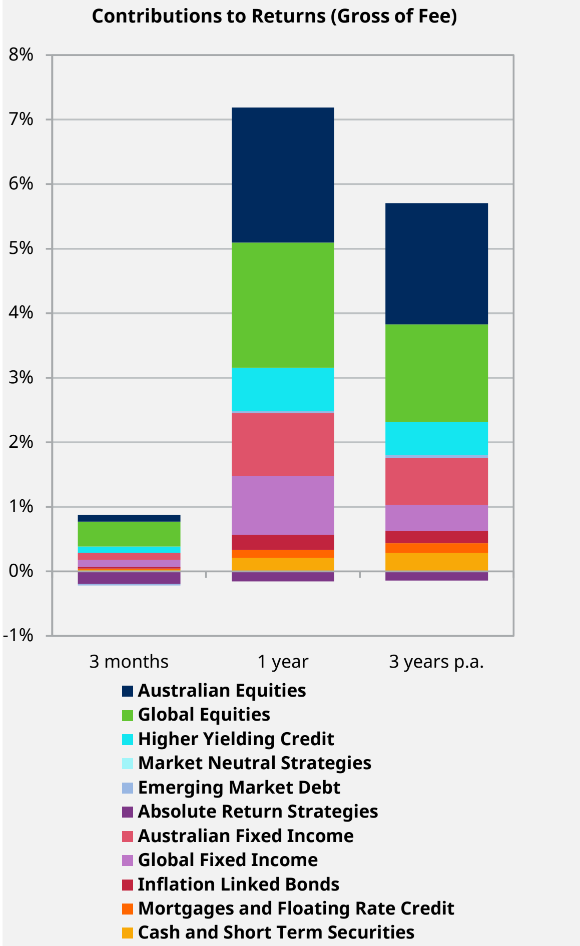
Performance



Fund details

APIR code	SCH0039AU
Fund size (AUD)	$1,814,709,537
Redemption unit price	$1.1920
Fund inception date	October-2008
Buy / sell spread	0.20%/0.20%
Management costs	0.60%
Minimum initial investment	$500,000
Distribution frequency	Normally twice yearly - June and December

Unless otherwise stated figures are as at the end of October 2019

Market Review continued

Firstly, we can spend less, save more, work longer and work harder. This is unlikely to be a popular or (for many) a practical strategy

Secondly, we can take more risk. With dividend yields on equities still relatively high, dividend income looks attractive, but it will come with more capital volatility and if your timing's wrong significant downside risk. Normal equity market volatility is around 12–14% p.a. and in bear markets prices can fall upwards of 30%. So higher income does place more capital at risk. Timing will matter.

Thirdly, restructure our portfolios. Here I'd suggest a "flatter" portfolio which makes more use of a broader capital structure – switching some cash into high quality, but slightly higher risk investments (like investment grade credit or mortgages) and switching some equity into higher yielding debt investments. This is arguably also supported by very low bond yields and the reduced ability of sovereign bonds to diversify equity risk. (This is similar to the basic premise of the Schroder Real Return Strategy, where we use broad ranges, flexible asset allocation and the full capital structure and opportunity set to generate relatively consistent real rates of return (not just income)).

Finally, we could incorporate some drawdown of capital to improve the consistency and predictability of the cash flow to the investor (as opposed to just using income). This idea is most consistent with the arguments outlined above with respect to the accrued asset price appreciation on the back of the structural decline in rates. Another way to think about this is that, in a world with higher interest rates, the rate of income would likely have been higher but on a much lower capital base. In a low interest rate world, the rate of income is lower but the capital base on which it accrues will be in many cases significantly higher.

This too may not be a popular suggestion, given the strong preference investors have to leave their capital base untouched, but for those who have been beneficiaries of the last two decades of ever declining rates and rising asset prices it may well be the least risky path to generating appropriate and predictable outcomes.

Market Outlook

Equity

We retain a relatively cautious view on equities, holding roughly a 20% exposure at the end of October. The gains in equities so far this year have almost exclusively reflected a re-rating of markets on the back of the Fed's policy "U-turn" in January. While economic momentum has stabilised with the trade issues yet to permeate the broader US economy, earnings growth is slowing, and, CEO confidence levels have plunged. The rally that we have seen is narrowly based and broadly still confined to a narrow, "growth" oriented collection of stocks. Outside the US, the picture is more mixed, with global stocks still well below their peaks of the beginning of 2018.

Within equities our preferred markets are Australia and Japan, while we continue to lean against "growth" as a style factor, given its stellar outperformance and increasing disconnect with fundamentals.

Fixed Income

Bond yields have backed up a little over the month, given signs of stabilisation in global PMIs (mainly due to China) and tempered comments with respect to future rate cuts by the Fed. Locally, the RBA has been busy mixing messages to the market and while they remain firmly on an easing bias, how much further rates fall remains a bit uncertain. The guidance on how QE in Australia may unfold does suggest credit and mortgages may be the biggest beneficiaries of asset purchases by the RBA, with the direct provision of lending facilities to the banks another channel.

We remain attracted to duration and are currently positioned with around two years of duration in aggregate in the portfolio. Over the medium term we do expect rates to move lower, and, if the downside risks to growth unfold, we would expect duration to be an important contributor to total returns.

With respect to credit we maintain a neutral stance in the investment grade space, particularly in Australia where the high quality of the sector provides some low risk carry. We are a bit more cautious further down the credit curve. We are relatively diversified in this part of the portfolio, with risk spread across global high yield, local subordinated securities and emerging market debt. We are also looking to make a small investment into the commercial mortgage market where bank regulatory capital changes have created an opportunity for the participation of non-bank capital providers. Reasonably high yields are still available in this space.

Currency

We believe that one of the main motivators for the RBA in cutting rates is to continue to keep the AUD as weak as possible. This should be helped by the fact that it is still fair value to slightly expensive on our valuation screens. The AUD has strengthened slightly in recent weeks, but this has not changed our broader thinking. We did add slightly to our GBP positioning in October on the basis that the risk of a hard Brexit would appear to have abated, but it is hard given the impasse in the British parliament and the looming election to have a strong view as to how this will ultimately unfold. We are monitoring closely.

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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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