

# Schroder Real Return

## Quarterly Investment Option Update

30 June 2022

### Aim and Strategy

To deliver an investment return of 4-5% pa before fees above Australian inflation over rolling three-year periods. Inflation is defined as the RBA's Trimmed Mean, as published by the Australian Bureau of Statistics. The portfolio invests across a broad array of asset classes including equity, alternatives and debt to ensure the portfolio is truly diversified in both an economic and asset class sense. The portfolio employs an objective-based asset allocation framework in which both asset market risk premia and, consequently, the asset allocations of the portfolio are constantly reviewed. As risk premia (and thereby expected returns) change, so too will the asset allocation of the portfolio (and sometimes significantly). The portfolio will reflect those assets that in combination are most closely aligned with the delivery of the objective. The investment manager believes that in effect it's not the asset classes that are important but the likely characteristics of the return. The approach utilises a combination of Schroder's longer-term return estimates together with their shorter-term value, cycle and liquidity framework.

Sector Allocation	%
Australian Equity	7.80%
Global Equity	11.27%
Absolute Return	-3.26%
High Yielding Credit	11.00%
Insurance Linked Securities	3.64%
Asian Credit	3.93%
Emerging Market Bond	4.88%
Australian Fixed Income	10.79%
Global Fixed Income	2.49%
Rate Strategies	1.99%
Cash & Cash Equivalents	45.46%

### Investment Option Performance

To view the latest investment performances for each product please visit [amp.com.au/performance](https://amp.com.au/performance)

### Investment Option Overview

Investment Category	Multi Sector (Specialist)
Suggested Investment timeframe	3 years
Relative risk rating	4 / Medium
Investment style	Active
Manager style	Single Manager

## Investment Option Commentary

The Schroder Real Return Fund posted a negative 1.90% (post-fees) return for June with the quarterly return of negative 4.09% (post-fees). For the calendar year-to-date, the Fund has returned negative 7.15% (post-fees).

### Largest contributors

Tactical short equity futures had a positive impact on returns both over the month and the quarter (though overall equities was a negative impact), while foreign currency had a 0.3% positive contribution to returns in June. Positive returns from real estate debt and private debt, as well as stock selection in active Australian equities also contributed positively to returns.

### Largest detractors

Through June, our equity allocation was the primary detractor from returns having a -1.4% impact with the breakdown between Australian and global equities evenly split. The continued increase in yields and widening of credit spreads resulted in the portfolio's diversified strategies such as Asian credit, and emerging market debt also contributing negatively to returns. Over the quarter, equities were also the primary detractor having a -1.9% impact on returns, followed by duration which had a -1.3% impact on returns.

## Market Commentary

### Equities

Global equities fell sharply through June as ongoing concerns about persistent inflation, the potential for slower growth and weaker earnings all weighed on asset prices. Global equities fell by -7.8% in local currency terms, while the Australian market underperformed with a return of -8.8%. Emerging markets outperformed, but still dropped sharply with a return of -6.6% in US dollar terms. One of the few markets to have a positive return in June was China, where growth is expected to rebound as Shanghai emerged from its recent COVID lockdown. The Chinese CSI 300 Index was a standout performer with a return of 10.4% for the month. Over the quarter, Global developed market equities fell by -14.4%, Australian equities fell by -11.9% and emerging market equities dropped by -11.4%. The fall in equity markets has resulted in somewhat improved valuations (especially outside of the US), though the ongoing risk is for downgrades to forward earnings, particularly as consensus expectations for earnings growth are still positive for 2022.

Within the portfolio, the Fund continue to maintain a defensive stance and reduced equity risk further taking the overall equity allocation to under 20%. Within equities, the Fund rotated the regional exposure through reducing the allocation to Australia, Japan and Europe, and rebuilding exposure to the US and emerging markets. Additionally, to provide some protection against sharp equity markets rebounds the Fund added some short-dated S&P 500 call options. While our base case is still negative for equities over the medium term, the poor sentiment and oversold conditions that Schroder has witnessed over recent months could result in a shorter-term rebound.

### Fixed Income

As developed market central banks aggressively raised official interest rates targeting persistent inflation, bond yields continued to climb over the month and the quarter. The US Federal Reserve increased its policy rate by 0.75%, while the RBA increased the local cash rate by 0.5%, with more hikes expected over the coming months. Australian 10-year yields increased by 0.31% over the month to close at 3.66%, while US 10-year yields increased by 0.17% to finish the month at 3.01%. German 10-year yields increased by 0.21%, while Japanese yields were flat as the Bank of Japan continues to maintain yields below 0.25%. It's also worth noting that US 30-year mortgage rates continue to climb, increasing by 0.70% over the month, and 1.00% over the quarter to reach 5.7% at the end of June. Credit spreads widened across all sectors as risk assets sold off, most notably in US high yield where spreads widened by more than 160bps over the month, and almost 250bps over the quarter.

With bond yields continuing to climb and some value starting to re-appear in government bonds, the Fund increased portfolio duration by 0.25 years to bring aggregate duration to 2 years – still a moderate level in an absolute sense. Additionally, the Fund moved 0.25 years of duration from short-dated maturities of the Australian curve (3-year bonds) to longer dated maturities (10-year bonds) as a way of reducing the portfolio's

curve steepening position. The portfolio continues to hold no exposure to global high yield credit.

## Currencies

The US dollar (USD) rebounded in June, once again drawing safe haven flows as other asset markets sold off. While most currencies weakened against the US dollar, the Japanese yen (JPY) remains one of the most significant underperformers, weakening a further 5.5% against the US dollar and reaching its weakest level since 1998.

Within our currency allocations, the portfolio's long JPY short Euro put positions expired, while the portfolio closed out the portfolio's remaining 1% short Chinese yuan position, as Schroder believes the move in the yuan has run its course. Within commodities, Schroder closed out our remaining allocation as global growth remains a concern, and recessions risks are rising, which would pose a medium-term risk to commodity prices.

## Outlook

The misalignment of policy setting, economic outcomes and asset prices has been a consistent concern for some time. While it has been easy to be confident that this was unsustainable and would break at some point, the more challenging questions to answer were: When and what would be the catalyst? and then: How broad and pervasive would the re-pricing be? Position too early and you missed out on the bull run of 2021. Position too late and the downside in 2022 would be significant. Inflation would always present the biggest challenge to central banks and their aggressive post-COVID accommodation. The inflation that arrived in late 2021 has been turbo-charged by surging energy and food prices and further disruptions to supply chains in 2022. Now markets are finally unravelling as central banks have no option but to 'take away the punch bowl'.

June was an ugly month – one of the ugliest. What made June different was that markets shifted from primarily focussing on surging inflation (and how fast and how high rates would need to rise to contain it) to contemplating the consequences of tighter policy and the growing risk of recession. The combination pushed asset prices for both equities and credit lower across the month. It was a more staggered response in the sovereign bond market, with higher inflation driving yields initially until recession fears were elevated following the Fed's 75bp rate hike. Overall, there were few places to hide.

Unfortunately, Schroder doesn't think that the pain is behind investors. The significant sell-off in equities in June and the year thus far has seen headline valuations improve. However, this mainly reflects a de-rating of the market to align with the rise in actual and expected interest rates, against a high and problematic inflationary environment. Earnings and the market's forward earnings estimates are yet to deteriorate materially, and Schroder expects them to do so, to align with the expected economic slowdown and material recession risk globally. Central banks around the globe aren't reacting (yet) as they have over the last decade to market dislocation. This is because monetary policy is firmly focused on curtailing rampant inflation. As such they have limited policy flexibility in this context. Unlike the GFC or the COVID market crises (where there were clear systemic issues in the case of the GFC or an exogenous shock in the case of COVID), economies face a relatively classic recession scenario, whereby pro-cyclical policy leads to inflation, which leads to policy tightening and eventually leads to recession. Energy and supply chain disruptions are exacerbating the inflation prognosis but are not the root cause. Schroder expects revised earnings expectations to be the driver of the next leg down in equities globally. Schroder thinks emerging markets can de-couple to a degree, as valuations are better and China is stimulating, albeit this will need to continue for the decoupling to continue. The key risk to this negative equity view is that inflation moderates and earnings hold up, but Schroder places a low probability on this outcome.

While credit spreads (and total yield) have risen, Schroder sees a significant risk of further material spread widening in both high yield and investment grade markets. Defaults have so far remained low, reflecting low interest rates and up to this point strong profits. However with the cost of refinancing rising and profit growth slowing (and likely contracting) as costs rise and sales decline, Schroder expects some further distress before a clear buying opportunity emerges. Schroder is seeing some selective 'buy and hold' opportunities emerging but caution is warranted.

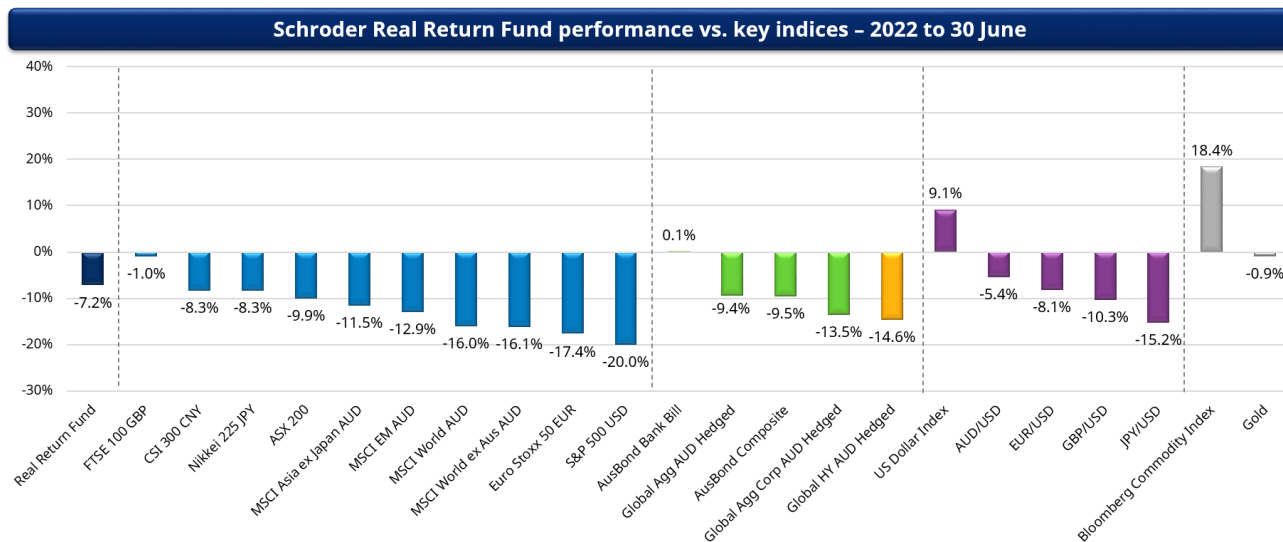
The Fund is becoming more constructive near term on sovereign bonds. This is because the sell-off in bond markets in recent months has extended to a point where Schroder believes that key sovereign yield curves are pricing sufficient monetary tightening to slow the economy enough to alleviate cyclically induced inflation. Consistent with this, Schroder has seen a moderate rally in bonds towards the end of June. That is not to say that the market will not overshoot (as it has a habit of doing) or that central banks won't overtighten, but Schroder

does think the risks are starting to look more balanced than they have for some time. The market is still trying to ascertain where the peak in inflation is and where it will settle going forward. Schroder believes that once the market focus shifts fully from inflation to growth, yields could start to decline, even in the face of elevated inflation prints – that is, bond yields will lead the inflation narrative on the way down. Keys to watch here are inflation momentum and energy prices, with signs of moderation of growth being a potential catalyst for a rally. This also means that the bond / equity correlation will shift to negative again.

Against this backdrop, Schroder continues to prefer defensive currencies – mainly the US dollar but also the Japanese yen.

## Schroder Real Return Fund performance comparison

### Schroder Real Return Fund performance vs. key indices – 2022 to 30 June



Source: Schroder, MSCI, Refinitiv from 31 December 2021 to 30 June 2022. Based on the net return of Schroder Real Return Fund wholesale class. Global high yield is represented by Bloomberg Barclays Global HY xCMBS xEMG 2% Cap (AUD Hedged), AusBond Composite is represented by Bloomberg AusBond Composite Index, Global Agg AUD Hedged is represented by Barclays Global Aggregate AUD Hedged, Global Agg Corp AUD Hedged is represented by Barclays Global Aggregate Corporates AUD Hedged, Gold is represented by Gold Bullion LBM \$/t oz. Past performance is not a reliable indicator of future performance.

The biggest challenge from a portfolio construction perspective in June (and more broadly so far this year) has been the breadth of the sell-off, which has left limited places to hide (only cash, commodities and US dollars offering any real return solace). Equities, bonds and credit have fallen significantly so any exposure (no matter how small) has hurt returns. The alternative, and more risky, approach would be to 'short' key asset classes (as hedge funds are able to) but this is not available to us as a 'long-only' strategy.

All this said, the market entered June in a very defensive position with elevated cash levels near 40%. To put our recent actions from an asset allocation level into context, since late 2021 both our equity and credit exposures have close to halved. More specifically, our equity exposure has declined from 37% late last year to around 19% in mid-June. Corporate credit has declined from 40% to less than 20% over the equivalent period and cash holdings have increased by 30%. These changes put the portfolio in a good position to mitigate the impact of the carnage across most asset classes, but insufficient to avoid some damage – given its breadth.

As outlined above, Schroder expects more weakness in equities and credit (particularly the riskier parts of the credit universe), but the manager thinks risks around sovereign bonds are shifting. Schroder is not making material changes to positioning on the risk side and are waiting for markets to start to better reflect recession risk on earnings. While the more speculative parts of markets have fallen sharply, the drawdown in key equity markets like Australia and the US are moderate compared to past recessions and market is still early in the tightening cycle. That said, Schroder is continuing to add moderately to our duration positioning, lifting the overall portfolio duration to around two years. This is well above the 0.75 years that prevailed in 2021, but well below the peak of 2.75 years in 2020 – as COVID impacted initially.

## Availability

Product Name	APIR Code
SignatureSuper*	AMP1858AU
SignatureSuper - Allocated Pension*	AMP1862AU

\* Closed to new investors

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