

Schroder Real Return

Quarterly Investment Option Update

31 March 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

Investment Option Performance

To view the latest investment performances for each product please visit 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

Sector Allocation	%
Australian Equity	10.08%
Global Equity	11.52%
Dividend Futures	2.50%
Absolute Return	-2.15%
High Yielding Credit	10.11%
Insurance Linked Securities	3.48%
Asian Credit	5.06%
Emerging Market Bond	5.03%
Commodities	0.00%
Australian Fixed Income	15.08%
Global Fixed Income	12.01%
Rate Strategies	4.02%

Investment Option Commentary

The Schroder Real Return Fund posted a negative 1.38% (pre-fees) for March with the quarterly return of negative 2.99% (pre-fees).

Largest contributors

The largest positive contributor to performance was Australian equities, which added 0.6% over the month. Commodities added an additional 0.12%. Over the quarter, Australian equities and commodities were also the primary positive contributors, adding 0.4% each to returns.

Largest detractors

The largest negative contributor was foreign currency, which detracted -1.1% over the month, driven by a weaker Japanese yen and stronger Australian dollar. Defensive fixed income assets detracted -0.7%, most notably driven by weakness in Australian government bonds and investment grade credit, while diversifying assets (particularly emerging market sovereign bonds and Asian credit) detracted -0.3%. Over the quarter, both the portfolio's defensive assets and foreign currency exposure were the primary detractors, costing -1.1% each over the quarter.

Market Commentary

Equities

Global equities started the month by falling over 6% on concerns over the escalation of the Ukraine conflict, higher inflation fears and a more hawkish Fed. However, after a positioning unwind, markets rebounded, ending the month up over 2%. Over the quarter, global equities remain down 5.4% in USD and down 8.1% in AUD terms. Commodity producing countries fared the best, with Latin America markets returning over 13% and Australian equities returning almost 7% over the month. Emerging markets ex Latam fared the worst, with the Hang Seng China Enterprises index falling over 6% on fears of continued regulatory clampdown, rising Covid-19 case counts and rhetoric from the US government about delisting Chinese American Depository Receipts. Officially, the MSCI Russia index returned -100% for the month, despite the onshore MOEX Russia index rallying over 9%. MSCI EM Europe, the Middle East and Africa fell almost 7% for the month.

During March, the Fund reduced equities by a further 3%, an 8% reduction over the quarter, to bring our overall allocation down to 22%. Given the strong outperformance of Australian equities relative to global equities year to date, Schroder used the global equity sell off in mid-March to rotate 2% from Australia to US and EU equities. Schroder used the spike in volatility at the start of March to sell options to gain premium, particularly in Eurostoxx banks, where the Fund sold 5% notional 35% out-of-the money put options. Towards the end of the month, the Fund re-invested the premium received to buy 10% out-of-the-money S&P puts to protect the portfolio into the June quarter.

Fixed Income

Duration assets were particularly hard hit in March, with US 10-year treasury yields spiking over 50bps to 2.34% and Australian 10-year yields spiking 70bps to 2.84%, translating to a total return of -3.6% and -5.8% respectively for the month, or -5.8% and -8.9% over the March quarter. The front end of the yield curve was particularly impacted, with US two-year yields jumping 90bps over the month to 2.33%, as the market priced in even more aggressive official rate increases by the US Federal Reserve. The return on US government bonds in March was nearly 2.7 standard deviations below its post GFC average. Inflation rose to 7.9% year on year in the US and to 7.5% in Europe. Corporate bond spreads widened during the start of the month before tightening towards the end as equity markets remained buoyant. However, spreads remain 20-30bps wider than they were at the start of the year.

Schroder used the widening of credit spreads to make an allocation into European investment grade corporates in March, where spreads were the widest they have been in the past 20 years outside of the GFC, the 2011 sovereign debt crisis and the Covid-19 spike in March 2020. Schroder also reduced our Asian credit exposure by 1%.

Currencies

The US dollar (USD) index rallied 1.7% for the month and 2.8% for the quarter, but underperformed the Australian dollar (AUD) by 3% for the month and quarter, and emerging market currencies by over 3% for the month and 1.8% for the quarter. The Euro (EUR) fell moderately but the real mover was the Japanese yen (JPY) which fell over 5.5% versus the USD and over 8% against the AUD for the month and quarter. Typically, JPY is seen as a safe haven during time of market volatility, but compared to the hawkish Federal Reserve, the Bank of Japan remains defiant in the face of higher inflation and continued to implement yield curve control. This intervention has kept 10 year yields below 0.25%, compared to 2.5% in the US, which is decreasing the attractiveness of holding the yen. Commodities rallied a further 8.6% to bring the performance over the quarter to over 25%, the largest quarterly increase since 1973.

Schroder used the recent spike in commodity prices to tactically sell down our commodity exposure to zero. Schroder will reassess once some of the war risk premium is removed. Schroder instead reduced the USD exposure via an options strategy as the AUD continues to benefit from the commodity uplift and the Fund also added to our JPY exposure against EUR via options as a tail risk hedge.

Outlook

March was a tough month for investors with equities, bonds and even some haven currencies selling off rather dramatically. Global equities fell over 6%, US 10-year treasuries fell 5.5% and the JPY fell over 7% peak to trough for the month. Most of the drop in risk assets was due to the escalating conflict in Ukraine and the inflationary impulse emanating from the resulting commodity price squeeze. With global bonds delivering their worst quarter on record, these moves served as a reminder of how the equity-bond correlation cannot always be relied upon and can turn positive during inflationary regimes. However, as the market became less fixated on the conflict, global equities staged an impressive rally, gaining over 10% trough to peak, ending the month up 1.9% in USD terms.

The sell-off in early March was due for a rebound. Typically, geopolitical events rock markets but are soon forgotten, with the average S&P 500 geopolitical drawdown over the past 100 years being around 6% and recovering to flat in 11 days. The relative strength indicator (RSI) for global equities fell below 30 (a technical buy signal), fund manager equity positioning was one standard deviation below its long-term average and the bull/bear ratio slipped below one, implying investors were very bearish. This kind of positioning always leads to a counter trend rally as these extremes wash out and fear of geopolitical escalation eventually gives way to unfortunately 'living with' the conflict. The one small but very important caveat is that once markets recover from geopolitical events, the focus of investors shifts back to the prevailing macroeconomic backdrop.

To put the recent rally into context, the percentage gain and speed of this counter trend rally ranked in the 99.5th percentile of snapbacks during bull markets since the 1920s and the 98th percentile of bear market rallies. Essentially the market has discounted the Ukraine conflict and is instead focusing on above trend global growth and the continuation of strong earnings from corporates. However, Schroder believes this view is complacent. While the conflict in Ukraine is a humanitarian tragedy which increases the likelihood of potential black swan events, the main story from a macroeconomic perspective is persistently high inflation and an increasingly aggressive global monetary tightening cycle. The markets believe central banks can engineer a soft landing, despite little evidence they've ever been successful at doing so.

Inflation remains stubbornly high across the world. US CPI has hit 7.9% year-on-year, the highest since the 1970s and even perpetually stagnant Europe has seen inflation rise to 7.5%. US Federal Reserve members have been out in force, highlighting their desire to tighten monetary policy to rein in inflation. December 2022 Eurodollar futures are pricing in a cash rate of 3% by the end of the year. From a liquidity perspective, the US shadow Fed Funds rate has already tightened by 2% (from -1.85% to +0.2%) and that's before the Fed embarks on aggressive balance sheet reduction.

Not only does this put downside pressure on growth and the likelihood of a hard landing, but inflation also tends to erode company profits and reduce margins. Schroder are already starting to see the start of increasing wages and input costs in the US and margins are already at all-time highs. US corporate profits as a percentage of GDP (both pre- and post-tax) are at the highest levels of the past 50 years. While consumer balance sheets are in excellent condition, real wages have collapsed and with that, consumer confidence has fallen. While our indicators still show minimal chance of a recession in the US (so far), the yield curve has inverted, the economy is slowing,

and the Fed has been too slow in its response and now is looking to hike aggressively. Recall that the economy doesn't die of old age, it is typically killed by the Fed overtightening.

Higher yields are starting to create some value in fixed income, but it is perhaps too early to start aggressively building duration risk. Inflation remains a problem, and central banks have only just started their rate hiking cycle. Equity valuations look more reasonable, but they are not reflecting the potential for a new inflationary regime. Since 1900, the average price-to-earnings ratio (PE) of the US equity market when inflation is around 8% is around 10 times, which is less than half the current US PE of 22. While Schroder doesn't believe the economy will stay at these heightened levels of inflation, a CPI band of 2-4% has historically seen US equities average PE of 16 times, implying the potential for further derating before this cycle is over.

Given the growing risks of an economic slowdown, an increasingly hawkish Fed and perhaps an inflationary regime shift, the Fund have not bought into this relief rally. Like in February, Schroder used the recent bounce to reduce risk even further, bringing equities down from 25% to 22% on a delta adjusted basis. Our defensive positioning has helped insulate the fund, which is down 3% (pre-fees) year to date, which compares favourably to the MSCI All Country World Index which is down 8% in AUD terms and global aggregate bonds down almost 5% in hedged AUD terms. Schroder continues to hold elevated levels of cash of over 20% and moderate levels of duration of 1.75yrs. While periods of regime shifts can be volatile, with both risk assets and safe havens selling off, this volatility helps embed some more attractive risk premium into assets, allowing a portfolio reset to gain more attractive long-term returns. The manager doesn't believe the time has arrived yet.

Availability

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

* Closed to new investors

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