AMP

# Schroder Real Return

Quarterly Investment Option Update

30 September 2021

## 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 | 15.19% |
| Global Equity | 13.90% |
| Dividend Futures | 1.05% |
| Absolute Return | 0.00% |
| High Yielding Credit | 10.35% |
| Insurance Linked Securities | 4.10% |
| Asian Credit | 6.14% |
| Emerging Market Bond | 5.05% |
| Commodities | 1.07% |
| Australian Fixed Income | 15.22% |
| Global Fixed Income | 10.04% |
| Cash & Cash Equivalents | 17.89% |

## Investment Option Commentary

The Schroder Real Return Fund returned -0.59% (pre-fees) for the month of September and 1.06% (pre-fees) over the quarter. For the 1-year and 3-year periods ending September 2021 the fund has returned 10.97% (pre-fees) and 5.65% (pre-fees) p.a. respectively.

**Largest contributors**

During September, the portfolio's duration overlays (interest rate risk hedges) added 0.2% to portfolio returns, while the portfolio's developed market foreign currency exposure and stock selection in Australian equities also added at the margin. Over the quarter, equities were the primary positive contributor delivering a contribution of 0.6%, while the portfolio's credit and foreign currency exposures added 0.3% and 0.2% respectively.

**Largest detractors**

Equities were the primary detractor from returns in September, resulting in a -0.5% contribution, with -0.4% from global equities and -0.1% from Australian equities. Emerging market (EM) sovereign debt and Asian credit also detracted 0.1% each. Over the quarter, Asian equities detracted 0.1% from returns, while duration, EM debt and Asian credit all detracted at the margin.

## Market Commentary

Investors suffered in September, but the manager remains optimistic about markets given the unwavering support of central banks. Given the pullback, forecasts for equity returns compared to cash and sovereign bonds have improved.

September was a tough month for investors and a timely reminder that markets don't always go up. It was a bit of a shock to the system after 11 consecutive months of gains for the Australian equity market. The relatively modest pullback in September can be linked to several factors, ranging from concerns around Chinese property (Evergrande, more on that below), the pending renegotiation of the US debt ceiling, the US Federal Reserve's considerations for policy tapering, moderating global growth following a stimulus-laden bounce back and, in Australia's case, sharp declines in the iron ore prices and extended lockdowns in the key eastern states of Victoria and NSW.

A pause after such a strong run is not unusual and is arguably welcome, with a more balanced view of risk reflected in pricing. The critical question is where to from here, and whether the factors coinciding with this modest pullback become more endemic forcing a broader de-rating of asset prices.

The bear case for risk assets from here is relatively easy to make – bear cases often are, but in the brave new world of heavy intervention by policymakers in financial markets, they are also often wrong. That said, there are some sound reasons to be cautious.

Firstly, valuations in both equity and credit markets are relatively demanding, notwithstanding the fact that the strong recovery in profits has seen many equity markets grow into their multiples. However even optimistic profit forecasts leave multiples in key markets like the US stretched by historic standards and therefore vulnerable. At a sectoral level, growth stocks (largely technology related) require unrealistic growth ad-infinitum and are suffering disproportionately as growth momentum moderates.

Secondly, the concerns about Evergrande (the large Chinese property developer) bring to the surface an issue that's been largely brushed aside in recent years – namely, debt. Evergrande has too much debt, can't service it and needs to be bailed out. This will probably happen as it's too big and too indebted to fail fully, so some form of bailout by the Chinese government seems likely. However, this is not unlike the US government which will also be bailed out soon (by an extension of the US debt ceiling and a complicit US Federal Reserve).

Finally, this highlights why the risk of inflation is important and why the market is worried about tapering. The reality is that the Fed can't afford to taper in any way other than moderately and gently. If a structural rise in inflation forces their hand, then it may be difficult for them to engineer a modest and gentle tapering without markets overreacting. There's too much debt for interest rates to rise too far.

The more constructive case (and in fact the manager's base case) is that the broader confluence of ongoing global economic recovery, which is supported by central banks that are unwilling to disrupt the economic recovery process (or capital markets) by aggressively tightening policy, will continue to provide a tailwind to asset prices. The most likely beneficiary in this environment will be equities. This is partly because profits are likely to grow, alleviating pressure on valuations and offering some upside to investors. This upside can, and

will, likely come through both broader earnings growth but also rotation away from the expensive "growth" stocks, to those more likely to benefit from ongoing re-opening. This is in contrast to credit markets, where the rally of the past 18 months has suppressed both credit spreads and yields offering limited further upside potential. Given these low yields, credit markets offer little safety margin and face significant downside should the cycle turn, or the bear factors outlined above permeate through. Reflecting both a moderate pullback in equities generally, and strong profit growth, the manager's forecasts for equity returns have improved moderately in absolute terms, but particularly compared to cash, sovereign bonds and credit

The strategy over the past 18 months has been to be both a cautious participant in the recovery in risk assets, but to also shift risk away from assets offering very suppressed yields (RMBS, sovereign bonds and even investment grade credit) into higher yielding and diversifying assets which still offered a risk premium. This strategy has been a positive contributor to performance – particularly in September when strategies such as private debt and direct commercial lending, insurance-linked securities and commodities all contributed positively while more corporate related exposures moderated. That said, the manager is re-evaluating this strategy following the broader rally in asset prices and have made some adjustments to positioning and expect to make more.

Consistent with the arguments above, the most notable change is that the manager has effectively sold out of global high yield credit on the basis that low yields and narrow spreads means it offers only moderate yields with limited upside but significant downside. For similar reasons the manager has also sold down emerging market hard currency debt positions. Some, but not all, of this risk has been allocated to equities, pending the potential for further volatility in equity markets and a preference to add equities on any re-pricing. At the margin a small amount of duration (+0.25 years) has been added, while some additional USD exposure is being used to help protect the portfolio should the downside risks eventuate. Options positions continue to be actively managed for low-cost downside protection and the manager has also implemented an options strategy that offers exposure to a rebound in equities.

A position noted previously is the exposure to Asian credit through the Schroder ISF Asian Credit Opportunities Fund. Importantly this strategy has no exposure to Evergrande but with some contagion to Asian credit more broadly, credit spreads have moved higher. While not without risk given the precarious situation of the Chinese property sector, from a valuation perspective this exposure continues to look attractive, and the fund is holding firm on its position here.

## Outlook

**Equities**
Concerns around slower growth, higher inflation, an unwind of central bank stimulus and ongoing concerns around Evergrande and the potential for broader contagion across the Chinese real estate and financial sectors, resulted in equities selling off during September. Developed market (DM) equities fell by 3.7% in local currency terms, while the Australia market fared a little better but still dropped by 1.9% for the month. Emerging markets (EM), continued to be the laggard, falling by 4.0% in USD terms. At a sector level, higher oil prices saw energy stocks be the standout performer both in Australia and globally, while the materials sector was the weakest performer. Despite the pullback through September, over the quarter, Australian equities still delivered a 1.7% return, while DM equities returned 0.6% in local currency terms. EM equities were the clear underperformer, falling by 8% in USD terms over the quarter.

During September, the manager reduced exposure to physical equities by 1%, however after taking our options positions into account, overall net exposure to equities has actually increased slightly. This is because the relative pricing between S&P500 equity put options and call options has enabled the manager to implement a bullish strategy over the S&P 500. Selling puts and buying multiple call options for zero premium has provided broadly similar exposure to the downside in equities, but significantly higher exposure to the upside should markets rally. In addition, the manager also added 1% in Australian equities, while also continuing to roll our put spreads which provide protection over a limited fall in the S&P 500.

**Fixed income**
The updated "dot plots" from the US Federal Reserve (Fed) minutes for their expected interest rate outlook were more hawkish than the market had initially anticipated, with the dots indicating one rate hike by the end of 2022, and further rate hikes that would bring the Fed Funds rate up to 1.75% by the end of 2024. Meanwhile, the Fed outlined a plan to taper asset purchases which also worried markets, with tapering expected to begin in November and for asset purchases to potentially finish by mid next year. This hawkish sentiment from the Fed and some other central banks such as the Bank of England, along with lingering concerns around higher inflation, resulted

in bond yields moving higher during September. The US 10-year yield rose by 0.18% to end the month at 1.5%, while Australian 10-year yields increased by 0.34% to also finish at 1.5%. Spreads were moderately wider in Australian investment grade credit and EM debt, while in global investment grade and high yield, credit spreads were generally flat. Over the quarter, longer end bond yields made a round trip, falling in July and August, before rising in September to finish roughly where they started across most markets.

During the month, the portfolio added 0.2 years to the duration target, bringing it to 1 year in total. While valuations remain poor for government bonds, this increase is aimed at providing the portfolio with some additional downside protection, given the increased uncertainty around the growth and inflation outlook. Additionally, the manager has closed its EM hard currency sovereign debt position (while maintaining an EM debt exposure through the Absolute Return Fund) and reduced net global high yield exposure to 0% as valuations look increasingly stretched in the high yield market, with further upside (beyond just carry) in the asset class looking very limited.

**Currencies**

Higher US yields and a broad sell off in risk markets resulted in safe haven currencies like the US dollar and Japanese yen outperforming the Australian dollar (AUD), the Euro and the British pound. While the AUD sold off relative to the aforementioned safe haven currencies, it held up relatively well against other major currencies despite the continued weakness in iron ore, where prices have fallen by roughly 50% from their peak earlier this year. The portfolio's foreign currency exposure has been maintained at 11%, primarily through the USD, however with the rally in oil prices some profits have been taken on the commodities allocation, trimming the exposure back to 1%.

## Availability

| Product Name | APIR Code |
| --- | --- |
| AMP Flexible Super - Super | AMP1866AU |
| AMP Flexible Super - Retirement | AMP1870AU |
| CustomSuper | AMP1850AU |
| Flexible Lifetime - Super | AMP1850AU |
| Flexible Lifetime - Allocated Pension | AMP1854AU |
| SignatureSuper | AMP1858AU |
| SignatureSuper Select | AMP1858AU |
| SignatureSuper - Allocated Pension | AMP1862AU |

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