Schroder Real Return

Quarterly Investment Option Update

31 December 2021

Aim and Strategy

To deliver an investment return of 4 to 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	14.73%
Global Equity	15.39%
Dividend Futures	1.57%
Absolute Return	-0.34%
High Yielding Credit	9.10%
Insurance Linked Securities	3.40%
Asian Credit	6.00%
Emerging Market Bond	2.97%
Commodities	2.56%
Australian Fixed Income	15.19%
Global Fixed Income	9.98%
Cash & Cash Equivalents	19.45%

Investment Option Commentary

The Schroder Real Return Fund ("Fund") returned +0.99% (pre-fees) for the month of December, +1.05% (pre-fees) over the quarter and +6.81% (pre-fees) over the over the calendar year. For the 3-year period ending December 2021 the Fund has returned +6.94% (pre-fees).

Largest contributors

Through December, the fund's allocation to equities was the primary contributor to returns with Australian equities adding 0.5% and global equities adding 0.6%. Diversifying assets such as dividend futures, commodities and high yield credit also contributed at the margin. Over the quarter equities contributed 1.4% to returns, with 0.4% from Australian equities, 0.3% from S&P500 options and 0.7% from global equities.

Largest detractors

Foreign currency (FX) exposure detracted by -0.3% for the month as the Australian dollar rebounded. Over the quarter Australian credit detracted by -0.2%, while FX and Asian credit detracted by -0.1%.

Market Commentary

It's typical at this time of year to both reflect on the year past and to outline the manager's thinking for the year ahead. By the standards by which 'predications' can deviate from reality the manager made some win. To summarise, Schroder made several key observations at the end of 2020:

- Starting yields meant cash and bond returns would be poor in 2021.
- Opportunities to spread risk across the capital structure (broader use of diversifying strategies) would help lift returns and mitigate the need to simply take on more equity risk.
- Volatility would be a feature in 2021.
- Investors needed to keep a close eye on inflation as it would likely rise and put pressure on bond yields.
- The key for equities would be profits: if profits came through then equities could do well given recovering economies and still plentiful policy support. The manager expected risk assets to remain supported but were cautious on how far to back this trade.

Schroder were nearest to the mark with regards to cash and fixed income returns, perhaps not such a hard one to forecast given the low level of yields, but with Australian composite bonds returning a negative 2.9% for 2021. Schroder also used diversifying assets to lift returns, allocating away from cash, sovereign bonds and low risk mortgage-backed securities toward higher yielding private debt and commercial real estate mortgages, securitised debt and insurance linked securities which boosted returns in the low-to-mid-risk part of the portfolios.

Inflation also became a key focus in 2021 as supply chain disruptions, coupled with recovering economies and pro-cyclical economic policy converged leading to US core inflation printing at rates not seen since the early 1990's (in headline CPI terms not since the early 1980s). While Schroder were directionally right for equities and for the right reasons (strong profits) the extent of the gains in equities were surprising (particularly in the US) – albeit the manager is starting to see some of these gains abate (half marks for this one). Backing this view with a more aggressive equity allocation would have produced higher returns, it would also have been accompanied by materially higher risk. While volatility was elevated compared to pre-pandemic (say 2019), it's hard to argue that volatility was a defining feature of 2021. So, a miss here.

There are several key factors that differentiate 2022 from 2021:

- Rising inflation is no longer a risk but a reality. Central banks will need to begin responding to this in 2022 through both the winding back of quantitative easing and through the cautious lifting of interest rates. The mismatch between nominal growth outcomes and policy settings is extreme and this gap will inevitably close but central banks will need to find a balance between rebalancing policy with the economic uncertainty of the pandemic and the inevitable pressure from markets.

- Both global growth and profit growth will moderate in 2022, not dramatically (Schroder is not forecasting recession) but a slowdown from the heady pace of the "re-opening" of the global economy. The manager thinks the risks here are probably to the downside, particularly if the pandemic is not managed and the disease becomes endemic in the near future (Omicron is a timely warning that complacency should be avoided).

- Valuations remain optimistic in key risk assets (very optimistic in US equities). Against a less accommodative policy and growth / profit backdrop, it is highly likely that these valuations will be tested in 2022 – particularly on the back of any negative surprise or disappointment in profits.

- While cash rates remain at or around zero in major markets (including Australia), sovereign bond yields have moved modestly higher, reflecting the tussle between rising inflation and high debt loads that likely limit the extent to which yields can move higher. While the manager still believes that higher yields (and low fixed income returns) are likely in 2022, this may ebb and flow as economic variability and pressure from markets oscillates.

At the end of the day though what really matters is the decisions Schroder makes and how risk is allocated in the portfolios. On this point, it's very likely that 2022 will be a more challenging year for investors than 2021.

Schroder expects equities to be an important source of returns over the year, but the manager also expects overall equity returns to be lower than in 2021 and importantly the path of returns to be more volatile. Having built up the equity exposure in 2021 (peaking at around 37% in October) the manager has trimmed its exposure materially, going into year end with a more defensive stance, expecting near term volatility to rise as countries struggle to reconcile health and policy settings. Schroder's focus is on markets that have lagged (Asia and other emerging markets) and on companies that can demonstrate genuine growth in earnings over time. Many of the stocks that have benefitted from a "growth at any price" focus (like technology) have been underperforming of late and this may continue for a while. Genuine and sustainable earnings growth will be valuable.

Schroder has also been trimming its diversifying asset exposure as the manager believes valuations for many assets in this space (particularly higher yielding credit) has run its course. The exception from a valuation perspective is Asian credit, which has been buffeted by its connection to Chinese property and looks cheap, albeit not without risk. At the margin, the manager prefers equities given the potential for upside which is not there in the credit space.

On the defensive side of the ledger, Schroder held low levels of duration for most of 2021 (typically less than 1 year particularly, in the second half) but have recently added back to increase its risk hedges.

Outlook

Equities

Equity markets moved sideways on uncertainty around the Omicron variant and a more hawkish shift from the US Federal Reserve (Fed), before rallying in the latter stages of the month as markets began to look through the shorter-term risks and focus on expected growth over the coming year, which at this stage is still expected to be quite healthy. Developed market equities rallied by 4.0% in December, while the Australian marked underperformed, but still delivered a return of 2.7% for the month. This was also the case for the 4th quarter, where developed market equities rose by 8.3% in local currency terms, while the Australian marked only rose by 2.1%. Emerging markets fell by -1.3% over the quarter in US dollar terms.

Through December, Schroder tactically reduced risk in equities by 2% through physical equities and close to 4% in delta adjusted terms as the manager let the put spread positions that the manager had maintained in the portfolio through large parts of this year, mature. This was driven by caution around the downside risks to consumer spending and economic activity as a result of Omicron and the reintroduction of restrictions in some regions. This brings the equity allocation back to 30%, which remains broadly consistent with a 5% volatility target for the portfolio.

Fixed income

Developed market central banks shifted towards a more hawkish outlook, with the Fed signaling a faster pace of tapering. This could see tapering end in March, rather than June, and as a result markets priced in a potential for a rate hike earlier than it had previously anticipated. Meanwhile the Bank of England lifted its policy rate to 0.25%, owing to inflationary pressures. Ultimately, the decisions going forward will be heavily dependent on the inflation data, which could ease to some extent if the current supply bottlenecks become more manageable. In China, it's a different story, as the People's Bank of China has been easing monetary policy through a 0.5% cut to the reserve requirement ratio. This easing bias could continue in to 2022. In December, Australian 10 year yields were broadly flat, ending the month at 1.67%, while US 10 year yields moved up by 0.07% to close at 1.51%. 10 year government bond yields were also generally unchanged in Japan, but moved higher by 0.17% in Germany. Over the quarter, the biggest moves were in the front end of Australia and the US, where Australian 3 year yields jumped by 0.60%, while in the US 2 year yields increased by 0.45% as both markets began to prince in more central bank hikes.

Within the portfolio, Schroder maintained overall duration at 1.0 year, but rotated 0.25 years from the US long end, which the manager thinks remains vulnerable to higher rates, into the Australian front end. Schroder has also been reducing its exposure to higher yielding credit where spreads tightened once again and valuations remain stretched – the manager sold down 1% in Australian higher yielding credit and hybrids, and reduced exposure to global high yield by 2.5% through credit derivatives.

Currencies

The Australian dollar rallied against most currencies but remained flat over the quarter. The Dollar Index (DXY) was down slightly over the month but remained 1.5% higher over the quarter. With shifts in central bank outlook / policy driving a large part of the movement over the past few months, this is also expected to be the case as the market moves into a period of tapering, rate hikes, and even potential quantitative tightening in the later stages of 2022. Over the month the manager added 3% JPY to the portfolio, as a way of increasing the risk hedges in the portfolio. This brings total FX exposure in the portfolio to 14%.

Availability

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

* Closed to new investors

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