Schroder Real Return

Quarterly Investment Option Update

30-June-2018

Availability

Product name	APIR
Flexible Super – Choice (Retirement)	AMP1870AU
Flexible Super – Choice (Super)	AMP1866AU
Flexible Lifetime – Allocated Pension	AMP1854AU
Flexible Lifetime – Super	AMP1850AU
Signature Super	AMP1858AU
Signature Super – Allocated Pension	AMP1862AU

Investment Option Performance

Investment performances are subject to product fees and where relevant tax as outlined in the product PDS. Therefore investment performance may differ between products. In addition, activity on your account such as contributions and deductions will also impact the investment performance specific to you. To view the latest investment performances for each product, please visit **www.amp.com.au**. You can also view the last investment performance specific to you by visiting your My Portfolio account.

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Overview

Aim & Strategy: To deliver an investment return of 5% pa 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.

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 a dynamic asset allocation framework in which both asset market risk premium, and consequently, the asset allocations of the portfolio are constantly reviewed. As risk premium (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 is 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 category: Multi-sector (Specialist)

Suggested Investment Timeframe: 5 years

Relative Risk Rating: Medium to High

Asset Allocation	Actual (%)	Range (%)
Australian Equities	13.97%	0-70%
Global Equities	13.86%	
Higher Yielding Credit	9.94%	0-70%
Emerging Market Debt	4.91%	
Absolute Return Strategies	-0.53%	
Australian Fixed Income	16.00%	0-100%
International Fixed Income	7.48%	
Inflation Linked Bonds	3.75%	
Mortgages and Sub Debt	4.30%	
Cash	26.33%	

Holdings

Industry Exposure	%
Cash	20.57%
Collateralised	5.12%
Corporates	24.18%
Derivatives	-3.65%
Equity	29.70%
Government	15.29%
Guaranteed Financials	0.03%
Semi	2.07%
Subordinated	5.30%
Supra/Sovereigns	1.39%

Regional Exposure	%
Africa	0.38%
Asia	4.42%
Europe	7.35%
North America	25.91%
Oceania	58.19%
South America	0.74%
Supernational & Global	0.81%
United Kingdom	2.20%

Top Ten Securities	%
US TREASURY INFL (TII) .25% 15 JAN 2025	3.18%
US TSY INFL IX NOTES .375% 15 JUL 2025	2.57%
US TREASURY INFL (TII) .125% 15 JUL 2026	2.24%
WESTPAC BANK NCD 28 SEP 2018	1.83%
CBA NCD 28 SEP 2018	1.39%
COMMONWEALTH BANK OF AUSTRALIA NPV	1.24%
BHP BILLITON LIMITED NPV	1.24%
AUSTRALIA AND NEW ZEALAND BANKING GROUP LIMITED NPV	1.01%
WESTPAC BANKING CORPORATION NPV	0.93%
WSTP NCD 09 JUL 2018	0.93%

Market Commentary

June was a challenging month as markets were buffeted by trade war tensions. Early in the month, President Trump imposed steel and aluminium tariffs on Europe, Canada and Mexico, prompting each country to retaliate with tariffs on US products. The Trump administration also announced a $US34bn list of Chinese goods that will be subject to tariffs beginning July 6.

Diverging economic trends saw a widening gap between global central banks, with the US Federal Reserve signalling more aggression in its policy tightening, and while the European Central Bank indicated it will end its bond purchases in December, it made clear interest rates will remain at their present level until at least the middle of 2019, if not longer. The June quarter also saw Italian politics cause volatility in bond markets as anti-establishment parties formed a government.

Developed market equities eked out modest gains in the month and the quarter, with emerging market equities suffering sharp falls in both time periods. The Australian equity market was the best performer returning 3.3% in the month of June and 8.5% over the quarter. The Fund has had a preference for the Australian equity market over global, and in particular the US market. Since end January the Australian equity market has returned 4.8%, while the US equity market returned -2.9%.

Global and Australian government bond yields closed June at similar levels to which they started. Over the quarter there were significant moves in German and US yields, with German yields lower and US yields higher. In global credit markets, poor performances were put in by emerging market bonds and to a lesser extent investment grade credit. Despite some volatility, high yield bonds unusually did well as lack of supply supported the market.

Investment Option Commentary

The primary driver of returns over both the last month and quarter has been Australian Equities, which has outperformed as the Australian dollar has sold off, while expectations of any RBA rate hike continue to be pushed out even further in to the future. The strategy's absolute return strategies, in particular the US inflation breakeven position also contributed to returns. Emerging market debt exposure was a moderate detractor as the sector comes under pressure from a strengthening US dollar and weaker investor sentiment.

US politics has been front and centre for around two years now, but more recently it has moved from a tailwind into a headwind. Donald Trump has shown himself to be very different from the usual politician, in that he is following through on his election promises. While markets initially focused on the "positive" policies, what the fund is now getting is the good with the bad. There were four key areas that Donald Trump focused on in the run up to the election: immigration, tax, trade and infrastructure. Tax and trade have been the key movers of markets recently.

President Trump has asserted that if you are in a trade deficit, like the US, trade wars are "good and easy to win" — an assertion Bloomberg News has already labelled as "fake news". The general view of economists is that everyone loses in a trade war, although markets have behaved more in line with President Trump's views. While the US equity market has returned 2.6% year to date, the Chinese equity market (Shanghai Composite) returned -15.6%, and the Chinese currency has also fallen, while the US dollar is higher.

Outlook

Most modelling suggests the direct impacts of a trade war are small, and given that tit for tat tariffs reduce both imports and exports, the direct effect on GDP is small. However, for me it is the indirect costs that are the real risk. These are around the impact on confidence. For corporates there is the disruption to supply chains as many large firms now source parts globally, rising input prices, and uncertainty around export sales. This will have an impact on investment and hiring. The consumer will also be hit by rising prices which will reduce spending in real terms.

This is in line with the economists' view, so why the divergent market performance? First, the tax cuts in the US have been a positive for the US equity market, earnings are expected to be up 35% this year, supported by corporate tax cuts. Second, the full potential impact on corporations has yet to be priced in, but this will become more so as companies report on the impact to their businesses

The key question is: how far does this go? You have a President that acknowledges he does not admit he is wrong; and his Chinese counterpart who noted that when somebody hits you on the cheek "in our culture, we hit back". This is not an environment that suggests an early breakthrough, so the fund has to think about a potential circuit breaker.

Given this has been driven by the Trump administration, while China, Europe and other countries caught up in this have so far been measured in their retaliation, the key is the US political landscape. This year is a mid-term election year and while it is highly likely the Republicans will maintain control of the Senate, current polling suggests the Democrats will take Congress in the November election. Mid-term elections are about turnout and President Trump has energised the Democrats. An early approach by Republicans to energise their base was to focus on the likelihood of impeachment if Congress was to fall to the Democrats, as this was the successful strategy used during President Clinton's term.

However, this approach was not favoured by President Trump, who believes he has a better political antenna than the establishment, and his belief is that immigration and trade will bring out his base. Given this, the trade war will most likely continue to grow, and the circuit breaker will be unintended consequences of this approach – a large confidence hit and dysfunctional markets, which will force President Trump back to the negotiating table.

Reflecting this outlook, the Real Return strategy has a defensive positioning, admittedly the fund has held for a while. The Fund's equity exposure is low at 27.8%, while including higher yielding credit and emerging market debt the risk exposure of the fund is 42.7%. The Fund has a bias away from US equities which it sees it as not only vulnerable from trade tensions but also due to stretched valuations, our preferred equity market remains Australia. While bonds are the traditional safe haven, the fund has maintained low duration level (0.7 years) as Schroder is cautious on the US inflation outlook. To protect the portfolio the Fund is using currency markets, owning US dollars and Japanese Yen, over Australian dollars. Schroder still thinks the Australian dollar is expensive and it will perform poorly in a risk off environment. The Fund also continues to hold put options on the S&P500.