Schroder Real Return Fund
ASX: GROW

A smarter way to invest. An easier way to grow your wealth.

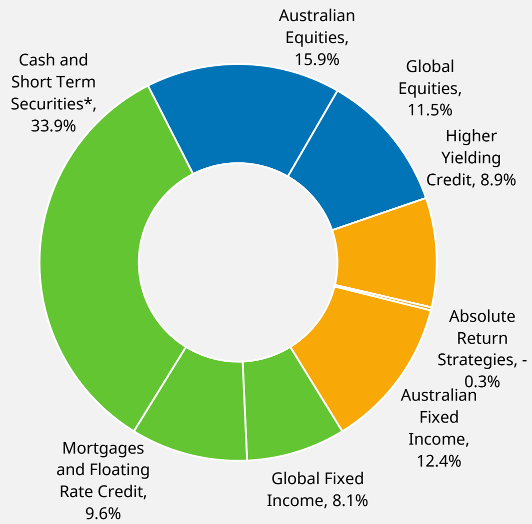
Quarterly Report - September 2017 | **For more information about the Fund visit www.schroders.com.au/grow**

Total return %	1 mth	3 mths	1 yr	3 yrs p.a.	5 yrs p.a.	Inception p.a.
Schroder Real Return Fund (Managed Fund) (pre-fee)	0.39	0.74	5.18	-	-	5.27
Schroder Real Return Fund (Managed Fund) (post-fee)*	0.32	0.51	4.25	-	-	4.33

Portfolio inception 09/08/2016, 1 years and 1 months

Past performance is not a reliable indicator of future performance. Returns over 12 months are annualised

Asset allocation



* Includes floating rate notes, term deposits, negotiable certificate of deposits, cash and other cash equivalents.

Fund objective

To deliver an investment return of 5.0% p.a. 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.

RBA CPI Trimmed Mean* as at 30 June 2017	
3 months	0.51%
6 months	1.00%
1 year	1.84%
3 years. p.a.	1.91%

*The RBA CPI Trimmed mean returns are published quarterly by the ABS. Historical returns may be subject to revisions.

Portfolio refers to investment in the Schroder Real Return Fund (Managed Fund)

Unless otherwise stated figures are as at the end of September 2017

Portfolio review

The Real Return Fund (ASX: GROW) produced a post-fee return of 0.3% in September and 0.5% (post-fee) for the September quarter. Over the year to September, the strategy's return of 4.3% represents a real return of just under 2.5% (post-fee). Portfolio volatility remains very low at less than 2% for the year, reflecting a combination of extremely low underlying market volatility (Australian equity volatility for the equivalent period was just 7.5%) and the underlying defensive positioning of the Strategy.

In terms of performance drivers, the weaker AUD contributed positively in September but this only partially offset the broader gains of the AUD over the quarter. Also contributing positively was the continued narrowing of credit spreads across the credit curve. Equity markets were mixed, but the strategy's overall tilt away from the expensive US market towards the higher yielding and better value Australian equity market did not payoff over the quarter as Australian stocks continued to lag.

Outlook and strategy

So far this year fortune has favoured the bold. Investors prepared to buy and hold risk assets have, by and large, done well. Emerging markets and tech stocks have headed the list but broader global equity market indices have also done well. Gains have also extended to credit markets with both high yield and investment grade benefitting from further spread compression. Volatility has been virtually non-existent – the ride has been smooth.

I think I'm one of the only Australians who has never been to Bali. There's no particular reason for this but it's just never been on my holiday list. Bali's hit the headlines due to the potential eruption of the Mount Agung Volcano and the evacuation of more than 130,000 people living around the volcano's crater. Increased seismic activity over recent weeks has been a handy precursor to a possible eruption and while no doubt inconvenient, it has allowed residents to get out of danger. At the time of writing though no eruption had occurred and the focus of media attention had shifted to the negative impact of the volcano warnings on tourism. Damned if you do, damned if you don't.

This increase in seismic activity is in stark contrast to the lack of volatility in financial markets. Unfortunately financial markets rarely provide the same warning signs as active volcanos. That said, the fact that market volatility is low does not mean we can stay relaxed and comfortable, but nor does it necessarily presage calamity. Markets are enjoying a cocktail of somewhat synchronised global economic growth, positive but low inflation and central banks with their feet still well and truly on the accelerator – even if some have eased off just a notch. This is a potent mix and one that typically correlates with strong markets and low volatility.

In the absence of an equivalent increase in "seismic activity", the critical issue for investors today is what breaks this cycle.

In my view there are 3 critical and interconnected things to look at:

The first is valuations. We know that valuations are crude tools in the short run but as our time horizon extends, so too does their worth. Valuations tell us that markets are extended, having in many cases discounted future returns into current prices – not that unusual to be sure, but clearly helped along by policy makers' intent on distorting the pricing and allocation of risk in the economy. This is true for both bond and equity markets. What this tells us is the base is shaky. To extend the volcano analogy – pressure below the surface is building.

The second issue is inflation. Despite flirtations with deflation and reflation, inflation globally has remained benign due largely to the overhang of capacity in both labour and product markets. However this excess capacity is disappearing. At the pointy end is the US labour market which has gradually tightened. The relationship between inflation / wages and the unemployment rate is non- linear which means that inflation responds more substantially when the unemployment rate falls significantly below the NAIRU. Current estimates have the NAIRU at 4.7% (albeit there is a range of estimates) compared to a current unemployment rate of 4.3%. If this trend continues we would expect inflation to respond.

Schroders

Post-fee performance of other Real Return products offered by Schroders

	1 mth	3 mths	6 mths	1 yr	3 yrs p.a.	mFund Code
Schroder Real Return CPI Plus 3.5% Fund Wholesale*	0.28	0.39	1.08	3.66	N/A	SCH12
Schroder Real Return CPI Plus 5% Fund Wholesale*	0.46	0.50	1.19	4.58	4.32	SCH11

*Both funds on offer are unlisted. An application into these funds may be made through an application form attached with the PDS, which is available on our website at www.schroders.com.au. The management fee for the Schroder Real Return CPI Plus 3.5 % Fund (Wholesale Class) is 0.60% and for the Schroder Real Return CPI Plus 5% Fund (Wholesale Class) is 0.90%.

Outlook and strategy continued

The third is central banks. The response of central banks to rising inflation, starting with the Fed, is what I think will ultimately lead to a repricing of risk in markets. The mismatch between rates and nominal growth in the economy is still significant meaning there is plenty of scope for rates to rise. Importantly, this would matter less if valuations were more supportive, but arguably extended valuations heighten the risk that even smaller changes in policy can have a disproportionate impact on asset risk premium.

Clearly, the Real Return strategy would have delivered higher absolute returns if we'd backed the risk trade. Ironically though, it's the markets that have performed the strongest this year that offer amongst the worst returns on a prospective basis, especially once adjusted for risk …. and have done for some time.

Our strategy remains to straddle the gulf between an environment of extended valuations and heightened capital risk with the more constructive cyclical backdrop of reasonable growth, low inflation and supportive policy. The likely pick-up in inflation will cause volatility to rise and some rebuild of asset risk premium. In the absence of a recession we expect (at this point anyway) to be a buyer on weakness but are not willing to risk investor capital on buying overextended and high risk markets at this point in the cycle.

While headline asset volatility (bonds and equities) has been low, sub-asset class volatility has seen more action. Currency markets have created opportunities. US dollar and GBP weakness (for different reasons) have created opportunities which we are taking in the portfolio. Likewise we are looking to position for a change in the volatility environment through a series of positions that will perform well should the current malaise be shaken off. These include a long US utilities v tech position, a long USD v AUD position, S&P put options and of course exposure to safe and liquid short dated securities and cash.

Fund details

ASX Code	GROW
Fund size (AUD)	$41,888,611
ASX Quoted Price	$3.6217
Fund inception date	August-2016
Management costs	0.90%
Distribution frequency	Normally twice yearly - June and December

Unless otherwise stated figures are as at the end of September 2017

Investment style

Our approach to inflation plus (or real return) investing is to choose the portfolio that has the highest probability of achieving the required return objective over the investment horizon with the least expected variability around this objective. The Fund employs an objective based asset allocation framework in which both asset market risk premium, and consequently, the asset allocation of the portfolio are constantly reviewed. The portfolio will reflect those assets that in combination are most closely aligned to the delivery of the objective.

Contact www.schroders.com.au
E-mail: info.schroders@linkmarketservices.com.au

Schroder Investment Management Australia Limited ABN 22 000 443 274 Australian Financial Services Licence 226473 Level 20 Angel Place, 123 Pitt Street, Sydney NSW 2000 Phone: 1300 136 471 Fax: (02) 9231 1119

Schroders