Schroder Real Return Fund
ASX: GROW

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

Monthly Report - May 2018

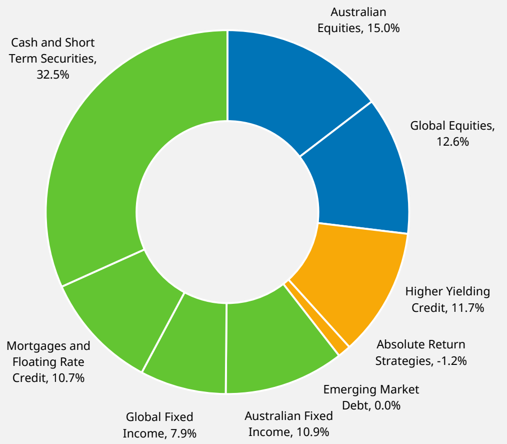
For more information about the Fund visit www.schroders.com.au/grow

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)	-0.29	0.37	3.64			5.11
Schroder Real Return Fund (Managed Fund) (post-fee)*	-0.36	0.15	2.71			4.17

Portfolio inception 09/08/2016, 1 years and 9 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 31 March 2018

3 months	0.53%
1 year	1.91%
3 years. p.a.	1.82%
5 years. p.a.	2.09%

*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 May 2018

Portfolio review

The Real Return Fund (ASX:GROW) posted a small negative return of -0.36% (post-fee) in May. The biggest drag on returns during the month was security selection in the active equity strategies which accounted for around 2/3 of the negative return during the month. This is turn largely reflected the ongoing “growth” thematic that has been a key driver of recent equity performance and a thematic we think has largely run its course. Modest gains in the $A, modestly wider credit spreads and a bounce in A-REIT’s on the back of developments in Westfield were also modest detractors.

Outlook and strategy

Markets were dominated by geo-political events in May, driving volatility over the month. The biggest impact came from Italy where the reverberations from the March 4th election continue. A power struggle between the Eurosceptic populists, strong performers during the March election, and the President, saw fears rise of another election and the potential of a populist win. This saw markets price in the risk of an Italian departure from the European Union. The US administration was also at the epicentre of the political uncertainties. With the US - China trade dispute, the US withdrawal from the Iran nuclear deal and negotiations around a historic meeting with North Korea's Kim Jong-Un adding to the uncertainty.

These concerns were felt most significantly in bond markets. After rising sharply in early May, global bond yields ended the month lower as events in Italy led to a 'flight to quality'. US 10 year Treasury yields initially rose by 0.18% to 3.13% before ending at 2.86% - a fall of 0.09% over the month. Both German and Japanese 10 year government bond yields also fell, with German bonds more impacted by issues in Italy. Italian 10 year bonds fully reflected the market’s fears with yields rising by 1.0% over the month. Credit spreads in both investment grade and high yield widened slightly over the month. Notwithstanding this volatility, equity markets had a reasonable month with US and Australian equities gaining ground. It was tougher going in Europe though as the concerns around Italy weighed on confidence.

At a recent investment conference I was challenged regarding our preference for Australian equities over global equities on a 1-3 year horizon. The overwhelming consensus in what was a relatively large room was that global equities were likely to be the best performing asset class over that timeframe, and that Australian equities would struggle.

I defended our position arguing we partly preferred Australian equities because the consensus was the other way inclined (the consensus isn’t typically right). While somewhat tongue in cheek there is an element of this in our thinking.

More fundamentally though, the key reason for our preference for Australian equities is that they look reasonable value in both absolute terms and relative to the global equity market. This generally translates through to better return prospects over the medium to longer term. To be clear, our valuation concerns with respect to global equities are mainly related to the US market, with the other major markets offering more favourable valuation support. This is important though as the US still comprises around 50% of the key global equity benchmark indices as well as being the tone setter in the shorter term.

The table below highlights this clearly. Across a range of metrics, the Australian market is trading on much less demanding multiple than the key US market.

		PE Ratio	Cyclically Adjusted PE	Price to Book	Price to Cash Earnings
US	Level	23.0	27.8	3.2	14.4
	% vs history	84%	86%	86%	91%
Australia	Level	15.4	17.3	2.0	10.8
	% vs history	45%	64%	66%	57%

Source: Datastream, MSCI and Schroders. Based on MSCI indices from 1970 to April 2018 (and 1975 for Price to Book Ratio).

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

Schroders

	1 mth	3 mths	6 mths	1 yr	3 yrs p.a.	mFund Code
Schroder Real Return CPI Plus 3.5% Fund Wholesale*	-0.44	-0.06	0.64	2.00	N/A	SCH12
Schroder Real Return CPI Plus 5% Fund Wholesale*	-0.57	-0.27	0.61	2.77	3.15	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%.

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Outlook and strategy continued

The reasons for this are partly compositional. The stocks that have been driving US multiples up are technology related stocks where investors have been prepared to pay up for future potential growth. This may or may not be the case, but certainly current pricing requires some pretty solid earnings outcomes to validate them. In contrast, Australian stocks have been somewhat unloved. While earnings growth has rebounded in Australia in recent years, much of this has come from resources, which are clearly much more cyclical than the US growth stocks that have been attracting all the attention and investor demand. That said, even conservative assumptions around commodity prices suggest decent and sustainable earnings from the major commodity producers. Another factor that has clearly held back the Australian stock market has been the banks. Australian banks represent 26% of the ASX200 and have been challenged by a potentially structural softening in credit growth, concern about the housing sector, and more recently, the focus and publicity of the Banking Royal Commission. Given the recent poor performance of banks, much of the potential downside appears priced.

To be clear, short run correlations between equity markets are likely to remain high. If our concerns about the US are validated, then at some point we will see a significant retracement in US stock prices and other markets (including Australia) will be dragged along. However, looking through this, we would rather own the market that has underperformed and has a more negative view priced in, then one that is arguably still priced for something close to perfection. None of this takes into account the higher dividend yields and franking benefits for Australian investors.

The above is reflected in the portfolio. We have more Australian equity exposure than we do global equity and with some short US S&P futures positions and some S&P put options have only a low, single digit effective exposure to the US. We also recognise that the US will have a big impact on the broader direction of markets and this is why our aggregate equity exposure is on the modest side. While the broader cycle in risk assets may not be over yet, we are much closer to the end than the beginning.

We did make a couple of changes to the portfolio in May. In early May (before the European concerns erupted), we closed the short Bund (German bond) versus US Treasury position given growing uncertainty over European growth and policy and we added a long Nikkei (Japanese equity) futures position given reasonable return prospects for Japanese equities.

Fund details

ASX Code	GROW
Fund size (AUD)	$46,996,687
ASX Quoted Price	$3.6521
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 May 2018

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.

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