

Schroder ISF* US Equity Alpha Fund Update

Covering May 2013

Overview

US equities continued its positive run in May and the S&P 500 ended the month up by 2.3%. Economic data was mixed but started off relatively positive as the US non-farm payrolls report for April surprised on the upside with an increase of 165,000 jobs. The May Chicago Purchasing Managers' index also rose and exceeded expectations. In the third week of the month investors were unnerved when the latest policy minutes from the Fed were released. Fed Chairman Ben Bernanke noted that if there is a continued and sustainable improvement in the US economy the Fed could reduce the pace of its asset purchases – which have been the main engine behind strength in US equities this year. Over the rest of May, the market came under pressure as investors remained uncertain over when the Fed would scale back its quantitative easing programme. We aim to provide investors with concentrated exposure to US equities, investing with a growth bias to identifying companies with unrecognised or under-appreciated earnings potential.

The market and the drivers of fund performance

The fund outperformed the benchmark over the month. The best performing stock was **Fortune Brands**, which outperformed after reporting first quarter 2013 earnings well ahead of expectations. In addition, the cash redeployment story is slowing starting with the announcement of a small, but accretive acquisition. **LyondellBasell** outperformed following its first quarter 2013 earnings report at the end of April. The company reported another strong quarter despite what continues to be a relatively soft macro environment, demonstrating the ability of the management team to execute well. The company also continues to redeploy all of its excess cash in the form of share repurchase, supporting our multi-pronged investment thesis. **Citigroup** continued its outperformance following its first quarter 2013 earnings release in mid-April, when the company delivered a strong quarter with high quality earnings. Capital markets activity, expense control, and the reduction of Citi holdings were all better-than-expected and net interest margin should be stable for the year.

SLM Corp also added value following an announcement that the company would split into two. This that highlights the value in SLM bank. We continue to like the company and have slightly raised our price target. Elsewhere, **Facebook** underperformed despite earnings results which were on target and a bounce in mobile advertising. Investors seem more worried about the weakness in desktop advertising, which we see as part of the Facebook evolution story. However, we think fundamentals will ultimately disprove these worries later this calendar year, as desktop activity finds a trough. Furthermore, consumer engagement remains strong despite these worries. Telecommunications was the second worst performing sector in the S&P 500 in May and our position in **SBA Communications**, operator of wireless communications infrastructure, detracted. Its wireless towers group have been weak reflecting macroeconomic concerns and also worries about capital spending given the acquisition of Sprint by Softbank. Our investment thesis, based on the ultimate need for infrastructure build in the US, should ultimately drive off these macroeconomic concerns.

The market outlook and portfolio strategy

Year to date, our market outlook has been one of cautious optimism as we expected 1) US economic growth and earnings to be stronger-than-expected in 2013 2) the Federal Reserve to remain extremely accommodative, 3) equity markets to begin to draw investor attention given the high valuations for bonds. All of these have played out into another shockingly strong year-to-date US equity market return, especially when compared to some other international equity markets. While some remained worried about a sharp correction, we think it is more likely we will see some consolidation in the summer months, from which we move higher later in the year. We simply need market fundamentals to catch-up to where we have moved today. We continue to focus on company specific stories where we think earnings growth is being underestimated. Given how strong the year has been so far, our view on US equity returns has increased to over 10% for 2013 – admittedly this is based more on an upward valuation than higher earnings. Perhaps we will prove to have been too optimistic, but we see US positioning as much stronger than other developed markets globally, and believe this should provide a strong long-term return profile for the US.

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