

Schroder ISF* Japanese Equity Fund Update

Covering April 2013

Overview

After a weak start to April, the Japanese equity market rallied strongly to produce a return of 12.6% in local terms over the month. The renewed strength in the market was triggered by the first meeting of the newly-constituted Policy Board of the Bank of Japan under the leadership of Mr Kuroda, the new Governor. The Board reached agreement for a new phase of monetary easing which at least matched or, in some respects, exceeded investors' expectations.

At the end of the month, a second Bank of Japan meeting produced no further policy changes, but did reveal significant increases in the Bank's internal forecasts for growth and inflation over the next two years. We maintain our mild cyclical bias and focus on laggards rather than recent winners and aim to identify stocks that will be able to show sustainable earnings improvement in the coming years.

The market and the drivers of fund performance

After a weak start to April, the Japanese equity market rallied strongly to produce a return of 12.6% in local terms over the month. Several financial-related sectors were exceptionally strong, especially securities firms, 'other financials' and real estate. Underperforming sectors were more mixed but several cyclical areas such as mining, pulp & paper, oils and wholesale trade lagging the market.

The fund outperformed the benchmark in April. Strong stock selection in the banks and electric appliances sectors contributed the most to relative performance over the month. Non-bank financial company, **Orix Corp** and one of largest banks in Japan, **Sumitomo Mitsui Financial Group** were among the largest contributors to returns, directly benefiting from the market rise. Our lack of exposure to **Mitsubishi Corp**, **Fanuc**, and **Sony**, added value after it underperformed the market. Elsewhere, general trading company **Mitsui & Co** continued to detract from performance after concerns about China's macroeconomic outlook continued to depress commodity prices. We believe this will reverse over the longer-term as its valuations and fundamentals are attractive. The fund was also hurt by our position in **T&D Holdings**, a life-insurance holdings company, and auto-part manufacturer **Aisin Seiki**.

Market outlook and portfolio strategy

The positive impact from the Bank of Japan's policy changes should continue to be felt in the equity market in coming months. Both the Bank of Japan and the Abe administration continue to make strong positive statements about future policy intentions, suggesting that a real shift in thinking has taken place. Combined with the weak yen, we believe equity market sentiment should remain strong over the short term. The next core event on the horizon is the Upper House elections in July, in which the Abe administration still appears on track to gain a majority. By June we should also see the formulation of the government's policies to stimulate longer term growth. The results season for the fiscal year to March 2013 had just begun at the end of April and will continue through the first two weeks of May. Early indications suggest that corporate profits are broadly in line with expectations but companies are making quite conservative forecasts for the year to March 2014. This should leave room for upward revisions to forecasts if conditions continue to improve in the first half of this fiscal year. We maintain our mild cyclical bias and continue to favour cyclical names, such as autos, trading companies and IT software developers. As a result, we are modestly overweight currency sensitive sectors. We currently focus on laggards rather than recent winners and aim to identify stocks that will be able to show sustainable earnings improvement in the coming years.

*Schroder International Selection Fund.

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