DOSSIER
Effective downside risk management

FUNDS
Gold equities: investing in bright perspectives

INVESTMENT IDEAS
ESG: Painting by numbers

SPECIAL FEATURES
The economic impact of Donald Trump’s election victory
## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SCHRODERS’ NEWS</strong></td>
<td>04</td>
</tr>
<tr>
<td><strong>DOSSIER</strong></td>
<td>06</td>
</tr>
<tr>
<td>Retirement planning:</td>
<td>06</td>
</tr>
<tr>
<td>an income strategy for old age</td>
<td>06</td>
</tr>
<tr>
<td>Effective downside risk management</td>
<td>12</td>
</tr>
<tr>
<td><strong>Funds</strong></td>
<td>18</td>
</tr>
<tr>
<td>Gold equities:</td>
<td>18</td>
</tr>
<tr>
<td>investing in bright perspectives</td>
<td>18</td>
</tr>
<tr>
<td>Oil: The lubricant of the global economy</td>
<td>22</td>
</tr>
<tr>
<td><strong>DEMOGRAPHICS CORNER</strong></td>
<td>24</td>
</tr>
<tr>
<td>Ageing and economic growth, revisited</td>
<td>24</td>
</tr>
<tr>
<td><strong>MARKETS</strong></td>
<td>26</td>
</tr>
<tr>
<td>Top performers</td>
<td>26</td>
</tr>
<tr>
<td>Global economy in pictures</td>
<td>27</td>
</tr>
<tr>
<td>Real estate: „Retail is Digital“</td>
<td>28</td>
</tr>
<tr>
<td>Trump victory: after initial boost, weaker growth and higher inflation likely</td>
<td>32</td>
</tr>
<tr>
<td><strong>SPECIAL FEATURES</strong></td>
<td>34</td>
</tr>
<tr>
<td>Painting by numbers – the difficulties of measuring sustainability</td>
<td>34</td>
</tr>
<tr>
<td>riskIQ – an intelligent balance</td>
<td>38</td>
</tr>
<tr>
<td><strong>MISCELLANEOUS</strong></td>
<td>40</td>
</tr>
<tr>
<td>You are what you (no longer) eat – Flexitarians</td>
<td>40</td>
</tr>
<tr>
<td>From the UK:</td>
<td>42</td>
</tr>
<tr>
<td>The most important playwright of all time – William Shakespeare</td>
<td>42</td>
</tr>
<tr>
<td>History of Schroders: Bond issue, 1856</td>
<td>44</td>
</tr>
<tr>
<td><strong>SERVICE</strong></td>
<td>47</td>
</tr>
<tr>
<td>Who we are</td>
<td>47</td>
</tr>
</tbody>
</table>
The future is and remains exciting!

Is it the same for you? It feels like only yesterday that I was wishing you a Happy New Year. And now I am already holding the winter edition of EXPERT in my hands. Could it be that this perception of speed has something to do with digitalisation, which is bringing both huge challenges and enormous opportunities for our industry?

But for anyone who looks to the long term and acts with deliberation, like Schroders, rather than focusing on the immediate, it’s perfectly clear: the benefits clearly outweigh the risks. I already mentioned to you that Schroders is using teams of specialists from Formula 1, making us ideally positioned to capture the key competitive advantages from smart data analytics.

It’s the same with another recent partnership: in August we launched Schroder GAIA Two Sigma Diversified in a UCITS wrapper with the now nearly legendary Two Sigma Advisors, focusing on the most innovative technical approaches to managing liquid alternative investments. Science and investors’ interests have rarely been so closely intertwined: not only does Two Sigma use massive computer power to crunch vast quantities of data, its 1,000 or so employees include over 150 PhDs in almost every area of IT and natural sciences.

The bottom line is that this exceptional partnership emphasises what matters in our industry: adding value, intelligently. If you can come up with smart ideas you can withstand the increasing regulatory pressure on margins and, as an active manager, counter the squeeze from passive ETFs.

For instance with solutions for the highly important group of pensioners, who need a combination of stable, real growth in early retirement with some sort of longevity insurance in later old age – read more about this on the following pages. Or for the young millennials, more than 90% of whom say they want to know more about financial matters and also need advice from financial advisors for their own decisions: these are the conclusions from our global survey of more than 20,000 investors, covered in this edition.

The future is and remains exciting – and all of us at Schroders are proud to be actively shaping the future with you as our partners. I wish you a successful year-end rally and a relaxing holiday period.

Yours,

Ketil Petersen
Country Head
Nordic Region
**Thought Leadership at Schroders – in a new light with commodities**

Carrying out pioneering research, demonstrating opinion leadership and elaborating the most relevant content and the most important success factors for solving the most important challenges for asset managers: These are the criteria the jury of the international magazine Funds Europe consider in awarding a prize for European Thought Leadership. The winner 2016 is Schroders – Not least because innovation, thinking out of the box and looking beyond our own world has been our tradition for more than 200 years. A very recent example is commodities in a new light: Investors have lost interest in commodities over the past few years and are questioning the value of an entire asset class. We, on the other hand, ask whether commodities can make a valuable contribution to a portfolio. In a comprehensive analysis we found that commodities are one of the few asset classes that we can justifiably claim is undervalued. To cut the chase, we believe that committed managers can now find ideal opportunities.

**GAIA platform with two new equity strategies: USA and Asia-Pacific**

Schroders is complementing its successful UCITS GAIA platform with two new funds: Schroder GAIA Two Sigma Diversified and Schroder GAIA Indus PacificChoice. The solution developed by Two Sigma Advisers and Schroders has been available since August, combining market-neutral US equity strategies with global macro topics. The objective of **Schroder GAIA Two Sigma Diversified** (unit class C, acc., LU1429039461) is, on the one hand, to enable investors to implement an effective portfolio diversification using a liquid alternative strategy. On the other hand, the fund should correlate to the smallest extent possible with traditional bond and stock markets. To achieve this, the investment strategy has a sound scientific basis and an algorithmic approach that leverage thousands of individual securities and hundreds of macro markets as an investment universe; a clear focus is on a market-neutral equity strategy.

Together with Indus Capital Partners, Schroders provides access to a pan-Asian long-short equity strategy, **Schroder GAIA Indus PacificChoice** (share class K, acc., LU1429038141) invests in equities and in equity-linked securities. The objective is to achieve high risk-adjusted returns while at the same time preserving capital in difficult market phases. The investment universe covers the entire Asia-Pacific region including Japan, China, India and Australia. The strategy is based on an existing UCITS fund under Indus management that has generated a positive annualised net return of 4.02 percent from its launch in January 2011 until the end of July 2016. By way of comparison, the MSCI AC Asia Pacific Index was only 1.34 per cent during the same period.

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1 Source: Schroders as per 31/07/2016.
"Investors overestimation of their own abilities and the help they seek" – under this headline, we present the results of a survey conducted among 20,000 investors in 28 countries in the spring of 2016. The first part to be published dealt with the, not always, bright prospects for the most carefree retirement possible with statutory retirement benefits. Since in many cases this is not sufficient, the second part of our study results concerns the Millennial generation, financial education and the role of asset managers.

Our study also shows that many investors have an unrealistic idea of the returns on their investments – combined with an inflated sense of their abilities, this can be an explosive mix for retirement. Here, we have developed incomeIQ in order to provide consultants with suitable tools, and we are continuously expanding our range of interactive tools and explanatory videos.

You can find out more about the Schroders Global Investor Study 2016 and the study results online at http://bit.ly/2fr2Xt0

**The most important figures at a glance:**

- Almost half, 45 per cent of respondents in Sweden compared to 37 per cent of all participants were able to correctly describe the role of an asset manager and, for example differentiate them from an investment bank.
- Despite what might be an astonishing result, 87 per cent of investors worldwide consider their investment knowledge to be at least average or believe they know more than the average investor.
- The good news: Even if investors greatly overestimate themselves and their abilities, the overwhelming majority of 89 per cent of all survey participants would like to learn more about financial matters – with the Millennials even reaching 91 per cent.
- A solid half of the approximately 20,000 respondents in both age groups (51 per cent of the Millennials versus 49 per cent of the over 36-year-olds) said they would like to consult a financial consultant for future investment decisions.

**Smarter access in emerging markets: Now with currency hedging in Euro**

“Our new multi-asset fund provides smart access to emerging market investment opportunities,” said Aymeric Forest, the European multi-asset and portfolio manager of Schroder ISF* Emerging Multi-Asset Income, in July 2015 when speaking about the latest multi-asset range by Schroders. The multi-asset expert saw the opportunity for higher risk-adjusted returns in mixed emerging market portfolios than in pure equity or bond portfolios. And based on the success, he’s right – after all, US dollar class A accumulation units were at the end of September 2016, at + 13.01 %, which gave the fund a top place among Schroders’ mixed funds from the start. The good news for investors in the euro zone: since 24 August 2016, a euro hedged distributing share class has been available (LU1469675745), which, in addition to currency hedging and the prospects for further positive development, also offers a fixed annual dividend of 5 %.

*Schroder International Selection Fund is referred to as Schroder ISF.
Retirement planning: an income strategy for old age

We have been looking into what people from around the world do with their defined contribution savings after they retire. No market has yet found the ideal strategy. The risks and degree of uncertainty involved often lead to conflicting objectives. Last year, we suggested some principles that any investment solution would need to follow to reconcile these conflicts. Having since drawn on the experience of other markets, we now propose an income strategy that combines stable, real growth in early retirement with some sort of longevity insurance in later old age.

LESLEY-ANN MORGAN
GLOBAL HEAD OF DEFINED CONTRIBUTION

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1 See “Global lessons in developing post-retirement solutions”, Investment Perspectives, May 2015, for the longer version of this article with the detail on individual countries. 2 See “Pointers towards a better pensions landscape”, Investment Horizons, issue 2, 2014.
In arriving at this solution, we discovered that certain risks and requirements were common to pensioners the world over. Four key areas of uncertainty stood out:

1. **Investment** – the risk of earning less than expected
2. **Longevity** – the risk of living longer than expected
3. **Inflation** – the risk of prices rising faster than expected
4. **Consumption** – the risk of spending more than expected.

Of these risks, the only one where the individual has any direct control is consumption. The relative importance of the other three changes over time. Figure 1 shows the impact of a small change in each of these key variables.

Early in retirement, the risk of not achieving sufficient returns is the major worry, as there is still a significant period of time over which to grow the assets. The threat from inflation is also at its highest early on for the same reason: there is a long period of time over which the uncertainty can manifest itself. Longevity risk starts out relatively small, owing to the high probability of survival through the early years. However, this risk grows with age, reflecting the fact that longevity is self-fulfilling, i.e. the probability of reaching 90 is much higher at 89 than at 65.

This insight helps to focus the solution on the appropriate risk at each stage of retirement. When the savings are largest, generating strong real investment returns with limited losses will provide the biggest benefit. As the pensioner ages, and withdraws income from the account, protecting them against the risk of their outliving their savings should be the main focus.

There is a clear gap between what individuals need in their post-retirement solution and what they want. To manage the economic and actuarial risks outlined above, individuals require a solution to provide certain features. Their most basic needs would include flexibility, stable returns, inflation protection and longevity protection (primary criteria). But they are also likely to want predictable income, simplicity, adequacy and legacy benefits (secondary criteria).

Clearly a number of these factors conflict with each other (for example, predictability versus flexibility) and it is therefore difficult to rank them in order of importance. As with many investment decisions for individuals, a balance of factors is likely to be most effective.

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**FIGURE 1: SENSITIVITY TO LONGEVITY RISK INCREASES THROUGH RETIREMENT**

Investors, on average, believe a state pension will contribute 18.8% of their retirement income

[Source: Schroders Global Investor Study 2016]

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For illustration only. Source: Schroders.
Components of a post-retirement solution

There are essentially three components of post-retirement income provision:

1. Cash lump sum
2. Investment accounts providing non-guaranteed income
3. Longevity protection, likely to include some type of annuity.

Any of these components is unlikely, in isolation, to be sufficient on its own. In Figure 2 we analyse how they stack up against our primary needs criteria.

In our opinion, the ideal solution should have as many “green lights” in the primary criteria box as possible. Since no single product meets all of these criteria, a combination of components is required. The solution should focus on maximising risk-controlled growth opportunities in the early stages before adjusting to protect against longevity risk later on, fitting the pattern of risk sensitivities as the pensioner ages.

There are a number of ways to hit these moving targets. We believe all would probably need to combine guaranteed income from an annuity with a non-guaranteed, variable income from an individual account. Here we have outlined three possible “blends” of these two components:

1. Account-based income with deferred annuity. All income in the first few years would come from an investment account, supplemented in later (“frail”) old age by an annuity bought at retirement but whose guaranteed income is deferred until needed. In our modelling, we have assumed 30% of the account would be spent at 65 on a deferred annuity which begins to pay out at 80. If the pensioner were to use a balanced portfolio of equities and bonds for the remaining savings, we found that account-based income would typically run out at around 89 using this approach, although the annuity would obviously continue to pay out.

2. Account-based income converted to an annuity in later years. All income for the first few years would come from an investment account, later transformed into guaranteed income from an annuity bought when needed in frail old age. We again assumed the pensioner would start drawing on the annuity at 80. The risk here is, of course, that annuity rates move unfavourably in the years between retirement and

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**FIGURE 2: HOW WELL DO THE TYPICAL COMPONENTS ANSWER THE PENSIONER’S BASIC NEEDS?**

<table>
<thead>
<tr>
<th>Primary criteria:</th>
<th>Longevity protection</th>
<th>Growth net of fees</th>
<th>Protect against big losses</th>
<th>Inflation protection (costs)</th>
<th>Inflation protection (spikes)</th>
<th>Flexibility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash lump sum</td>
<td><img src="true" alt="Likely to satisfy" /></td>
<td><img src="false" alt="Unlikely to satisfy" /></td>
<td><img src="true" alt="Likely to satisfy" /></td>
<td><img src="false" alt="Unlikely to satisfy" /></td>
<td><img src="true" alt="Likely to satisfy" /></td>
<td><img src="false" alt="Unlikely to satisfy" /></td>
</tr>
<tr>
<td>Individual accounts</td>
<td><img src="true" alt="Likely to satisfy" /></td>
<td><img src="false" alt="Unlikely to satisfy" /></td>
<td><img src="true" alt="Likely to satisfy" /></td>
<td><img src="false" alt="Unlikely to satisfy" /></td>
<td><img src="true" alt="Likely to satisfy" /></td>
<td><img src="false" alt="Unlikely to satisfy" /></td>
</tr>
<tr>
<td>Fixed annuities</td>
<td><img src="false" alt="Unlikely to satisfy" /></td>
<td><img src="true" alt="Likely to satisfy" /></td>
<td><img src="false" alt="Unlikely to satisfy" /></td>
<td><img src="true" alt="Likely to satisfy" /></td>
<td><img src="false" alt="Unlikely to satisfy" /></td>
<td><img src="true" alt="Likely to satisfy" /></td>
</tr>
</tbody>
</table>

- **Likely to satisfy**
- **Unlikely to satisfy**
- **Mixtures depend on product, investments and market environment**

For illustration only. Source: Schroders.

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3 Assumptions used. Pensioner: final salary of $50,000; aiming to replace 60% of work income; savings equal to 12 times final salary; retirement age of 65; annual withdrawals midway through year; mortality probabilities from UK life office male pensioners combined lives’ data, Institute and Faculty of Actuaries. Investment: period covered, 1952 to 2013; cash, all invested in US three-month deposits; equities, 70% S&P 500 Index, 30% MSCI EAFE Index; balanced fund, 50% S&P 500 Index, 50% US 10-year Treasury bonds; inflation, US Consumer Price Index All Urban, seasonally adjusted.
reaching 80. Our backtest showed that the remaining “pot” of savings would typically only purchase an annuity sufficient to provide four-fifths of the income target of 60% of pre-retirement earnings.

Account-based income with immediate annuity. All income from start to finish would be provided by a combination of an investment account and an annuity. In this case, we assumed that half the initial income would come from a level annuity, with the investment account providing a rising top-up to that. We found this continued to pay out until after 90 in half the backtested scenarios, although in 30% of cases it had run out at 85.

Weighing up the pros and cons, we considered that option 1, which relied on an account-based income and a deferred annuity, came out ahead. Testing this strategy against the pensioner’s “needs” and “wants” mentioned earlier, we see an increased number of green lights, as shown in Figure 3.

Principles for a successful post-retirement solution

There are many variables in retirement: how long people will live for, the costs of goods and services, interest rates and so on. Faced with this degree of uncertainty, people tend to make poor decisions.

In light of this, we believe that pensioners need guidance on what constitutes a good quality retirement solution. Given the general absence of such guidance, some have argued for the creation of a post-retirement “default strategy” to provide pensioners with a better starting point for these decisions.

However, it is not an approach we would advocate for several reasons. Clearly, every individual’s circumstances differ and no single default can fit all. As a result there is the potential for mis-buying/mis-selling risks. At the same time, although financial literacy remains low in many markets, greater access to the internet and more sophisticated financial analysis using the web make it easier for people to make investment decisions. And, of course, there is always a minority who welcome choice so that they can tailor their own finances. Last, and by no means least, it is difficult to see how one would get agreement on what should constitute a “default” approach.

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**Primary criteria:**
- Longevity protection
- Growth net of fees
- Protect against big losses
- Inflation protection (costs)
- Inflation protection (spikes)
- Flexibility

**Account-based income with deferred annuity**

- Likely to satisfy
- Unlikely to satisfy
- Mixtures depend on product, investments and market environment

**Secondary criteria:**
- Predictability of income
- Legacy benefits
- Simplicity
- Sufficiency

**Account-based income with deferred annuity**

For illustration only. Source: Schroders.
Instead, we favour an approach that seeks to establish a set of principles which are the necessary conditions for good quality retirement solutions. In the UK there have been preliminary discussions about awarding a “kitemark” to suitable funds which meet certain standards. This would be comparable to “QDIA-approved” funds in the US which are officially authorised for use as a default in the pre-retirement stage.

However, an overarching solution is far broader than simply a fund or insurance product. Where a fiduciary is involved, for example in a corporate pension plan, a pensioner could be given a shortlist of suitable investment funds and a shortlist of suitable longevity protection options from which to choose (see table below). The individual would choose the proportion to allocate to each list, subject to a minimum. If permitted and tax-efficient, a partial cash lump sum might also be taken. A typical set of choices might be as follows in Figure 4.

Using technology and real-world assumptions, individuals could assess the likely impact of different choices on the illustrative outcomes they receive, with a clear distinction between guaranteed and non-guaranteed benefits, and the purchasing power of future income. This choice could be revisited on a regular basis. At some point, as our earlier analysis showed, there is a tipping point beyond which the protection component becomes far more valuable.

The options in list A would provide stable, real investment returns and be

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**FIGURE 4: SELECT ONE EACH FROM LIST A AND LIST B. CHOOSE THE AMOUNT TO ALLOCATE TO EACH.**

<table>
<thead>
<tr>
<th>List A</th>
<th>investment component</th>
<th>List B</th>
<th>protection component</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Fund targeting inflation 1–2 % p.a.</td>
<td>1.</td>
<td>Immediate annuity</td>
</tr>
<tr>
<td></td>
<td>over the long term</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>Fund targeting inflation 3–4 % p.a.</td>
<td>2.</td>
<td>Deferred annuity (starting at age 85)</td>
</tr>
<tr>
<td></td>
<td>over the long term</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td>Delay annuity purchase until later in</td>
<td>3.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>retirement</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

For illustration only. Source: Schroders.

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£s difference between average earnings and maximum state pension in Australia. Schroders Global Investor Study 2016 reveals that investors are potentially sleepwalking into a financial crisis later in life.

[Source: Schroders Global Investor Study 2016]
able to adapt to changing requirements. In reality, this means that the funds in list A are likely to be well diversified and fairly liquid. Clearly the kitemarked/approved components in both lists should offer value for money, but this should not be confused with “cheap”. A purely passive strategy is unlikely to deliver the outcomes that pensioners need. Individuals should be encouraged to make their selection with guidance or advice at this important point in their lives.

For pensioners where no fiduciary is involved, providing guidance and having approved choices should help them with this difficult decision and improve outcomes for them. Asset managers and insurers should take some responsibility for the thoughtful design of these strategies.

CONCLUSIONS

We looked at how different parts of the world tackle the conundrum of how to create a safe and sufficient income in retirement. We concluded that a successful post-retirement strategy needs to adopt principles that address certain common risks: stable, real investment returns, flexibility to adapt to changing requirements, simplicity in implementation and communication, and reliable protection against longevity risk.

The resulting solution will therefore combine investment and insurance components. With lengthening life expectancies, we anticipate account-based strategies will blend a growth and income approach for the first 15–20 years after retirement, with longevity protection engaging in later life. We believe this approach would help shift the post-retirement conversation towards a long-term investment solution more likely to provide an income that would match pensioners’ realistic expectations.
Effective downside risk management
Since 2008, the desire to avoid significant portfolio losses has, more than ever, been at the front of investors’ minds. The approach to managing downside risk, however, necessarily differs for every investor. We present some of the issues which should be considered, looking at different ways of managing downside risk, before putting these all together.

**The demand for downside risk management**

Since the market crisis in 2008, the demand for strategies that protect against significant negative returns has increased substantially. It is partly the fear that we are in a market environment that is unfamiliar to most market participants, with limited central bank policy options and with uncertain outcomes, that has led to this interest.

Meanwhile, yields on ‘safe haven’ government bonds have fallen so low that there is no obvious diversifying asset. Traditional balanced portfolios have become better diversified over time through the addition of new asset classes, but increased globalisation, and the consequent interdependence of asset classes, has led to an increase in their correlation at times of crisis.

Institutional investors and pension funds are looking for new ways of limiting risks as they face greater pressure from stakeholders to be better protected in the event of a repeat of the 2008 crisis. This is evidenced by an exponential increase in the demand for volatility-based instruments such as options and volatility futures.

**Issues that investors should consider**

Investors’ approach to managing risk should be determined by a number of key decisions:

“**Risk tolerance** – it is important to be able to assess the investor’s tolerance of failure to achieve his or her objectives, such as target return and the ability to cope with a large loss. This will help define how much downside protection an investor requires. Risk tolerance also needs to be continually reassessed in the light of market movements. An investor who can tolerate a 10% fall in markets may not retain the same tolerance after markets have already fallen 10%.

“**Time horizon** – downside risk management may not be appropriate if investors are comfortable with the short-term volatility from marking to market on a daily basis.

“**Cost** – investors need to assess how much they are willing to pay for protection against an event affecting their portfolio given the probability of that
event occurring. Downside risk strategies have a cost that is either fixed or could, by capping upside returns, have an opportunity cost if the event does not occur. So investors need to assess the trade-off between any potential gains and losses.

"The assets to be protected" – while downside risk management is often thought to apply primarily to equity markets, in the recent liquidity crisis most asset classes became high correlated. We believe that it is more appropriate to apply such strategies at the overall portfolio level.

Strategies for managing downside risk

1. Effective portfolio construction
The traditional 60% equity/40% bond portfolio is still exposed to the systemic risk of a collapse in markets precipitated by a severe downturn. Increased globalisation and the interdependence of asset classes have led to an increase in their correlation at times of crisis, and in 2008 liquidity risk was not adequately diversified away for most investors.

Effective portfolio construction is essential in managing downside risk and the evolution of more sophisticated diversification methodologies has helped to reduce risk without materially compromising expected return. Some traditional balanced portfolios have become better diversified over time through the addition of new asset classes. This should improve the quality of the growth engine by mixing or replacing the equity portfolio with alternative assets that deliver equity-like returns but with lower volatility.

Many leading investors are now focusing on risk weighting rather than capital weighting, and on risk premia rather than asset classes. This should lead to better diversified portfolios that are less susceptible to drawdowns. Even risk premia, however, are subject to mispricing and a liquidity shock can cause a dramatic increase in their correlation.

We recommend that, in addition to effective portfolio construction using risk premia, investors who are sensitive to downside risk should also consider other strategies such as core downside risk protection strategies and tail risk hedges.

2. Core protection
Core protection is designed for normal market conditions and provides a positive pay-off in moderate corrections. Core strategies are low cost and are typically spread strategies which involve buying one instrument and selling another simultaneously to reduce the cost of the protection. Examples of core protection include:

"Put spread" – buying a put option and simultaneously selling another put option with a lower strike price. This will provide protection for falls above the price at which protection was sold but will offer no additional support for much deeper corrections. Put spreads should be considered in situations where volatility has already spiked but where there is a risk that the market continues to
sell off. This would offer investors the opportunity to add protection at a lower cost, while the already elevated levels of volatility suggest that the probability of a more pronounced downturn is limited. The risk is of a more severe correction, that would see the loss from the protection that has been sold overwhelming the gains from the protection that was purchased.

"Collar" – buying a put option and selling a call option to fund the protection. The strategy is outright long protection and will outperform during a crisis, however the capped upside can cause severe underperformance if the market rallies sharply. Collars should be considered when equities appear expensive and large upside gains are believed to be limited. The strategy will do well at the beginning of a correction and when the trend to the downside is strong, although the upside cap makes collar strategies more sensitive to bear market rallies.

"Rolling calendar collar" – in its simplest form the rolling calendar collar involves buying a long-dated put option and funding the purchase by selling a succession of short-dated call options. By selling short-dated call options the strategy benefits from the time decay on the call. Additionally, the probability that the call is exercised over the one-month time frame is low, reducing the risk of losses on the upside cap. Rolling calendar collars are useful in a normal market environment where the risk of a sharp rally is low.

3. Tail risk protection
Tail risk hedges are designed to provide significant absolute gains during extreme market corrections. Tail risk strategies exhibit a negative correlation to risk assets; consequently these assets have gained popularity amongst investors as an alternative source of diversification. However, the biggest drawback for tail risk strategies is the cost of maintaining the exposure. Put simply these strategies offer portfolio insurance but the upfront premium that must be paid can be significant. There are specific volatility-based instruments to provide tail risk protection.

"Buying put options" – provides a large pay-off during a crisis. The disadvantage is the upfront premium which can lead to a meaningful performance drag for a buy and hold strategy. Moreover, put options are sensitive to the movements in the underlying equity index and the time to maturity. The value of the option erodes with the passage of time and a significant fall in the underlying index may be required to offset the losses incurred as the option approaches expiry.

"Volatility (VIX) futures" – exchange-traded futures on implied volatility indices such as the VIX index are the most commonly traded volatility instrument. Periods of market stress are often associated with a spike in volatility and, as a result, buying volatility futures can hedge against a fall in markets. But there are also limitations to holding these instruments. In
order to maintain a constant exposure to volatility, the futures contracts are rolled at expiration. During calm markets the volatility futures curve is upward sloping, where the price of long-dated volatility is higher than short-dated volatility and as a consequence the investor is exposed to a roll cost. This cost can be significant and damaging to returns. Additionally, volatility is mean reverting and high levels of volatility cannot be sustained for an extended period.

“Volatility options (VIX Options) – a long volatility position is established by buying a call option. The maximum loss is limited to the premium outlay; however, this outlay can be high and reflects the slope of the volatility futures curve as well as the supply and demand dynamics for the options.

“Third party indices – to overcome the high costs of holding volatility instruments a number of third party indices have been developed to provide exposure to volatility at much lower costs. These indices are based on a set of rules that determine the allocation to volatility futures. They can provide a way to mitigate the disadvantages of volatility futures although no single approach holds the answer.

“Variance swaps – provide exposure to future realised variance and, like volatility futures, they exhibit a negative correlation with risk assets. In addition, variance swaps can magnify the returns during periods of market stress.

Because the systematic purchase of tail risk protection can be costly, a tactical approach is inherently appealing. The time available to make a profit through the tactical management of options or volatility futures can be very short since, by its very nature, a crisis does not tend to endure and may reverse quickly. Therefore tail strategies must be opportunistically applied. A framework for when to apply tail protection is essential.

4. Rules-based approaches
We have discussed taking a dynamic approach, but there are also systematic approaches that can be applied to portfolios. Rules-based strategies offer protection that is permanently embedded and that can insulate against severe market falls. These strategies involve trading decisions that are not based on active judgment but on the signal from a rule that is triggered by the prior performance of the asset. They can be suitable for investors who prefer approaches in which cause and effect can be easily identified. They contain elements of both core and tail strategies.

“Volatility cap strategies – set a maximum ‘acceptable’ level of volatility and reduce market exposure when the volatility of the portfolio exceeds this level. Volatility caps are often used as a tool to reduce, or give more certainty to, the hedging costs associated with guaranteed products.

Volatility cap strategies have typically been successful in meeting their objective of limiting
volatility and may result in reduced drawdowns in the case of a sustained market sell off. Although market exposure is unlikely to be fully restored during any rebound, the volatility-capped portfolio will typically start from a higher valuation base than a portfolio that lacks this mechanism for derisking.

"Constant Proportion Portfolio Insurance (CPPI)" dynamically allocates between a growth portfolio and risk-free assets in order to target a guaranteed minimum level of return. CPPI can deliver some exposure to a growth strategy as well as capital protection. However, the cost of this insurance can be that participation in any capital growth is limited. The outcome of a CPPI strategy can be affected by several factors including: 1) the degree of leverage to the growth asset 2) the time to maturity 3) changes in interest rates 4) a deterioration in the quality of the safe asset. Costs are associated with rebalancing, managing the gap risk and the quality of the bond portfolio used to construct the floor.

**5. Tactical asset allocation (TAA)**
This is a market timing strategy that allocates actively between different asset classes. This means increasing or decreasing exposure to various asset classes in response to changes in economic and financial conditions. TAA is usually based on a combination of quantitative and fundamental inputs but ultimately depends on the skill of the manager, and on the efficacy of his or her process, so as to enable a quick and accurate response to changing conditions.

TAA can add flexibility to a strategic portfolio and can potentially limit some of the downside risk in a prolonged cyclical downturn and reduce the risk of being exposed to elevated valuation levels.

**Putting it all together**
We propose a rigorous and diversifying approach to downside risk management through effective portfolio construction in combination with core protection and tail risk strategies, rules-based strategies or TAA. This requires a clear understanding of many factors, such as the investor’s risk tolerance and time horizon, so as to be able to use the most appropriate and cost effective strategies available.

Investors need to decide what risks they are concerned about: whether it is the risk of moderate but persistent falls (and therefore a core protection strategy is required) or the risk of very large market falls (in which case tail risk protection is more appropriate).

Or perhaps an investor is sensitive to both risks, in which case they might consider allocating a portion of their risk budget to a basket of conditioned strategies to hedge tail-risks, thereby improving diversification, and allocating another part of their risk budget to core protection strategies.

The manager must be aware of the cost of running these strategies, how to access them and the hidden risks – and have in place robust risk management systems and an effective operational platform.
Interview

Gold equities: investing in bright perspectives

We caught up with Mark Lacey and James Luke, managers of the new fund Schroder ISF Global Gold, to find out more about it and why it provides an attractive multi-year opportunity.

Please can you explain a little about the fund and its origins?
Schroders took the decision to convert Schroder AS* Gold and Precious Metals Fund, which primarily invested directly in the commodities themselves, into a fund which invests predominantly in the equities of companies involved in the gold industry. We are the same fund managers and there will be no changes to the process or the investment philosophy, but the fund’s benchmark did change from one which blends physical gold and gold equity exposures to one which is solely gold equity focused. In its new form the fund aims to outperform the FTSE Gold Mines Index by 3% p.a. Outperformance will still come from stock selection and through commodity asset allocation decisions, in line with our long-running active commodity strategy. The fund is still able to gain outperformance by allocating strategically to physically backed gold, silver, platinum and palladium ETFs when stocks appear expensive, as well as use cash to preserve performance when necessary.

Why are you so positive about the long-term prospects for gold at the moment?
We think we are just entering a multi-year structural bull market for gold. Potential outcomes for currency, financial markets and inflation are arguably more extreme now than at any point since the end of the Second World War.

One of the core tenets of our view is that real interest rates (i.e. the nominal interest rate adjusted for inflation) are going to remain extremely low or even negative. Inflation risks are rising while Central Banks remain inherently dovish, partly due to worries over potential systemic risks emanating from Asia. Indeed, China has the potential to be highly influential on gold prices. Being long gold is an expression of a bearish view on China, in our opinion. Gold is also a hedge against potentially more extreme central bank policy, the inflationary outcomes of which are highly uncertain. With the effectiveness of QE apparently exhausted, a shift to more direct fiscal stimulus (so called print-and-spend or “helicopter money”) has become increasingly mainstream as a potential policy.

In addition, the biggest criticism gold gets as an investment is that it doesn’t offer any yield. However, when more than $7 trillion of debt assets are generating negative yields as is the case today, gold has a positive yield at zero. Gold is also massively under-owned by private investors and by central banks at a time when political and geopolitical risks are rising. Who would have predicted the rise of Donald Trump and Bernie Sanders, or who can predict the dynamics of events in the South China Sea?

Why would you want to back gold equities over physical gold?
There is a time for physical gold and a time for gold equities. By some measures

*Schroder Alternative Solutions is referred to as Schroder AS.
Gold equities have underperformed the gold price for the past 20 years and haven’t been this cheap relative to gold since the late 1970s. Although they have risen sharply in the first half of 2016, gold equities remain 70–80% down from their peak five years ago.

Furthermore, gold equities continue to offer significant leverage to higher gold prices. Over the prior bull and bear markets, gold equities underperformed due to two factors: severe cost inflation which eroded producer margins in the up-cycle and management indiscipline which led to a “growth at all cost” mentality and significant increases in debt.

These left companies exposed in the downcycle. However, we believe that in the new bull market for gold, good quality management teams will stay focused on generating free cashflow and – more importantly – positive return on invested capital (ROIC) over their cost of capital. We are also finding management teams to be more disciplined, particularly when it comes to avoiding value-destructive mergers and acquisition activity.

**How do you go about picking companies for your portfolio?**

Our stock selection criteria are very value-oriented, with a strong focus on net asset value (NAV) and on company management. We use the FTSE Gold Mines Index, which our valuation screen narrows down around 60 companies, on which we run our own NAV models and also look at near-term multiples and balance sheet strength. We have a strong focus on underlying free cashflow generation and ROIC.

Execution risk and geopolitical risk are important factors we consider too, as the companies we look at operate in diverse locations with different implications. For example, we speak to lots of companies who have assets in North America, but we also talk to companies with assets in places like Latin America, Kyrgyzstan, China, or even Greece, and this makes a huge difference to their operational risk profile.

Ultimately, everything has to tick the boxes for investment: valuation, management credibility, corporate governance and sustainability of business model.

**Can you tell us some of the factors that differentiate this fund from some of your competitors?**

Our top-down analysis is an important edge. Most of our competitors will just say “the gold market is not forecastable, so we will just focus solely on underlying valuations”. We think the valuation layer is absolutely critical, but we also believe you can actually forecast the gold market based on certain macroeconomic factors. This can have a big impact on the way you’re positioned. So, we have the ability to rotate from higher leverage names to lower leverage names depending on our macroeconomic view, or actively time the market through our use of cash.

**Mark Lacey** is co-manager of Schroder ISF Global Gold and Schroder ISF Global Energy. He joined Schroders in 2013 having formerly been portfolio manager of Investec Global Energy funds and Head of Global Energy at Goldman Sachs. In 2006 he was ranked as #1 Energy Investment Specialist in the 2006 Thompson Extel survey. Mark’s career commenced in 1996 at Credit Suisse Asset Management, managing gold and resource funds.

We also have the option to invest in the underlying commodities themselves. We can have up to 40% of the portfolio in gold, silver, platinum and palladium (10% maximum in each).

**How do currency considerations affect your decision-making?**

Another factor that differentiates us from our peers is that we sit quite literally next to Schroders’ emerging market debt team, who are constantly developing and refining very strong views on key macroeconomic drivers, particularly currencies. Within our gold universe, relative performance globally can be highly impacted in the short-term by the South African rand, Australian dollar, Canadian dollar, and obviously the US dollar, and we are constantly discussing these as a team. Currently, for example, the emerging market debt team has a strong view on the South African rand, which is affecting our view on the country’s gold and platinum sector. Their view on the rand is currently bullish, which is negative for the equities of producers, but positive for the underlying commodity.

“We think we are just entering a multi-year structural bull market for gold. Potential outcomes for currency, financial markets and inflation are arguably more extreme now than at any point.”

**Why do you place so much importance on company management?**

Management teams and the market’s perception of them are very important in this sector. We have so many management meetings because checking they are maintaining a consistent approach and a consistent message is one way of monitoring that our investment is working.

Also, if management teams are hated, it’s very hard for the equity to start to perform. The inflection point in the cycle of investors’ perception of management is sometimes the biggest catalyst for equity performance. For example, there is a CEO of one well-known gold company who is detested by the resources investor base, particularly in the US, but from meeting him we feel we are coming to the end of a cycle for this particular company. The pain and criticism he has taken has forced him to take a more conservative and reserved approach to things such as the development of projects, meeting quarterly guidance and remuneration. He should be coming into a period where he will become more liked by the market and this has a huge impact on ownership of shares and ultimately on valuation.
A winning approach to income

Schroder ISF* Global Multi-Asset Income offers a regular and sustainable source of income with a focus on quality and diversification, using our active asset allocation and robust risk management strategies.

We employ a global, flexible and unconstrained approach, taking advantage of yield opportunities in whichever region or asset class they arise.

Get ahead with our winning approach to income at www.schroders.com/gmai
Oil: The lubricant of the global economy

**Schroder ISF Global Energy** invests globally and exclusively in energy stocks. As a specialised equities fund, the actively managed portfolio offers access to companies which are active in research, development and production of energy sources and which, in so doing, contribute to global economic growth.

**Good reasons for oil stocks**

Across the globe, demand for energy will remain high far into the distant future. The rapid industrialisation of emerging economies over recent years and the massive expansion of infrastructure, above all in China and India, have driven up global energy consumption substantially. Evidence of this is found in the sales figures for cars – and in particular for SUVs – in China: Month for month, 1,800,000 cars are sold in China, a good third of these are SUVs (source: Bloomberg, Schroders. As at: July 2016). This class of vehicle is, on the one hand, a status symbol based on the Western model, while on the other, SUVs are especially suitable for the poor road conditions which are extremely widespread in China. But all-terrain vehicles are popular not only in China. Their popularity remains unbroken in the US too – thanks to the low price of oil in the past, the number of road miles driven by the average American has reached new records.

Also a factor: The price of oil has risen considerably since the beginning of 2016. This is explained by the fact that, in order to consolidate debt levels, mergers and acquisitions coupled with investment cuts for plant and infrastructure have meant production volumes have fallen. Also, OPEC states have recently agreed on a limit to production volumes which can almost be described as historic. This, too, should provide price support – even if some members don’t stick to the quotas yet to be determined.

If geopolitical risks increase, energy stocks have historically proved to be somewhat of an insurance. In contrast to many other sectors, energy stocks benefit from rising oil prices – which can make such companies valuable sources of diversification in sector allocation.

**No energy from yesterday: Stock selection in the foreground – in the current year with plus 24.56 per cent**

Since Schroder ISF Global Energy is not linked to an index (the MSCI World Energy Sector Net TR serves only to illustrate performance), John Coyle and Mark Lacey are able to make use of whatever they believe to be the most promising opportunities free of any restriction. This freedom is one of the defining features of the fund. In particular in this difficult phase for the sector, it is of crucial importance to concentrate on the possible winners of tomorrow and to exclude loss-makers as far as possible. That this isn’t always easy, but can be done, is illustrated by the fund’s performance over 2016. For the current year, the fund is trading 24.56 per cent higher. (Source: Schroders. As at: 30 September 2016).

**High conviction approach with the best investment ideas:**

**Transparent investment process**

The fund pursues a high conviction approach in portfolio construction. The result is a concentrated portfolio of 20 to 30 stocks. The fund aims to implement the managers’ best investment ideas and thus make a commitment possible to what they view as the best-yielding stocks in the sector.

The first stage in the investment process is disciplined research into the companies themselves. The investment universe is comprised of more than 750 globally active energy companies from which, in a second stage, a “focus list” of around 100 companies is compiled. The fundamentally driven bottom-up approach is therefore built upon the long experience of the management team together with their tight network of contacts with industry: John Coyle and Mark Lacey have excellent contacts into the upper echelons of the corresponding companies: “In the energy sector in particular, success or failure depend crucially on mutual cooperation and strategic alliances,” Mark says. “Meeting and exchanging information and therefore gaining a certain information advantage is an extraordinarily important foundation upon which to make viable investment decisions,” the energy expert went on.

**Valuation, valuation, valuation**

For each company on the focus list, the Schroder ISF Global Energy team works out an appropriate valuation and target value for the respective stock. As well as contacts to the company, what counts here above all is an exact-as-possible forecast of cash flows and the respective sources. Numerous other indicators for the companies on the focus list provide a comprehensive picture of the current and future expected situation of the stock: Based on the current share price and on the potential for exceeding the target valuation, the team compiles a range of investment candidates.

**High energy prices as driver**

Within the repeatable investment process, individual stock picking is focused on
undervalued companies with good growth prospects. Accordingly, it tends to be companies active in exploration and extraction that find their way into the fund portfolio rather than integrated groups which generally grow more slowly – an approach which distinguishes the fund in its weighting both from the sector index as well as from rivals. But also an approach which reflects the high conviction of the two managers with the 20 to 30 stocks in the portfolio. John Colye summarises: “With rising energy prices, we exploit our opportunities especially effectively – and can more than hold our ground against other strategies.”

JOHN COYLE & MARK LACEY

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**SCHRODER ISF GLOBAL ENERGY**

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<thead>
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<th>Class A Accumulation USD</th>
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Source: Schroders as at 31 August 2016.

1 The ongoing charges gure is based on the last year’s expenses for the year ending December 2015 and may vary from year to year.
Ageing and economic growth, revisited

Clients will recall that we have written frequently about the relationship between demographics and economic growth. There is an increasingly consensual view that population ageing will result in structurally lower growth, with various studies suggesting that the “new normal” level of trend GDP growth in the US will fall to around 1%.

Today, we revisit the topic in light of a new paper from the National Bureau of Economic Research (NBER), which adds an interesting data point.

Labour force and productivity
Recall that the relationship between demographics and growth is primarily driven by labour force dynamics. At its simplest, gross domestic product (GDP) is the product of the number of workers in the economy (the labour force) and the output per worker (labour productivity). Population ageing will result in slower growth in the working age population, and may also – more controversially – impact the productivity of the labour force. The impact of an ageing labour force on productivity is a topic we explored extensively in an earlier newsletter (April 2014), concluding that the drag will be far less than implied by traditional economic models.

The NBER paper takes a new and interesting approach to testing this hypothesis by looking at state-level data in the US. The authors note that demographic trends vary significantly at the state level, with many states already experiencing significant population ageing over the period 1980-2010. This provides a rich data set, with fewer extraneous variables than cross-country comparisons.

Lower US trend growth implied
The authors find that a 10% increase in the proportion of the population aged over 60 decreases per capita GDP growth by 5.5%. This implies that the trend rate of US GDP growth will decline by 1.2 percentage points over 2010–20 and 0.6 points the following decade, implying a 2010–30 average

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1 As first discussed in our November 2012 monthly and more extensively in our February 2014 Talking Point, Investing in a Low-Growth World. Please contact us for copies.
rate broadly consistent with the previous 1% estimate. This is well below the growth rate assumed by the Federal Reserve and the Congressional Budget Office, which both use 2% real GDP growth for their long-term forecasts, suggesting risks to fiscal and monetary policy-making.

Positive productivity spillover
The paper also contributes to the debate about the mechanism by which ageing impacts growth. The authors estimate that two-thirds of the decline is attributable to a reduction in the rate of GDP growth per worker (productivity growth), while the remainder is due to slower labour force growth. This is the opposite of what we (and the prevailing wisdom) would have expected, and contradicts our prior assertion that ageing should not have a major impact on productivity. However, the authors find that productivity growth appears to have slowed across all age groups, rather than being driven by a change in workforce composition towards older workers. This is a puzzling result, which the authors attribute to “positive productivity spillovers” from older to younger workers i.e. younger workers learning from older colleagues. We find this explanation somewhat unconvincing, and welcome further research as to why this dynamic might exist.

More opportunities for alpha generation
This study broadly supports our thesis that growth in the US and other developed economies will slow significantly due to population ageing. As discussed at length in our 2014 Talking Point, we believe this need not be a disaster for equities in the long-run, but will result in a painful adjustment period for many stocks (which we are arguably in the midst of already). Ultimately, we believe slower trend growth will create more opportunities for alpha generation, with the best returns from companies that can achieve sustainable growth in this challenging environment. A thorough understanding of demographic drivers combined with in-depth fundamental analysis, as employed by Schroders Demographic Opportunities Fund, will be essential for identifying “growth gaps” and picking stocks. This paper also supports our ongoing interest in companies that improve the outlook for labour force productivity (as captured in the “competitiveness and labour dynamics” theme), primarily automation and education stocks, where we have invested in the past although we do not currently have any holdings.
Top performers

The tables show a selection of Schroders funds that are among the top performers in their peer group over one, three and five years.

<table>
<thead>
<tr>
<th>Quartile</th>
<th>Ranking/comparison group</th>
<th>Comparison group Morningstar</th>
<th>Fund (calculated in Euro)</th>
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### 1 year

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### 5 years

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Source: Schroders and Morningstar, as of 30 September 2016. Performance based on the net asset value of the given share class on a EUR basis/translated into EUR. Calculated net of the annual management fee and internal fund costs and based on reinvestment of all income (BVI method). Foreign currency investments are subject to currency fluctuations. Past performance is not a reliable indicator of future performance.
The global economy in pictures November 2016

The US election result

Donald Trump has defied the odds to become the oldest elected president of the US

Globalisation in crisis

Roots of backlash against globalisation

The flexible labour market has created employment, but there is a scarcity of good jobs

Gains from growth have not been evenly distributed, leading to rising inequality

Weak growth: global economy is forecast to grow only 2.5% this year

Real incomes have been squeezed

The main crisis points:

New technology gains are not being recycled back into the economy

80% of job losses in the US have been due to technology not trade

However, the root of weak income growth is falling productivity

Baby boomers head into retirement, training younger workers will take time

Loss of dynamism in the economy

Workers are taking less risks due to lack of opportunity and job mobility

Source: Hicks & Devaraj (2015), Manufacturing in America

The response?

The IMF (International Monetary Fund) said: we need to spread the benefits of globalisation more widely

...However

There is no consensus on how to deliver this and there will be little pressure to act until things get worse

China: problems are building

Chinese third quarter growth of 6.7% means the 6.5% target is safe

However, there are reasons to believe that growth will decelerate during the rest of 2016:

Following a surge in Chinese property prices, policy has been tightened by the regulators and the People’s Bank of China

Policymakers seem to be saving their firepower for 2017 to ensure strong growth ahead of the 19th Party Congress

Capital outflows mean the central bank will be reluctant to ease policy if growth does slow

Growth should largely meet its target this year and in 2017, but the longer term picture is deteriorating

From deflation to inflation?

The European Central Bank (ECB) will soon decide whether to extend quantitative easing (QE) beyond March 2017

The impact from last year’s fall in oil prices will drop out of the annual comparison of prices, causing the year-on-year inflation rate to rise

However, if the impact from energy then fades, this would result in a fall in the headline inflation rate back below 1%

All else being equal, eurozone inflation will return to near 2%, before falling back down

UK inflation is expected to rise above the 3% upper target next year, but the fall in sterling and rise in imported prices will be deflationary further out

Source: Schroders as at November 2016.
The undreamed-of diversity in global retail seems to materialise in virtual high streets. But not exclusively...

It is dangerous to generalise about retail real estate in continental Europe. Its demise has long been predicted, yet this dynamic sector continues to evolve even in the face of a complex mix of cyclical and structural forces. The only constant is that investors need to be careful to pick assets which will either benefit from, or are relatively resistant to these changes.
in retail sales over the next few years according to Oxford Economics.

Likewise, with one or two exceptions (e.g. Milan), there is little immediate risk of retail rents in Europe being undermined by a wave of new schemes. In general, developers remain cautious and PMA estimates that the total amount of shopping centre floorspace in France, Germany, Italy and Spain will only grow by around 1.5% p.a. between 2015–2020, compared with 5% p.a. between 2000 and 2008.

**Retail real estate under threat**

Although both consumer spending and new building are likely to support retail rents in continental Europe over the next few years, they are only part of the mix. Investors also need to factor in a number of long-term structural forces which are independent of the economic cycle. Probably the most important is the internet which is expanding rapidly as an alternative channel for retailers.

While there are some synergies between physical stores and online retailing such as click & collect, or the “halo effect” whereby a store can help to promote a brand, the reality is that most online sales are at the expense of conventional stores.

So far the internet has made bigger inroads in northern continental Europe, where it accounts for 8–12% of retail sales.

The main cyclical forces of consumer spending and new building should have a positive impact on European retail rents. Eurozone retail sales grew by 2% between the first half of 2016 and the first half of 2015 in volume terms (source: Eurostat) and while eurozone consumer confidence dipped a little after the Brexit vote in June, it remains fairly strong. Consumers are benefiting from low interest rates, particularly in Denmark and the Netherlands where many homeowners have big mortgages and in Germany and Sweden unemployment is low and wage awards are running well ahead of inflation, boosting real incomes.

The main laggards are France and Italy, although even here both countries are expected to see a modest increase and footwear account for between 40–50% of floorspace in many shopping centres, but over 15% of clothing sales in Germany, for example, are now online. By comparison, food stores and out-of-town retail warehouses have been less affected because consumers still wish to touch items like food, furniture, DIY and homewares before they purchase and because these stores are typically convenient for click & collect sales. However, there are exceptions. Demand from electrical retailers for retail warehouses has fallen as sales have migrated online and retailers like Carrefour and Casino are downsizing their large hypermarkets as they have lost non-food sales to the internet.

Three other structural changes are shaping European retail real estate. The first is that Europe’s big cities are generally seeing faster economic and population growth than surrounding towns and rural areas. This continues a long-standing trend of increased urbanisation as large “gateway” cities such as Berlin, Madrid, or Paris are a magnet for international and internal migration. The UN suggests that the urban population of western Europe excluding the UK will increase by 35 million, or 12% between 2014 and 2050, while the rural population will fall by a similar amount.

Secondly, younger Europeans in their 20s and 30s appear to be less materialistic than their parents and are more inclined to share goods and spend their money on experiences such as eating out, leisure and travel. Steve Howard, Chief Sustainability Officer at IKEA, has suggested that wealthy countries have now passed “peak stuff”. While this may be borne out of necessity – youth unemployment in the eurozone is still very high – it probably also reflects an increasing emphasis on sustainability and the responsible use of natural resources. The silver lining...
from a landlord’s perspective is that the increase in eating out is supporting the growth of bars, restaurants and coffee shops. A survey by CBRE found that around a quarter of the people who visited shopping centres in France and Germany in 2015 went solely to eat, or drink.

Finally, there is the growth in long-haul tourism, particularly from emerging market countries. The number of Brazilians, Chinese and Russians visiting Europe has more than doubled in the last five years (source: Eurostat). While recent terrorist incidents may discourage tourists in the short-term, growth is likely to resume as living standards rise and the number of people who can afford to travel increases.

Retail is detail
Where are the opportunities in European retail real estate? Our strategy is to focus on five sectors which either complement, or are relatively resistant to online sales. First, larger shops over 750 square metres in big city centres and tourist destinations. While city centres are generally benefitting from the growth in tourism, retailers particularly favour large “flagship stores”, because they allow the display of their entire range of goods and can be used to host events which promote the brand and complement online advertising. The flagship concept was pioneered by luxury goods retailers, but has since been adopted by mass market fashion retailers (e.g. H&M, Primark, Zara) and by consumer goods companies (e.g. Apple, Nike, Samsung). The main issue for investors is that competition for shops in Europe’s big city centres is intense and prime yields are currently between 3.0–3.5% (source: CBRE). We therefore prefer to buy stores in central locations which are regenerating (e.g. Kreuzberg in Berlin, Canal Saint-Martin in Paris) and where yields are higher.

A second bright spot are shopping centres which dominate their catchment area. The diversion of sales online means that retail real estate is becoming “a winner takes all” sector. Shopping centres which have a wide range of retailers and leisure facilities and are therefore a destination in their own right.

The winner takes it all
Shopping centres which have a wide range of retailers and leisure facilities and are therefore a destination in their own right.

Thirdly, we favour smaller supermarkets and convenience stores which are relatively immune to online sales. The sub-sector is also gaining from a shift towards higher frequency shopping and away from the “big weekly shop” at a hypermarket. In France and the Netherlands grocery chains such as Carrefour and Ahold have spotted
this trend and expanded their network of smaller supermarkets, particularly in the main cities. In Germany, Italy and Spain the sub-sector is dominated by discounters. Here, Aldi and Lidl are gradually closing their smaller stores and focusing on slightly larger supermarkets of between 1,000–1,500 square metres where they can stock a wider range. Another interesting trend is the growth of specialist organic food retailers such as Biocoop in France and Denn’s in Germany. Schroder Real Estate already has a significant investment in convenience stores in the UK and is now replicating that strategy in continental Europe.

Fourthly, we also see good opportunities in out-of-town retail warehouses let to retailers selling bulky goods (e.g. DIY, floorcoverings, furniture, homewares) where the main attraction is their relatively immunity to the internet. However, in addition, retail warehouse yields tend to be relatively high at 5.5–6.5% (source: CBRE), because in many countries they are perceived to be more like an industrial asset than retail. Although spending on bulky goods is linked to some extent to house prices and we avoid locations with weak housing markets, it is interesting to note that in Germany, for example, a lot of DIY is done by tenants, because they have strong security of tenure.

Finally, we favour logistics warehouses, which although not retail real estate, are clearly benefitting from the rapid growth in retail sales. In general, we prefer modern, mid-sized warehouses close to city centres, where supply is restricted. We are cautious about large warehouses on motorway junctions, because there is usually a plentiful supply of land and occupiers often have the option of moving to a new unit at the end of their lease.
Trump victory: after initial boost, weaker growth and higher inflation likely

Donald Trump’s victory in the US presidential election could lead to trade wars, with tariffs likely to rise.
Congratulations to Donald Trump who has defied the odds and the naysayers to become the oldest elected president of the US.

This is an extraordinary achievement for a Washington outsider who had to beat 16 others for the Republican nomination, as well as a seasoned politician like Hillary Clinton for the presidency. Meanwhile, commiserations to Hillary for whom the election was hers to lose.

Investors must now absorb the reality of a president who has promised to create 25 million jobs and build a wall across the border with Mexico.

**High probability of trade wars**

President Trump’s fiscal policies will cut taxes and spending, but will most likely lead to higher interest rates, inflation and a bigger budget deficit. We would expect Congress to temper the new president’s fiscal plans, while he will have more freedom on trade. Consequently, we are likely to see modest fiscal stimulus and a trade war break out as the president raises tariffs on China and Mexico.

The net effect is that after a brief boost from tax cuts, the economy will cool as inflation and interest rates rise. With higher tariffs pushing up prices and wages rising as immigrant labour supply falls, the overall outcome is likely to be stagflation, i.e. weaker growth and higher inflation.

**Volatility likely as low rate environment unwinds**

This is unlikely to be favourable for markets: bond yields may rise as investors seek greater compensation for inflation risk, while equity markets are expected to derate.

We are likely to see significant volatility as the low rate environment of recent years, which has supported equity valuations and driven the “bond proxy” stocks, unwinds dramatically.

Cuts in corporate tax rates will offset some of this and sectors such as energy and financials could benefit from reduced regulation.

More broadly, the prospect of protectionism and lower global growth will hit equity markets and risk assets worldwide. Emerging markets are particularly vulnerable given their dependence on global trade.

**Safe havens in demand but dollar outlook uncertain**

It is not clear how the US dollar would behave in this environment. Some see a stronger currency driven by higher yields, but as this will be accompanied by higher inflation such a conclusion is not obvious. In addition, many investors may be deterred by a deterioration in US foreign relations with the rest of the world.

The best bet is that safe haven currencies such as the Japanese yen and Swiss franc are likely to be in demand and investors are also likely to favour gold.
Fund sustainability ratings are an increasingly popular tool for investors but one number may paint a misleading picture.

Fund sustainability ratings have been popping up everywhere over the last few months. Amid much fanfare, Morningstar launched its scoring using Sustainalytics rating of portfolio companies; MSCI is close behind with fund analysis based on its own data; and Lipper has announced a tie up with Princeton University. The idea that a fund’s sustainability credentials can be distilled to a single number is alluring, but the reality is sadly more complicated.

Environmental, social and governance (ESG) concerns have been moving up investors’ agendas for years, most obviously reflected in the growth of the UN-backed Principles for Responsible Investment (PRI). Launched a decade ago, that initiative – which commits investors to integrating ESG factors into investment decisions and ownership – now encompasses nine in every ten of the world’s largest active fund managers.

That investors should be more interested in comparing fund “sustainability” is unsurprising. On the one hand, recent moves to quantify a fund’s “sustainability” are a logical step and a welcome reflection of the growing interest we are seeing from our clients. On the other, while most Schroders’ funds score well on Morningstar and MSCI ESG ratings, we feel that a single letter or number should not be the final answer.

The challenge of defining sustainability
Other fund features can be distilled into a single number: volatility, turnover, concentration and performance all require interpretation but all are objective and valuable measures. Why not sustainability?

Most critically, there is no consistent definition of what sustainability looks like, let alone how to measure it. While they use similar terminology and present their results in similar ways, ESG ratings are fundamentally different to other ratings, like those given to bonds.

Bond ratings are designed to measure the risk that companies default, and have been reasonably accurate in...
doing so most of the time. Without a consistent definition of what ESG ratings are supposed to measure or even a consistent view of what constitutes a relevant ESG issue, it is impossible to gauge their effectiveness.

Even the UN PRI – which commits investors to incorporating ESG factors into investment analysis, decisions and ownership – has yet to provide a definition.

Different organisations, different approaches

Despite similar sounding approaches, the main ESG rating organisations can reach very different conclusions for the same companies. On average, across over 1,600 stocks in the MSCI World benchmark, only 26% of the scores assigned by one of the two largest rating agencies can be explained by the scores the other agency assigns to the same companies (the “R-squared” value).

For example, online marketplace eBay is a strong top quartile performer according to Sustainalytics, but a bottom quartile laggard in MSCI’s assessment. Both sources cannot possibly represent the definitive view of companies’ ESG strengths.

Neither is right or wrong; both represent a perspective and may well be considering different factors, for different purposes. Recognising that they have different approaches and generate different conclusions is critical before leaping onto ratings as evidence of a company or fund’s sustainability qualities.

To demonstrate the challenge this poses to fund analysis, we randomly divided the companies in the MSCI World benchmark into 55 hypothetical portfolios of 30 stocks each. We looked at the average ratings of stocks in each portfolio using five common ESG ratings (labelled A-E below), as well as a Super Rating we created, and then ranked those portfolios according to their average ESG strength using each type of rating. Those rankings represent a rough approximation of the fund ESG ratings you will see proliferate.
The fact there is little correlation between rankings based on different sources of data should raise a red flag; rankings based on one source of ESG information differ from those using other sources by about 25% on average. Every ESG fund rating has to be seen as one perspective of many, and of limited use without knowing exactly how it is calculated.

Focusing on the two main fund ratings already published – by MSCI and Morningstar – shows similar discrepancies. One in five of the funds that appears to be a leader using one of the main ratings is below average through the lens of the other.

The Super Rating looks like it might provide at least the most consistent view; on average, the fund ratings calculated using the Super Rating approach were more closely correlated to other key ratings than any other rating approach. The Super Rating appears to include criteria and conclusions that are common to most of the other ratings.

Tellingly, that Super Rating is nothing more complicated than a formula based on companies’ size and region, and nothing more fundamental. The values are obviously meaningless for ESG analysis but nonetheless manage a reasonably good approximation of widely used ratings.

This highlights a fundamental failing of most ESG rating methodologies: they are heavily influenced by the size
and resources companies are able to spend on disclosure and the local regulations and pressures they face to report specific information. This is why we place so much value on our analysts forming their own view on ESG issues to incorporate into investment decisions.

**Ratings are not the only answer**

The exercise highlights the dangers fund ratings pose to investors persuaded to focus on one fund rating methodology or another. Our concerns are not with ratings in themselves. ESG rating agencies provide valuable analysis and insights to investors – across Schroders we use data from several well known sources – but they should be inputs to company evaluation rather than an answer in themselves.

At Schroders we have worked hard for close to 20 years to develop tools, frameworks and data to help us better understand and integrate ESG issues into the funds we manage for our clients. We understand that the insights this yields cannot be distilled into a single value, for either a company or fund, but must be considered in the context of the investment case for each equity or fixed income instrument that we invest in.

We try hard to be transparent in our approach to examining ESG trends, assessing company performances and integrating conclusions into our investment strategies. We also recognise growing interest in evaluating how well we do these things. However, while fund ratings are compelling in their simplicity, they risk misleading investors into conclusions that promise more than they can deliver.

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**HOW SIMILAR ARE FUND ESG RATINGS USING DIFFERENT SCORING SYSTEMS?**

![Graph showing correlation between different ESG rating systems.](image-url)

Source: Based on ratings by MSCI, Sustainalytics, RepRisk, EIRIS and Asset4 through data aggregator services. Ratings are converted to numerical values and normalised on a 1–100 scale. Data extracted in March 2016.
Receiving regular returns: That is what many investors wish for nowadays, especially when it comes to retirement planning, their children’s education or being able to afford the finer things in life. But it is becoming ever more difficult to reach this goal. To achieve the highest possible return at the lowest possible risk? This is best accomplished with investments that are flexible and wide ranging.

But that is only one side of the coin. What is at least equally important to Schroders’ approach is to accurately assess risks and deliberately take worthwhile risks, and intelligently avoid risks that do not pay. This is where our approach comes in to examine risk premia: Investing with riskIQ.

Risk premia reward investors for their exposure to a variety of risk factors. Those who want to robustly assess risk premia will compare the expected gains – risky investment against a virtually risk-free investment, such as a government bond with the highest possible credit rating. The best known example is probably the equity risk premium, which rewards the uncertainties in comparison with a “risk-free” investment. In addition, equities may contain further risk premia, but these largely depend on the characteristics of the individual stock. And those who also combine a variety of asset classes in their portfolio can sustainably improve the balance between risks and returns. Hence, at Schroders we are more consistent than other funds in implementing this strategy in our multi-asset funds. Instead of relying on only two or three asset classes, the fund management resorts to more than ten. That is how we develop a truly diversified portfolio on the basis of riskIQ. For example, equities, bonds, commodities and alternative investments are all in the mix. Gold and real estate can also be included in the fund.

But the strategy goes well beyond purely mixing different asset classes. Analysing risk premia is a main focus of the Schroders multi-asset strategy, because the risk premia of the individual asset classes are the major drivers of returns. As an additional return, the risks that investors take are balanced out.

What are further advantages of the risk premia-based approach? It can at least partly offset the undesirable effect of a portfolio developing in line with the market, in other words it correlates. The correlation between the risk premia across all asset classes is far lower than that between the different asset classes. This is particularly true in turbulent market phases, when the individual asset classes tend to correlate more strongly with each other. The chart illustrates these correlations.

**WHY DO WE FOCUS ON RISK PREMIA?**
**THEY ALLOW FOR BETTER DIVERSIFICATION THAN PURELY LOOKING AT ASSET CLASSES**

![Correlation chart](source)

In calm markets
- Risk premia 10%
- Asset classes 50%

In normal markets
- Risk premia 30%
- Asset classes 40%

In turbulent markets
- Risk premia 40%
- Asset classes 10%

Source: Schroders. For illustrative purposes only.
riskIQ can do even more – with its defined values the risk-return profile remains balanced at all times

Once a robust portfolio has been built thanks to riskIQ, the next task of riskIQ kicks in – maintaining a balanced risk-return profile. If one asset class performs particularly well, its share of the overall portfolio value also increases. Conversely, the share of less well performing investments declines over time. At first glance this may appear positive, but in the long term the portfolio would indirectly mirror market developments – which goes against the aim of wide-ranging diversification and independent performance.

In order to prevent this undesirable effect, our fund managers check on a daily basis the share and weighting of asset classes and risk premia, thereby keeping the balance at all times. Targeted purchases or sales of individual positions will bring the share of that particular asset class back to its predefined target. As a result the risk-return profile remains at a constant level at all times. This level varies, however, depending on the fund and the different investment goals.

Whether the need for security takes precedence or investors target higher returns during periods of volatility, riskIQ ensures investments are intelligently balanced.

What are the issues without riskIQ?

Those who build a “classic” portfolio with 60 percent equities and 40 percent bonds are evenly diversifying their capital, but the risks remain highly concentrated, as the chart on the right shows. Especially in difficult market times, the performance of this type of portfolio tends to decline in line with the market and its value clearly falls. Why? On the one hand, a large part of the portfolio risk derives from the equity market, while on the other hand corporate bonds and equities are exposed to comparable economic risks because they depend on the “economic growth” risk as the main driver of risk and returns. Equally problematic – this approach does not answer the question how much each individual position contributes to the portfolio’s overall risk.
You are what you (no longer) eat – Flexitarians
Individualisation is the thing

How do the trend to individualisation and changed eating habits go together? In the truest sense, it depends on the person. This is because the drive to individualisation involves all aspects of life and affects changed working patterns as well as the nature of leisure and the attitude to personal health, sport, travel or free-time activities. All activities involve particular eating habits and preferences. Nutrition is increasingly becoming an instrument of self-realisation, in some respects also of self-awareness – and, not infrequently, of self-representation. Farming, shopping, cooking and eating seem to be omnipresent and highly emotionally-charged subjects: food, along with philosophies of nutrition, is increasingly becoming a form of personal expression. What you eat says as much about you as what you don’t – any longer – eat.

Enjoying responsibly: flexitarians

Whereas in the developing countries, especially, meat consumption is increasing rapidly (this is an expression of individuality, too, in the sense of greater personal prosperity), over a third of all Swedes, have one to several meat-free days a week. In the home of barbecues and beef, US Department of Agriculture statistics show that the demand for red meat has been declining markedly for several years. While this may have economic causes, the sociological reasons are clearer. Many people have recognised that in the future they will have to feed themselves differently, i.e. in a manner that is more sustainable, environmentally friendly, respectful of nature and generally healthier. They are seeking a personal balance between responsibility for their own health, the love of animals and their appetite for meat: a combination of moderation, quality and a good conscience.

Given this approach, the future quite clearly belongs to the flexitarians. And if this leads to an end to ideological trench warfare between strict vegans and out-and-out flesh eaters, this is to be welcomed. Having said that, eat up now! —

1 Source: Studies made by SIPO and published by the Swedish Television (SVT) Nov 8 2015.
All the world’s a stage …
The most important playwright of all
time passed away 400 years ago

“All the world’s a stage, and all the men and women merely players.”
That is how Lord Jacques in “As you like it” begins his monologue describing
the seven ages of man. And who could have put those words in his mouth?
A poet, an actor, a bard – and one other who many believe never even
existed. The 400th anniversary of William Shakespeare’s death is in 2016.

William Shakespeare, Shaksper, or even Shakspeare was
born in Stratford-upon-Avon, presumably on 23 April 1564 –
we don’t know exactly. What we do know, and the Holy Trinity
Church’s records confirm it, is that he was baptised on 26 April. But
this date is perhaps conjecture based on the fact that he died on 23 April 1616.
Presumably. More certain: William was the
second child of John Shakespeare and Mary
Arden. In the summer of that year, the Black Plague
had broken out in England, a fact that inspired journalist Bill
Stage”, that Shakespeare’s great life achievement wasn’t
writing “Hamlet” but making it past the age of one.

Most likely, but this also can’t be proven, William went
to Latin school, the grammar school of Stratford. The half-
timbered house on Church Street is still there and is still
a residential building. Whether Will developed his love for
language games as a way of compensating for the strictness
of school we will never know. At the very least, his vocabulary
was phenomenal. The English language certainly
has this poet to thank for countless new expressions
that first appear with his arrival
on the scene: amazement and
accommodation, generous,
lonely, majestic and sportive. It’s
a chicken-and-the-egg problem,
however, because on the one hand,
English in the 16th century was nowhere
near firmly established and new words were
being invented daily. On the other hand, the
Oxford English Dictionary favoured sources that used
Shakespeare as a reference.

Borrowed plumes:
Did someone else perhaps do the writing?
Indeed, the elaborate prose have been the catalyst
for centuries of debate about the true authorship and
identity of their creator. Almost worse than the Wars of
the Roses between Lancaster and York is the conflict
between Stratfordians and Oxfordians about who the real
author of these dramatic works really was. A boy from the
country? The son of a glover? Impossible says the Oxford camp. Instead, it must have been the well-travelled, career diplomat Earl of Oxford, a confidant of Elizabeth I, who crafted them. Others see the playwright Christopher Marlowe as the true Shakespeare. Contrary to what literary history would have you believe, he wasn’t beaten to death in a tavern or stabbed by a widow at all. Rather, he bought the name from a marginal actor and simulated his own death to escape a conviction for high treason. Dissenting opinions even support the notion that Queen Elizabeth I herself was in fact Shakespeare.

Naturally, doubts are never fully unfounded. After all, Shakespeare’s father was just a craftsman who worked his way up to being mayor of Stratford. Yet, in addition to attending grammar school and possessing a brilliant talent, perhaps it was the provincial town of Stratford itself that lay the foundation for a supernatural work of superb drama. The town was on an important trading route, had a bridge over the river Avon and was accordingly quite affluent. The idea that actors would be able to practise their craft here is anything other than implausible. Shakespeare would have almost certainly seen theatre performances, so there would be little reason to doubt that he read literature and ultimately could have written some of his own.

The Globe Theatre: the big world stage

Othello, Julia, Hamlet, Lear, Shylock, Richard III., Falstaff – Shakespeare’s characters “lived” in the Globe Theatre on the south bank of the Thames, not far from where we now look from the Millennium Bridge at St. Paul’s or enjoy art in an old power station that is now the Tate Modern. It is also where the reconstructed Shakespeare’s Globe takes us back to the time of Elizabethan theatre. An audience of about 2,000 fit inside the venue. Proportionately speaking, when comparing the population of London in Shakespeare’s time and the population now, that is like having a sold-out performance at Wembley Stadium. All walks of life came here, from day labourers to nobility, to experience decay, love and death with the figures on the stage. On such stage where the bard presents every human fate – yesterday, today and tomorrow ...  

A poor player who struts and frets
his hour upon the stage and then is heard no more.
It is a tale told by an idiot, full of sound and fury,
signifying nothing.

MACBETH, ACT 5

And yet everything. Even 400 years after William Shakespeare’s death.
NEW ORLEANS, JACKSON AND GREAT NORTHERN RAILROAD

Bond issue, 1856

The Schroder family had long-standing business connections to the American South. When Christian Matthias Schröder (1742–1821) set up his firm of merchants in Hamburg in 1767, the Atlantic trade was an integral part of his business. This was first conducted through French and Portuguese Atlantic entrepôt ports, and later directly with America, the Caribbean and Brazil.

Railway map accompanying the prospectus for the bond issue, August 1856. [Credit: Schroder Archive]
Christian Matthias Schröder’s descendants were equally interested in the South. His son Johann Heinrich Schröder (1784–1883), who had come to London in 1802, set up a second firm in England in 1839 in Liverpool to handle Atlantic trade, particularly American cotton being imported for the booming Lancashire textile industry. Christian Matthias’s grandson, Edward Schröder (1818 – 1865), together with a cousin set up the firm of Schröder, Mummy & Co. in New Orleans in 1848. These deep connections enabled J. Henry Schröder & Co. in London to develop its business in the region: first as merchants, then as financiers of the trade of others, and in 1854 for the first time as financiers of regional development and infrastructure.

The New Orleans, Jackson and Great Northern Rail Road Company was set up in 1851, to connect New Orleans to the port’s hinterland in cotton-growing Mississippi. Having exhausted local sources of capital, James Robb, one of the company’s directors and a Louisiana senator, came to London in 1853 to raise additional funds. His timing was not propitious: American securities were out of favour with investors and none of the big names in bond issuing were prepared to help him. Despite their strong regional connection, Schroders was not an obvious choice for Robb: the firm had only previously issued one bond, that same year, financing a railway on the island of Cuba. Nevertheless, the firm provided a £50,000 cash advance in November 1854 to allow work to continue on building the railway until such time as the market improved. That time came in 1856 when Schröders issued a bond for £450,000 for the company, with an 8% coupon and thirty year term.

By early 1861 the New Orleans, Jackson and Great Northern Rail Road was 206 miles in length, from New Orleans to the junction with the Mississippi Central Railroad, and thence to the wider US railway network. The company advertised that passengers could travel from New Orleans to New York in just 3 days and 16 hours (the same journey can be made in a third of the time today); Chicago could now be reached by rail, with just an 18 mile interruption for a steamboat ferry across the Mississippi River. The projected net earnings promised in the 1856 bond prospectus seemed remarkably prescient: $595,600 against actual earnings in 1860 of $556,712.

Nevertheless, the firm provided a £50,000 cash advance in November 1854 to allow work to continue on building the railway until such time as the market improved. That time came in 1856 when Schröders issued a bond for £450,000 for the company, with an 8% coupon and thirty year term.

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But peacetime freight shipments of cotton, rice and other agricultural products were soon to give way to soldiers and war materiel. The outbreak of the American Civil War in April 1861 turned the railway into an asset – or target – of immense strategic importance. After using it to evacuate Confederate troops following the Union navy’s capture of New Orleans in April 1862, General Lovell cut the track fourteen miles north of the city.

This was the beginning of years of war damage. Colonel Wright, serving under the Union army’s General Grant, reported his own contribution to the destruction in May 1863: “I at once placed one-half of the command in the best position for defense that the circumstances would admit, and with the other half proceeded to destroy the telegraph line and railroad. I took out 1½ miles of wire, and burned it on top of three bridges I destroyed. I cut the road by tearing up the rails at three points. I burned out one culvert, and warped the rails materially at two points by building large fires on them. In the aggregate 1½ miles of road is destroyed [...]”

By the time the war was over in May 1865, bridges, road bed, and rolling stock had been destroyed, damaged or dilapidated right along the line. Eighty-one miles had been abandoned since the spring of 1863 with virtually every bridge unusable. The company was reported as having not “a dollar of available funds”. Evidence from the Schroder Archive suggests that bondholders had received no interest payments on their investments since 1862. After the war the company negotiated an agreement with them, with J. Henry Schröder acting as their trustee, whereby the 25 unpaid coupons from the 1856 bond would be exchanged for a new bond with 48 coupons attached.

The line was fully restored and is today part of the Illinois Central Railroad and the wider US national rail network.
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Important information. For professional investors or advisers only. *Source: Schroders, as at 31 October 2016. Past performance is not a reliable indicator of future results, prices of shares and the income from them may fall as well as rise and investors may not get back the amount originally invested. Issued in April 2016 by Schroder Investment Management Limited, 31 Gresham Street, London EC2V 7QA. Registered number 1893220 England. Authorised and regulated by the Financial Conduct Authority. w48772
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### Visiting Addresses

<table>
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<th>Location</th>
<th>Address</th>
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