Convertible Bonds

Schroder ISF\textsuperscript{1} Global Convertible Bond
Schroder ISF Global Conservative Convertible Bond
Schroder ISF Asian Convertible Bond

\textsuperscript{1} Schroder International Selection Fund is referred to as Schroder ISF throughout this document.
Convertible Bonds

Low interest rates mean that income from time deposit accounts is very low, and yields on safe bonds are also at historic lows. Uncertainty in the stock markets may rebound after an unusual calm period, and many investors are therefore taking a sceptical and cautious stance towards equities.

Weighing up opportunities and threats
Convertible bonds combine the protection of a fixed income investment with the potential return of a stock. The blend of individual elements that make up a convertible bond – bond, equity and right of conversion – produces an asset class that has unique risk-return characteristics compared to a traditional portfolio of equities and corporate bonds.

In today’s uncertain market environment, investments with a potentially attractive return profile like that of convertible bonds are worth looking at.

Investors benefit if there is a rise in the share price and also have the possibility of limiting the fall in value of the shares to the price of the convertible bond.

A specialist approach to convertible bonds
Convertible bonds are often classified as a niche bond investment or as an alternative strategy. However, we view them as a unique asset class that should be managed by specialists to ensure that their full potential can be exploited. Two of our convertible funds, Schroder ISF Global Convertible Bond and Schroder ISF Asian Convertible Bond have a track record of almost 10 years. The team launched the defensive Schroder ISF Global Conservative Convertible Bond in 2014 to offer a convertible solution for risk averse and fixed income investors. Our convertible investment specialists have full access to the global resources for research and asset allocation that are available at Schroders.
Added value included

Put simply, convertible bonds are corporate bonds with a built-in purchase option that enables the investor to exchange the bond for equity at a fixed price. The value of the option increases as the volatility of the equity market rises – the more the market fluctuates, the greater the likelihood that a convertible bond will exceed the agreed price.

If the price of the underlying share is relatively low, the convertible bond has more of the characteristics of a bond; for example, the risk of loss is reduced in difficult times. In contrast, if the share price rises, the price of the convertible bond also increases and it is more like a stock. Essentially, convertible bonds imitate the way in which diversified investors traditionally adjust the assets in their portfolio, as share prices rise and fall.

Due to their short maturities and exposure to equity markets, convertible bonds are less sensitive to interest rates than traditional bonds. These low levels of sensitivity to interest rates are apparent in the pricing of the convertible bond, because both the share option (using the underlying equity volatility) and the bond components (taking into account the risk premiums [credit spread]) are valued.

Typical path of a convertible bond

Source: Schroders. For illustrative purposes only.
Automatic asset allocation

Convertible bonds currently offer a wide range of advantages and present an opportunity to combat market uncertainties. They are fairly valued, but they provide more security than equities. Investors can use this asset class to increase their exposure to the equity market without having to give up the advantages of bonds in terms of security. However, investors can also increase the security of a diversified portfolio without reducing the equity component.

In addition, convertible bonds can benefit from high equity volatility. Historically, when share prices have risen, convertible bonds have appreciated two-thirds as much over the long term. However, when stock-markets have performed badly, convertible bonds have suffered considerably less.

This is because the asymmetrical payment profile of a convertible bond (more opportunities than risks) becomes more valuable as the underlying equity fluctuates in value.

Historical performance

Source: Schroders as at 30 November 2017.

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 the amount originally invested.
Convertible bonds show significant protective qualities. As defensive equities, they do however come with short-term losses. But even the Great Financial Crisis only lead to a single year of negative performance. The table shows all possible buy and sell dates of our opportunistic convertible strategy. So, investing in 2008 and staying invested to the end of 2010 already brought absolute performance up to 4% annualised. The amount of “green” field combinations of buy and sell dates and hence positive annualised returns for our investors show the attractiveness of this asset class.

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Convertible bonds offer protection from rising interest rates

The right of conversion also gives a form of protection against rising interest rates. Traditional government and corporate bonds react to rising interest rates with drops in value. Convertible bonds, however, can benefit from the equity market in this kind of environment but do not lose out as a result of rising interest rates. This ‘exotic’ interest rate put option is regarded as an important added benefit of these hybrid products.

Convertible bonds regularly provide protection in the event of rising interest rates.

**Performance of a convertible bond in a rising interest rate environment**

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<td>-5</td>
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</table>

Source: Schroders, as at November 2017.

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 the amount originally invested.
**Investment process**

<table>
<thead>
<tr>
<th>Top-down process</th>
<th>Macro research</th>
<th>Equity, credit, interest rates as performance drivers of convertibles</th>
<th>20% Alpha contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bottom-up process</td>
<td>Credit research</td>
<td>Veto right for the Credit Team</td>
<td>10% Alpha contribution</td>
</tr>
<tr>
<td></td>
<td>CB selection/convexity</td>
<td>Responsibility for top-picks</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Equity</td>
<td>Momentum and Value in underlying stocks</td>
<td>70% Alpha contribution</td>
</tr>
</tbody>
</table>

Source: Schroders, September 2017.

**Top-down analysis**

On the basis of key economic data, Schroders produces a top-down view of the current market cycle. The team also uses the resources and expertise of leading investment specialists from Schroders’ Multi-Asset, Fixed Income and Equity teams in order to determine the strategy.

**Bottom-up analysis**

Schroders’ research and presence across the globe facilitates the qualitative analysis of companies’ management and business strategies, which forms an important part of the research process for corporate bonds and equities.

Technical analysis of convertibles, looking at delta, conversion premia, gamma, rho, and other metrics is a complex process, requiring extensive experience, as well as a highly disciplined, repeatable approach. A truly international perspective also considerably expands the opportunity set.

**Portfolio construction**

Portfolio construction is designed to identify bonds with optimal combinations of specific characteristics, such as implied volatility, redemption yield, convexity and equity sensitivity (delta).
Key opportunities

Reasons to invest
- Hybrid asset class with bond and equity elements that create a balance between risk and return
- Possible added value through the integrated option of converting from a bond to equity in order to participate in the growth of the equity market
- Unique advantages derived from automatic adjustment of asset allocation, which convertible bonds offer through their conversion option
- A diversified return strategy that focuses on high-quality companies with good creditworthiness
- Three Schroders convertible bond funds that capture opportunities in the global and Asian markets

Risk considerations

Schroder ISF Global Convertible Bond, Schroder ISF Global Conservative Convertible Bond and Schroder ISF Asian Convertible Bond
- The capital is not guaranteed
- Non-investment grade securities will generally pay higher yields than more highly rated securities but will be subject to greater market, credit and default risk
- A security issuer may not be able to meet its obligations to make timely payments of interest and principal. This will affect the credit rating of those securities
- Investments denominated in a currency other than that of the share-class may not be hedged.
- The market movements between those currencies will impact the share-class
- Investment in bonds and other debt instruments including related derivatives is subject to interest rate risk. The value of the fund may go down if interest rate rise and vice versa
- It may be difficult to sell quickly positions of one or more companies to meet redemption requests upon demand in extreme market conditions.

Schroder ISF Asian Convertible Bond - additional risk considerations
- Emerging markets will generally be subject to greater political, legal, counterparty and operational risk
- Emerging equity markets may be more volatile than equity markets of well established economies. Investments into foreign currencies entail exchange risks.
Schroder ISF Global Convertible Bond

Schroder ISF Global Convertible Bond invests on a cross-market basis in highly convex convertible bonds in the US, Asia, Japan and Europe. The portfolio generally comprises approximately 150 securities. Fund managers have the flexibility to seize opportunities in all convertible bond markets across the world.

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<tr>
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<tbody>
<tr>
<td>Fund managers</td>
<td>Dr Peter Reinmuth and Chris Richards</td>
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<tr>
<td>ISIN</td>
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<td>LU0352097942</td>
<td>LU0484518450</td>
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<td>Launch of share class</td>
<td>14 March 2008</td>
<td>28 March 2008</td>
<td>21 September 2011</td>
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<td>Benchmark²</td>
<td>Thomson Reuters Convertible Bond Global Focus Index</td>
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<tr>
<td>Entry charge</td>
<td>Up to 1% of total subscription amount³</td>
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<tr>
<td>Ongoing charges⁴ (latest available)</td>
<td>1.05% p.a.</td>
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</table>

² For illustrative purposes only.
³ Equates to up to 3.09278% of the net asset value per share.
⁴ The ongoing charges figure is based on the last year’s expenses for the year ending December 2016 and may vary from year to year.
Schroder ISF Global Conservative Convertible Bond provides a return of capital growth primarily through investment in a global portfolio of convertible securities. This defensive convertible strategy invests in high quality convertibles with an average credit quality of investment-grade at all times. The conservative approach emphasises protective elements of convertibles with a focal point on above-average downside protection.

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<td>Benchmark</td>
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<td>Ongoing charges⁷ (latest available)</td>
<td>0.82% p.a.</td>
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5 For illustrative purposes only.
6 Equates to up to 3.09278% of the net asset value per unit.
7 The ongoing charges figure is based on the last year’s expenses for the year ending December 2016 and may vary from year to year.
Schroder ISF
Asian Convertible Bond

Asian equity markets can be a volatile investment region. The fund focuses on the attractive growth story in Asia and invests on a diversified basis in highly-convex convertible bonds. Convertibles offer a smart way to build equity investments in one of the fastest growing regions in the world. In comparison with other asset classes, the investment universe for Asian convertible bonds is very cheap and offers attractive bond yields and interesting equity market opportunities in numerous sectors and countries.

<table>
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<tr>
<th>Fund facts</th>
<th>Share class C USD, Acc.</th>
<th>Share class C, EUR, hedged, Acc.</th>
<th>Share class C, CHF, hedged, Acc.</th>
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<tr>
<td>Fund managers</td>
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<td>Launch of share class</td>
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<td>28 March 2008</td>
<td>7 January 2010</td>
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<tr>
<td>Benchmark</td>
<td>Thomson Reuters Convertible Bond Asia ex Japan Index⁸</td>
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<tr>
<td>Entry charge</td>
<td>Up to 1% of total subscription amount⁹</td>
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<td>Ongoing charges¹⁰ (latest available)</td>
<td>1.07% p.a.</td>
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⁸ For illustrative purposes only. The benchmark for EUR Hedged share class is Thomson Reuters Convertible Bond Asia ex Japan.
⁹ Equates to up to 3.09278% of the net asset value per unit.
¹⁰ The ongoing charges figure is based on the last year's expenses for the year ending December 2016 and may vary from year to year.
At Schroders, asset management is our business and our goals are completely aligned with those of our clients - the creation of long-term value.

We have responsibility for €488.3 billion on behalf of institutional and retail investors, financial institutions and high net worth clients from around the world, invested in a broad range of asset classes across equities, fixed income, multi-asset and alternatives.

We employ over 4,100 talented people worldwide operating from 41 offices in 27 different countries across Europe, the Americas, Asia, Africa and the Middle East, close to the markets in which we invest and close to our clients.

Schroders has developed under stable ownership for over 200 years and long-term thinking governs our approach to investing, building client relationships and growing our business.

Source: Schroders, as at June 2017. Assets data as at 30 September 2017.


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