Negative yields; How to stay positive

Schroders IAM 12th Annual Investment Conference

16 December 2016
2016 - Politics
The people flex their muscle
<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Return (%)</th>
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<tr>
<td>UK Equities</td>
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<td>EMD Local Currency</td>
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<td>Cash</td>
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<td>Hedge Funds*</td>
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<td>Japanese Equity</td>
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<td>Infrastructure</td>
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<td>High Yield</td>
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<td>European Equity</td>
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<td>Emerging Markets Index</td>
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<td>Eurostoxx 50 Index</td>
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<td>S&amp;P 500 Index</td>
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<td>JPM EMBI Global Composite Index</td>
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<td>JPM GBI-EM Global Diversified Composite Index</td>
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<td>BoA/ML Global High Yield Index</td>
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<td>Investment Grade Credit</td>
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<td>BoA/ML Non-Gilts All Stocks Index</td>
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<td>US Treasuries Master USD</td>
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<td>Commodities</td>
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<td>DJ-UBS Commodity Index</td>
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<tr>
<td>Hedge Funds Funds of Funds</td>
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<td>Index</td>
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<tr>
<td>International Public Partnership (representative only)</td>
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<td>Cash:3 month £ LIBOR</td>
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<td>Property: UK IPD Index</td>
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Source: Schroders, Datastream as of 30 November 2016. UK Equity: FTSE All Share Index, Emerging Equity: MSCI Emerging Markets Index, Japanese Equity: Topix Index, European Equity: Eurostoxx 50 Index, US Equity: S&P 500 Index, EMD (US dollar denominated): JPM EMBI Global Composite Index, EMD (local currency denominated): JPM GBI-EM Global Diversified Composite Index, High Yield: BoA/ML Global High Yield Index, Investment Grade Credit: BoA/ML Non-Gilts All Stocks Index, US Treasuries: Bank Of America Merrill Lynch Treasury Master (USD), Commodities: DJ-UBS Commodity Index, Hedge Funds: HFRI Funds of Funds Composite Total Return Index, Infrastructure: International Public Partnership (representative only), Cash:3 month £ LIBOR; Property: UK IPD Index. All show total return either in local currency or currency of denomination since passive currency exposure is hedged. *12 months to 31 October 16 as November data isn’t yet available.
Contents
Schroders 12th Annual Investment Conference at Lloyd’s

Agenda
Speaker biographies

Presentations
Economics: Bonds... All change!
Fixed Income: the hunt for yield continues
Multi-asset: investing for the capital aware
Emerging Market Debt: is 2016 the beginning of a post crisis era?

Page 4
Page 5
Page 8
Page 33
Page 52
Page 67
Agenda

Schroders 12th Annual Investment Conference at Lloyd’s

09.15  Introduction
Charles Matterson, Insurance Asset Management

09.30  Economics: bonds...all change!
Trump, Brexit and the Emerging Markets
Keith Wade, Chief Economist

10.00  Fixed income: yield hunting
How value investing can help
David Harris, Investment Director, US Fixed Income

10.30  Coffee break

10.45  Multi-Asset: investing in risky assets as an insurer:
Four challenges and a solution
Ugo Montrucchio, Fund Manager, Multi-Asset
Clara Yan, Insurance ALM Director

11.15  Emerging Market Debt: is 2016 the beginning of a post crisis era?
Opportunities after 3 years of seismic change
Matthew Michael, Product Director, Emerging Market Debt and Commodities

11.45  Closing remarks
Charles Matterson, Insurance Asset Management

12.00  Depart for lunch at The Factory House
No. 10 Lime Street, EC3M 7AA
Speaker biographies

Charles Matterson, Insurance Asset Management

- Charles joined Schroders in 2008 to help manage relationships and design investment solutions for insurance clients. He has extensive experience covering clients in the UK and the US.

- Prior to joining Schroders Charles was a Managing Director and Head of Interest Rate Sales at Dresdner Kleinwort Benson. His 30 years investment experience include Fixed Income sales roles at Barclays and Credit Lyonnais.

- Charles has an MA in Arabic Studies from Cambridge University.

Keith Wade, Chief Economist & Strategist, Schroders

- Keith is responsible for our economics team which sets our house view on the Global economy. He is a member of Schroders’ Global Asset Allocation Committee, which is responsible for Asset Allocation views across our Multi-Asset strategies.

- Keith became our senior economist responsible for international economic forecasting in early 1992. He joined Schroders in 1988 as UK Economist. Prior to Schroders he was a researcher at the London Business School’s Centre for Economic Forecasting.

- He is a Member of the UK Society of Investment Professionals (UKSIP) and the Society of Business Economists. A Trustee and Chair of the Investment Committee at Addenbrookes Charitable Trust in Cambridge. He is a regular contributor to the financial press and has co-authored a book on macro-economics for MBA students.

- Keith has an MSc (and BSc) in Economics from the London School of Economics.
Speaker biographies

David Harris, Senior Fixed Income Director

- David joined Schroders in 1992
- In 1990, he joined Irwin Management Company as a Financial Analyst, prior to which he worked with Weston Financial Group
- David’s Investment career commenced in 1986 at State Street Bank & Trust
- MBA, J.L. Kellogg Graduate School of Management, Northwestern University. BBA, University of Massachusetts at Amherst

Ugo Montrucchio, CFA, CAIA - Multi-Asset Portfolio Manager

- Ugo joined Schroders in December 2013 and is based in London. He is a portfolio manager for the Strategic Beta portfolios. He is a member of the Credit risk premia research team
- Prior to joining Schroders, Ugo worked as a Director at BlackRock from 2007 (formerly Barclays Global Investors) where he was the lead portfolio manager specialising in diversified growth and risk parity strategies. He joined as a research associate in 2006 in the Liability Driven Investment (LDI) Team.
- Ugo also worked as a fixed income investment analyst at Barings Asset Management from 2004 to 2006. He was the joint portfolio manager specialising in a bespoke cash-based LDI strategy. Ugo’s career commenced in 2000 at Barra International Ltd, where he worked as a consultant to portfolio/risk managers
- CFA and CAIA Charterholder
- BSc in Economics, Turin (Italy); MSc Finance, Greenwich (UK)
Speaker biographies

Clara Yan, Insurance ALM Director

- Joined Schroders in 2015 to provide technical insurance and ALM expertise for insurers in the UK and Continental Europe.

- From 2009-2015 Clara was at the investment banking arm of UBS where she worked with UK and European insurance clients on ALM issues and helped build UBS’s Delta ALM modelling tool. Previously, she was Senior ALM strategist at Legal and General, helping to build its ALM model and manage its balance sheet.

- BCom in Actuarial Studies from Macquarie University; an MSc in Financial Mathematics from the Cass Business School.

- Fellow of the Institute of Actuaries in the UK and Australia.

Matthew Michael, Product Manager – Emerging Market Debt & Commodities

- Matthew joined Schroders in 2004, as an Investment Executive for Emerging Market Equities later joining the EMD, Commodities & Currencies team as Product Manager in 2006.

- His Investment career commenced in 2000 at The Royal Bank of Scotland as a junior currency trader. He then joined Russell Investment Co. as a rebalancing analyst

- MSc in International Finance, CERAM European Business School, France. Investment Management Certificate (IMC), Financial Planning Certificate (FPC)
Yields rise, but many bonds remain on negative yields

$4 trillion developed market sovereign bonds have a negative yield

Source: Bloomberg, Schroders Economics Group, at 2 December 2016
The global macro outlook

Key questions

- President Trump – what can we expect for the economy?
- Europe after Brexit
  - Has the UK shrugged off Brexit?
  - A year of political risk ahead in Europe
- Emerging markets, brighter outlook?
- Outlook and risks

Source: Schroders
Global snapshot

GDP since the crisis, dispersion persists

Index (100 = 2007 Q4)

Source: Thomson Datastream, Schroders Economic Group, at 18 November 2016
Emerging markets show signs of life

Developed markets vs emerging markets PMIs

Source: Thomson Datastream, Markit, Schroders Economics Group, at 10 November 2016
US
President Trump
Grow the economy 4% p.a. and create at least 25 million new jobs

Economy has not grown at 4% since 2000

Source: Thomson Reuters Datastream, Schroders Economic Group, at 10 November 2016
Create 25 million jobs
I would not start from here

Source: Thomson Datastream, Schroders Economics Group, at 15 November 2016
Will Trump label China a “currency manipulator”?

RMB continues to depreciate, but reserves are falling

Source: Thompson Reuters Datastream, Schroders, at November 2016
Brexit

“England has collapsed politically, monetarily and economically”

Mark Rutte, Dutch PM
Brexit
What they said

- “You cannot discern that anybody in the British Isles had a plan”
  Frank-Walter Steinmeier, German foreign minister

- “The Brexit vote…yet again reflected the drawbacks of Western democracy”
  Yang Chengxu, former Chinese ambassador to Vienna

- “Brexit means Brexit” Theresa May UK Prime Minister
Near-term impact of Brexit on UK economy

New post-Brexit forecast: Stagflation looms

Europe

Brexit, Trump…Le Pen?
Concerns have shifted from the economy to immigration
What are the two most important issues facing the EU?

Note: numbers do not sum to 100. Source: Standard Eurobarometer report No.85 Spring 2016. Schroders Economics Group
## Political risk set to return in Europe

A roadmap and guide to upcoming events

<table>
<thead>
<tr>
<th>Country</th>
<th>Event risk</th>
<th>Date</th>
<th>Probability</th>
<th>Market impact</th>
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</thead>
<tbody>
<tr>
<td>Hungary</td>
<td>Migrant quota rejected in referendum</td>
<td>02 October 2016</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Austria</td>
<td>Re-run of presidential election with far-right Freedom party winning</td>
<td>04 December 2016</td>
<td>Medium</td>
<td>Low</td>
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<tr>
<td>Italy</td>
<td>Constitutional referendum, leading to Renzi losing his job</td>
<td>04 December 2016</td>
<td>Medium</td>
<td>High</td>
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<tr>
<td>Netherlands</td>
<td>General election with the Party for Freedom calling an EU referendum</td>
<td>15 March 2017</td>
<td>High</td>
<td>Medium</td>
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<td>France</td>
<td>Presidential elections with the National Front winning</td>
<td>23 April and 7 May 2017</td>
<td>Low</td>
<td>Extreme</td>
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<td>Germany</td>
<td>Federal election with Alternative for Deutschland winning</td>
<td>Aug – Oct 2017</td>
<td>Very low</td>
<td>Extreme</td>
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<tr>
<td>UK</td>
<td>Article 50 triggered</td>
<td>By March 2017</td>
<td>High</td>
<td>Low</td>
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</table>

Source: Schroders Economics Group, at 28 September 2016
ECB QE continues, but for how long?
QE set to end March 2017, but expect an extension

Source: Thomson Datastream, Markit, CBI, ONS, Schroders Economics Group, at 14 November 2016; RHS Thomson Reuters Datastream, Schroders, at 18 November 2016
Emerging markets

Return to favour?
Currencies remain in focus
CNY detaches from strong dollar, whilst GBP, RUB and BRL are cheap

EM inflation trending lower
Provides scope for rate cuts

China activity model shows improving picture

Effects of stimulus being felt

Source: Thomson Datastream, Schroders Economics Group calculations, at 19 September 2016
Outlook and risks
Forecast update: Trump raises growth and risks
Global growth is upgraded for the first time in nearly two years

<table>
<thead>
<tr>
<th>Year</th>
<th>US</th>
<th>Europe</th>
<th>Japan</th>
<th>Rest of advanced</th>
<th>BRICS</th>
<th>Rest of emerging</th>
<th>World</th>
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</table>

Contributions to World GDP growth (y/y), %

Source: Schroders Economics Group, at 25 November 2016
Political risk is captured by “US fiscal reflation”, “Trump trade wars” and “Le Pen breaks Europe”. We have also brought back “Russian rumble” which assumes that President Putin invades the rest of Ukraine.

In “Bond yields surge” a US recession is triggered by a severe tightening of monetary conditions.

“Currency wars return” assumes a series of competitive devaluations. “Secular stagnation” that the world is in a chronic downturn.

Source: Schroders Economics Group, at 25 November 2016. Please note the forecast warning at the back of the document
The global macro outlook

Key takeaways

- **President Trump**
  - Fiscal plans spell higher growth, but also higher inflation, rates and USD
  - Trade war? Creates stagflation risk, but probably more talk than action

- **Europe after Brexit**
  - UK? OK so far, but Brexit impact yet to come and will be aggravated by delays to trade deal
  - A year of political risk ahead in Europe: do not ignore Le Pen

- **Emerging markets, brighter outlook?**
  - Fed rate hikes are challenge, but growth returning, currencies are competitive and capital accounts better balanced
  - China Party Congress points to year of macro stability, but serious challenges remain

Source: Schroders, at 30 November 2016
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Yield hunting

How value investing can help

16 December 2016

David Harris | Senior Investment Director, Fixed Income
Yields are low
Really low

US 10yr Treasury yield since 1790

Source: Deutsche Bank; data at September 2016
Lessons from 2016

Enough financial repression

Brexit

Trump

No Matteo

Next....

Low savings incentive + income inequality = FRUSTRATION!

The views and opinions contained herein are those of the Schroders US Fixed Income; at December 2016.
Trump’s challenge for the markets
Focus on tax cuts, infrastructure spending and trade policies

- Corporate taxes
- Personal taxes
- Spending
- Trade
- Immigration
- Healthcare

Sources: Schroder Economics Group, Trump Campaign; at 30 November 2016
US interest rates
No longer an easy call...

Cyclical:
- Capacity
- Wages rising
US interest rates

Wages picking up – job-switchers are seeing 4+% wage increases

Wage Growth Tracker¹
(median YoY change in matched individuals’ wages)

Personal Consumption²

¹Source: Atlanta Fed; data at October 2016
²Source: Bloomberg; data at October 2016
US interest rates
No longer an easy call…

Cyclical:
- Capacity
- Wages rising
- Inflation
- Fiscal stimulus
- Trade barriers
- Supply!

Secular:
- Demographics
US Interest rates

The real issue is not if inflation shows, it’s where

Impact of negative REAL interest rates

<table>
<thead>
<tr>
<th>Negative real rates</th>
<th>Boomer age</th>
<th>Price increases</th>
<th>When</th>
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<tbody>
<tr>
<td>IV Mar 2008 – Now</td>
<td>55 – 58</td>
<td>Healthcare/bonds</td>
<td>Mid 2010’s</td>
</tr>
</tbody>
</table>

Source: Schroders, BLS, NSA
US Interest rates
No longer an easy call…

Cyclical:
- Capacity
- Wages rising
- Inflation
- Fiscal stimulus
- Trade barriers
- Supply!

Secular:
- Demographics
- Globalisation
- Debt load
- Technology
- Profits
- Wealth

Cyclical/Secular ebb and flow will elevate uncertainty

The views and opinions contained herein are those of the Schroders US Fixed Income; at December 2016
Macro trends are difficult to predict
Market pricing continues to suggest rate hikes...to no avail

Fed fund futures at different points in time

Source: DB Global Markets Research; FRB, Bloomberg, Haver Analytics; at November 2016
The yield desert
Low yields everywhere

Yield to worst

Credit quality

Note: Red represents USD-denominated bonds, light blue represents Euro-denominated bonds, orange represents GBP-denominated bonds and grey represents EMD and others. Bubbles size represents size of market value.
Sources: Schroders, BoAML; data at November 2016
## The US yield desert

**Less arid: 4 year yield-to-worst, market size, and rating**

### Yield to worst (%)

<table>
<thead>
<tr>
<th>Credit quality</th>
<th>Agency MBS</th>
<th>Corp - AAA</th>
<th>Corp - AA</th>
<th>Munis - AA</th>
<th>Corp - A</th>
<th>ABS</th>
<th>EMD Corp - IG</th>
<th>EMD Sov - IG</th>
<th>Non-Agency MBS - IG</th>
<th>CMBS - IG</th>
<th>US Treasury</th>
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</thead>
<tbody>
<tr>
<td>AAA</td>
<td>0%</td>
<td>0%</td>
<td>1%</td>
<td>2%</td>
<td>3%</td>
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<td>6%</td>
<td>7%</td>
<td>8%</td>
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<td>2%</td>
<td>3%</td>
<td>4%</td>
<td>5%</td>
<td>6%</td>
<td>7%</td>
<td>8%</td>
<td>4%</td>
</tr>
</tbody>
</table>

### Source

Bloomberg, SIFMA, at November 2016
US investment grade corporates – industry divergence

Target five-year maturities, single-A rated

Monthly sector excess returns
(Barclays US Corporate Index – last 5 years)

Source: Barclays, at November 30, 2016
### Issuer price divergence

**Turbulence beneath the appearance of calm**

### 6 month total return

(Barclays US Corporate Index – A Rated, 3-7 year maturity)

<table>
<thead>
<tr>
<th>Description</th>
<th>Coupon</th>
<th>Maturity Date</th>
<th>Price</th>
<th>YTW</th>
<th>OAS</th>
<th>Ratings M</th>
<th>Ratings F</th>
<th>Ratings S</th>
<th>6M Total Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>CONTINENTAL AIRLINES INC</td>
<td>4.8</td>
<td>1/12/2021</td>
<td>105.18</td>
<td>2.94</td>
<td>135.4</td>
<td>A3</td>
<td>-</td>
<td>A</td>
<td>2.79%</td>
</tr>
<tr>
<td>AMERICAN AIRLINES</td>
<td>5.3</td>
<td>1/31/2021</td>
<td>106.77</td>
<td>2.84</td>
<td>126.4</td>
<td>A3</td>
<td>-</td>
<td>A</td>
<td>2.77%</td>
</tr>
<tr>
<td>RIO TINTO FINANCE USA LTD</td>
<td>3.5</td>
<td>3/22/2022</td>
<td>103.81</td>
<td>2.69</td>
<td>73.6</td>
<td>Baa1</td>
<td>A-u</td>
<td>A-</td>
<td>1.67%</td>
</tr>
<tr>
<td>RIO TINTO FINANCE USA PLC</td>
<td>2.9</td>
<td>8/21/2022</td>
<td>100.86</td>
<td>2.71</td>
<td>65.2</td>
<td>Baa1</td>
<td>A-u</td>
<td>A-</td>
<td>1.56%</td>
</tr>
<tr>
<td>HUNTINGTON NATIONAL BANK</td>
<td>2.9</td>
<td>8/20/2020</td>
<td>101.29</td>
<td>2.50</td>
<td>89.9</td>
<td>A3</td>
<td>A-</td>
<td>BBB+</td>
<td>1.33%</td>
</tr>
<tr>
<td>BHP BILLITON FINANCE</td>
<td>3.9</td>
<td>9/30/2023</td>
<td>105.73</td>
<td>2.92</td>
<td>74.4</td>
<td>A3</td>
<td>A+u</td>
<td>A</td>
<td>1.29%</td>
</tr>
<tr>
<td>AIRGAS INC</td>
<td>2.9</td>
<td>11/15/2022</td>
<td>100.33</td>
<td>2.84</td>
<td>74.4</td>
<td>A3</td>
<td>-</td>
<td>A-</td>
<td>1.10%</td>
</tr>
<tr>
<td>CONOCOPHILLIPS</td>
<td>2.9</td>
<td>11/15/2021</td>
<td>100.39</td>
<td>2.79</td>
<td>87.8</td>
<td>Baa2</td>
<td>A-</td>
<td>A-</td>
<td>1.02%</td>
</tr>
<tr>
<td>SOUTHERN CALIFORNIA EDISON</td>
<td>1.8</td>
<td>2/1/2022</td>
<td>98.71</td>
<td>2.35</td>
<td>79.5</td>
<td>Aa3</td>
<td>A+</td>
<td>A</td>
<td>0.73%</td>
</tr>
<tr>
<td>TRANSCANADA PIPELINES</td>
<td>2.5</td>
<td>8/1/2022</td>
<td>97.21</td>
<td>3.04</td>
<td>100</td>
<td>A3</td>
<td>-</td>
<td>A-</td>
<td>0.69%</td>
</tr>
<tr>
<td>UNITED TECHNOLOGIES</td>
<td>8.8</td>
<td>3/1/2021</td>
<td>124.17</td>
<td>2.69</td>
<td>99.3</td>
<td>A3</td>
<td>A-u</td>
<td>A-</td>
<td>-4.68%</td>
</tr>
<tr>
<td>STATE STREET CORP</td>
<td>3.7</td>
<td>11/20/2023</td>
<td>104.58</td>
<td>2.97</td>
<td>77.9</td>
<td>A1</td>
<td>AA-</td>
<td>A</td>
<td>-4.82%</td>
</tr>
<tr>
<td>KIMBERLY-CLARK CORP</td>
<td>2.4</td>
<td>6/1/2023</td>
<td>98.00</td>
<td>2.74</td>
<td>58.5</td>
<td>A2</td>
<td>A</td>
<td>A</td>
<td>-4.90%</td>
</tr>
<tr>
<td>BRISTOL-MYERS SQUIBB</td>
<td>7.2</td>
<td>6/15/2023</td>
<td>124.49</td>
<td>3.00</td>
<td>89.3</td>
<td>A2</td>
<td>A-u</td>
<td>A+</td>
<td>-4.96%</td>
</tr>
<tr>
<td>HERSHEY FOODS CORP</td>
<td>2.6</td>
<td>5/1/2023</td>
<td>98.46</td>
<td>2.89</td>
<td>73.3</td>
<td>A1</td>
<td>-</td>
<td>A</td>
<td>-5.00%</td>
</tr>
<tr>
<td>PHILIP MORRIS INTL INC</td>
<td>3.6</td>
<td>11/15/2023</td>
<td>103.63</td>
<td>3.02</td>
<td>82.8</td>
<td>A2</td>
<td>A</td>
<td>A</td>
<td>-5.09%</td>
</tr>
<tr>
<td>BRISTOL-MYERS SQUIBB</td>
<td>3.3</td>
<td>11/1/2023</td>
<td>103.37</td>
<td>2.71</td>
<td>52.5</td>
<td>A2</td>
<td>A-u</td>
<td>A+</td>
<td>-5.14%</td>
</tr>
<tr>
<td>COCA - COLA ENTERPRISES INC.</td>
<td>8.5</td>
<td>2/1/2022</td>
<td>128.07</td>
<td>2.65</td>
<td>75.6</td>
<td>WR</td>
<td>A+</td>
<td>AA-</td>
<td>-5.39%</td>
</tr>
<tr>
<td>LACLEDE GAS</td>
<td>3.4</td>
<td>8/15/2023</td>
<td>101.50</td>
<td>3.14</td>
<td>96.1</td>
<td>A1</td>
<td>A</td>
<td>A</td>
<td>-5.67%</td>
</tr>
</tbody>
</table>

Source: Bloomberg, at November 30, 2016
Alpha matters

Compound effects of excess return

Source: eVestment, at September 2016.
Past performance is not a guarantee of future results. The value of an investment may go down as well as up and is not guaranteed. Performance is stated gross of fees.
Value at work
Effects of return differentiation

5 year risk / return

Source: eVestment, at 30 September 2016. Past performance is not a guarantee of future results. The value of an investment may go down as well as up and is not guaranteed. Performance is stated gross of fees. Please see the Appendix for additional information.
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Investment summary
2017 US bond market guidelines

- **US interest rates higher, but probably not too much**
  - Secular deflationary forces ultimately limit the impact of cyclical inflationary forces
  - Higher US yields are already attracting capital from low-yielding regions

- **Without rising interest rates, yield will be the main driver of returns**
  - Risk premium vary widely by sector and industry

- **Growth not too hot or too cold for corporate credit**
  - Rapidly evolving policy outlook suggests divergent industry returns

- **Security selection determined by more than just industry**
  - Idiosyncratic factors will be at least as important as the last two years

- **Characteristics of some non-corporate sectors offer good risk-adjusted yield and diversification**
  - The securitised market is naturally short maturity, a large part of which is floating rate
  - Commercial MBS stand out as having good value
No longer just matching maturities or replicating market exposures

Use markets to your advantage

- Understand your primary/secondary goals, as well as less conventional tools at your disposal
- Survey the market for the broadest possible universe of investments
- Balance credit, structure and liquidity risks

Seek out a customised solution

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Investing in risky assets as an insurer:
Four challenges and a solution

December 2016

Ugo Montrucchio | Fund Manager, Multi-asset
Clara Yan | ALM Director, Insurance Asset Management
Agenda

- Four challenges posed by investing in risky assets as an insurer
- Our solution
Challenge 1 - Volatility
Problems with holding risky assets

- Years of monetary stimulus may have turned investors unduly complacent towards market volatility
- …and potentially distorted some relationships between asset classes

**S&P 500 (inflation adjusted) drawdowns**

**Rolling asset class correlations**

Future returns will be challenging; dynamic asset allocation is key

Source: Schroders, BoA, at December 2016. Performance attribution assumes no transaction costs as well as flat yield curves (providing no roll-down component). Simulation analysis assumes defaults to be in line with current market expectations, no transaction costs and a yield shift occurring at mid point of the scenario horizon.
Challenge 2 - Diversification

Asset allocation exposure does not equal risk exposure

- Exposure-based asset allocation can lead to an over-concentration of risk
- Simply adding asset classes does not improve diversification

By exposure

- 60/40
- Long-term investment model

By Risk

- 60/40
- Long-term investment model

Diversify by risk, not asset class

Source: Schroders. The views and opinions are those of the Multi-Asset team and may change.
Long-term Investment Model is calibrated upon the asset allocation of a large North-American endowment scheme.
Challenge 3 – risk vs capital

Risk does not equal capital for an insurer

Risk is defined as the standard deviation of return over five years. Capital is calculated using Solvency II standard formula.

The return used above are the result of statistical modelling, based on a number of assumptions and should not be considered as a prediction of future returns.

Screen out capital inefficient investments

Source: UBS Delta, Swiss Re, Barclays Point, EIOPA

Risk is defined as the standard deviation of return over five years. Capital is calculated using Solvency II standard formula.

The return used above are the result of statistical modelling, based on a number of assumptions and should not be considered as a prediction of future returns.
Challenge 4 – Capital instability
Dynamic asset allocation can lead to capital volatility

Dynamic asset allocation:
- React to market changes.
- Take advantage of short term market opportunities.
- Apply active risk management process.

Capital impact:
- Capital impact is not typically considered in a standard dynamic asset allocation process.
- Varying asset allocation can lead to capital uncertainty.
- Capital can be prohibitively high, exceeding the standard equity capital charge of 39%.

Typical dynamic asset allocation vs SCR

Insurers need the ability to control the capital consumption of their risk assets

Source: Schroders, Insurance ERM, at December 2016. For illustration purpose only.
We want a diversified, actively managed strategy with lower capital than equities

Source: Schroders. For illustration purpose only
1. Diversification by risk factors and not exposure

Construct portfolio by grouping assets that are driven by similar risk factors

<table>
<thead>
<tr>
<th>Growth</th>
<th>Slowdown</th>
<th>Inflation</th>
<th>Alternative Risk Premia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investments that perform best when economic growth is rising/positive</td>
<td>Investments that perform best when economic growth is falling/negative</td>
<td>Investments that perform best when inflation is rising</td>
<td>Investments that are not primarily linked to the economic cycle</td>
</tr>
</tbody>
</table>

**Equities**
- Developed markets
  - Asia Pacific ex-Japan
  - Europe ex-UK
  - Japan
  - North America
  - UK
- Emerging markets
  - Broad emerging markets

**Credit Spreads**
- Investment Grade
- High Yield

**Sovereign bonds**
- Developed markets
  - Asia Pacific ex-Japan
  - Europe ex-UK
  - North America
  - UK
- Emerging markets
  - Mexico
  - Poland

**Commodities**
- Inflation breakevens
  - Inflation linked vs Nominal bonds

**Credit Spreads**
- Investment Grade
- High Yield

**Credit Spreads**
- Investment Grade
- High Yield

Source: Schroders, at 30 November 2016. For illustrative purposes only and subject to change
2. Dynamic asset allocation

We actively tilt exposure to risk premia according to our market views

1. Initial allocation by risk premia

Balance risk exposure across portfolio

2. Asset allocation by value tilts

Build long-term exposures

3. Risk management with volatility targets

A

Reducing exposure to a factor

Ex-ante portfolio risk (%)

B

Reducing the total portfolio risk

Source: Schroders, for illustrative purposes only
3. Capital Screening
We identify Solvency II capital-inefficient trades and exclude them.

Unconstrained SCR Strategy, SCR ~ 32%

Capital Constrained Strategy, SCR ~ 16%

Source: Schroders, at 30 November 2016. For illustrative purpose only.
4. Capital stability
We systematically control Solvency II capital to max 20% (equities are 39%)

SCR screening
At portfolio construction

Systematic monitoring of SCR

Rebalance Portfolio

Reports for insurers
QRT Tripartite SCR

Source: Schroders. For illustration purpose only
Model portfolio
Positioning*

Risk allocation

Risk allocation (% of total portfolio risk)

<table>
<thead>
<tr>
<th>Risk premia</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth</td>
<td>37%</td>
</tr>
<tr>
<td>Slowdown</td>
<td>27%</td>
</tr>
<tr>
<td>Inflation</td>
<td>22%</td>
</tr>
<tr>
<td>Alternative Risk Premia</td>
<td>14%</td>
</tr>
</tbody>
</table>

- **Growth**
  - Regional equities: 37%

- **Slowdown**
  - Developed Market Government bonds: 27%

- **Inflation**
  - Commodities: 18%
  - Inflation Breakevens: 4%

- **Alternative Risk Premia**
  - Carry: 6%
  - Cross-Asset Momentum: 5%
  - Value: 2%
  - Size: 2%

**Target Return**: LIBOR + 3%

Source: Schroders, December 2016. *Positions and securities are mentioned for illustrative purposes only and should not be viewed as a recommendation to buy/sell. Current model portfolio does not contain any active decisions. Portfolio holdings can change at any time. Totals may not sum due to rounding.
Model portfolio

Simulated since inception performance

<table>
<thead>
<tr>
<th>Schroder Capital Aware Backtest</th>
<th>S&amp;P 500 Total Return Index</th>
<th>Schroder Multi Asset Fund</th>
<th>SCR Capital Aware Backtest (RHS)</th>
<th>SCR Equity (RHS)</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Schroder Capital Aware Backtest</th>
<th>Since Inception p.a.$^2$</th>
<th>Since Inception Volatility p.a.$^3$</th>
<th>Return over risk</th>
<th>Max Drawdown</th>
<th>SCR Range</th>
<th>Return on Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500 Total Return Index</td>
<td>4.4%</td>
<td>4.6%</td>
<td>0.9</td>
<td>-11.6%</td>
<td>17% to 19%</td>
<td>0.24</td>
</tr>
</tbody>
</table>

Source: Schroders, 31 October 2016. Performance shown above for the “Backtest” portfolio represents a simulated track record, optimised for the solvency capital ratio, using weekly data, gross of fees and presented in Pound sterling. $^1$ Schroders Strategic Beta Fund $^2$ Inception date was 3 May 2006 for the Capital Aware Backtest and S&P 500 Total Return Index. $^3$ Volatility is unaudited, annualised and calculated using gross weekly returns. Past performance is not a guide to future performance and may not be repeated. Please see the important disclosures at the end of the presentation.
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Emerging Market Debt

Is 2016 the beginning of a post crisis era?

December 2016

Matthew Michael | Product Director – Emerging Market Debt and Commodities
Why Emerging Market Debt
Over 50 Countries, a world of opportunities

EMD fixed income universe

Total universe by sector

Emerging Market Debt TOTAL = US$18.2 trillion

Source: Schroders, at 31 March 2016. The information on this page is for illustrative purposes only and should not be viewed as a recommendation to buy/sell.
EMD: 2016 – A Post Crisis Era?

<table>
<thead>
<tr>
<th>Stage 1 Post Crisis</th>
<th>Stage 2 Recovery</th>
<th>Stage 3 Euphoria</th>
<th>Stage 4 Crisis</th>
<th>Stage 1 Post Crisis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Macro adjustment, high asset price volatility</td>
<td>Reforms and sound fundamentals, differentiation in asset performance</td>
<td>Policy mistakes and macro imbalances</td>
<td>Devaluation, emergency rate hikes and credit crisis. Panic selling</td>
<td>Macro adjustment, high asset price volatility</td>
</tr>
</tbody>
</table>

Source: Bloomberg; Schroders, at 30 June 2016. Past performance is not a guide to future performance and may not be repeated.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Return</strong></td>
<td><strong>Vol</strong></td>
<td><strong>Sharpe</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GBI EM</td>
<td>11.23</td>
<td>11.83</td>
<td>0.80</td>
<td>-10.07</td>
</tr>
<tr>
<td>ELMi+</td>
<td>8.24</td>
<td>10.97</td>
<td>0.44</td>
<td>-5.59</td>
</tr>
<tr>
<td>EMBI+</td>
<td>9.86</td>
<td>19.21</td>
<td>0.24</td>
<td>-0.30</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Sharpe</th>
<th>Vol</th>
<th>Return</th>
<th>Sharpe</th>
<th>Vol</th>
<th>Return</th>
<th>Sharpe</th>
<th>Vol</th>
<th>Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.80</td>
<td>11.83</td>
<td>11.23</td>
<td>1.0</td>
<td>9.58</td>
<td>2.49</td>
<td>0.30</td>
<td>5.70</td>
<td>-5.59</td>
</tr>
<tr>
<td>0.44</td>
<td>10.97</td>
<td>8.24</td>
<td>0.97</td>
<td>6.73</td>
<td>12.96</td>
<td>1.95</td>
<td>7.56</td>
<td>-0.30</td>
</tr>
<tr>
<td>0.24</td>
<td>19.21</td>
<td>9.86</td>
<td>0.98</td>
<td>11.58</td>
<td>11.58</td>
<td>9.81</td>
<td>6.73</td>
<td>0.00</td>
</tr>
</tbody>
</table>

69
The collapse in EM Currencies appears overdone


Source: JP Morgan; Bloomberg, at 30 November 2016
South Africa: real effective exchange rate
cheap and oversold

REER: still at historically depressed levels

Source: Bloomberg; Schroders, at 22 September 2016
Investment outlook

Global Environment Valuations

EM Local vs. EM External yields: highest, lowest and current

Local Bond Yield %

External Bond Yield %

Source: Schroders; Bloomberg; JP Morgan, at 31 October 2016
Investment outlook

Emerging Markets  Fundamental Analysis

EM sovereign and corporate credits remain broadly unattractive

External Debt Spread (EMBI+ Index) vs. EM Currencies (JPM EM Currency Spot Index)

EMBI+ Spread in bps

JPM EM Currency Spot Index

Spreads in 5 year range

Source: Schroders; Bloomberg, at 30 November 2016
Investment outlook

Crisis brings change

Emerging Markets

Fundamental Analysis

India
Prime Minister N. Modi

Indonesia
President J. Widodo

Argentina
President M. Macri

Brazil
President D. Rousseff

South Africa
President J. Zuma

For illustrative purposes only
Investment outlook

Crisis brings change

Indonesia – Back to external trade surplus
Trade balance in $ billion – 12 month rolling sum

Indonesia – Inflation back to target

Source: Schroders; Thomson Datastream; Bank of Indonesia, at 31 August 2016
Country Risk Score – September 2016

Source: Schroders, at September 2016
Investment outlook

Country Risk Score before and after crisis

Score

Source: Schroders; Thomson Datastream, at November 2016
Investment outlook

Brazil – Country Risk Score by Vulnerability Indicator (1980 – 2016)

Growth dynamics

Sovereign External Liquidity

Hot Money Indicator

Banking System Ext. Liquidity

Competitiveness

Credit Cycle

Total Country Risk Score

Source: Schroders, at September 2016
Country Risk Scores

**Indonesia**

**India**

**Mexico**

Source: Schroders; Thomson Datastream
Investment outlook

Hot Money Indicator – Average country score by region

Source: Schroders, at 30 September 2016
China: Forced quantitative tightening over?

PBOC Total Asset Annual Growth (%)

Key Central Banks Assets % GDP

FX Reserves % M2

Source: Bloomberg; Datastream; Schroders, at August 2016
A unique approach to EMD investing

Well established process: focusing on risk-adjusted returns

<table>
<thead>
<tr>
<th>Objectives</th>
<th>Investment approach</th>
<th>Role in portfolios</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. No losses in any 12 month period</td>
<td>Broad investment universe in over 50 countries</td>
<td>Low-risk or entry level EMD exposure</td>
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<tr>
<td>2. Maximise returns whilst achieving objective 1</td>
<td>Long-only, Absolute Return</td>
<td>Complements EMD beta strategies</td>
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<td>No leverage or complicated derivatives</td>
<td>Absolute return; diversifies risk and enhances returns</td>
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<td>Simple but effective risk controls</td>
<td>A liquid alternative investment</td>
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<td>Experienced, stable team unchanged for over 16 years</td>
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Source: Schroders, at November 2016. For illustrative purposes
Performance
Proven diversification: low correlation to other fixed income sectors

Schroder ISF EMD Absolute Return

3-year rolling correlations

Managing risk and Maximising Returns

Source: JP Morgan; Bloomberg – 30 November 2016

*C share class NAV to NAV net of fees. **Absolute Return † GBI – EM inception July 2001 ^ Based on average monthly returns of peer group
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