Schroders

Marketing material for professional investors and advisers only

Schroder ISF* Asian Total Return

Monthly Fund Update

November 2019

Fund Performance

Performance of Schroder ISF Asian Total Return ('C' Class Accumulation Units)

Since Inception (16 November 2007) to end of November 2019, indexed returns in USD

Calendar year returns (%)

	Fund	Index
2018	-14.6	-13.9
2017	40.2	37.0
2016	7.2	6.8
2015	-2.5	-9.4
2014	7.1	2.8
2013	5.0	3.4
2012	22.2	22.3
2011	-3.8	-15.6
2010	25.4	18.1

Source: Schroders, bid to bid, with net income invested. Index: MSCI AC Asia Pacific ex Japan, USD terms

Past performance is not a reliable indicator of future results, the prices of shares and the income from them may fall as well as rise, and investors may not get back the full amount originally invested.

%	November 2019	YTD	1 Year	3 Years Annualised	Annualised Since Inception	Annualised Standard Deviation	Sharpe Ratio (RFR = USD 3-month LIBOR)
Schroder ISF Asian Total Return (C Class USD)	0.7	13.7	11.0	10.2	9.5	15.9	0.5
MSCI AC Asia Pacific ex Japan index	0.4	12.9	9.8	9.8	3.0	20.7	0.1
USD 3-month LIBOR	0.2	2.2	2.4	2.0	1.1	0.3	--
Lipper Equity Asia Pacific ex Japan universe	0.0	12.1	9.0	8.2	2.0	20.4	0.1
Quartile Ranking (Fund Ranking)	Q2 (181/603)	Q2 (243/585)	Q2 (239/584)	Q2 (138/521)	Q1 (1/256)	Q1 (6/256)	Q1 (1/256)

Source: Bloomberg, Lipper IM, Schroders, as at end of November 2019. Quartile data source: Lipper universe.
Lipper universe annualised standard deviations and Sharpe ratios are calculated for the period since the fund's inception, and annualised returns are calculated based on number of days since inception. For illustrative purposes only and should not be construed as a forecast, prediction or projection of the future or likely performance of the fund. The fund is not managed with reference to any specific benchmark(s) but its performance may be measured against one or more.

*Schroder International Selection Fund referred to as Schroder ISF throughout this document

PORTFOLIO REVIEW

Continued balance sheet expansion by the Federal Reserve, coupled with a strong third-quarter US earnings season and embryonic signs of global growth stabilising, helped to bolster investor confidence and lift global markets this month. The MSCI World index posted gains of +2.8%. However, the global rally in developed markets failed to trickle down to Asian markets where sentiment remained fragile on the back of escalating violence in Hong Kong SAR between pro-democracy protesters and the police. The Indonesian market also suffered a severe bout of weakness this month, dropping by -2.8% even though headline news had been light. On-the-ground feedback is pointing to likely insolvency issues, with two large funds being forced to sell shares into illiquid markets.

Against this backdrop, the fund rose +0.7% (C class share in USD) in November, which compares to a return of +0.4% by the regional MSCI AC Asia Pacific ex Japan index. This represents a reasonable outcome for the fund given the amount of hedges maintained through the month. This brings the year-to-date returns of the fund to +13.7% versus the regional index of +12.9% and USD 3M LIBOR of +2.2%.

RISK CONSIDERATIONS

Capital may be subject to circumstances and periods where returns could be negative. Therefore, capital is not guaranteed and may decrease.

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.

Investments in small companies can be difficult to sell quickly which may affect the value of the fund and, in extreme market conditions, its ability to meet redemption requests upon demand.

Emerging markets will generally be subject to greater political, legal, counterparty and operational risks.

The fund may hold indirect short exposure in anticipation of a decline in the prices of these exposures or an increase in interest rates.

The fund enters into financial derivative transactions. If the counterparty was to default, the unrealised profit on the transaction and the market exposure may be lost.

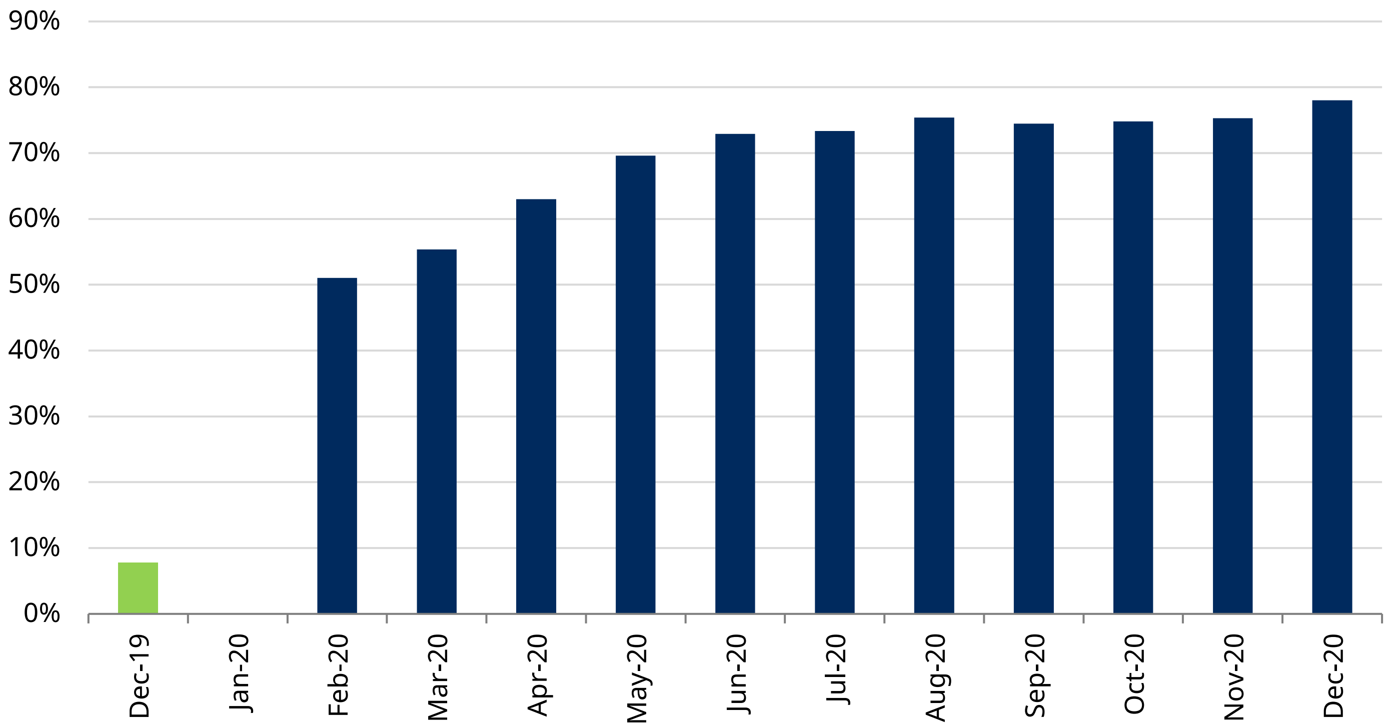
Changes in China's political, legal, economic or tax policies could cause losses or higher costs for the fund.

STRATEGY REVIEW AND FUND STRATEGY

Australian banks: dividend opportunities or dividend traps?

As widely expected by the market, the Reserve Bank of Australia (RBA) decided, at its December meeting, to hold its interest rate at the historical low of 0.75%. In his statement, RBA governor Philip Lowe highlighted that even though risks are "still tilted to the downside", these have already started to abate recently. With the global economic outlook looking "reasonable", he expects the Australian economy to successfully navigate through its current soft patch. This is as the effects of "low level of interest rates, recent tax cuts, ongoing spending on infrastructure, the upswing in housing prices and a brighter outlook for the resources sector" start filtering through. Despite the RBA's sanguine narrative, market experts are not convinced. In fact, three-quarters of them now expecting lower rates in one year's time.

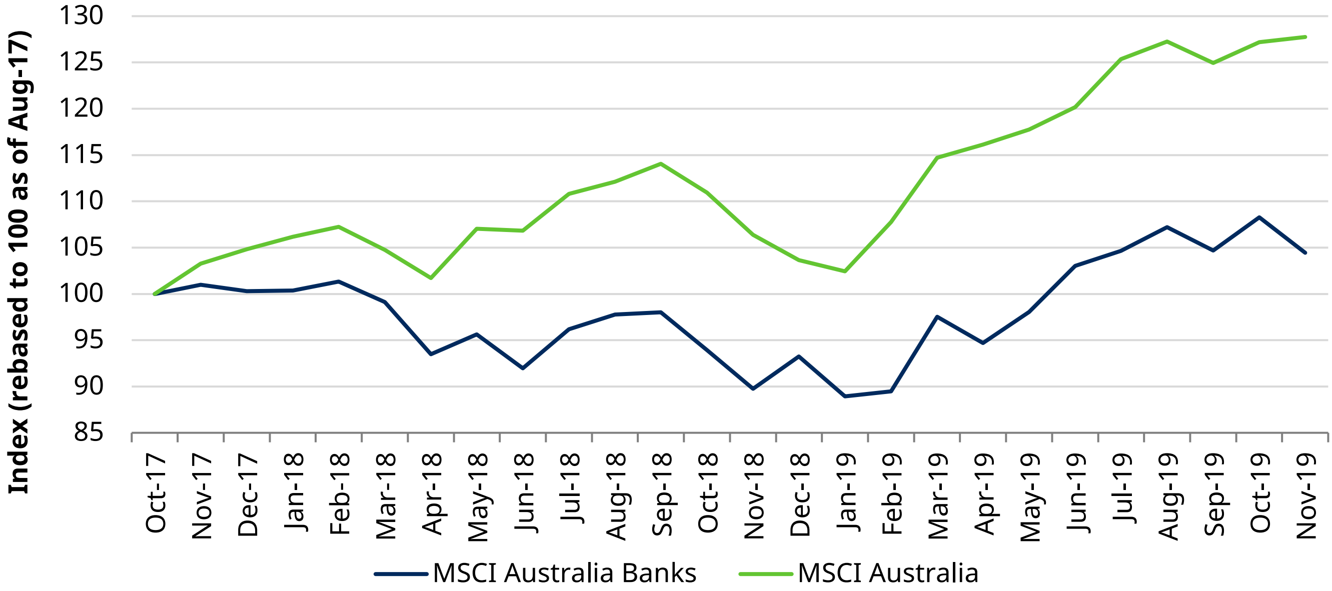
Chart 1: Market sees 75% probability of lower Australian rates over the next one year



Source: Bloomberg, Schroders

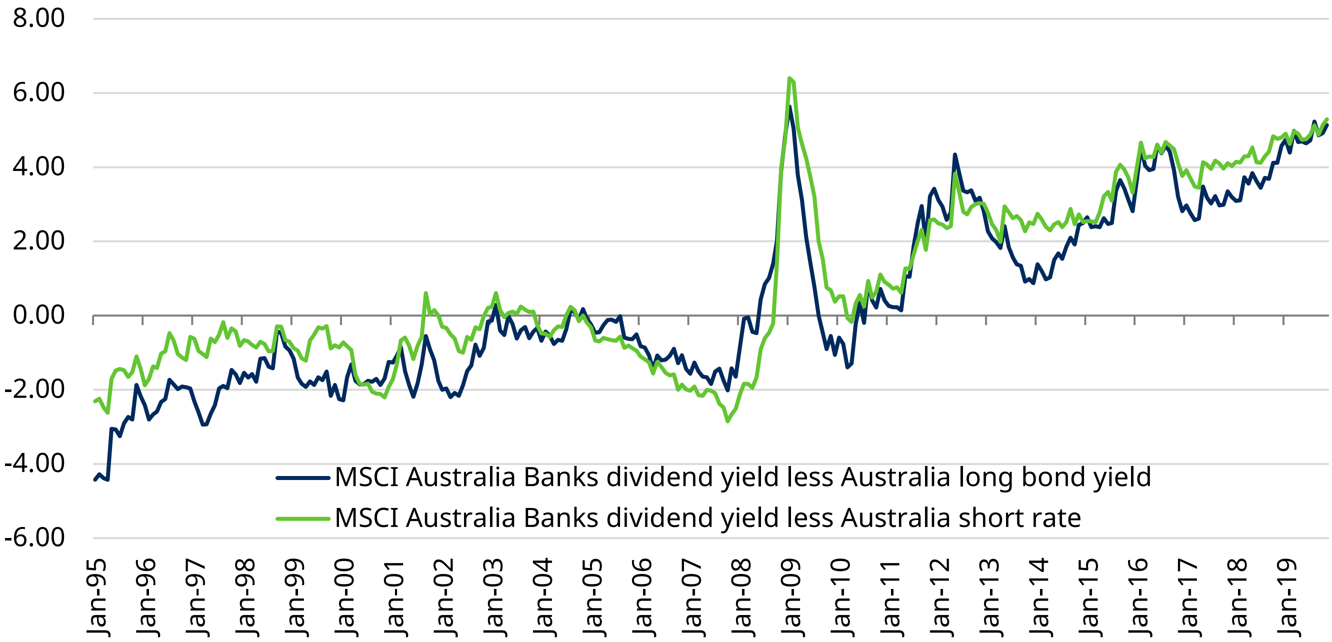
As interest rate expectations plummet and investor interest in dividend-yielders mount, attention invariably turns to Australian banks again. After all, the sector has already underperformed the broader market by almost 25% over the last two years. Meanwhile original fears about the Hayne Royal Commission have also largely fizzled into dozens of misconduct recommendations that, while numerous, amounted to little that will threaten the market dominance of the "Big Four". With the yield carry of the banks now back near historical highs, one can be forgiven for giving the sector another look-over.

Chart 2: Australian banks have lagged the broader market by almost 25% over the last two years



Source: MSCI, Factset, Schroders

Chart 3: Spreads between dividend yields of Australian banks and local interest rates are near historically high levels



Source: MSCI, Factset, Schroders

Readers will remember that your fund managers have been pessimistic on Australian banks for a couple of years. Hence, before readers are being lured back into the sector on what are likely to be unsustainable dividend yields, the recent episode at Westpac Bank should hopefully give cause for pause. On the 20th of last month, regulator AUSTRAC (Australian Transaction Reports and Analysis Centre) announced a lawsuit against the bank, accusing it of more than 23 million breaches of money-laundering laws, the largest in the country's history. Among them were allegations that the bank had turned a blind eye to individuals paying for child pornography in Philippines, while also failing to report more than A$11 billion in payments into and out of the country using a bank-to-bank system that was originally intended to facilitate pension transfers. CEO Brian Hartzer swiftly resigned within days of the charge, and Chairman Lindsay Maxsted simultaneously announced his early retirement.

However even before the public outcry had a chance to subside, details on National Australia Bank's earlier self-reported breaches to AUSTRAC were already emerging. According to local newspaper The Australian, the transgressions span a range of issues including a failure to correctly monitor thousands of customer transactions to sanctioned countries as well as inadequate screening of 150,000 customer accounts to guard against money laundering and terrorism financing. When all these are taken together with the 2018 breaches of the same laws by the Commonwealth Bank of Australia, it is difficult not to conclude that a more systemic problem is plaguing the sector. Years of under-investment in financial crimes detection systems and processes have finally caught up, and it is now payback time. This will mean sustained elevated spend on compliance and systems, higher costs, lower profits and eventually lesser dividends.

Fines and penalties are also a given. This will represent a depletion to banks' capital that also has to adhere to APRA's recently raised standards for being "unquestionably strong", and should further undermine dividends. As of today, the quantum of these fines is too early to determine. The last time the Commonwealth Bank settled with AUSTRAC, it was to the tune of $700 million, a record for corporate fines then. Given the enormity of the Westpac breaches, a figure north of that is a certainty. Sell-siders are generally assuming a $1 billion penalty. Your fund manager suspects that there is not much science behind this estimate other than it being a nice, round number that is also substantially more than $700 million. The stock market has clearly taken a much more negative view as more than $6 billion has been wiped off the bank's market capitalisation since the allegations came to light.

The industry's latest AML-CTF debacle cannot have come at a worse time. As it is, the sector is already buckling under the weight of consumer debt saturation, softening housing credit growth and falling business lending. The two consecutive interest rate cuts by the RBA in June and July, together with the latest in October, have only served to further crimp net interest margins. This is despite the banks having not passed through the rate cuts in full to their customers, a move that has infuriated Treasurer Josh Frydenberg and prompted his call for an investigation by competition watchdog ACCC. If the market's expectation for more cuts next year does eventuate, then profits and dividends of the major banks will remain under pressure.

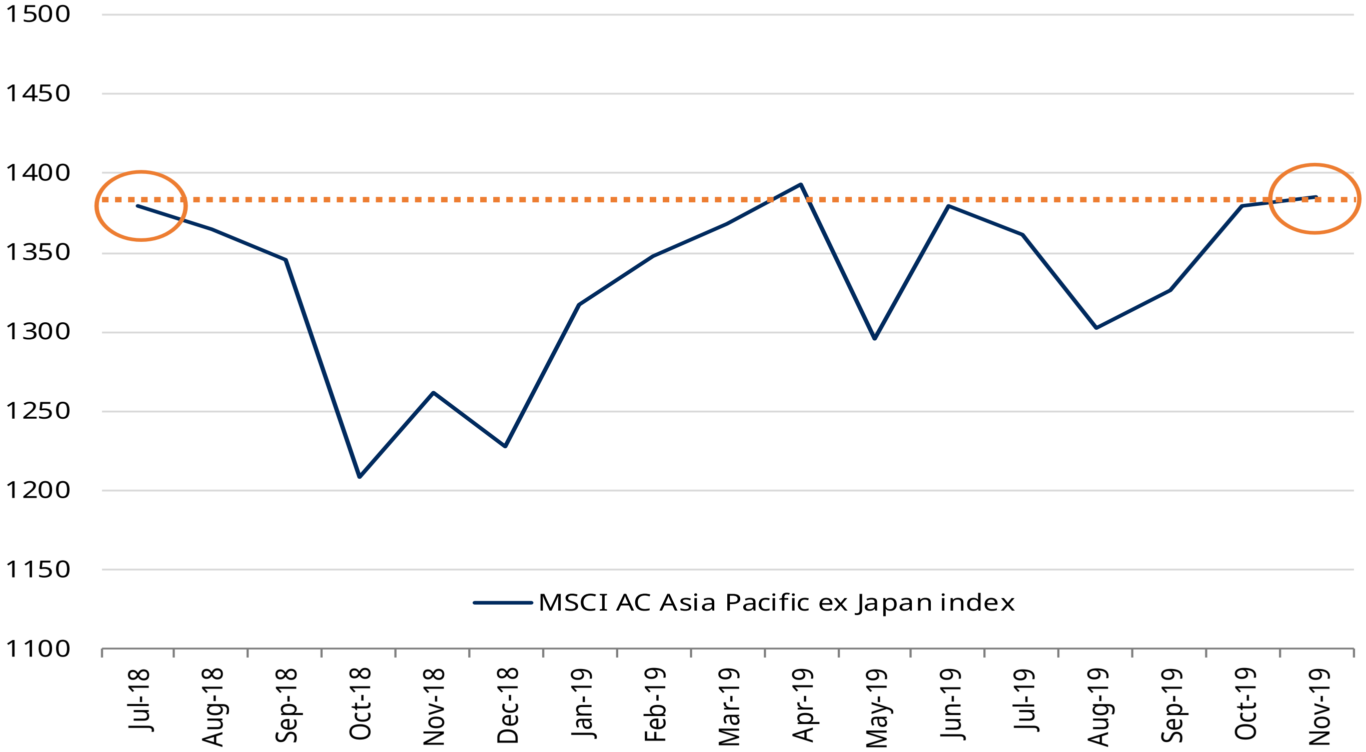
None of these should, however, suggests that the sector is permanently un-investible. After all, there is a price for everything, and more so for a cosy oligopolistic structure that should still underpin steady returns over the long-term. One just needs to see that the compliance issues are being properly addressed, and that the bad news, plus a healthy dose of caution, is being sufficiently impounded in share prices. Based on our calculations, that remains some distance away.

Tactical hedging: going nowhere fast

This month, we briefly review our tactical hedging model which has been giving us a neutral (i.e. hold) signal for much of the last one-and-a-half years. Amidst all the market volatility, Brexit concerns and Trump tweets on will-we-won't-make-a-deal-with-China, it is interesting to note that through all the ups-and-downs, the Asian regional index has ended up at pretty much where it was 18 months ago. It seems that, like the indicators within our CART model, nothing has really changed.

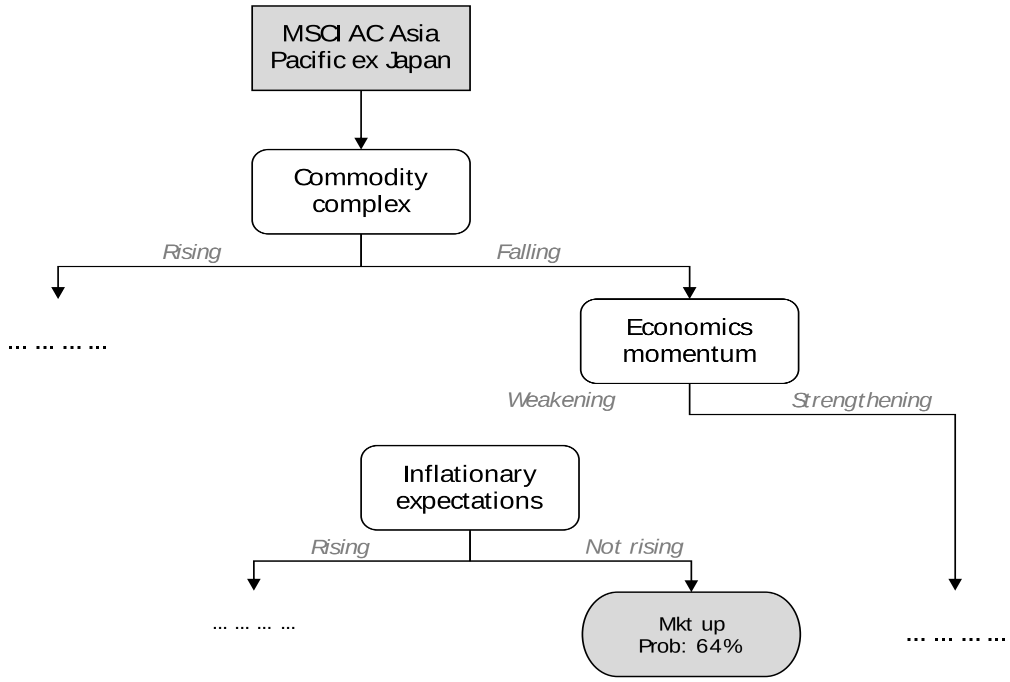
Much of the reticence of our tactical model stems from the fact that whilst a generally declining commodity complex should be supportive of Asian earnings, that is being offset by a broader slowdown in economic momentum which has historically proven to be poor for Asian stock market performance. With the other indicators such as valuation and inflationary expectations sitting on the fence, our model suggests that the Asian index is likely to go up over the next three to six months. The conviction of the call is however not high. On average when our indicators are ticking the same boxes as current readings, markets have tended to rise by an insipid +1.1%, while the probability of positive returns is also uninspiring at 64%. With the 4D's continuing to afflict the global economy, coupled with brewing troubles in Hong Kong, we are maintaining our hedges in the portfolio. These are mostly in the form of put options on the HSI and HSCEI, where we have been able to take advantage of market volatility to acquire them on days when pricing is cheap. This leaves our net long at ~85%, a level that should allow a high degree of market participation while balanced with an appropriate degree of downside protection.

Chart 4: Through all the ups and downs, we are where we were 18 months ago



Source: MSCI, Factset

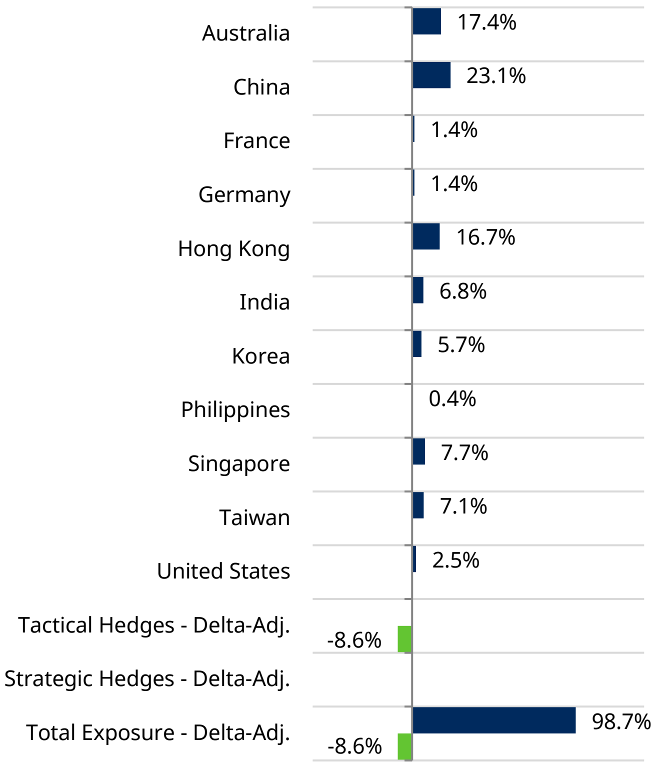
Chart 5: Our tactical hedging model continues to give a neutral signal - forecasting 64% chance of positive returns with an average 1% rise in markets over three months

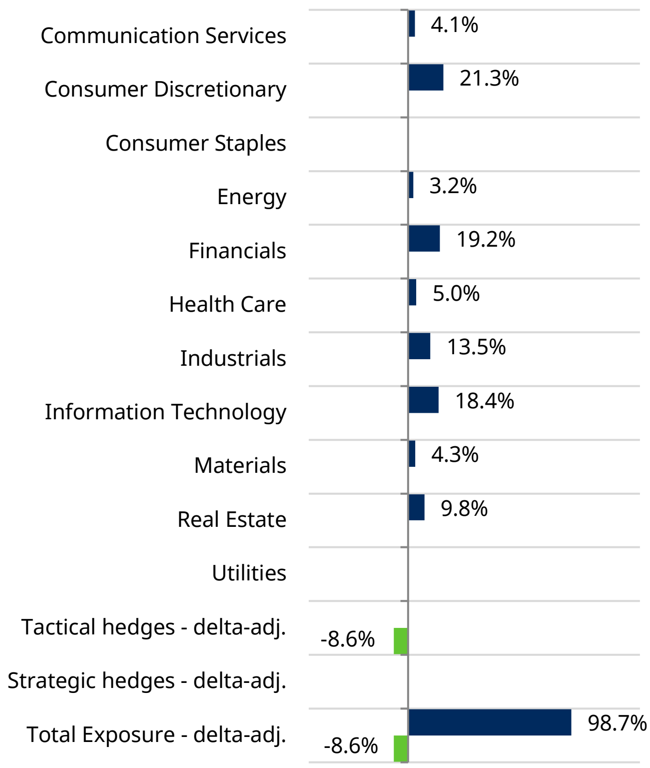


Source: Schroders

Lee King Fuei, Robin Parbrook
3 December 2019

FUND POSITIONING





Source: Schroders, as at end of November 2019.

For illustrative purposes only and does not constitute any recommendation to invest in the above mentioned countries.

TOP 10 HOLDINGS

Stock	Fund (%)
Samsung Electronics	5.7
TSMC	5.7
Alibaba	4.9
HDFC Bank	4.3
Tencent	4.1
AIA	3.9
Jardine Strategic	3.6
Techtronic Industries	3.2
Galaxy Entertainment	3.1
BHP Group	2.9
Total	**41.3**

Source: Schroders, as at end of November 2019.

For illustrative purposes only and does not constitute any recommendation to invest in the above mentioned countries.