Schroders

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Schroder ISF* Asian Total Return Fund Update

March 2021

Fund Performance

Performance of Schroder ISF Asian Total Return ('C' Class Accumulation Units)
Since Inception (16 November 2007) to end of Mar 2021, indexed returns in USD

Calendar year returns (%)

	Fund	Index	Comparator
2020	31.0	22.4	0.7
2019	18.5	19.2	2.4
2018	-14.6	-13.9	2.4
2017	40.2	37.0	1.3
2016	7.2	6.8	0.8
2015	-2.5	-9.4	0.3

Index: MSCI AC Asia Pacific ex Japan, USD terms.
Comparator: USD 3 Month LIBOR (or an alternative reference rate).
Source: Schroders, bid to bid, with net income invested.

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.

%	Mar 2021	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)	-2.4	4.4	71.1	11.5	11.5	16.6	0.6
MSCI AC Asia Pacific ex Japan index	-2.1	2.7	58.6	9.1	4.7	20.8	0.2
USD three-month LIBOR	0.0	0.0	0.3	1.6	1.0	0.3	--
Lipper Equity Asia Pacific ex Japan universe	-2.4	3.6	60.4	8.2	4.1	20.8	0.1
Quartile Ranking (Fund Ranking)	Q3 (302/563)	Q2 (232/558)	Q1 (101/537)	Q1 (108/491)	Q1 (2/232)	Q1 (6/232)	Q1 (1/232)

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.
Source: Bloomberg, Lipper IM, Schroders, as at end of Mar 2021. Quartile data source: Lipper universe.

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

MARCH PERFORMANCE

March was a more difficult month for Asian stockmarkets, with most markets ending up down or flat. A combination of worries over rising inflationary pressures and increasing signs that US/Western vs. China trade tensions could escalate unnerved investors. Of the bigger markets MSCI China was the weakest, falling over 6% as most internet and electric vehicle stocks corrected sharply. This was partly due to the collapse of Archegos Capital but was also due to a significant rotation from growth to perceived "value" stocks on the back of hopes of global reflation. This resulted in the MSCI Singapore, which is very heavily weighted in banks and property, being the best performing market over the month rising 6%.

Elsewhere, most markets were flat. Results season was generally positive in Taiwan and Korea, with technology stocks in particular mostly producing very strong results. However, after very significant share price moves, the results appeared to have been well-anticipated and share prices consolidated. In ASEAN, performance was more mixed, with the Philippines and Indonesian stockmarkets falling sharply as a second (or third) wave of Covid cases led to renewed lockdowns.

The fund's reference benchmark the MSCI AC Asia Pacific ex Japan index fell 2.1% in USD over the month, while the Schroder ISF Asian Total Return Fund (C Class shares, USD) fell 2.4%. Given the fund tends to be lowly weighted in cyclical names, financials and stocks that would be considered reflation plays, we were not too disappointed with the performance. For Q1 as a whole the fund was up 4.4% (C Class shares, USD) which compares with the reference benchmark, which was up 2.7%.

March was a more active period for the fund. At the beginning of the month we trimmed some of our Hong Kong/China stocks that had rallied hard in January and February and exceeded our fair values. This included our remaining China biotech stock, internet names and a Macau gaming stock. The proceeds went into Indian private sector financials, Australian healthcare and a Taiwan exporter. We also let cash drift up. This reflects the fact that while we are not outright bearish on markets, we do expect volatility ahead given uncertain vaccine rollout and new Covid variants, rising US-China tensions and the potential for inflation scares. This is consistent with the fund's hedging models which are generally neutral to cautious. Hedging-wise, the fund continues to run with a small position in puts which we intend to roll if pricing is reasonable. However, we feel no urgency to raise hedging as with our China and internet weightings now significantly lower (vs middle of last year) the fund should be more defensively positioned.

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.

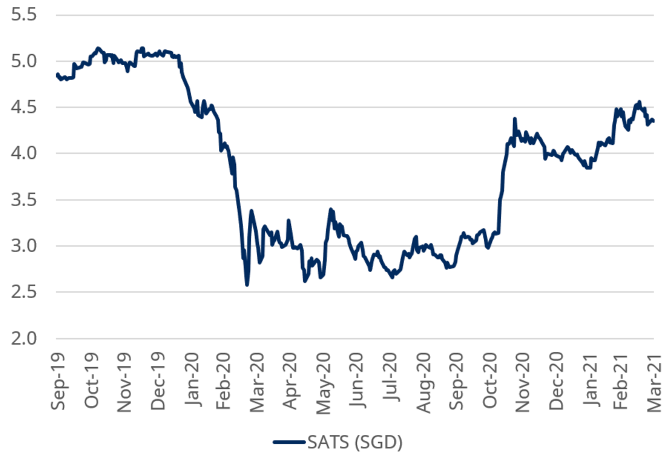
So, what are your fund managers debating at the moment? This really falls into three key areas:

1) Is the post-Covid recovery/normalisation trade over?
2) Will inflation be transient or more permanent (and what does this mean for discount rates, and the “growth” vs “value” trade)?
3) Can we find anything we really want to buy at current market levels?

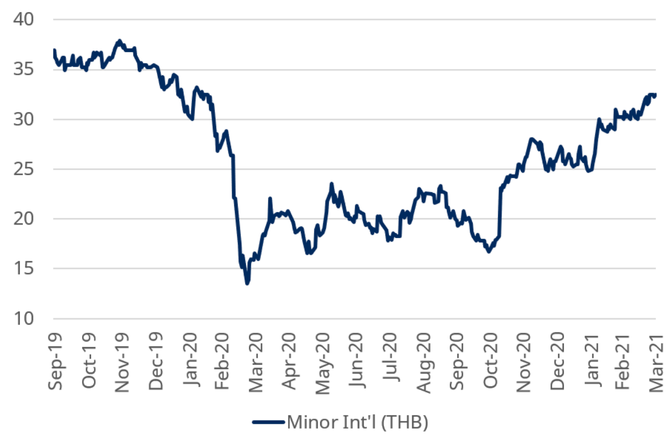
Looking at the first topic, we are quite strongly of the view that the hoped-for post Covid recovery in many Asian travel, hospitality and related names is now fully discounted. As shown in the charts below (some of which are names we hold in the fund) most Asian travel-related names have now fully rebounded (or in some cases exceeded) pre-COVID trading levels. This is despite very little visibility on travel relaxation in the region and very slow vaccine roll out. We remain of the view that business travel may not return to former levels given how easily the world has functioned without pointless business meetings. And of course, given corporate pressure to reduce environmental impact – it would seem investors are way too optimistic on Covid normalisation. Particularly for those names facing structural headwinds from technology and changing behaviours. At this point we are looking to sell into further Covid “normalisation” rallies. We feel markets are forgetting we have moved to a new normal – Covid has accelerated many disruptive trends.

Chart 1: Many Asian Covid recovery stocks are already at or above pre-Covid levels – the risk / reward now looks unattractive

Share price of SATS (Airport Services)

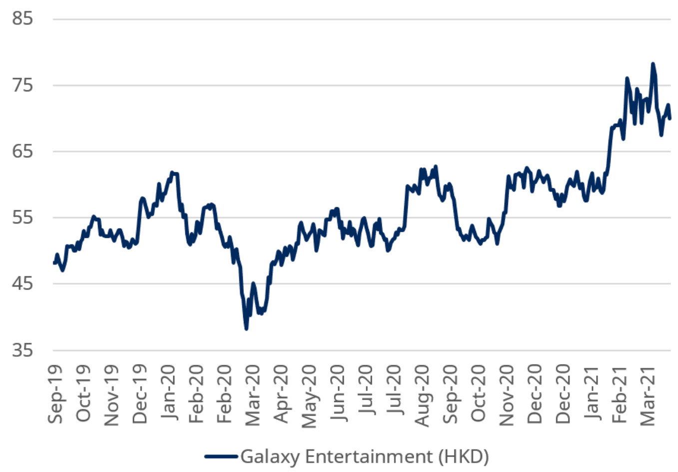


Share price of Minor International (Asian Hotels)



Share price of Huazhu Group (China Hotels)

Share price of Galaxy Entertainment (Macau Gaming)



Source: Refinitiv Eikon, April 2021

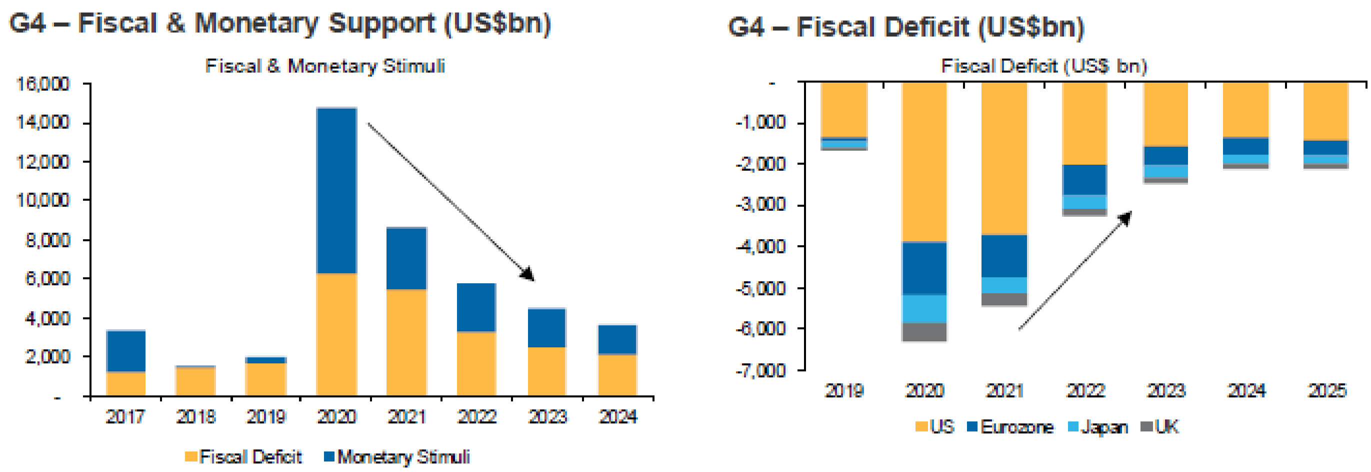
The bigger debate between your fund managers continues to be on inflation – how big will be the pick-up be and will it be transient or more permanent? This is important, as clearly if it is permanent it results in higher discount rates. It also leaves growth stocks (or in particular the "hope" stocks in China) vulnerable to falls and a much more significant derating than we have seen to date.

Based on our recent corporate catch-up calls, inflationary pressures are indeed very real. Several of our manufacturing companies - whether it be bicycle companies in Taiwan, window blind manufacturers in ASEAN or white good producers in China have all flagged significant raw material cost pressures. Most of which they expect to pass on to consumers i.e. higher inflation is coming. This is before we get the "normalisation" trade highlighted above and the reflation fully feeding through from the US's stimulus programmes. The next round of price pressures, as economies open up, will be service inflation as Covid measures mean significantly higher prices for hotels, airlines, restaurants etc. The combination of these factors does, we feel, mean there is plenty of potential for more inflation "noise" and value-based rallies (or rallies in deep cyclicals, financials, commodities, steel stocks etc).

We will not be chasing these rallies. We have added to selected financials in Singapore and India where we feel they will benefit from reflation, though the real attraction was more bottom up. That is, Singapore benefitting from becoming the regional financial and service hub (at the cost of Hong Kong) and the best Indian private sector banks taking share from the structurally impaired state banks. The Asian steel, chemical, financial, commodity, shipping, cement sectors are dominated by companies that are state-owned or in general have a long history of poor investment decisions and a destruction of shareholder value. For long-term investors there is little attraction. In a world of rapid change, whether from accelerating technological disruption, changing nature of jobs and employment, demographics or emerging US-China commercial cold wars, there are more important issues for us to analyse and prevaricate upon.

We also suspect the inflation scare will be temporary, unless as highlighted in our recent Year of the Ox report we do see a wholesale move to MMT style policies. Why is this? The post Covid fiscal and monetary measures we are seeing at the moment are likely to be withdrawn quite quickly over the next two years as highlighted in Chart 2. This is especially likely to be the case if economic recovery and inflationary pressure come through strongly in 2021.

Chart 2: Fiscal and Monetary Stimulus is forecast to be withdrawn fairly fast



Source: IMF, Bloomberg, Macquarie, April 2021

China, which has already withdrawn much of its monetary and fiscal stimulus, is perhaps six months ahead of much of the rest of the world in this regard. As the stimulus is withdrawn, we expect the deflationary 4Ds (Disruption, Debt, Demographics, Disparity in Income) we have discussed many times to reassert themselves. The biggest deflationary factor we believe remains technological change or Disruption.

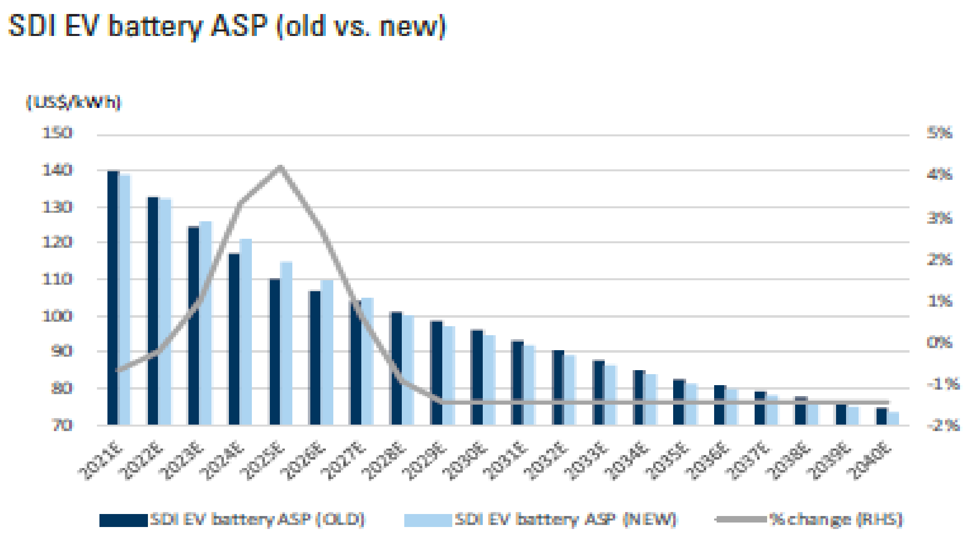
Covid has, as discussed in past reports, accelerated this disruption. Whether this be retailers who have to get their costs down to compete with online retail (why retail landlords are not an attractive reflation play), restaurants that need to rethink models to compete with dark kitchens and on-line food delivery, large offices that need to be reconfigured for flexible working (and a big drop in occupancy and rent levels), free Zoom calls that replace business travel – many of the trends we look at are deflationary.

We increasingly believe this deflation will spread more widely to professional services that to date have proved immune to deflationary pressures (or productivity gains). If doctors can perform online consultations for much of their work. do they need so much surgery space or do they need even to be based in expensive locations? And can they see patients more quickly and in greater numbers? Similarly, for education the potential is significant for blended online and offline learning to raise productivity in an industry that has proved utterly resistant to productivity enhancements for years.

And something that slightly worries your fund managers; if has now been proved you don't need to really ever see your colleagues to run a business, or an investment fund, should professional services be offshored to cheaper locations? With many countries in Asia offering increasingly well-educated, young, English speaking professional staff at a much lower cost, will roles and salaries for many financial, legal, accounting roles become vulnerable (and this is even before we discuss the potential for A.I. based programmes to replace lower level service roles)? All of this keeps us convinced that whilst the inflation scares for 2021 will be real (and is one of the reasons for our relative caution on stockmarkets), unless we have full blown MMT and financial repression (admittedly possible further out especially in the EU) it will be temporary.

A last chart on the topic of deflation. One of the products where we expect to see the most rapid falls in pricing over the coming years are electric vehicles – as competition and huge investments lead to pricing pressures and large productivity gains, especially for electronics and motors. Even for batteries which are chemical based so harder to get gains, and where demand outstrips supply, we are seeing large falls in pricing. This is disruptive deflation in action – but it is good deflation – the consumer gets better products at cheaper prices.

Chart 3: Battery prices forecast to continue to fall fast despite extremely strong demand and supply constraints

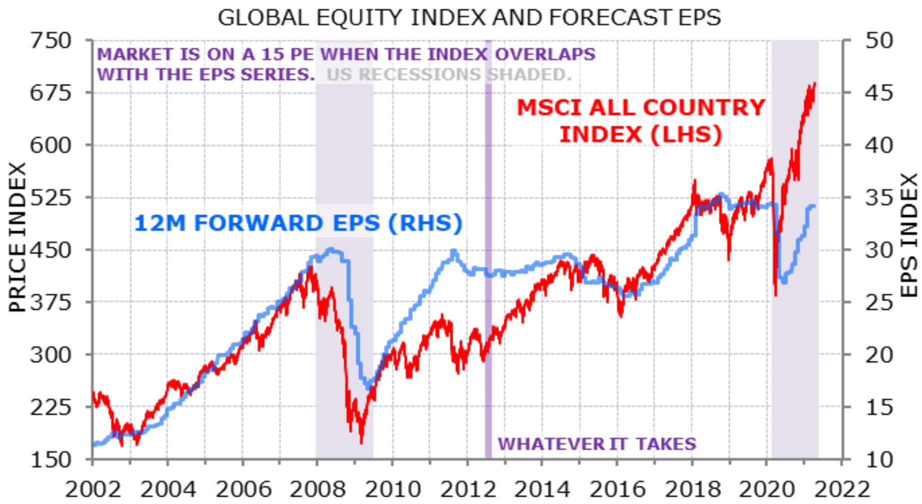


Source: Goldman Sachs, February 2021

So going back to the last question – Can we find anything we want to buy at current levels, and given our discussion above if we think inflation is just a scare should we be relooking at growth stocks that have corrected like the internet stocks in China?

We are in no rush. As Chart 4 highlights markets in general have got ahead of themselves and are now discounting a very significant jump in earnings. As mentioned at the beginning of this report, most Taiwan and Korean technology stocks produced very strong 2020 earnings and guided positively for 2021 but stocks have not reacted to the news – the good news was anticipated. Meanwhile, for many Chinese internet and EV stocks, they have corrected as it has become clear forecasts for rapidly improving near term profitability won't be met. For the e-commerce names in particular intense competition, and new retail formats like community group buying and livestreaming, are resulting in more marketing expense and investment and an ever-more distant prospect of improving margins (or in some cases positive cash flow). With plenty of noise around internet regulation, US-China tensions, and inflation scares to come we are happy to sit on our hands and wait for further falls before relooking at most of the Chinese internet stocks.

Chart 4: No rush to buy – Markets are discounting a lot of EPS growth, we may get better opportunities

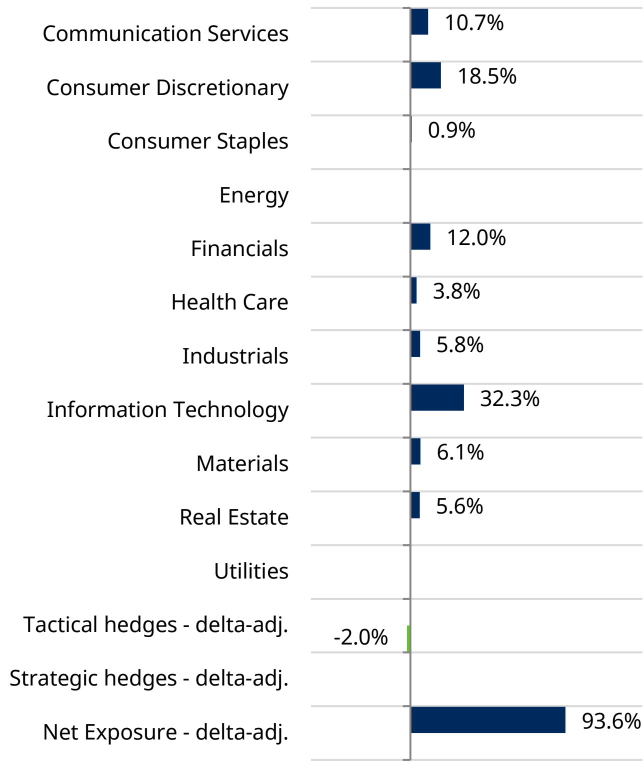


Source: Minack Advisor, February 2021

So, what are we looking to buy? March is normally conference season in Asia, unfortunately your fund managers were stuck at home doing Zoom calls rather than meeting companies face to face. Some of our Zoom catch ups did throw up potential new ideas to explore. Indian IT companies were surprisingly upbeat – we added to this sector in 2020 and will look for pull backs to add more. Perhaps resonating with some of the comments above, the pipeline of new deals is strong as end clients see the potential to move more services offshore to cheaper locations. We also had some good discussions with some of our higher end, value added, branded exporters. As mentioned earlier, most are seeing raw material price pressures and market concerns on their ability to pass on these costs have caused some share price corrections. For those export companies enjoying strong end demand and good product/brand positioning we may use this as an opportunity to add. We also had good meetings with some of ASEAN's DIY/Home Improvement retailers. This is a sector we feel is less vulnerable to e-commerce disruption (as Home Depot has proved) so we may look for any Covid-related pullbacks as new lockdowns are imposed to add to positions. Overall, we are happy to keep a little bit of cash in the fund (3-5%) to pick up stocks opportunistically as we expect markets to remain volatile for the reasons outlined above.

Robin Parbrook and Lee King Fuei
7th April 2021

FUND POSITIONING



Source: Schroders, as at end of Mar 2021.

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TOP 10 HOLDINGS

Stock	Fund (%)
TSMC	9.0
Samsung Electronics	8.3
Tencent	5.4
Techtronic Industries	3.8
Alibaba	3.1
Mediatek	2.9
Galaxy Entertainment	2.3
AIA	2.3
HDFC Bank	2.2
Ping An Insurance	2.1
Total	**41.4**

Source: Schroders, as at end of Mar 2021.

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