Schroders

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Schroder QEP Emerging Markets

Strategy Overview

What is QEP Global Emerging Markets?

The Schroder QEP Emerging Markets is an index-unconstrained strategy investing in stocks on the basis of valuations and business quality.

Analyzing a broad universe of 4,000 stocks across more than 27 emerging markets, the team constructs highly diversified portfolios without sacrificing conviction (active share 70%+, see below).

Benefits of our approach

- Designed to take advantage of strategic diversification between Value and Quality drivers, offering investors the potential for outperformance across a broad range of environments
- All cap exposure; exploits a wide opportunity set, tapping into all sectors and regions
- Innovative approach to portfolio construction combining high conviction with broad diversification
- Highly experienced and well-resourced team

Complementary fundamental drivers

This is a blend approach – we invest on the basis of both valuations and business quality. In the case of the former we are using fundamentals such as dividends and earnings to identify companies which we believe are undervalued by their current market price; in the case of the latter we look for quality companies by assessing measures of profitability, stability and financial strength. The advantage of combining Value and Quality opportunities in a single portfolio is that while both strategies have tended to outperform through time, they have tended to deliver their returns at different stages of the economic cycle, offering investors the potential for outperformance across a broad range of market environments.

Exploiting genuine breadth of opportunity

We maximize the opportunity set by looking beyond the index to an investment universe of more than 4,000 stocks globally. The strategy is highly diversified, typically investing in over 300 stocks, which enables us to gain exposure to many more potential return opportunities in a risk-controlled way. More stocks does not mean compromising on conviction and the strategy's active share[1] is typically higher than 70% – the strategy looks very different to the index.

Intelligent portfolio construction

Our process is focused on delivering returns through stock selection, with minimal top-down constraints, enabling us to invest wherever we find the best opportunities. Moreover, by weighting stocks based on their fundamentals and not their size, our portfolios express genuine conviction and are not forced to hold higher weightings in more expensive stocks. Our portfolio construction tools allow us to manage the risk-return trade-off efficiently and we also focus on cost-effective implementation. In addition, an understanding of the risks involved in investing in different countries is critical, particularly in emerging markets. We monitor and manage our portfolios' exposures using a proprietary Country Risk Model which looks at factors such as currency strength, risk of default, economic growth and political risks.

[1]Active share is a measure of the proportion of a portfolio's holdings that are different to the benchmark; an indexed portfolio identical to the benchmark would have a 0% active share, and a portfolio with no overlap at all with the benchmark would have an active share of 100%.

About the team

The QEP Investment Team was established in 1996 and has managed assets since 2000. The team, led by Justin Abercrombie, consists of 31 team members based in London, Sydney and New York. It manages around $31 billion in a comprehensive range of global and emerging market equity strategies for clients all over the world, including pension funds, insurance companies and sovereign wealth funds.

Source: Schroders, team as at 30 July 2019, assets as at 30 June 2019.

A strategic approach to equity investing

There are three distinct components to the QEP team's investment philosophy:

1. All stock selection is focused on two key fundamental drivers of long-run equity returns: stock valuations and business quality.
2. We then use quantitative models to 'scale up' our process, which allows us to access the best opportunities across a broad global universe. These models enable us to maximise the opportunity set and re-balance portfolios in a disciplined way as opportunities evolve.
3. Finally, experienced investors are responsible for implementing every trade decision, ensuring proper diversification and identifying future risks and return opportunities.

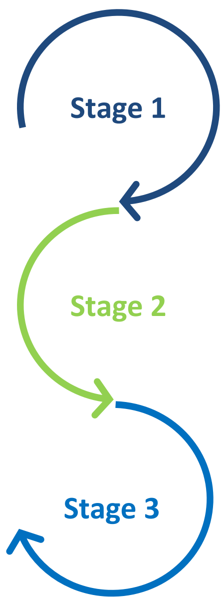
Key features of QEP Emerging Markets

Active share	70%+
Number of holdings	300+
Stock weights	Target 1.5% at the company level (at time of purchase)
Region weights	Unconstrained except maximum of 10% in Frontier Markets

Source: Schroders. Guidelines only and subject to change.

Investment process

Our investment process can be summarized in three stages:



Fundamental drivers

- Universe of 15,000 stocks to maximise the opportunity
- Rank stocks by Value (cash flows, dividends, earnings and assets) and Quality (profitability, stability, financial strength and governance)

Stock selection

- Industry-specific decision tree 'trades off' value and quality
- Invest in stocks offering an attractive combination of value and quality
- Stock weight (target 1.5%[1]) determined by conviction, risk, ESG, liquidity and size

Portfolio construction

- High active share +70%; stocks: 300+[1]; attractive risk/return trade-off
- Diversified across region, country, sector, market cap and style
- Disciplined re-balancing (buy/sell) to take advantage of market volatility

Source: Schroders. [1]Internal guidelines only and are subject to change.

Investment process (continued)

Stage 1 – Fundamental drivers

To maximise the potential investment opportunity, the team analyses as broad a universe as possible: over 4,000 stocks of all sizes (screened for liquidity) across more than 27 emerging markets.

We start by assessing each of these stocks in terms of their Value and Quality. The Value of a company is determined across measures of dividends, cashflow, earnings and assets. Quality is assessed using measures of profitability (returns on capital employed and margins), stability (operational volatility), financial strength (leverage and funding, servicing capacity, liquidity and asset quality) and governance (board efficiency, pay, ownership, accounting standards). These ranks are re-calculated on a daily basis in order to ensure that the latest information is incorporated e.g. price movements and company fundamentals.

Stage 2 – Stock selection

We select stocks which are attractive on our Value Rank or Quality Rank within our Emerging Markets universe, focusing upon stocks with a favourable combination of Value and Quality. Amongst these stocks we then decide whether to invest in each one, and if so how much, according to our assessment of the company's fundamentals, the stock's liquidity and its volatility.

Our level of conviction in each stock is determined using decision trees. These models use a statistical technique called recursive partitioning to combine several fundamental metrics in order to calculate each stock's probability of outperforming similar stocks. Stocks with better fundamentals and a higher probability of achieving outperformance receive a higher weight. Stocks with a lower probability of outperforming are held, if at all, at a lower weighting – we spread these holdings across a greater number of smaller positions.

We have fine-tuned a decision tree for each area of the market, to ensure that we are using the most appropriate and relevant fundamental metrics for that type of stock.

Stage 3 – Portfolio construction

Risk management is integrated throughout our investment process and in particular in portfolio construction. The most critical role of our portfolio managers is to understand when stocks are attractive on a risk–adjusted basis, maximising return opportunities within a comprehensive risk framework.

We take a disciplined and sophisticated approach to portfolio construction. Portfolio managers review their accounts on a daily basis to determine whether rebalancing is appropriate. Every day our models are run and a proprietary allocator tool, which takes account of the particular parameters appropriate to that portfolio, produces a list of recommended trades. Portfolio managers review every trade which has been recommended and make the final decision on implementation; no trade is made automatically. These experienced investors monitor a range of portfolio characteristics and ensure that the risk profile of the portfolio remains appropriate, as well as providing an important overlay in terms of awareness of future opportunities and risks in global markets.

Portfolios are exceptionally diversified, accessing a genuinely broad opportunity set across countries, sectors and market capitalisations, while reducing stock-specific risk. Stock selection is primarily driven by bottom-up decisions made on the basis of our evaluation of a company's fundamentals and other metrics as described above. Sector, country and regional allocations are generally allowed to build from our stock selection process – we only invest where we see the best opportunities.

We are particularly mindful of the importance of country risk in the management of an emerging market strategy. We recognise that less developed financial systems and more concentrated economic outputs tend to amplify the sensitivity of individual countries to both internal and external shocks. As such, our proprietary Country Risk Monitor is designed to offer a measure of country 'quality' and a means of monitoring our overall exposure to areas of mounting risk.

An overall country risk 'ranking' is driven by consideration of five key groups of metrics:

- **Currency Valuation** – A measure of a currency's fundamental attractiveness when compared to other global currencies and to its own history
- **Currency Credibility** – Looks at the strength of support for a currency from sources such as the government's foreign exchange reserves and the country's current account balance
- **Credit Risk** – An assessment of a country's ability to finance its sovereign debt; we examine financing requirements and debt servicing costs to evaluate the potential for any default
- **Growth Prospects** – We measure the ability of a country to sustain growth without creating economic imbalances such as excessive trade deficits, rising government debt or unsustainable levels of private sector borrowing
- **Political/ESG (Environmental, Social & Governance)** – Indicators of cohesion and economic freedom (e.g. the importance of property rights, labor laws and the regulatory environment).

Should we observe a disconnect between the attractions of a market from a bottom-up perspective and the level of risk involved in investing in that market, this may lead our portfolio managers to consider implementing currency hedging or to adjust our criteria for stock selection.

Risk disclosures

All investments, domestic and foreign, involve risks including the risk of possible loss of principal. The market value of the portfolio may decline as a result of a number of factors, including adverse economic and market conditions, prospects of stocks in the portfolio, changing interest rates, and real or perceived adverse competitive industry conditions.

Investing overseas involves special risks including among others, risks related to political or economic instability, foreign currency (such as exchange, valuation and fluctuation) risk, market entry or exit restrictions, illiquidity and taxation. These risks exist to a greater extent in emerging markets than in developed markets.