Schroders

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Schroder ISF* Japanese Opportunities Fund Update

Covering September 2019

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

At a glance

Fund manager: Ken Maeda

Performance: The Fund outperformed the benchmark in September

Market overview: The Japanese equity market was up 6.0% for the month

Largest stock contributors: Softbank (not held)

Largest stock detractors: Nexon Co

* Source: Schroders, net of fees, NAV to NAV with net income reinvested. C Acc share class. Past performance is not a guide to future performance and may not be repeated.

Discrete yearly performance (%)

	Fund	Benchmark
YTD 2019	+3.4	+8.8
2018	-23.2	-16.0
2017	+28.1	+22.2
2016	+1.7	+0.3
2015	+15.0	+12.1
2014	+16.7	+10.3

Source: Schroders, net of fees, NAV to NAV with net income reinvested. C Acc share class.

Past performance is not a guide to future performance and may not be repeated.

The value of Investments and the income from them may go down as well as up and investors may not get back the amount originally invested. Some performance differences between the fund and the benchmark may arise because the fund performance is calculated at a different valuation point from the benchmark. Please see the respective fund factsheets for the performance of other share classes.

Market Review

The Japanese market moved higher for most of September, before declining in the last few days of the month, to record a total return of 6.0%. The yen weakened during the month, despite a cut in US interest rates which has not yet been matched by any policy move from the Bank of Japan.

Foreigners returned as net buyers of Japanese equities throughout the month, while the Bank of Japan stepped back from purchases of ETFs, having maintained a very consistent run-rate ion the first eight months of the year. Meanwhile, survey data suggests that corporate managements are increasingly viewing their own share prices as attractive, which is one factor behind the near-doubling, year-on-year, in the value of share buybacks announced in the period from April to September. Although this total value can be distorted by a few large companies, we have also seen a greater number of companies announcing buy backs compared to last year, which is consistent with our belief that better governance is also helping to drive these trends.

Although trade friction between the US and China remains the main global concern, sentiment improved slightly in September. Bi-lateral negotiations between the US and Japan also seemed to make some progress. So far, this process seems relatively straightforward for Japan, as many of the "concessions" which the US is seeking were already on offer within the framework of the multi-lateral TPP negotiations, from which the US withdrew.

The recent cut in US interest rates has again raised expectations for additional easing moves by the Bank of Japan in coming months. In the very short term, the counter-intuitive weakening of the yen has created some breathing-space by easing deflationary pressure. The timing of the consumption tax increase on 1 October is also likely to delay any significant moves from the central bank. The only real policy development during September was a fine-tuning of bond purchases in an attempt to encourage a steeping of the yield curve.

Portfolio Review

The Fund outperformed the benchmark in September. Sector allocation had a small positive impact overall, but most of the performance was driven by stock selection.

The fund benefited from a sharp reversal of market leadership in early September as value stocks bounced from their very oversold levels. Although this initial move was relatively short-lived, it was encouraging to see the portfolio respond as we would expect to this environment.

For the second consecutive month, the largest positive contribution came from Softbank, the telecom conglomerate, which is not held in the portfolio. The stock has now unwound most of the gains seen earlier in the year, with renewed weakness in September prompted mainly by problems encountered by WeWork, in which Softbank is a major investor. TDK, the electronic component maker also performed well on reduced concerns over supply chain issues within the smartphone market.

The largest individual negative contribution again came from Nexon, which develops online PC games. After a relatively strong performance in the previous months, the stock had fallen sharply in August after the company missed short-term profit expectations and this underperformance continued into September. Nakanishi, a manufacturer of specialist dental equipment, has also underperformed in both August and September, following poor quarterly results. We believe most of the problems relate to timing issues as orders which had been expected to be booked in that period have moved to later quarters. Once these short-term factors play out, we expected renewed focus on the scope for new products to drive long-term growth.

Outlook

In the short-term, investors and the central bank will be examining economic data in the wake of the consumption tax increase on 1st October. The government is also likely to start discussion on a supplementary budget for next year, in addition to the current targeted fiscal stimulus, which is aimed at mitigating the fiscal drag from the tax rise. On 1 October the Bank of Japan also released the latest Tankan survey data which, although weaker than the previous quarter, showed a smaller deterioration than expected in the outlook. In some specific sectors, particularly retail, the negative impact on corporate sentiment from the consumption tax increase is clearly much smaller than the previous tax rise in 2014. Overall, the Tankan data is consistent with no immediate change in monetary policy but market expectations are still growing for interest rates to be cut further into negative territory later in the year. If, in the process, the Bank of Japan can successfully steepen the yield curve, the implied coordination of both fiscal and monetary policy could be taken positively. We should, however, remain slightly wary of the impact on the financial sector, unless banks are able to generate new revenue sources such as account maintenance fees.

At the corporate level the recent expansion in share buybacks could continue as we move towards the announcement of results for the first half of the fiscal year. Although companies are unlikely to make aggressive forecasts while global trade conditions remain uncertain, the recent weaker trend in the yen should be supportive for overall expectations, at a time when market valuations already appear attractive.

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