Schroders

Schroder ISF* Italian Equity

Fund Update

A look back on Q3 2019

At a glance

Fund manager: Hannah Piper.

Performance: The fund returned 3.0% (C Acc share class) over the quarter** versus 4.5% for the FTSE Italia All-Share index.

Largest contributors: HelloFresh supported fund returns.

Largest detractors: MaireTecnimont detracted.

**Source: Schroders, as at 30 September 2019. Net of fees, with net income reinvested.

Calendar year performance (%)

	Fund	FTSE Italia All-Share
2018	-19.1	-13.9
2017	21.3	19.1
2016	-8.1	-6.4
2015	22.8	18.5
2014	2.1	2.3

Source: Schroders, net of fees, bid to bid, with net income reinvested. C Acc share class as at 31 December 2018.

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

What happened in the markets?

Italian shares made gains in the quarter. In September, the European Central Bank took steps to boost the flagging economy, including cutting the deposit rate further into negative territory and restarting quantitative easing. The eurozone economy expanded by just 0.2% in Q2 and Italy's economy showed zero growth.

Italian politics was back in focus as the governing coalition of the right-wing League and populist Five Star broke up. Instead, Five Star formed a new coalition with the Democratic Party, which is expected to be less confrontational over EU budget rules.

Sector performance in Italy was very varied during the quarter. Information technology and utilities posted strong gains, followed by healthcare and financials. Consumer discretionary, consumer staples and energy posted negative returns.

How the fund performed

The fund posted a positive absolute return but lagged the benchmark's strong advance. Stock selection within industrials weighed on relative returns, with the position in engineering firm **MaireTecnimont** being a notable detractor amid concerns over a temporary squeeze on working capital over the summer. Maire has an unusually large number of projects finishing this year, which will need testing before final payments are made, while at the same time it has a significant contract with Gazprom which is tying up a large chunk of working capital. The squeeze on working capital has caused net debt to rise at the H1 mark and ignited some concerns in the market. However, the company is confident that this will reverse in the second half of the year with strong visibility on cashflow. Given the group's good long-term track record, we are keeping our position.

Steel tubes producer **Tenaris** is sensitive to oil price and detracted during the period amid oil price volatility. It is also exposed to the US where the recovery hasn't come through as strong as expected yet; US rig counts remain weak. An acquisition in the US is also taking longer to close than anticipated. We

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

are also overweight **Saipem**, another oil services stock that was a detractor in the period. However, our underweight in oil producer **ENI** was beneficial for relative returns. The fund's exposure to oil is neutral overall.

Utilities performed strongly in the quarter and so our underweight in index heavyweight **Enel** was a detractor. Enel accounts for 13% of the benchmark but the rules of the fund mean we have to be underweight. Our maximum allowed holding would be 10% and we have in fact allocated over 8%. We do not think allocating the full 10% would be the best use of our capital. We believe there are more interesting, higher quality growth companies that over time should generate higher returns. Although Enel has had a strong run in the last three years, the shares are actually at the same level as they were in 2008 and substantially below the price at which they were brought to market twenty years ago. Our overweight positions in the smaller utilities firms – **Iren** and **Hera** – made a positive contribution to relative performance.

Elsewhere, meal kit delivery firm **HelloFresh** was the top individual contributor. The company's Q2 results showed profitability at a group level. This demonstrated the sustainability of the business model and excellent management execution. This is crucial as many fast-growing firms are struggling to make a profit. It should be noted that since end of September the company has pre-reported Q3, which is also showed profitability despite being a more marketing heavy quarter. HelloFresh also raised guidance for the full year. Despite the significant outperformance of the shares this year, we still see good prospects for the shares and remain holders.

Another positive contributor was **Carel Industries** which manufactures controls for air conditioners. It enables greater energy efficiency, which is of increasing importance as awareness grows regarding the dangers of climate change. The company unveiled good quarterly results during the period, showing that its strategy is working.

In terms of new investments, we have initiated a position in hearing aid maker **Amplifon**. An ageing population means greater demand for hearing aids. At the same time, technological advances mean hearing aids are now smaller and more likely to be widely used. Amplifon has launched a new own brand range in Italy which has been very successful and can be rolled out in other countries. It has also acquired a business in Spain and we see scope for Amplifon's management to improve the profit margins of that business.

Another new position is tyremaker **Pirelli & C**. Stocks related to the automotive industry have been under pressure this year and we took advantage of the share price weakness to build the position. Also weighing on the shares were worries that major shareholder ChemChina could sell part of its stake. However, this overhang risk was removed in July as it and its allied investors extended their shareholder agreement until 2023.

Among financials, we have built a holding in **Mediobanca**. It has a positive track record in capital strength, credit quality and returns. Core businesses are consumer banking, corporate & investment banking, and wealth management. Mediobanca is due to unveil a new business plan in November which will set new targets. An increase in shareholder returns is anticipated. There is also some speculative appeal to the stock since Leonardo Del Vecchio, founder of eyewear firm Luxottica, has bought a 7% stake. We have also built a position in insurance giant **Generali** for risk management purposes, but remain underweight.

Looking ahead

Political risk in Italy appears to be receding with the formation of the new coalition between the PD and Five Star. The new government appears more likely to win some flexibility from the EU in terms of budget spending. However, it remains to be seen how sustainable the coalition will prove.

Equity markets continued to make gains in Q3 but this came against a weakening macro backdrop. Interest rate cuts from the US and European central banks have lent some support to stock markets. However, forward-looking indicators – such as the purchasing managers' indices - have continued to decline, most notably in the manufacturing sectors. Brexit uncertainty and the ongoing trade wars remain additional risks. In this uncertain environment, investors have continued to favour growth stocks over value. There were some tentative signs of this changing in early September but growth returned to favour towards the end of the month.

Against this backdrop, we continue to look for long-term ideas and will stick to our process of buying stocks based on their fundamentals.

Risk considerations

The capital is not guaranteed.

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.

The fund will not hedge its market risk in a down cycle. The value of the fund will move similarly to the markets.

The fund may hold large positions in a particular investment and if market declines or the issuer defaults, then the fund will be adversely affected.