Schroders

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Schroder ISF* European Opportunities

Fund Update

A look back on Q3 2019

At a glance

Fund managers: James Sym and James Rutland.

Performance: The fund returned 2.1% (C Acc share class) over the quarter** compared to the MSCI Europe net index return of 2.6%.

Largest contributors: Overweights in pharmaceuticals and technology were positive contributors.

Largest detractors: Stock specific negatives included Maisons du Monde and TKH.

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

Calendar year performance (%)

	Fund	MSCI Europe
2018	-15.5	-10.6
2017	9.1	10.2
2016	-3.9	2.6
2015	16.2	8.2
2014	6.0	7.3

Source: Schroders, net of fees, NAV to NAV with net income reinvested. A 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.

Market review

The market returned 2.6% over the course of the third quarter, ending at around the highs for the year so far. When you take a step back, that feels somewhat surprising given the numerous uncertainties around, of which the US-China trade war clearly is most important. The effects of this uncertainty is now beginning to have a relatively large impact on activity related data points: the German manufacturing PMI is at 41.4, the lowest since 2009 and the US ISM similarly weak at 47.8. Recession worries are definitely on the rise and at a recent conference we attended, it was very much the topic de jour.

At the market level this is reflected in the fact that utilities and real estate were amongst the best performing sectors and a list of the more cyclical sectors at the bottom. A mild recession looks somewhat ‘priced in’ to the market. Key point: this may sound an odd statement with the market within a few percent of its all time highs, but the overall market level masks significant bifurcation between defensive (e.g. food and beverage +24% over one year) and cyclical sectors (e.g. banks -18% over one year). Notwithstanding the relative valuation argument, downgrades are forthcoming, but it is instructing to note price action in certain early cycle areas of the market to bad news e.g. autos and semiconductors. For what it is worth, our base case remains that we muddle through without a severe recession.

Elsewhere, the most important and interesting market development to focus on in our view was the rotation we saw in September. Typically we do not talk about short term market moves, but we witnessed a violent style rotation in September. In fact it was the sharpest we can recall during our career and on some measures the sharpest since record began. During this period of just two weeks value outperformed growth by 5%. We want to examine this, particularly since being underweight growth stocks has been such a big headwind for us this year.

*Schroder International Selection Fund is referred to as Schroder ISF

Firstly let's note the present very strong correlation between bond yields and interest rate expectations and the relative outperformance of growth and growth defensive stocks. Then consider how the price of duration has moved over the last 24 months – to illustrate, the 100-year Austrian bond has moved from a yield of 2.2% in 2017 to 0.6% just before the rotation: in price terms from 100 to 210; the 60-year swap is slightly negative implying the average interest rate for the rest of our lifetimes will be below zero. And Nestle is up 40% this year. Let that sink in for a moment.

What then caused this rotation? Mario Draghi used his final European Central Bank (ECB) meeting to announce a cut in rates and infinite quantitative easing (QE). But bond yields ended the day higher: expectations were much more dovish that even this! More importantly however, he then went on to give a two-hour press conference focused on the need for more expansionary fiscal policy. His successor, Christine Lagarde, is perhaps even more enthusiastic for fiscal policy to be loosened[1]. We share this view. Monetary policy has reached its limits and increasingly governments look to be falling behind this view. If we have indeed reached the limitation of monetary policy (lacklustre economic growth and the rise of populism being two major side-effects), then this has profound implications for the sort of portfolio you want to hold. It speaks to a portfolio of value stocks and real assets vs that of growth stocks and asset light business models that has performed well during the Draghi years.

Turning back to the rotation, we suspect the cat is out of the bag, although this episode was a relatively short period of around four weeks. A sharp break in momentum normally presages a change in market leadership, and this tallies with our fundamental view that the correct business cycle positioning is for recovery phase and bond yields should be higher for a number of reasons. It also confirmed what we have long believed i.e. we are positioned anti-consensually and our peers are not positioned for this with just over one quarter of funds outperforming during the rotation.

The results are even starker if we compare the performance of Schroder ISF European Opportunities to its largest five peers over the same time period, with the fund bettering the performance by an average of 4.0% over that four-week time period. To put the move in context, value regained 4% vs growth's outperformance of 18% year-to-date, so not all that much when we put it in a longer term context (growth has outperformed value by 43% over the last five years). This rotation was driven by just a 20bps move in the German Bund. We invite clients to consider what the relative performance of growth stocks vs value would look like if Bund yields rose by 100bps to +50bps – still a 400 year low. Or, god forbid, back to 2%. This sort of move would still pale in comparison to previous episodes when fiscal policy was deployed.

At this point, we want to remind readers that we are pragmatic business cycle investors. Our predilection for value stems from an open minded assessment of relative merits of any particular style. Furthermore, we believe we are now at the turning point we have been waiting for and for which we are positioned. We suspect 2016-19 will mark a generational trough of bond yields when future stockmarket historians reflect on today. To wit, we have now reached infinite QE. From a fiscal standpoint, there are definite winds of change even in traditionally fiscally conservative Holland and crucially, Germany. In fact, things in Holland are moving in a particularly alarming direction as under current rules Dutch pensions will be cut due to low interest rates, which may not go down particularly well with voters. There are increasing instances of negative rates being passed on to savers. This is unlikely to continue. Lagarde wants the ECB to be seen on the side of the people[2].

Another catalyst could be a potential trade war resolution. With US data looking a little weaker, Trump's willingness to do a deal may increase as we head into election year.

Portfolio overview

The business cycle process requires us to also take a shorter term view of where we are in the cycle. At its heart, and especially at turning points, it is a contrarian value approach. Simply put we should be buying defensives when the PMIs are high and consensus is bullish on the economic outlook and cyclicals when PMIs are low and consensus is bearish. Today the PMIs are at levels last seen in the Global Financial Crisis. Our process therefore suggests we should have a cyclical tilt, as it did in 2009, 2012 and 2016.

The fact that many cyclical stocks profit-warned with Q2 results and saw sharp share price appreciations increases our conviction we could be at one of these points. That combined with some of the weak data has opened up an opportunity in some of the cyclical areas in the market, in our view. Whilst we have not shifted the portfolio materially, what we have done has been about reinforcing our value bias and adding a bit more cyclicality. We have added to our position in the banks and now have an overweight position for

[1] Lagarde calls on European governments to launch fiscal stimulus

[2] Opening Statement by Christine Lagarde to the Economic and Monetary Affairs Committee of the European Parliament

the first time this year. We have also added to auto stocks (both OEMs and suppliers) as well as chemicals.

There will still always be space in our portfolio for powerful bottom-up ideas. For example, we have invested in a reasonably significant position in **Fresenius SE**, a German medtech company that has had a difficult 12 month period and after numerous meetings with management over the last few months we are confident we are somewhere near the bottom for many of the issues facing the business. This is not cyclical but it is value and we believe there is significant recovery and rerating potential on a three-year view.

This has been funded with a reduction in some of our expensive higher quality names like **DSM**, **Zurich**, **Orpea**, and **DCC** as well as a reduction in the overweight in pharmaceuticals. This is clearly consistent with our views discussed above. We have also reduced our weighting in oil & gas producers given our clear preference for service names.

The fund continues to be skewed to benefit from rising bond yields with an overweight in value stocks and is increasingly tilted towards more cyclical areas.

Portfolio performance

In the third quarter the fund gained 2.1%, underperforming the benchmark MSCI Europe Index rise of 2.6%, representing 2nd quartile performance. In terms of return, the key drivers were stockpicking. On the positive side our big overweight in pharma (**Sanofi**, **Roche** and **GlaxoSmithKline**) contributed 91bps as well as our overweight in tech (**STM**, **ASML**, **Siltronic**) at 89bps.

Our detractors were more single stock specific unfortunately. In two cases we have had positive capital market days which have been taken positively but then been followed by disappointing results and have seen the shares decline relatively meaningfully. **Maisons du Monde** costing us 62bps and **TKH** costing us 36bps fall into this bracket. The longer term attractions of each are still intact and we have added to both names. The other detractors worth mentioning are in the offshore drillers which have combines to cost us 35bps. The data continues to point to a tightening market and we remain patient.

Looking ahead

European markets remain around the highs achieved on three separate occasions we are at close to long-run fair value. Below the surface, there is however significant bifurcation between both cyclical and value sectors vs growth and defensive. A number of macro uncertainties remain, driven primarily by the trade war between the US and China and to a smaller extent Brexit. As discussed above, earnings expectations perhaps look a little high for next year, but we are getting to the point where this looks priced in to the market. Positioning remains bearish with European investors crowding into the same names. Value and increasingly cyclical value is where we see the biggest three-year opportunity. Our conviction in the anti consensual positioning of the fund has increased this quarter. As we have written for some time now, we continue to remain cognisant of this cycle's increasing duration and capital protection must form part of our thinking at this stage.

Our concerns around the end of the cycle remain: traditionally defensive areas of the market are expensive and the end of cycle must be likely to involve disruptions in the bond market, particularly as we believe inflation will make a return.

We will continue to use a pragmatic approach to try to generate the best stockpicking returns we can, coupled with the ability to take outsized bets in out of favour areas of the market which offer the potential for significantly higher returns as a whole.

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.

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