Schroders

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Schroder ISF* European Alpha Absolute Return

Fund update

A look back on October 2019

At a glance

Fund managers: Nick Kissack and Bill Casey.

Performance: The fund returned -0.1% (C Acc share class, EUR) over the month**.

Outlook: We have seen a sharp slowdown in industrial production globally in the past 12 months, and we have been watching closely for signs that this was beginning to infect the much larger services economy. We have seen a marked slowdown in this regard since the summer, but we are yet to see defining evidence that a recession is imminent.

**Source: Schroders, as at 31 October 2019. Net of fees, bid-bid, with net income reinvested.

Calendar year performance (%)

	Fund
2018	-6.6
2017	1.3
2016	-0.0
2015	8.4
2014	4.2

Source: Schroders, net of fees, bid-bid, with net income reinvested. C Acc share class as at 31 December 2018. The fund is not managed with reference to a benchmark but its performance may be measured against one or more.

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.

Please see the respective fund factsheets for the performance of other share classes.

Portfolio overview

In October net of fees, the fund returned -0.1% versus the MSCI Europe NTR index of 0.9%. Our average gross and net exposures were 146.5% and 4.1%. Our long book added 74 basis points (bps) and our short book subtracted 63 bps during the month.

In recent newsletters we have highlighted the many signs of late cycle behaviour which have informed our cautious positioning and avoidance of the more expensive areas of the market. In recent weeks we have seen an acceleration of central bank action which has flooded the global economy with liquidity in order to stave off recession.

You need to look no further than the Federal Reserve's (Fed) balance sheet which has grown by 1.2% of GDP in just two months. However, the effort to avoid recession has not been consigned to just the US – we have now seen some 58 rate cuts from global central banks year-to-date. With this in mind, as we moved through October and the Q3 results season we noticed many cyclical stocks responding positively to bad news - against lowered expectations in Europe, some 57% of companies have reported better earnings than expected. This is primarily due to the industrial recession not deteriorating further compared to the summer correction.

Coupled with the recent détente on trade war escalations and a decline in the risk of a no deal Brexit in the UK, the market has begun to look to the recent economic weakness as a mid-cycle adjustment and preceded to drive global equities markets to new highs.

Whist we remain sceptical of a lasting economic recovery and believe that we are still very much in a late cycle regime, market internals have improved markedly through October along with a near stabilisation in lead indicators. The bond markets are signalling a lower likelihood of recession, particularly corporate spreads and a recovery in sovereign yields from extremely depressed levels. For this reason we have tilted the portfolio slightly more to cyclical value through October and allowed the net exposure of the fund to drift up gently during the month.

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

Federal reserve balance sheet, total assets (USDm)

Overall performance was volatile intra-month. The fund protected well on the downside in the early part of the month, as European markets dropped almost 4% in the first few days of October, but this was largely offset by a weaker second half. Performance was driven by stock specifics, as the Q3 earning season progressed, rather than any significant portfolio exposure changes.

While there has not been any particular newsflow in the month for **G4S**, we would note that we are still awaiting news of the potential sale of the Cash Solutions division which is set to be decided upon by Q1 2020. We believe that this potential disposal will highlight the substantial discount that the core Security Services business trades on relative to peers such as Securitas and unlock material shareholder value.

Our long position in **Gerresheimer**, a medical device manufacturer, had a strong move in October after a good set of results.

Just Group had another strong month again helped by a more resilient property market in the UK and relief that the country didn't crash out of Europe. Following confirmation of the group's strategic direction and capital comfort at the recent AGM, the story continues to evolve positively. Just has had a very difficult year as questions mounted over their capital level in a changing regulatory regime in the UK. We have been in close contact with the new management team and chairman, and we are beginning to see light at the end of the tunnel with regard capital needs and the future paths the business can take. We believe a number of these paths offer lots of upside to the share price from here.

Our long position in **Valeo**, an auto parts supplier, reported a strong set of Q3 results. Organic growth was some 8% above global auto production, testament to the high quality order book that has been built up over the past three to four years. Valeo is a very well managed business with strong market positions with the world's top OEMs for its technology on hybrid and electric vehicles. This outperformance really shone through in Q3, with indications that this will continue into 2020.

Our short position in a beverage bottling company benefited from further earnings downgrades into the Q3 trading update on 13 November. It has become apparent there is increasing pressure on management's 2019 revenue guidance. After management set guidance of 5% for 2019, it is clear that certain of their key markets such as Nigeria and Russia are still seeing weak consumer trends and management are likely to miss their guidance. We continue to believe these core markets are highly unpredictable and that their medium-term guidance of 5-6% revenue growth set at the capital markets day in May will provide further downside risk as we move into 2020. In addition, the short benefited from the rotation away from defensives.

Our short in a tobacco company benefited from ongoing disruption to next generation products in the US market. The Trump vaping crackdown announced at the start of September impacted the sector and contributed to the breakdown of the proposed Altria-Phillip Morris merger. Along with ongoing heavy declines in US traditional cigarette volumes, the company's largest individual market, sentiment toward the sector remains negative. The balance sheet also remains highly leveraged at ~4x net debt:EBITDA, which given current trends is a concern. In addition, the short benefited from the rotation away from defensives in the month.

Our short position in a banking stock was a strong contributor to performance as Q3 results showed a very weak picture in terms of growth and capital generation. A new management team has taken the helm, which we believe has a long and difficult road ahead of them to restructure the business. This position remains a key part of our "cost jaws" theme in the short book.

Anheuser-Busch InBev (AB InBev) was a key detractor in October. In addition to sharp underperformance by defensives, AB InBev had a weak Q3 earnings report with EBITDA guidance for 2019 downgraded from strong to moderate growth. This was primarily due to price increases implemented in Brazil and South Korea that competitors did not follow. Management did not give sufficient confidence regarding the Q4 2019 and FY 2020 outlook on the conference call and our concerns on further earnings downgrades were not clarified. Therefore, we exited the position as it approached our stop loss limit.

Another detractor for the month was an online portal for the residential property market in the UK. Relief in October following the UK securing a Brexit agreement with Europe helped sentiment in the property market. At close to 30x earnings, the valuation of the firm is excessive, particularly when faced with the structural decline of the High Street estate agent that is continuing in the UK.

A renewable fuels producer impacted performance following a better margin result for its core business in the third quarter. We have since reduced the risk of this position.

Outlook

We have seen a sharp slowdown in industrial production globally in the past 12 months, and we have been watching closely for signs that this was beginning to infect the much larger services economy. We have seen a marked slowdown in this regard since the summer, but we are yet to see defining evidence that a recession is imminent. In August we were faced with an aggressive escalation of the US–China trade war and the prospect of the UK crashing out of Europe. Since then some common sense has prevailed on the political front, but for how long this lasts remains uncertain. We are also yet to see a meaningful inflection in earnings estimates, with downgrades continuing, albeit at a more modest pace. We continue to run the book in a conservative way, and look to idiosyncratic risk as a primary driver of returns.

Over the medium-term, with signs that monetary policy in the West is failing to deliver the intended outcomes of driving investment and inflation, we expect the response in the next recession to be fiscal in nature. One reason QE and monetary easing has failed to generate sufficient inflation has been the delayed destruction of excess capacities. The baton must be handed over to the more potent fiscal stimulus to generate inflation. It is our view that inflation is the most important variable in this market cycle in deciding the end of the bull market, but also for the turn in style rotation between growth and value. We expect fiscal stimulus will come when recession is more evident on the "Main Street" rather than just on "Wall Street", something which will be clearer as we go through the final quarter of the year.

Risk considerations

The capital is not guaranteed.

All equity forward sales are with a single counterparty. In case of default, the relevant equities will be sold in the market and this may affect performance.

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 may hold indirect short exposure in anticipation of a decline of prices of these exposures or increase of interest rate.

There is no guarantee that a financial derivative contract will achieve its intended outcome, even if the terms of the contract are completely satisfied.

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