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Schroder ISF* European Alpha Absolute Return

Fund Manager: Nick Kissack and Bill Casey | Fund update: October 2021

Performance overview

– The European stock market rebounded in October, erasing September's decline. Positive earnings revisions waned during the month and are now just above the key 1.0x level (i.e. positive minus negative revisions). Companies are particularly tight-lipped about the 2022 outlook due to the rapidly evolving environment regarding input cost inflation.

– It is clear to us that the recent energy shortages and lingering Covid-related lockdowns in emerging economies are likely to extend the so-called "transitory" period of inflation into 2022. Rising inflation expectations are reducing central banks' room to manoeuvre. Consequently, the US Federal Reserve (Fed) is continuing with its tapering despite clear signs of a slowing global economy – be that supply shocks, GDP growth revisions, or a declining credit and fiscal impulse. Investors have grown to rely on central bankers to rescue the market when it weakens, especially in the US, but the picture has become muddied with the inflation backdrop.

– Despite the deteriorating fundamentals, there has been a tremendous amount of fund flows into risk assets (especially equities). TINA, or 'there is no alternative,' is a 'buy-any-dip' mentality that has gripped markets for the past 12 months, and once again in October. This has been very much helped by negative real interest rates and a resultant flight from cash. Retail and institutional ownership of equities are at new record highs in a sign of bubble-like behaviour; for example, the recent share price moves in stocks such as Tesla and Avis.

– Money creation is now slowing rapidly from central banks (quantitative easing), governments (fiscal spending) and the private sector (borrowing). Combined, they are about to turn negative in terms of the year-on-year flow. Fed tapering, a winding-down of wage support schemes, and China's de-leveraging of its property sector are just a few of the forces at work here.

Calendar year performance (%)

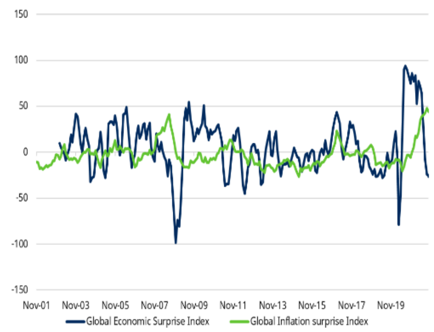
Year	Fund	Target	Comparator
2020	6.0	-3.3	-0.4
2019	-7.1	26.0	-0.3%
2018	-6.6	-10.6	-0.4%
2017	1.3	10.2	-0.3%
2016	-0.0	2.6	-0.2%

Source: Schroders, net of fees, bid-bid, with net income reinvested. EUR C Acc share class as of 31 December 2020. The fund is not managed with reference to a benchmark, but its performance may be measured against one or more. The target benchmark is MSCI Europe TR index and comparator is 3M EUR Libor.

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.

This picture of peaking growth expectations and stubbornly high inflation keeps us cautious on the direction of equity markets in the coming months. We are not arrogant enough to call a big market top at this point, but are vigilant, as we know that persistently higher inflation could lead to a potential regime shift. As ever, we are responding to what we see in front of us regarding company-specific fundamentals, liquidity, positioning and market dynamics. Long-market positioning rose rapidly in October. We have retained our net short stance and short exposure to the more cyclical areas of the market.

Figure 1: Inflation surprises are at a record high, while growth surprises have turned negative



Source: Bloomberg, Citigroup. Data as at 31 October 2021

Drivers of fund performance

– The fund had a negative month in October, in part due to our net-short position in the market. There was also some negative alpha (- 0.7%) in the month, following particularly strong alpha in September (+2.0%). There was no clear thematic trend and the move higher was primarily driven by stock specifics.
– We finished the month with a net exposure of -14% and a gross exposure of 207%. The fund's volatility remains at the lower end of our 5-8% target range.
– The fund remains net short cyclical sectors including capital goods, materials and transportation. This is founded on our observation of the declining trend in the global credit and fiscal impulse that began in the early summer. At best, China will have to manage the decline of its property sector from extremely high activity levels (based on historic comparisons with any other country in the world). Industrials were again a good source of alpha over the month.

Top stock contributors:

– **CapGemini** delivered another upgrade to its revenue, operating margin and free cashflow guidance, with the improvement in business momentum apparent across all regions. The order book remains strong into 2022 and the group's ongoing shift to digital, supported by the recent Altran acquisition, is bearing fruit.
– **Veolia Environnement**, the global water and waste solutions business, had an impressive bounce following a weaker September, again on very little news. We believe this business is going from strength to strength as regulatory tailwinds drive higher water and waste management standards. The upcoming merger with the largest global peer, Suez, is also helping the shares, given the synergies on offer and increased certainty of the deal passing anti-trust rules. We recall a recent conversation with the CFO, in which he said "remember, inflation is good for Veolia," referencing its cost pass-through clauses and sticky customer base.
– **DNB**, the Norwegian bank, has seen its shares benefit from the beginnings of a Norwegian rising interest-rate cycle. The Norwegian central bank is historically one of the few developed market central banks to actually hike rates after signalling that it intends to do so. It is currently signalling a multi-hike cycle in the coming years, something that a strong and underleveraged Norwegian economy can handle. In our view, DNB is the best bank in Europe in terms of its competitive market structure, franchise, capital generation and shareholder friendliness.
– **Sodexo**'s results showed demand for its core business of catering and facilities management is recovering well. In addition, the presence of a new activist on the shareholder register, as well as a board that is already progressing with a strategic review and new CEO search, resulted in a strong performance in October.

Top stock detractors:

– A short position in a UK-listed, Hong Kong-based bank detracted in the month, as we saw some mean reversion in the shares after a very weak period. The stock has massively underperformed the Euro STOXX Banks Index over the past 18 months and has been a successful position for us paired up with DNB and KBC Bank in the long book.
– **Cineworld Group** was impacted by ongoing questions over the box office recovery as well as the group's capital structure. However, recent box office trends in the US and Europe are supportive, with the UK and Germany at, or above, 2019 levels in recent weeks, and the US at around 80% of 2019 levels. With the box office able to sustain a release schedule without interruption, the market should begin to focus on the deep value apparent in the stock.
– A short position in a semiconductor manufacturer detracted in the month after a good set of results that highlighted still strong demand and favourable pricing in its end markets. With the acute semiconductor shortage globally, it is our view that there is extensive over-ordering in place across multiple sectors, including automotive and consumer electronics. This feeds into our theme regarding the over-consumption of consumer goods in the past 18 months due to a lack of alternatives on which people could spend their savings.
– A short position in a toll road operator rebounded in the month after multiple months of underperforming the market (-28% relative to the STOXX Europe 600 Index between June 2020 and September 2021). Market hopes of a recovery were realised in results, in late October, that showed toll-road traffic was recovering faster than expected in North America. This was the case in September, but traffic once again trended down (compared with the pre-pandemic period of 2019) in October. Most notably, the traffic congestion in its key Toronto toll road (50% of net asset value), at the higher priced peak times, is still 30% below pre-Covid levels. This impacted the mix, resulting in

unit pricing being down 6% compared with 2019. There was nothing in these results to prove our structurally lower traffic and tariff thesis wrong.

Outlook/Positioning

- As the world economy emerges from the worst global shock of a generation, it has become clear that, to date, the life support provided by Western governments has been sufficient to avoid financial ruin in both stock and credit markets. The burden of protecting populations from Covid-19 has fallen primarily on the taxpayer as fiscal budgets ballooned.
- Vaccination programmes should push much of the Western world through the crisis by the end of 2021. At that point, the economy will have to stand on its own two feet as the fiscal and credit boosts are withdrawn, or at least, tapered.
- Predicting what happens in the next phase will depend on one's view of how transitory the current rising inflation trend will be. It is clear to us now that the global economic recovery has softened in recent months. Consequently, we are beginning to have reservations on how strong 2022 will be, given the extremely high comparative period of 2021 for both fiscal spending and credit impulses. High savings rates for the middle classes and pent-up demand will potentially drive higher inflation in the short term, all things remaining equal. This will be important for equity and bond markets, factor leadership, and of course stock performance.
- It is important to remember that at certain points in time the stock market does not always reflect the real economy. Longer term, our view on the market remains unchanged: that as long as we have benign inflation and negative/very low real interest rates, the market can continue to move higher, extending this late-cycle secular bull market further into the future. In the meantime, we have to get used to a period of higher volatility and more frequent cyclical bear corrections of >10-20%, which we feel is an environment in which we can thrive with this fund.

Risk considerations

Liquidity risk: In difficult market conditions, the fund may not be able to sell a security for full value or at all. This could affect performance and could cause the fund to defer or suspend redemptions of its shares.

Operational risk: Operational processes, including those related to the safekeeping of assets, may fail. This may result in losses to the fund.

Currency risk: The fund may lose value as a result of movements in foreign exchange rates.

Concentration risk: The fund may be concentrated in a limited number of geographical regions, industry sectors, markets and/or individual positions. This may result in large changes in the value of the fund, both up or down.

Derivatives risk – Efficient Portfolio Management and Investment Purposes: Derivatives may be used to manage the portfolio efficiently. A derivative may not perform as expected, may create losses greater than the cost of the derivative and may result in losses to the fund. The fund may also materially invest in derivatives including using short selling and leverage techniques with the aim of making a return. When the value of an asset changes, the value of a derivative based on that asset may change to a much greater extent. This may result in greater losses than investing in the underlying asset.

No capital guarantee: Positive returns are not guaranteed, and no form of capital protection applies.

Counterparty risk: The fund may have contractual agreements with counterparties. If a counterparty is unable to fulfil their obligations, the sum that they owe to the fund may be lost in part or in whole.

Performance risk: Investment objectives express an intended result but there is no guarantee that such a result will be achieved. Depending on market conditions and the macroeconomic environment, investment objectives may become more difficult to achieve.

IBOR: The transition of the financial markets away from the use of interbank offered rates (IBORs) to alternative reference rates may impact the valuation of certain holdings and disrupt liquidity in certain instruments. This may impact the investment performance of the fund.

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