Schroders

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Schroder ISF* Global Equity Alpha

Fund Update

A look back on October 2019

At a glance

Fund manager: Alex Tedder.

Performance: The fund returned 2.5% (A Acc share class) over the month**.

Market overview: Global equities gained and the MSCI World index returned 2.5%.

**Source: Schroders. Net of fees, bid-bid, with net income reinvested as at 31 October2019.

Calendar year returns (%)

	Fund	Benchmark***
2018	-10.3	-8.7
2017	24.5	22.4
2016	1.1	7.5
2015	-1.1	-0.9
2014	1.0	4.9

Source: Schroders, net of fees, NAV to NAV with net income reinvested. A Acc share class, as at 31 December 2018. ***MSCI World - Net Return

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?

Global equities gained in October, despite continued sluggish economic growth, as improvements in US-China trade talks and Brexit negotiations combined with central bank dovishness to bolster sentiment. As expected, the Federal Reserve cut rates by 25 basis points but softened language pertaining to further easing. Details of a US-China "mini-deal" emerged, including increased China purchases of US agricultural goods, and a suspension of proposed US tariff increase on Chinese imports. The UK and EU seemed to reach a deal for the withdrawal pact, but the accelerated timetable was voted down by Britain's MPs, leading to a further extension of Article 50.

Performance was broad-based with nearly all regions and sectors posting gains during the month. Emerging market (EM) equities outperformed developed market equities for the first time since January. Asian indices, including Japan, were also particularly strong. By sector, a strong start to the Q3 earnings season drove healthcare stocks to perform well. IT also benefited from waning trade worries. Energy and consumer staples stocks were relative laggards.

How the fund performed

The portfolio generated a positive return in line with the benchmark over the month. Positions in the financial sector contributed, balanced by a weaker month for our positions in IT. North American names were stronger while Europe detracted.

United Health (UNH) contributed to gains over the month after the company, which provides health care products and insurance services, reported a robust set of Q3 results. Revenue over the quarter rose by 7% and the company increased its full-year net earnings outlook. Our investment thesis for UNH remains predicated on the expansion of its Optum health platform. Optum Health uses big data to manage patients more

*Schroder International Selection Fund is referred to as Schroder ISF

effectively, reducing healthcare costs through more effective allocation of resources and better use of preventative treatments. UNH's Q3 results showed that revenue from Optum Health grew by 34% compared with the same period a year earlier.

GEA Group contributed too, after Q3 earnings showed an increase in orders and revenue. The German food equipment producer also raised its outlook for the full year. GEA plans to cut 800 jobs worldwide by 2020 as part of a global restructuring plan to boost efficiency, but plans to maintain its dividend payment. It also plans to sell off a number of non-core divisions, such as the compressor manufacturer GEA Bock, to focus on its main strategic markets in the food, chemical and pharmaceuticals industries. We continue to see GEA as a longer-term turnaround story, and are encouraged by the moves by company management to bolster profitability and dispose of non-core assets. The company has a strong balance sheet and initiatives around costs in sales and procurement processes will help deliver better margins and cash generation.

Danone was a weaker position in October after a weaker-than-anticipated Q3 led the company to warn on its full year 2019 numbers. The diversified nutrition company referenced slower water sales in Europe compared to the same period last year, which benefited from an especially hot 2018 summer. The company remains confident of a more consistent Q4. Management also noted its prioritisation of margins relative to peers, which aligns with our view that Danone is now more focused on predictable profit delivery. We believe the thesis for Danone remains valid, but have increased concerns about the medium term growth rates in the dairy and waters divisions and will continue to monitor closely.

Garanti Bank also weighed over the month, as the US imposed tariffs and sanctions against Turkey to deter Syrian incursions. Garanti remains exposed to the health of the broader Turkish economy, and the sanctions further cloud the outlook for growth. Nonetheless, the company released stable Q3 results and we continue to believe the recent rate cut will deliver wider net interest margins and improve loan growth in the next few quarters. Garanti individually remains a quality franchise and a well managed, profitable bank with attractive margins.

Outlook

As we look to the end of 2019 and into 2020, markets remain finely balanced. Valuations on a trailing P/E basis are still lower than they were in much of 2018, but earnings estimates are also falling amid fading economic growth and a number of geopolitical headwinds. The US-China trade war is a major swing factor which could provide either a positive tail-wind on resolution or pose an increasing drag to confidence and investment. The UK's path to Brexit remains unclear, despite recent indications of a deal, as the UK heads to a general election, and political unrest across the world is otherwise prevalent.

Investors have become increasingly fixated on the potential for a rotation in style performance, given that growth stocks have materially outperformed value stocks over the past few years. While predicting the timing of style rotations is particularly difficult, we believe that businesses with strong quality characteristics should remain well positioned and likely trade at a premium. With growth increasingly scarce, we expect quality businesses to continue to command a premium as they offer greater resilience and growth visibility. Sluggish economic growth and the persistent low rate environment may also continue to weigh on sectors such as financials and energy, providing a further head wind for the performance of value. We are focussed on finding companies where growth is unappreciated, in both economically resilient and the more cyclical parts of the market.

We continue to focus on generating value primarily through bottom-up, stock selection. More recently we have been finding attractive opportunities in some of the un-loved cyclical areas outside the US. Expectations in areas such as Japanese machine tools and German industrials are now low, and it will require only modest improvement in the operating environment to generate material year-on-year earnings growth. Self-help and restructuring should also drive incremental returns. Similarly, we have begun to take a more positive view on end market demand for semiconductors, now that excess inventory has been flushed out, as we head into year end.

There will inevitably be a number of companies that find themselves ill-equipped to deal with a tougher economic environment. Our focus remains on choosing stocks with strong return-on-capital, resilient balance sheets and good cash flows. It is also increasingly important for

companies to have elements of pricing power and self-help. Companies dependent on macro support alone – as alluded to earlier - are unlikely to deliver in a slowing growth environment. We expect companies with these positive characteristics are not only more resilient, but will retain greater flexibility to adapt to the evolving competitive landscape.

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. Changes in China's political, legal, economic or tax policies could cause losses or higher costs for the fund.

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