Schroders

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Schroder ISF* Strategic Credit

Quarterly Fund Update

Fund Manager: Peter Harvey | Covering Third Quarter 2021

European High Yield Market Review

Non-investment grade bond prices fell by 0.2% in the third quarter, according to the ICE BofAML index of BB-B securities. The credit spread on that index widened by some six basis points (bps) and now sits at 294bps above government bonds. The total return for European high yield debt was just +0.6% in the quarter, including interest income. European B-rated securities (+0.8% for the quarter) outperformed BBs (+0.5%), which in turn outperformed euro BBBs (+0.2%). The European high yield market's worst performing sector was real estate (-1.7%) where a cloud hangs over the Berlin residential rental segment. Olaf Scholz, the next German Chancellor, is a vocal advocate of rent restrictions and landlord regulation.

Performance

The SISF Strategic Credit Fund C-shares generated a total return of 0.7% after fees in Q3 to 30 September 2021. Our strongest performance was again found in the healthcare sector, where we own the bonds of pharmaceutical companies like Grünenthal, Advanz, Organon, Cheplapharm, Stada and Teva. This sector, which also includes laboratory testing, medical devices and care homes, now accounts for 16% of net asset value.

The SISF Strategic Credit Fund aims to generate a total return substantially above cash interest rates, within a framework of risk-control. The historic return on C-shares was in excess of 4.9% per annum over 10 years. The annualised dividend yield on C-income shares is currently 4.0%, based on the next semi-annual distribution of 1.93p payable on 7 July 2021.

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

Source: Schroders, Bloomberg as at 30 September 2021 (NAV to NAV, bid to bid, net of ongoing charges, GBP).

Portfolio Activity

During the third quarter we continued to increase exposure to the telecommunications sector, which benefits from relatively predictable revenues, as well as the shift towards fibre optic broadband and 5G mobile telephony. We provide a brief description of the largest purchases in the Strategic Credit Fund:

Altice France Secured $5.5% (B2/B): SFR is a key player in French telecoms, serving 25 million customers. With an optical fibre network of nearly 24 million outlets, SFR has launched 5G in France and also covers 99.7% of the population with 4G. In 2020, Altice France achieved sales of €10.9 billion. We purchased $8-year bonds at 5.5% p.a. yield.

Iliad €2.375% (NR): Iliad is a French telecoms group with 13.3 million mobile and 6.5 million fixed subscribers. The company is majority owned by Xavier Niel, whose other telecom interests include Salt in Switzerland. Mr Niel has offered to buy out minority shareholders in a deal which values Iliad at €11 billion and is mainly debt financed. We purchased 5-year bonds at euro swaps plus 2.5%, shortly after this transaction was announced.

Almirall €2.125% (Ba3/BB-): Almirall develops and distributes pharmaceuticals in Europe, with an emphasis upon medical dermatology, including psoriasis. The Madrid listed company has approximately 2x net debt and EBITDA covers interest expenses approximately five times, after capital expenditures. We purchased the €2.125% 5y notes at new issue, given strong credit metrics and initial spread of euro swaps plus 2.4%.

ADT Secured $4.125% (Ba3/BB-): ADT provides intruder alarms and other security systems in the US. The NYSE listed co offers home and business automation solutions which includes temperature, burglary, flood, fire and smoke, and medical alert monitoring. Senior secured net debt is about 3.3 times EBITDA. We purchased 8yr secured US dollar bonds at 4.125%, for a credit spread of swaps plus 3.0%.

Daily Mail General Trust £6.375% (BB/BB+): DMGT owns and administers a wide range of media interests, publishing online and physically. The majority owner, Viscount Rothermere, has proposed a take private transaction, to de-list the Group from London's Stock Exchange. We purchased DMGT 6 year bonds in the secondary market at £4% p.a. to yield sterling swaps plus 3.4%.

Grünenthal €4.125% (B1/B+/BB+): Post-patent pharmaceuticals company, with a diversified portfolio of drugs and an emphasis upon pain management. With €1.3bn revenues, 2.5x net leverage and 4x post-capex interest cover, the B1/B+ ratings may have upside. We added to the senior secured €4.125% 2028 bonds in a secondary tap at 102c.

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

Our largest sectors remain healthcare, telecom, real estate and insurance. Following the above purchases and some maturities, non-investment grade debt remains 75% of Net Asset Value against 25% in investment grade, cash, collateral and unrated bonds. This split reflects our view on relative value between high yield and investment grade, as well as the carry available in shorter dated BB corporate bonds. The portfolio's expected average life is 3.6 years, but the interest rate duration remains only 2.5. The underlying investments in the Schroder ISF Strategic Credit Fund yield 3.7% to expected redemption or 4.3% to maturity.

Market Outlook

After a strong start to 2021, the European high yield market is fully valued, with the average credit spread on BB-B securities at +3% above government bonds. Valuations are supported by low default rates, fiscal largesse and monetary stimulus. It is the latter that concerns us most, as most asset classes have benefitted tremendously from low interest rates during the past ten years.

At this point, a view on inflation is essential. Is it transitory or enduring? Retail prices have risen by 4.8% year on year in the UK, 3.0% in the Eurozone and 5.2% in the US. Some of this rise in prices is undoubtedly temporary, as economies are restarted, post Covid-19. As the economic machinery is cranked up, not all factors of production can be turned on at the flick of switch. Some shipping containers are sitting in the wrong port, some labour has relocated during the pandemic. This type of inflation is probably temporary and prices linked to supply chain shortages may stabilise or subside in 2022. At least that is the ECB's narrative, which sees consumer price inflation falling back down to circa 1.7% by the end of next year.

But there is an alternative view. Perhaps some types of inflation will be more persistent, or deferred. Here are just two anecdotal examples of delayed inflation:

(1) By April 2022, the OFGEM UK electricity price cap, may have risen by 20% year on year. A substantial part of that energy hike is pre-determined by a formula based on current spot prices. The impact on UK households will be fully felt by mid 2022, at which point those consumers may lobby for a more meaningful wage rise in 2023.

(2) House prices in the US have risen by a nationwide average of 17% over the past year, according to the Federal Housing Finance Agency. While property capital is not actually in the CPI basket, it stands to reason that owner-equivalent rents will follow upwards over the coming years.

Central banks may have been behind the curve for several months now, perhaps quite deliberately. The risk here is that bond market participants finally start to question the wisdom of that monetary policy. With a nod to Lady Thatcher, the ECB's Christine Lagarde recently said "the lady's not for tapering". We'll see about that.

Peter Harvey, 4 October 2021

Historical Performance

Performance	2020	2019	2018	2017	2016
Schroder ISF Strategic Credit (C Acc)	3.8	8.8	-1.8	4.3	5.9
LIBOR 3-month GBP	0.1	0.7	0.6	0.2	0.4

Source: Schroders, Bloomberg as at 31/03/2020. C Accumulation shares, NAV to NAV, bid to bid, net of ongoing charges, GBP. Unaudited. 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. The value of investments and the income from them may fall as well as rise and investors may not get the amount originally invested.

Some performance differences between the fund and the benchmark may arise because the fund performance is calculated at a different valuation point from the benchmark.

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

Risk Considerations

ABS and MBS risk: The fund may invest in mortgage or asset-backed securities. The underlying borrowers of these securities may not be able to pay back the full amount that they owe, which may result in losses to the fund.

Capital risk / distribution policy: As the fund intends to pay dividends regardless of its performance, a dividend may represent a return of part of the amount you invested.

Contingent convertible bonds: The fund may invest in contingent convertible bonds. If the financial strength of the issuer of a contingent convertible bond falls in a prescribed way, the value of the bond may fall significantly and, in the worst case, may result in losses to the fund.

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.

Credit risk: A decline in the financial health of an issuer could cause the value of its bonds to fall or become worthless.

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

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.

High yield bond risk: High yield bonds (normally lower rated or unrated) generally carry greater market, credit and liquidity risk.

IBOR risk: 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.

Interest rate risk: The fund may lose value as a direct result of interest rate changes.

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.

Market risk: The value of investments can go up and down and an investor may not get back the amount initially invested.

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

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

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 macro economic environment, investment objectives may become more difficult to achieve.