Schroder ISF* Global High Yield

Monthly Fund Update

August 2019

At a glance

Fund manager: Martha Metcalf

Performance: The fund returned was flat (I Acc share class), underperforming the Global HY Index which returned 0.5%.

Largest contributors: Security selection in communications and consumer non-cyclical

Largest detractors: Asset allocation in local authority and sovereigns

**Source: Schroders, as at 30 August 2019. Net of fees, bid-bid, with net income reinvested. Index: Bloomberg Barclays Global High Yield ex-CMBS ex-EMG 2%

Calendar year performance (%)

(%)	Fund (A Acc)	Fund (I Acc)	BM**
2018	-4.99	-3.81	-1.80
2017	6.72	8.04	7.82
2016	13.26	14.68	15.63
2015	-2.33	-1.15	-2.99
2014	1.87	3.17	3.25

Source: Schroders, as at 31/12/18, net of fees, NAV to NAV (bid to bid), EUR returns.

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.

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.

Market overview

The global high yield (HY) market (Barclays Global High Yield Excl CMBS & EMG 2% Cap) posted another month of positive total returns in August, returning +0.52%. Year-to-date returns are now +11.12%. This puts the global HY market just behind global investment grade (IG) (Bloomberg Barclays Global Agg Corporate), which is up +12.17% on the year. This is because the shorter duration in global HY has made it difficult for the market to keep pace with the longer duration in global IG in an environment where US Treasury rates have rallied so strongly. The 10-year US Treasury yield finished August at 1.50%, down 118 basis points (bps) so far this year.

Risk markets held strong in August despite a flurry of negative market headlines and developments regarding trade and global macro-economics, among other things. Risk assets fell sharply at the start of the month as the on-going trade tensions between the US and China escalated further, with the US implementing additional 10% tariffs on the remaining $300 billion in imports from China. China later retaliated in the currency markets, allowing the yuan to depreciate beyond the key psychological level of seven per US dollar.

This sparked concerns that the trade war could develop into a full-blown currency war and that a resolution was less likely than previously anticipated. On the macro-economic front, Germany posted its worst industrial production numbers in more than a decade, while China's factory production data was equally soft. This global manufacturing weakness finally started to appear in US numbers as well, with the ISM Manufacturing Index reporting its first contraction since 2016. Additionally, a key part of the UST yield curve, the 2-10 spread, inverted (the two year yield fell below the 10-year yield) for the first time since before the Global Financial Crisis.

Despite these negative developments, equities and credit spreads remained anchored as investors stayed focused on the US Federal Reserve (Fed)/Trump put option, which provides risk markets with downside protection, as well as the very healthy consumer in the

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

US. The strong technical from overseas buyers reaching for yield has also supported valuations.

In credit markets, the Global HY Index (+0.52%) underperformed the Global IG market (+2.31%), as measured by the Barclays Global Agg Corporate Index, and outperformed EM (+0.25%), as measured by the EM USD Aggregate Index for the month. Spreads on the Global HY Index moved 16 bps wider to +385 bps. The yield dropped 18 bps to 5.12%.

Regionally, positive HY returns were skewed towards European markets. The Pan-European market (+0.96%) outperformed the US HY market (+0.40%). In terms of quality, the higher quality buckets outperformed. BBs (+0.82%) outperformed Bs (+0.13%) and CCCs (-1.43%).

In terms of corporate sectors, insurance (+1.21%), finance companies (+1.12%) and electric utilities (+0.85%) led the way. The laggards were energy (-2.46%), other industrial (-0.23%) and other utility (-0.08%).

Fundamentals softened slightly in August as defaults, particularly in energy, accelerated. Some of the riskier, highly leveraged energy names have suffered as oil prices have remained low given elevated levels of supply from non-OPEC countries. This difficult operating environment, combined with leveraged balance sheets, has driven defaults in this space. Despite this, the Moody's default rate projections for 2019 and 2020 are expected to remain well below the long-term average of 4.3%. Distressed ratios for the remainder of the Global HY market are much more stable and are well off of the highs we experienced during the 2016 Oil Crisis.

Technicals remain a strong tailwind for US credit. The growing universe of negative-yielding debt, which is now close to $16 trillion, has made yields in the US look attractive on a relative basis. This, combined with stabilized hedging costs due to expectations of further cut rates by the Fed, has significantly bolstered demand for the US segment of Global HY.

In terms of supply, the new issue market was less active in August, typically the slowest month of the year, with 13 new bonds pricing totalling $11.0 billion. Year-to-date issuance now stands at $176.9 billion, representing a +18% year-over-year nominal increase. Monthly new-issue volume has averaged $22.1 billion YTD, compared with $15.6 billion per month in FY18. However, net supply, accounting for calls, tenders, maturities and rising stars, has been negative for most of 2019 as the market continues to shrink.

The non-USD high yield new issue market was even less active with three new bonds pricing for a total of $1.0 billion in August, versus the 13 new bonds totalling $5.8 billion in July. Year-to-date new issuance now stands at $40.5 billion versus the $56.6 billion produced in the first half of last year (-40% decline).

In terms of demand, flows were negative for US-domiciled HY funds which saw outflows of about -$3.2 billion during the month, bringing year-to-date inflows to +$12.7 billion. Flows were positive for non-US domiciled HY funds, and stood at about +$399 million. This brings year-to-date inflows to +$7.7 billion.

Portfolio overview

The fund underperformed its benchmark in August. Asset allocation was the primary detractor, with our small Argentinian allocation coming under pressure. Regional and quality allocation did not have a material impact on relative returns. The positive contribution from our off-benchmark IG allocation was offset by our underweight in BBs and our overweight in CCCs.

Asset allocation in corporate sectors was modestly positive. The overweight in banking was the standout in terms of contributors. The primary driver of negative asset allocation over the month was in sovereigns and local authorities. The fund had a small exposure to two Argentinian bonds, both of which sold off sharply after the surprise election results that favoured Fernandez over Macri, who is considered much more market-friendly and was responsible for the recent macro-economic improvement.

Overall, security selection in corporates was not a meaningful contributor in August. Strong selection in communications and consumer non-cyclical was offset by weakness in energy and consumer cyclical.

Trading activity was dedicated to trimming exposure in communications through various sales, as we lock in profits in the many names that have rallied strongly in recent months. Our credit quality barbell remains intact, but we have reduced our exposure to the riskier triple-C bucket. Cash remains elevated as we maintain our defensive posture and to ensure we have adequate dry powder in the case of a large upward move in spreads.

Outlook and strategy

Throughout August, we saw an escalation in the US-China trade war, deteriorating global manufacturing data, softening US Credit fundamentals and the inversion of the 2s10s portion of the UST yield curve. However, risk markets in the US appeared shockingly unperturbed. We view this as an illustration of how powerful the overseas bid for US risk assets has been with global rates at all-time lows. Foreign investors with yield targets have been forced into longer-maturity bonds and into the riskier segments of their domestic markets, but have now had to re-allocate to the highest-yielding parts of the developed market, USD credit. This has driven UST yields to all-time lows and has capped the majority of potential spread widening. With signs that global central banks are planning additional easing, we believe this trend will continue moving forward.

However, we also believe that there is limited room for further tightening from here. While spreads will likely be somewhat capped, we feel that if the foreign bid falls through, the downside greatly outweighs the upside. Given the current macro, geopolitical and fundamental backdrop, we find it difficult to justify a retracement back to near cycle lows. Thus, we remain defensive, favouring higher quality paper in more defensive industries.

Risk Considerations

The capital is not guaranteed.

The capital may be subject to circumstances and periods where returns could be negative. Therefore the capital is not guaranteed and may decrease.

Non-investment grade securities will generally pay higher yields than more highly rated securities but will be subject to greater market, credit and default risk.

A security issuer may not be able to meet its obligations to make timely payments of interest and principal. This will affect the credit rating of those securities.

Investments in money market instruments and deposits with financial institutions may be subject to price fluctuation or default by the issuer. Some of the amounts deposited may not be returned to the fund.

Currency derivative instruments are subject to the default risk of the counterparty. The unrealised gain and some of the desired market exposure may be lost.

Investment in bonds and other debt instruments including related derivatives is subject to interest rate risk. The value of the fund may go down if interest rate rise and vice versa.

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

The fund may be leveraged, which may increase its volatility.

The fund enters into financial derivative transactions. If the counterparty were to default, the unrealised profit on the transaction and the market exposure may be lost.