Fund performance

The fund posted a return of +2.54% for October. This compared to the FTSE Gold Mines Index benchmark return of +4.01%.

Year to date, the fund returned +42.18%, which compared to the FTSE Gold Mines Index benchmark return of +36.41%.

I shares gross

<table>
<thead>
<tr>
<th>US$ %</th>
<th>Oct 2019</th>
<th>YTD 2019</th>
<th>2018</th>
<th>2017</th>
<th>2016</th>
<th>Since Inception¹</th>
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<td></td>
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<td>Cumulative</td>
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<tr>
<td>Fund</td>
<td>2.54</td>
<td>42.18</td>
<td>-13.90</td>
<td>11.28</td>
<td>-17.21</td>
<td>Performance</td>
</tr>
<tr>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Annualised</td>
</tr>
<tr>
<td>Benchmark²</td>
<td>4.01</td>
<td>36.41</td>
<td>-10.04</td>
<td>10.23</td>
<td>-23.13</td>
<td>Performance</td>
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Calendar year performance

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<tbody>
<tr>
<td>Fund</td>
<td>11.3</td>
<td>-13.9</td>
<td>42.2</td>
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<tr>
<td>Benchmark²</td>
<td>10.2</td>
<td>-10.4</td>
<td>36.4</td>
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</table>

Source for performance: Bloomberg I shares gross USD. Performance is on a NAV to NAV basis. ¹Inception 29 June 2016. ²FTSE Gold Mines Index.

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.

Risk Considerations:

The counterparty to a derivative or other contractual agreement or synthetic financial product could become unable to honour its commitments to the fund, potentially creating a partial or total loss for the fund. A failure of a deposit institution or an issuer of a money market instrument could create losses. The fund can be exposed to different currencies. Changes in foreign exchange rates could create losses. A derivative may not perform as expected, and may create losses greater than the cost of the derivative. Emerging markets, and especially frontier markets, generally carry greater political, legal, counterparty and operational risk. Equity prices fluctuate daily, based on many factors including general, economic, industry or company news. A rise in interest rates generally causes bond prices to fall. 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. Failures at service providers could lead to disruptions of fund operations or losses.

Gold and broader market commentary

As we write, gold prices continue to move closely with the path of US Treasury yields, oscillating around the US$1,500/Oz level. Overall, a more positive risk environment and resilient US economic data are weighing on bond prices, suggesting an upward bias to yields into year-end. Confidence that the US is taking a more conciliatory tone to trade negotiations, with Europe as well as with China, is a large part of this. Those looking for imminent US recession have been disappointed by relatively robust employment data which included both significant prior month upward revisions as well as strong wage growth. So far a US manufacturing recession has not morphed into drastic damage to services or employment. When we add to this the additional pro-risk nature of recent Federal Reserve policy interventions (much more generous use of the balance sheet) we are somewhat surprised gold has not sold off further.

Perhaps this is simply a lag and gold will play a little catch-up over the short term. While global negatively yielding debt has reduced from over US$16tn in late August to below US$13tn trillion today, gold prices have stayed firm around the US$1,500/Oz level. This marks a clear divergence of what had been quite a strong relationship.
An alternative read is that gold prices are stickier because the market is more willing to hedge bigger picture macro risk. The Federal Reserve has already drawn a final close to its attempts at monetary policy “normalisation”. The risk of a deeper Global / US slowdown, and the extraordinary policy responses it may trigger, may have been pushed back by recent resilient cyclical data, however the precariousness of the global macro picture has not really altered at all.

The best prism through which to view broad gold price possibilities remains real yields. Our view is still that against a backdrop of record high global debt, record low interest rates, and extremely growth-negative demographic and political trends globally, by far the most likely deleveraging “solution” is going to involve deeply negative real interest rates.

The US is likely to be at the vanguard of this. With US total federal debt/GDP of over 100% at end 2018 and domestic deficits forecast to expand significantly over the coming years even without a recession, policy makers are increasingly shifting to the view that with monetary policy exhausted, driving inflation will require more extreme interventions (i.e. print and spend where the fiscal authority is directly financed by the monetary authority). This indeed sounds extreme, but is being increasingly explicitly signalled. Take, for example the October 2019 paper authored by Bartch, Boivin, Fischer and Hildebrand entitled “Dealing with the next downturn: From unconventional monetary policy to unprecedented policy coordination”. It is worth quoting:

“All unprecedented response is needed when monetary policy is exhausted and fiscal policy alone is not enough. That response will likely involve “going direct”: Going direct means the central bank finding ways to get central bank money directly in the hands of public and private sector spenders. Going direct, which can be organised in a variety of different ways, works by: 1) bypassing the interest rate channel when this traditional central bank toolkit is exhausted, and; 2) enforcing policy coordination so that the fiscal expansion does not lead to an offsetting increase in interest rates. An extreme form of “going direct” would be an explicit and permanent monetary financing of a fiscal expansion, or so-called helicopter money. Explicit monetary financing in sufficient size will push up inflation”.

“Enforcing policy co-ordination so that the fiscal expansion does not lead to an offsetting rise in interest rates” to us sounds a lot like “use QE to pin interest rates at very low or even ZIRP levels, and use direct spending policies to drive inflation higher”. We are not clear at all what the difference is between that and Modern Modern Theory (MMT) which often receives very negative press from economists of very similar pedigree to the authors of the above referenced paper. At least for real interest rates the impact is the same. Low nominal rates and high nominal inflation would mean deeply negative real interest rates – that in turn would imply much higher gold prices.

We are convinced the extreme policy proposals suggested above are on their way, though precisely timing it is impossible. However even a mild US recession would likely trigger negative real rates. A scatter plot of gold prices against five-year real rates helps explain why we think even a mild US recession in 2020 could see gold prices above US$2,000/Oz.

Chart 2: A mild 2020 recession in the US would likely take US real rates below -1.5%, implying gold prices above US$2,000/Oz

Source: Bloomberg; Schroders.

1 https://www.suerf.org/docx/f_77ae1a5da3b68d6e5a9d1648242a29a7_8209_suerf.pdf, Dealing with the next downturn: From unconventional monetary policy to unprecedented policy coordination, page 2.
Gold equities

Gold equities (FTSE Gold Miners Index) rose 4% in October, roughly tracking the 2.7% increase in gold prices.

In recent months we have talked a lot about the macro case for including equities in any broader allocation for gold and outlined why we think gold equities are very strongly placed to outperform a range bound or rising gold price over the coming years. This month we turn more granular and focus on an individual position within the portfolio.

Investors familiar with our investment process will know that we often focus on companies nearing the end of capital intensive spending periods and approaching free-cash-flow (FCF) inflection points. For those not familiar chart 3 highlights how this overlay complements our core overweight positions.

Chart 3: SISF Global Gold investment process focuses on core overweights augmented by overlays

Source: Schroders

These boxes are not entirely distinct. On occasion a particular position will overlap across different parts. Endeavour Mining is one such example currently. It screens strongly enough to warrant a position as a core overweight in the fund (strong management, strong NAV upside, high quality assets with organic growth potential, strong FCF generating potential).

On top of these qualities, the company is also going through a major FCF inflection point following a period of significant capital investment over the past three years. The combination of these two factors explains in simple terms why over recent months we have been building the size of our Endeavour overweight to the point that it is now one of our top three positions by load weight in the fund. Having underperformed the benchmark YTD (up 12% vs up 30% for the benchmark at time of writing) we expect significant outperformance from Endeavour shares over the quarters ahead as balance sheet de-leveraging picks up pace and the company moves rapidly towards initiating a dividend policy.

To give some more colour on the nature of this FCF inflection, the company has invested US$800m in growth capital since 2016. This was heavily concentrated in 2017 (US$317m) and 2018 (US$267m) as the Hounde (Burkina) and more recently Ity (Ivory Coast) projects were brought to completion. YTD capital investment has been US$92m while growth capital in the third quarter dropped to US$6m.

This completed capex cycle now leaves the business in a very strong position to generate significant FCF, significant and probably sector leading returns on capital, as well as begin to de-lever rapidly its balance sheet and begin to directly return capital to investors over the next couple of years. At US$1,400/Oz gold FCF yields well over 15% should be expected in 2020 and 2021 (see charts 4 and 5 below).

3Q results have begun to reward our patience. Despite heavy rainfall (Burkina rainfall in 3Q was ~3x more than the 2016-2018 average) operating results continue to show good momentum. The rainfall-impacted quarter at Hounde (Burkina) was more than offset by performance at Ity where production of 64Koz and all-in-sustaining-costs of US$575/oz both marked quarter on quarter improvements. The combination of strong operational momentum and decreased capital spend saw group FCF generation of US$42m, itself impacted by a significant net working capital outflow likely to be reversed in coming months. All in all the annualised return-on-capital-employed (ROCE) in the quarter was 15% and Net Debt / Adjusted EBITDA decreasing from 2.75x at end June 2019 to 1.94x at end September (and 1.24x based on annualised adjusted 3Q EBITDA).
One of the other factors we often stress, is that the definition of “operating momentum” needs to be extended to exploration success. The ability to add ounces to mine plans via near-mine exploration is by far the lowest capital-intensive route to NPV accretion. On this front Endeavour are also showing good progress. A million ounces of indicated resource have been added at Hounded for a cost of US$9/oz, while the Le Plaque discovery at Ity has added half a million ounces of indicated resource for US$15/Oz. For reference and to illustrate the cost effectiveness of drill-bit success, the Canadian miners we currently track trade on an average EV/reserve ounce of US$358/Oz and recent acquisitions, for example the recent Northern Star acquisition of explorer Echo Resources, have been carried out at above US$100/Oz per reserve ounce.

**Equity subsector performance and positioning – 31 October 2019**

The Australian gold equities (ASX Gold Mining Index) decreased by 4.8% in USD terms during October. At month end, the fund had around 22% exposure to Australian listed gold equities. This compared to the benchmark weight of 18%.

The South African gold equities (JSE Gold Mining Index) increased by 22.8% in USD terms in October. At month end, the fund had around 15% exposure to South African gold equities. This compared to the benchmark weight of 9%.

The North American gold equities (S&P/TSX Gold Index) increased by 6.7% in October USD terms. At month end, the fund had around 48% exposure to North American gold and precious metals producers. This compared to the benchmark weight of 68%.

**Performance attribution and portfolio activity**

The fund outperformed the benchmark in October. overweight positions in Sibanye, AngloGold, Pan American silver as well as underweight positions in Pretium and Newcrest were the largest contributors to positive fund attribution.

**Monthly chart pack**

**Chart 1:** Spot gold prices expressed in various currencies

**Chart 2:** Consumer price index (CPI) for major economies
Chart 3: US core personal consumption expenditures (PCE) vs civilian worker wage costs

Chart 4: Total ETF gold holdings vs spot gold price

Chart 5: US Five-Year TIPS plotted against spot gold

Chart 6: CBOE SPX volatility Index (VIX)

Chart 7: Total Shanghai gold exchange volume plotted against spot gold price

Chart 8: Gold vs US dollar

Source: Bloomberg – October 2019.
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