Schroders

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Schroder ISF* Strategic Bond

Fund Manager: Paul Grainger, James Ringer, Robbie Boukhoufane & Global Fixed Income and Currency Team | Fund update: February 2023

Performance overview

- Global government yields were higher in February. Risk assets performed poorly. US credit spreads widened as markets anticipated higher rates for longer. European credit fared better. The Federal Reserve hiked rates by 25bps at the beginning of the month while the ECB raised rates by 50bps.
- The Bank of Japan appointed a new governor, a development markets are assessing for any implications for monetary policy, particularly with respect to yield curve control.
- US credit saw poor relative performance, with US investment grade corporates down sharply. High yield outperformed investment grade. US high yield fell, while European high yield was down marginally.
- The US 10-year yields rose from 3.51% to 3.92%, with the two-year rising from 4.21% to 4.82%. Germany's 10-year yield increased from 2.29% to 2.65%. The UK 10-year yield rose from 3.34% to 3.71% and two-year increased from 3.46% to 4.07%.
- The US dollar gained ground in February, with the currency outperforming most G-10 peers.

Drivers of fund performance

- The fund posted negative performance for the month.
- Rates were the main detractor to performance, followed by currencies. Our credit positioning generated some positive performance.

Portfolio activity

- We added risk to the UK steepening trade, which remains a high-conviction position. We continue to expect lower short rates in the UK given the frailty of the UK economy and the dovishness of the Bank of England, while anticipating that greater issuance of gilts in the coming months will keep long rates relatively high.
- In the US Treasury market in contrast, it appears that pension fund demand is supporting the long end of the US curve, introducing risks into being underweight the 30-year area. Accordingly, the risk in the portfolio's US curve trade was rotated from a 5s-30s steepener into 5s-10s. The US outright duration position was traded tactically through the month, including adding additional risk in the final day given the more attractive yield levels.
- Reflecting the same disinflationary theme, we maintained short inflation exposure, with short positions in both the US and Europe. In response to market moves, we added to these US positions towards the end of the month.
- Early in 2023, we made profitable use of cross-market trades, especially by being short European bonds versus the US and UK. These positions were closed out at the start of the month ahead of the ECB meeting reflecting our belief that the ECB were now approaching a peak in their hiking cycle and that their hawkishness would start softening.
- We also tactically traded our long position on Swedish government bonds, feeling that Sweden is more prone to medium-term economic weakness, in part because of its high levels of consumer leverage. On a shorter-term basis, we closed our position ahead of the Riksbank's February meeting and its 50bp rate rise, and subsequently bought back at higher yield levels.
- The portfolio was slightly short to Japanese government bonds.
- In credit, while spreads widened over the month, the portfolio's stance favouring investment grade over high yield - along with significant hedging (implemented through CDS indices) of the portfolio's high yield exposure - meant that performance was largely protected.
- We added to this protection during February as spreads widened, before tactically reducing it again late in the month to increase exposure to credit at more attractive levels.
- In somewhat choppy FX markets, currency positioning also generated negative performance.
- The portfolio started the month with a bias to be short the US dollar against a basket of other currencies, again reflecting the view of disinflation and slower growth in the US - and a potentially more dovish Fed. But stronger data has supported the dollar and our short positions, particularly

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

against the Japanese yen, correspondingly detracted.

– Other positions held against a short dollar - notably longs in the Australian dollar and Korean won - were implemented to benefit from the theme of China's reopening. These also contributed negatively as market enthusiasm for cyclical risk declined. A more tactical long position to the high-beta Norwegian krona was also unhelpful.
– To mitigate this impact, we introduced some tactical positions long to the US dollar versus the euro, New Zealand dollar, and Taiwanese dollar, which helped balance performance in the second half of the month. There was also a strong positive contribution to performance in early February from exposure to the Mexican peso and Brazilian real before the shift in investor risk sentiment took hold. We took profits in mid-month and continue to look for opportunities to re-engage.

Outlook/positioning

– Economic data releases have been providing mixed signals, with markets in response oscillating between positive and negative viewpoints. February saw portfolio risk reined back as data releases were less supportive of the US disinflation theme, while indicators of growth in both the US and Europe also remain robust. Even the UK economy may not be as weak as had been thought: our economic forecasts now suggest that it may suffer only two quarters of recession (the BOE is notably more pessimistic).
– Market expectations of terminal rates and potential future cuts have changed dramatically in the last few weeks. Pricing currently suggests that at the end of 2023 UK base rates will be 75bp higher than now, and that the ECB will be at 4% at the end of the year (150bp higher than at present). The Fed, meanwhile, is expected to raise rates again in March. Their messaging around that meeting will be as keenly scrutinised as ever.
– On a tactical basis, with yields and spreads back at more attractive levels, we have added some risk back into the portfolio, in the form of additional duration, short inflation positions and credit exposure.
– More broadly, we remain of the view that there is still a disinflationary impulse during the first half of 2023, but February has paused the progress on this. Similarly, conviction in the US leading a growth slowdown has been dented by the ISM services survey and non-farm payrolls figures early in the month. Upcoming data releases should provide greater clarity on whether this strength is becoming more persistent and suggesting a reacceleration of growth, or simply represents a minor bump in the road – which would potentially enable us to allocate more risk back to these themes.

Calendar year performance (%)*

Year	Fund (A Acc)	Fund (I Acc)
2022	-5.3	-4.2
2021	-0.7	0.6
2020	-1.3	-0.1
2019	7.7	9.0
2018	-3.0	-1.7
2017	1.2	2.5
2016	2.9	4.2
2015	-3.5	-2.3
2014	2.0	3.3
2013	1.1	2.3
2012	7.0	8.3

Source: Schroders, Bloomberg, as at 31/12/2022. Performance net of fees (where applicable), NAV to NAV (bid to bid), USD. Fund performance should be assessed against its objective of providing a positive return over a 12-month period in all market conditions.

– 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.
– **Bond Connect risk**: The fund may be investing in the China Interbank Bond Market via the Bond Connect which may involve clearing and settlement, regulatory, operational and counterparty risks.
– **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. A reduction in the financial strength of the issuer of such bonds 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**: Derivatives may be used to manage the portfolio efficiently. The fund may also materially invest in derivatives including using short selling and leverage techniques with the aim of making a return. 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.
- **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.
- **Issuer risk**: The fund is permitted to invest more than 35% of its scheme property in transferable securities and money market instruments issued or guaranteed by an EEA State / governments of the following country: United States of America.
- **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.

Important information