Quarterly Fund Update: Schroder ISF Global Credit Income[1]

Fund Update

Covering Q3 2021

At a glance

Fund managers: Julien Houdain & Martin Coucke*

Performance: 0.2% (A Dis); 0.3% (C Dis); 0.5% (I Dis).

Largest contributors: European healthcare & services, US and European rates

Largest detractors: European real estate, US inflation swaps and EUR CDS crossover

Source: Schroders, Morningstar, as at 30/06/2021. Net of fees, NAV to NAV (bid-bid), USD returns.

*** Martin Coucke was named Co – PM on September 1 with Julien remaining as Lead Portfolio Manager**

Market Review

US and European government yields were unchanged for the quarter as an initial decline reversed in September amid a hawkish shift from central banks and continuing inflationary pressure. The UK bond market underperformed, with a significant rise in yields on increased expectations for policy tightening.

The US 10-year Treasury yield finished the quarter at 1.49%, one basis point (bps) higher than it started. Yields fell initially as the rapid economic recovery appeared to be moderating. However, as the market's focus turned to rising inflation and the prospect of the withdrawal of monetary policy support, yields rose back to similar levels seen at the beginning of the quarter. The Federal Reserve (Fed) became increasingly hawkish, suggesting that asset purchase tapering could start as early as November and that it could be wound up by mid-2022, earlier than expected.

The UK 10-year yield increased from 0.72% to 1.02%, with most of the move occurring in September. There was evidence of a marked hawkish shift among Bank of England (BoE) policymakers, with a suggestion that rate rises might be warranted before the end of the year. Recent economic indicators came out worse than expected, while year-on-year consumer price inflation rose to 3.2% in August, the highest since 2012.

In Europe, the German 10-year yield was one basis point (bps) lower at the end of the quarter compared to the beginning at -0.19%. Italy's 10-year yield finished 4bps higher at 0.86%. Economic activity continued at a robust pace, the region benefiting from the release of pent-up demand, having come out of lockdowns relatively late. Eurozone inflation hit a decade high of 3.4% year-over-year in August.

Among corporate bonds, high yield made positive returns, while investment grade credit was little changed. European investment grade outperformed government bonds, while the US market was in line with Treasuries.

Emerging market (EM) government bond yields rose, particularly in September and EM corporates remained under pressure later in the quarter led by Asia. Emerging market currencies broadly fell against the US dollar.

[1]Schorder International Selection Fund is referred to as Schroder ISF.

Performance Review

Performance over the quarter was driven by our security selection within European healthcare as well as US real estate, which continued to benefit from the post-Covid recovery.

Elsewhere, the impact of the interest rate risk in the portfolio was marginally positive given the move in rates over the quarter although our decision to reduce the US in favour of Europe helped to protect the portfolio from the sharp move in yields seen in September.

Our high yield exposure contributed positively to returns, particularly within the services sector which continued to benefit from the return to normality.

Our allocation to emerging markets, particularly within high yield, were mixed with energy related names benefiting from the strong move in oil markets. However this was somewhat tempered by underperformance in EM relative to developed markets (DM) towards the end of the quarter.

Cumulative performance (%)	3 months	YTD	1 year	Since inception
Schroder ISF Global Credit Income I Distribution (USD)	**0.5**	**2.1**	**6.6**	**6.8**
Schroder ISF Global Credit Income C Distribution (USD)	**0.3**	**1.5**	**5.8**	**6.0**
Schroder ISF Global Credit Income A Distribution (USD)	**0.2**	**1.0**	**5.1**	**5.3**
BBgBarc Multiverse ex Treasury A+ to B- USD Hdg	0.1	-0.2	3.3	5.5
BBgBarc Gbl Agg Corp TR	-0.8	-2.4	1.7	5.0
BBgBarc Global High Yield TR USD	-0.4	1.7	9.5	5.9
JP Morgan EMBI Global TR	-0.5	-1.5	3.9	4.9

Performance (%)	2016	2017	2018	2019	2020
Schroder ISF Global Credit Income I Distribution (USD)	**-**	**9.3**	**-0.3**	**12.9**	**8.0**
Schroder ISF Global Credit Income C Distribution (USD)	**-**	**8.5**	**-1.0**	**12.0**	**7.3**
Schroder ISF Global Credit Income A Distribution (USD)	**-**	**7.8**	**-1.6**	**11.3**	**6.6**
BBgBarc Multiverse ex Treasury A+ to B- USD Hdg	-	6.7	-1.4	13.2	7.9
BBgBarc Gbl Agg Corp TR	-	9.1	-3.6	11.5	10.4
BBgBarc Global High Yield TR USD	-	10.4	-4.1	12.6	7.0
JP Morgan EMBI Global TR	-	9.3	-4.6	14.4	7.0

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 amounts originally invested. Exchange rate changes may cause the value of any overseas investments to rise or fall.

Source: Morningstar, bid to bid, net income reinvested, net of fees. The fund does not have a target benchmark. The investment manager invests on a discretionary basis and is not limited to investing in accordance with the composition of a benchmark. The fund is not managed with reference to a benchmark but its performance may be measured against one or more.

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Portfolio Activity

Our portfolio continues to maintain a ballast within investment grade credit, but our allocation remains at the lower end of our historical allocations. Over the quarter we continued to reduce our exposure to longer-dated issues where the yield curve had flattened and we were no longer being adequately compensated for the additional risk incumbent in holding longer-dated debt issuance.

We were able to identify a number of attractive opportunities in high yield, particularly within healthcare and energy which came attractively priced with strong business models and high cash flow visibility.

Environmental, social and governance (ESG) factors continue to be inputs in to our investment analysis and decision making process. We participated in a number of high yield issuances with strong ESG characteristics, one being an issuer which offers waste recycling for oil and gas companies, as well as an Indian renewable energy company.

Elsewhere, we increased our allocation to high quality emerging market bonds which offer a yield pick-up relative to developed market bonds.

Our largest credit allocations continue to be in defensive sectors such as real estate, telecommunications and healthcare which have business models which offer consistent and stable cash flows.

Our active approach to duration management (or interest rate sensitivity) has meant we have been able to respond to the volatility present in the rates market over the quarter. We ended the quarter toward the bottom of our duration range, at a time where central bank tone has become more hawkish in response to inflationary pressures on the horizon.

Outlook

Global markets have enjoyed a run of continued recovery, enabled by both respective monetary and fiscal policy support. The global outlook has moved in a stagflationary direction as growth momentum fades and price pressures rise. Valuations are fairly full but remain supported by healthy corporate fundamentals with selective opportunities which could drive total return going forward.

We have seen job openings accelerate and expect an accompanying drop in unemployment to follow shortly, helping to extend the credit cycle a bit longer. We also see consumers in developed markets well positioned following the surge in savings across 2020/2021. We tread carefully, focusing on identifying the pockets of value, balancing cyclical and non-cyclical, and areas with further recovery potential.

Central banks remain in a difficult position as they are trying to manage the equilibrium between tighter policy in the face of slowing growth momentum and stubbornly high inflation driven by disruptions in the supply chain. Some central banks, including the People’s Bank of China still have plenty of firepower available to continue support, and our regional active security selection will aid us in navigating broader local themes.

We continue to see opportunities in the high yield space where valuations are still relatively attractive and defaults are expected to remain low.

Risk factors:

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ABS and MBS risk: 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.
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.
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.
Sustainability Risk Factor: The fund has environmental and/or social characteristics. This means it may have limited exposure to some companies, industries or sectors and may forego certain investment opportunities, or dispose of certain holdings, that do not align with its sustainability criteria. Therefore, the fund may underperform other funds that do not apply similar criteria. The fund may invest in companies that do not reflect the beliefs and values of any particular investor.
Counterparty risk / money market & deposit: A failure of a deposit institution or an issuer of a money market instrument could create losses.
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.
Emerging Markets & Frontier risk: Emerging markets, and especially frontier markets, generally carry greater political, legal, counterparty, operational and liquidity risk than developed markets.
High yield bond risk: High yield bonds (normally lower rated or unrated) generally carry greater market, credit and liquidity risk.
Interest rate risk: A rise in interest rates generally causes bond prices to fall.
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.
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.
IBOR: 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.
Derivatives risk: 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.

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