Schroders

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Schroder ISF* EURO Credit Conviction

Monthly Fund Update

September 2019

At a glance

Fund managers: Patrick Vogel

Performance: The fund returned -0.3% (A Acc share class) over the month**, ahead of the iBoxx EUR Corporate BBB Index TR, which returned -0.7%.

Largest contributors: Underweight to consumer non-cyclical, overweight and security selection in telecoms, and emerging market holdings

Largest detractors: Overweight real estate and underweight capital goods

**Source: Schroders, as at 30/09/19, net of fees, NAV to NAV (bid to bid), EUR returns

Calendar year performance (%)

	A Acc	I Acc	BM**
2018	-3.6	-2.4	-2.0
2017	6.2	7.5	3.3
2016	6.8	8.1	5.4
2015	1.5	2.8	-0.9
2014	9.1	10.5	8.0

Source: Schroders as at 31/12/2018 net of fees (where applicable), NAV to NAV (bid to bid). **iBoxx EUR Corporates BBB Total Return 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.

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

Optimism towards October's US-China trade talks saw government bond yields rise, while corporate bond spreads ended the month with little change.

Investment grade corporate bonds saw negative total returns due to rising yields, but broadly outperformed government bonds. The aggregate yield on the euro IG market rose 15 basis points (bps) and the spread increased by 1 bp resulting in a marginally favourable return relative to government bonds. High yield (HY) and emerging market bonds performed relatively well.

In Europe, the 10-year Bund yield was 13 bps higher, with the bulk of the move occurring around the announcement of stimulus measures by the European Central Bank (ECB). The announcement led to a marked drop in the 10-year Italian yield, which was 20 bps lower on the month, also helped by more constructive news on the political front. UK yields were unchanged at 0.49%.

The US 10-year Treasury yield rose by 17 bps to 1.67%. The yield retraced from an intra month high of 1.9% after Saudi Arabian oil fields were attacked, raising geopolitical risk and reigniting global growth concerns. The US Federal Reserve (Fed) cut rates by 25 bps in line with expectations.

Portfolio overview

The fund returned -0.3% over the month (A Acc share class), while the benchmark returned -0.7%.

The main positives were the underweight to consumer non-cyclical, the overweight and security selection in telecoms, and emerging market holdings.

We participated selectively in new issues. We purchased two in the healthcare sector, which is an area we are broadly attracted to given its stable and non-cyclical nature. Both were multi-tranche euro deals from US businesses in which we purchased several tranches across maturities. One was from an A-rated US conglomerate using the issue proceeds to finance an acquisition of a pharmaceuticals business. The company benefits from significant recurring revenues and has positive long-term prospects.

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

We reduced our A-rated exposure overall, in different sectors, allowing us to purchase new issues.

We bought a euro BBB primary issue in the media sector, from a UK broadcaster. The company's management has an appealing conservative approach to managing its balance sheet and is benefiting from a strengthened and successful range of content. At the same time, we took profit from a position in a German media company. Additionally, we purchased the debut issue from a newly-formed European oil and gas company where we found the valuation particularly attractive.

We maintained core positioning to real estate, where we added over the month, and utilities. Our preference for more defensive issuers remains in place, with an overweight position to utilities and significant exposure to telecoms. We have protection positions in basic industry, and little exposure to capital goods and consumer sectors.

We added to sterling exposure, purchasing a new issue, used for refinancing, from a BB-rated real estate company, which owns filming studios. The company has signed long-term contracts with Disney and Netflix for all their existing studio space, which significantly boosts its credit fundamentals. We also bought a BBB 30-year new issue from a solid UK insurance and asset management company.

We remain very much engaged in the sterling market looking for opportunities where Brexit related uncertainty has resulted in mispricing.

Outlook

The market seems content to take central bank support as the remedy to all ills. With policy and rates at already extremely low levels we are not so sure that it is. Taken another way, the latest raft of measures from the European Central Bank (ECB), with asset purchases to continue indefinitely, underlines the extent of the continued deterioration in economic fundamentals.

While central bank action can keep sentiment benign, it has proved less effective at kick-starting growth. Draghi, at his final meeting, suggested governments should start to consider fiscal measures to try and spur growth. His comments could be seen as an acknowledgement that central bank measures have not quite had the desired impact and that something else is needed. The possibility of fiscal measures seems higher now and we are still some way off a return to "normalisation".

There is still little cause for optimism in terms of the economy with the slump in global manufacturing and trade deepening, and also finally being felt in the US. Whether a resolution to US-China trade tensions may come about to alleviate this is still very difficult to predict. Arguably, President Trump will likely see the impact his trade policies are having as evidence that they are working. The uncertainty this causes, along with other geopolitical issues such as Brexit, is likely to continue to hinder businesses from making important investment decisions.

Having performed strongly in September, ultimately riskier parts of the financial markets still don't seem to fully reflect economic reality as we see it. Parts of high yield and cyclical sectors look fairly unappealing at current levels. Given the economic backdrop, a moderate increase in corporate insolvencies and defaults within high yield and lower quality areas looks quite likely. There are some potential near-term positives for credit markets as a busy period of new investment grade supply is likely to ease off, while the ECB will commence asset purchases.

We also remain engaged in the UK market, as Brexit related uncertainty has created value in certain areas. UK growth has slowed and indicators suggest it will remain lacklustre over the near term or until greater clarity is provided over Brexit. Some financials and banks continue to offer value, as well as certain non-cyclical and more defensive issuers.

Overall, a world of unusually low yields, slowing growth, albeit with resilience in certain areas, and accommodative central banks, looks quite supportive of corporate bonds. We continue to find some attractive valuations and new issue premium selectively within favoured, mostly less-cyclical sectors. Real estate and healthcare are notable examples. A defensive, higher quality bias seems warranted.

A selective approach, with a strong focus on valuations and fundamentals is certainly all important. We will continue to seek out the pockets of value where systemic or top-down factors may have led to mispricing, as well as idiosyncratic security selection opportunities.

Risk Considerations

The capital is not guaranteed.

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.

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.

Investments denominated in a currency other than that of the share-class may not be hedged. The market movements between those currencies will impact the share-class.

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.