Schroders

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Schroder ISF* Global Multi Credit

Fund Update

Third Quarter 2019

At a glance

Fund managers: Patrick Vogel

Performance: The fund returned 2.1% (A Acc shares) over the quarter**, while the Bloomberg Barclays Multiverse ex Treasury A+ to B- USD Hedged index returned 2.4%.

Largest contributors: Emerging market hard currency corporate bond holdings, US dollar investment grade telecoms positions

Largest detractors: Euro investment grade positioning, notably in real estate and telecoms, and individual euro high yield positions

**Source: Schroders, as at 30/09/2019. Net of fees, bid-bid (NAV to NAV), USD returns. Benchmark for reference. The fund is not managed with reference to a benchmark but its performance may be measured against one or more.

Calendar year performance (%)

	A Acc	C Acc	BM**
2018	-3.4	-2.7	-1.4
2017	7.9	8.7	6.7
2016	-	-	-
2015	-	-	-
2014	-	-	-

Net of fees, NAV to NAV (bid to bid), USD returns. Source: Schroders, as at 31/12/18. Fund launched 08/06/16. **Bloomberg Barclays Multiverse ex Treasury A+ to B- USD Hedged. Fund not managed with reference to a benchmark but its performance may be measured against one or more.

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 review

Government bond yields declined markedly over the quarter due to risk aversion in August when US-China trade tensions escalated. The US announced a marked increase in tariffs and China retaliated with its own measures including allowing a devaluation of the renminbi. There was some retracement in September as the US and China announced talks would resume in early-October, giving rise to optimism.

September saw the European Central Bank (ECB) announce a much anticipated new round of stimulus measures which helped sentiment. The Federal Reserve (Fed) cut rates again, but disappointed markets by downplaying the prospect of further easing.

Economic data continued to show a slowdown in activity. In the US, the services sector and labour market remained resilient despite a continued downturn in manufacturing. Eurozone leading indicators deteriorated further, particularly in manufacturing.

Corporate bonds outperformed government bonds, mainly due to income returns, spreads were broadly unchanged. Credit benefited from the decline in global yields in August, and improved risk sentiment in September was helpful. Globally, investment grade (IG) outperformed high yield (HY). In the euro market, however, both IG and HY returned 1.3% with HY outperforming government bonds by a wider margin.

The US 10-year Treasury yield was over 30 basis points (bps) lower, finishing the quarter at 1.67%. The 10-year yield reached below 1.5% in late-August, and briefly dipped lower than the two-year yield, a yield curve inversion indicating significant economic pessimism among bond investors.

In Europe, the 10-year Bund yield fell 24bps to finish even deeper in negative territory at -0.57%. The Italian 10-year yield saw a substantial move, falling 126bps to 0.82% due to anticipation, and ultimately announcement of new stimulus measures and a calmer political backdrop. The UK saw further escalation in Brexit uncertainty. The 10-year UK yield

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

fell 34bps over the quarter, with most of this occurring in July.

Across emerging market bonds, corporate debt and local currency government debt made positive returns, while emerging market currencies broadly weakened against the US dollar.

Portfolio overview

The fund returned 2.1% (A Acc share class). The main positives in absolute terms were emerging market hard currency positions in corporates and positions in US IG telecoms.

The main positioning change was the reduction in emerging markets, mainly in A-rated sovereign and quasi-sovereign exposure, which we reallocated to US dollar IG. The US dollar market continues to offer relatively attractive yield, while in spread terms (the difference in yields on corporate versus government bonds) it underperformed in August resulting in opportunities.

We added meaningfully to A-rated senior banking, and in various sectors in BBBs, notably telecoms, real estate and energy.

We increased our bias to IG overall. The reduction in EM, while implemented across ratings, resulted in a reduction to HY exposure to around 20%. This is notably low, but we are comfortable with this given economic conditions.

Overall, the portfolio maintains a broadly defensive sector stance with substantial exposure to utilities and telecoms and little exposure to consumer and industrial cyclical, including some select short positions through credit default swaps (CDS) within this space. We also maintain short index positions on euro and US dollar IG, given the significant moves so far this year.

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 has 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

Mortgage or asset-backed securities may not receive in full the amounts owed to them by underlying borrowers.

A failure of a deposit institution or an issuer of a money market instrument could create losses.

A decline in the financial health of an issuer could cause the value of its bonds to fall or become worthless.

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.

High yield bonds (normally lower rated or unrated) generally carry greater market, credit and liquidity risk.

A rise in interest rates generally causes bond prices to fall.

The fund uses derivatives for leverage, which makes it more sensitive to certain market or interest rate movements and may cause above-average volatility and risk of loss.

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.