Schroders

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Schroder ISF* US Small & Mid Cap Equity

Fund Manager: Robert Kaynor, CFA | Fund update: February 2023

Performance overview

- Markets were weaker in February, performing much more rationally after January's curiously strong rally.
- The fund outperformed the benchmark during the month.

Drivers of fund performance

- Stock selection and sector allocation contributed equally in February. The primary contributors were healthcare, financials and real estate.
- Within healthcare, stock selection in the medical supplies sub-sector contributed to performance. **Catalent**, which provides technologies and development solutions for drugs, led the group after positive earnings and an upbeat cell and gene therapy outlook. Additionally, the fund's underweight to biotechnology added value as the industry was one of the worst performers within healthcare during the month. In financials, full line insurance and reinsurance performed well due to improved outlooks. Finally, in real estate, the fund's underweight positioning was beneficial as the sector lagged in February.
- Detractors for the month were technology and consumer discretionary. In technology, stock selection in consumer digital services detracted from returns. **LiveRamp Holdings**, which provides an enterprise data connectivity platform, saw a deceleration in marketplace revenue as macroeconomic uncertainty has lowered demand from advertisers using third-party data. Media and internet company **IAC** also detracted after earnings came in below consensus forecasts, partially owing to a slowdown in its services business. In consumer discretionary, stock selection in the restaurant and bars sub-sector significantly weighed on performance.
- Regarding the fund's three alpha categories[1], "steady eddies" outperformed, while "turnarounds" and "mispriced growth" lagged.
- Major contributors included **Catalent, NeoGenomics** and **RenaissanceRe Holdings**.
- Major detractors included **Aramark, Azenta,** and **LiveRamp Holdings**.

Portfolio activity

- We added **Pure Storage** and **Wolfspeed**.
- We exited **Maxar Technologies**.

Calendar year performance (%)

Year	Fund	Target	Comparator 1	Comparator 2
2022	-13.3	-18.5	-20.4	-13.0
2021	21.6	17.8	19.4	24.4
2020	6.8	20.4	22.4	13.0
2019	28.9	28.6	29.9	26.7
2018	-12.4	-11.5	-10.8	-12.9
2017	15.2	17.2	16.1	15.9
2016	17.6	16.4	13.6	19.4
2015	0.7	-3.2	-2.6	-2.7
2014	11.6	7.8	8.3	10.8
2013	35.0	38.4	37.7	34.6
2012	9.1	14.7	12.0	15.0

Source: Schroders, net of fees, NAV to NAV, with net income reinvested. USD C Acc share class as at 31 December 2021. The target benchmark is Russell 2500 TR Lagged index, comparator 1 is Morningstar US Mid-Cap Equity sector, comparator 2 is S&P Mid Cap 400 Lagged (Net TR) 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.

[1] We target three types of opportunities: "mispriced growth stocks" – stocks where we think the market continues to undervalue a company's growth prospects; "steady eddies" – strong companies with recurring revenues and/or cashflows; and "turnarounds" – firms that are addressing their problems, often with new management, which are likely to outperform over time.

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

Outlook/positioning

- A combination of a strong backdrop for the US consumer, government spending (infrastructure and social bills) and corporate capital expenditure will be supportive of US economic growth over the next few years. This growth will likely be more broad-based and focused on a de-risking of supply chains, automation to tackle overdependence on a tight labour market, and emerging technologies to address climate-change risk.
- In this environment, US small- and mid-cap companies are set to benefit more than in the past. This is partly due to the greater choice of companies participating in the domestic economy, as well as more broad-based growth opportunities that did not exist in the past few years. As growth broadens, the greater breadth and diversity of the small- and mid-cap market will provide more ways to access that expansion.
- Although the supply-chain bottlenecks and raw material cost inflation seen in 2021 may prove transitory, wage pressures will be more persistent as both skilled and unskilled labour remain scarce. Companies that can protect profit margins will be the biggest winners. Looking forward, company valuations will depend more on profit metrics and returns than simply nominal growth. This will require a lot of analytical skill to differentiate between winners and losers.
- The market has transitioned from fear of inflation to fear of growth. To date, we have avoided any credit-related event and weakness in housing has so far been normal by historical standards. We have not seen major job cuts aside from companies that hired too many people during the Covid period, such as technology businesses. The likely peak level of interest rates has come into view, which provides greater certainty around multiples. However, we believe that the market focus must shift to appropriate levels of earnings and cashflows. We expect conservative guidance for fourth-quarter earnings, similar to 2018, but the difference in 2023 is that the US Federal Reserve will not be cutting interest rates in a hurry.
- We continue to take a very measured approach, with a preference for companies where earnings and cashflows are less dependent on particular macroeconomic circumstances. We will also be cautious investing in highly leveraged companies. This is not only because interest-rate costs have increased, but also because the previous tax advantages from borrowing that were made available during ex-President Trump's tax-cutting programme have expired. A positive factor is that after years of underperformance against large caps, valuations for small and mid-caps are already pricing in a lot of risks. We believe this will partly support a change in leadership over the next few years from large caps to small and mid-cap companies. The experience of previous cycles supports this view.

Risk considerations

Concentration risk: The fund may be concentrated in a limited number of geographical regions, industry sectors, markets and/or individual positions. This may result in large changes in the value of the fund, both up or down.

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.

Currency risk: The fund may lose value as a result of movements in foreign exchange rates.

Currency risk /hedged shareclass: The hedging of the share class may not be fully effective and residual currency exposure may remain. The cost associated with hedging may impact performance and potential gains may be more limited than for unhedged share classes.

Derivatives risk: Derivatives may be used to manage the portfolio efficiently. 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.

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.

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.

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 macroeconomic environment, investment objectives may become more difficult to achieve.

Smaller companies' risk: Smaller companies generally carry greater liquidity risk than larger companies, and they may also fluctuate in value to a greater extent.

Sustainability risk: 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 chosen by the investment manager. The fund may invest in companies that do not reflect the beliefs and values of any particular investor.

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