Schroders

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Schroder ISF* US Large Cap
Fund Update
Q2 2019

At a glance

Fund managers: Frank Thormann

Performance: The fund rose 1.9% (A Acc share class) over the quarter** and underperformed the S&P 500 Net TR Lagged, which gained 4.2%.

Largest contributors: Stock selection in healthcare.

Largest detractors: Stock selection in communication services.

**Source: Schroders, as at 29 June 2019. Net of fees, bid-bid, with net income reinvested.

Calendar year performance (%)

	Fund Net	Standard & Poors 500 Net TR Lagged
2018	-6.6	-6.2
2017	19.4	21.2
2016	7.1	10.7
2015	-0.6	0.7
2014	12.8	14.6

Source: Schroders, net of fees, bid-bid, with net income reinvested. A Acc share class as at 31 December 2018.

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 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

US shares gained in Q2 and the S&P 500 set a new record high. Uncertainty surrounding the US' trade stance caused a mid-quarter market wobble. However, investors were broadly cheered by continued dovishness from the Federal Reserve (Fed) and indications of progress in trade tensions by the end of June.

Economic data was mixed. US gross domestic product (GDP) grew 3.1% (quarter-on-quarter, annualised) in Q1, revised down from 3.2% as expected. Employment data remained broadly encouraging despite slowing in June. The unemployment rate remained stable at a 49-year low of 3.6% while average hourly earnings climbed 3.1% from a year earlier, below expectation of a 3.2% gain. However, consumer and business confidence indices weakened, and survey data indicate business activity is slowing. The Fed did not cut rates at its June meeting, but the "dot plot" signals easier policy ahead.

More cyclical areas of the market, generally performed strongly. Financials, materials and IT all generated robust gains. Healthcare remains challenged by potential changes to pricing legislation, and more defensive (i.e. less cyclical) areas of the market made modest gains. Energy stocks largely declined.

Portfolio overview

The portfolio delivered a positive return but underperformed the benchmark in Q2. Our positions in communication services, industrials and consumer staples detracted the most, while healthcare and consumer discretionary names added value.

Occidental Petroleum fell after reporting a fall in Q1 profits and negative reaction to the company's take over of Anadarko. The bid conflicted with previous

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

commentary from management which exuded capital discipline and a focus on shareholder returns. Given our significantly reduced conviction in our investment thesis, we took the decision to sell our holding.

Alphabet shares have been under pressure of late due to a combination of a revenue miss in Q1 and mounting regulatory scrutiny. The latter was exacerbated in June by activists raising a proposal at the company's AGM to break up the business in order to reduce its dominant competitive position. We are alert to the growing amount of regulatory scrutiny faced by companies of Alphabet's size. ESG analysis is integrated into our investment process and forms an important part of our overall risk assessment. However, we continue to see Alphabet as one of the best companies in the world. Its scale and span mean its competitive advantages are unmatched in almost any industry, with a strong runway for growth in revenue and earnings. We continue to believe its unrivalled market share and underappreciated innovation can deliver better-than-expected earnings growth.

JP Morgan (JPM) contributed after the US investment bank reported record revenue and profits in Q1 with growth recorded across all its business units. Mid-single digit top-line growth with lower expense growth was further augmented by buy-backs. We believe that JPM – through its scale and revenue mix – can continue to deliver superior earnings relative to peers in the institutional lending space, while its strong execution in retail banking is another key element of our thesis.

AutoZone contributed positively over the period as investor sentiment supported stable growth stocks. AutoZone sells and distributes automotive parts to consumers and garages, principally in the US, and has historically demonstrated robust operating and financial performance through the economic cycle. Reflecting this, AutoZone reported robust revenue and profit growth and is holding up well in the face of competition from online retailers. It also opened a number of new stores in the quarter (in the US, Brazil and Mexico), demonstrating the strength of its business.

Outlook

We maintain a cautious view on global markets given macro risks and softening fundamentals. Global economic momentum is weakening – with earnings expectations moderating as a consequence – but expansion broadly continues, although margins are facing increasing headwinds. Additionally, prolonged policy uncertainty continues to weigh on business investment and sentiment. Valuations, although relatively full in aggregate are not egregious. Ongoing policy support from major central banks has been confirmed rhetorically if not in action.

Interest rate expectations have come full circle since late last year. In December, consensus expectations were for two Federal Reserve (Fed) rate hikes in 2019. Two to three months ago, this had dropped to zero. Now consensus is forecasting rate cuts. The European Central Bank has suggested that renewed stimulus measures remain on the table if inflation fails to pick up. The Bank of Japan has also committed to extending its low rates until at least 2020.

We remain concerned about the complacency around financial leverage amidst low interest rates. Bond-proxy equities have moved higher as discount rates have fallen again. With yield-seeking investors funnelling into bond proxy stocks, we are increasingly observing dividend payers with significant leverage and relatively weak financials refusing to cut their dividend payment for fear of losing their investor base.

Business confidence and investment remains under pressure from the unclear outlook for trade terms between the US, Europe and China. While the G20 meeting in June brought a respite and commitment from the US and China to resume talks, it is far from certain that the two sides can bridge their differences, and so the spectre of further tit for tat tariffs remains. It is also quite possible that the US will impose tariffs on EU auto exports later in the year, further complicating relations between the US and EU.

While earnings expectations have come down in 2019, consensus forecasts continue to point to expectations for a second half acceleration. If this fails to materialize, there is increased risk of selling pressure with "growthier" names likely more vulnerable. The high levels of debt held by many companies, particularly if increased at the top of the economic cycle without a credible plan to pay off the debt, could also leave a number of stocks vulnerable.

There will inevitably be a number of companies that find themselves ill-equipped to deal with a tougher economic environment. Our focus remains on choosing stocks with strong return-on-capital, resilient balance sheets and good cash flows. It is also increasingly important for companies to have elements of pricing power and self-help as companies dependent on macro support alone are unlikely to deliver amidst the slowdown. We expect companies with these positive characteristics are not only more resilient, but will retain greater flexibility to adapt to change in a shifting competitive landscape.

Risk considerations

The capital is not guaranteed. 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.

The fund will not hedge its market risk in a down cycle. The value of the fund will move similarly to the markets.

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