Schroders

Schroder ISF* Hong Kong Equity
Fund Update
Q3 2019

At a glance

Fund manager: Toby Hudson

Performance: The fund fell 8.8% (A Acc share class, US dollars)**, but outperformed the FTSE Hong Kong Net index, which declined 11.1%.

Largest contributors: Stock selection in consumer services and overweighting of the oil & gas sector.

Largest detractors: Stock selection in oil & gas.

**Source: Schroders, as at 30 September 2019. Net of fees, NAV to NAV, with net income reinvested.

Calendar year performance (%)

	Fund Net	FTSE Hong Kong Net TR
2018	-14.1	-10.1
2017	51.6	37.4
2016	0.5	4.1
2015	-5.2	-4.5
2014	4.2	2.2

Source: Schroders, net of fees, NAV to NAV, 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

Both the Hong Kong and Chinese markets fell over the period. They fell over the quarter alongside other Asian equity markets, as a re-escalation of US-China trade tensions and continuing political unrest in Hong Kong sent shockwaves through equity markets. In this environment, returns from the Chinese market were marginally worse than the Asian region as a whole. Regarding the Hong Kong market, share price weakness was more pronounced amid ongoing and steadily escalating protests and demonstrations in the city. By sector, in the FSTE Hong Kong Net index, weakness was marked in basic materials, financials and industrials. Technology and particularly oil and gas were the two sectors that gained over the period.

The US announced 10% trade tariffs on $300 billion of goods imported from China, some of which took effect in September. Following the announcement, the renminbi weakened beyond the symbolic RMB7/$1 threshold and, in response, the US Treasury labelled the country a currency manipulator. The US also announced plans to increase existing tariffs on $250 billion of Chinese goods from 25% to 30% in October. China responded by announcing tariffs on $75 billion of US goods.

Portfolio overview

The fund fell 8.8% (A Acc share class, US dollars) over the quarter, and outperformed the FTSE Hong Kong Net index, which declined 11.1%.

Sector allocation was the key driver of relative returns over the quarter. Overweight exposure to the oil & gas sector contributed most significantly while a weighting in healthcare (a sector not included in the benchmark) was also a prominent contributor. Stock selection had a mildly negative impact on returns, most notably in the oil & gas and technology sectors. The contribution from consumer services, however, was positive.

At the stock level, key contributors included our holding in **Alibaba**. The shares gained on positive

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

quarterly results due to its strong core e-commerce business, more prudent content spending and higher operational efficiencies. An overweight position in **WuXi AppTec** also contributed positively after first-half 2019 results showed better-than-expected 32% core profit growth. **New Oriental Education and Technology** was strong owing to the release of quarterly results which featured strong revenue growth and margin expansion, and a positive outlook for 2020.

On the negative side, our position in **Jardine Strategic** detracted from returns as some of its main subsidiaries, such as Hongkong Land and Dairy Farm, were affected by the prolonged social unrest in Hong Kong. This also accounted for weakness in both **Kerry Properties** and **Swire Properties**.

Outlook

After a strong start to the year for equity markets, performance in recent months has been more volatile in response to the shifting messages from the US Federal reserve (Fed) and the China-US trade talks. Markets were negatively impacted as the anticipated resolution to the trade talks collapsed at the last minute and the US threatened further tariffs on imports from China. US moves to prevent the Chinese company Huawei Technology from purchasing key US components also represented a further escalation in the conflict with the US. More recently in mid-October, a partial deal was agreed and both sides together announced plans to negotiate in phases, but the scheduled tariff hike in September was implemented without any exemptions.

More dovish commentary from the Fed has led to a sharp fall in US long bond yields as the market moved to price in further rate cuts in the remainder of the year. The weaker outlook for global growth, especially outside the US, has produced this change in monetary policy. A rally in markets in the late summer was short-lived as the US again ratcheted up the pressure on China with another round of tariffs, and markets fell sharply again in the first half of August.

Against the broader backdrop of slowing global growth, weak trade volumes and disappointments across many parts of the technology sector (notably smartphones), earnings estimates have continued to be downgraded.

Some earlier hopes for a robust stimulus package in China have also faded slightly as authorities have continued to restructure and force deleveraging on the weaker parts of the financial system. Although growth in broader credit has accelerated moderately this year in China after a sharp slowdown in 2018, this rebound is relatively modest compared to past easing cycles. Hence, the prospects for growth in the second half of 2019 look similarly sluggish.

The ongoing political protests and demonstrations in Hong Kong in recent weeks are now having a major negative impact on local activity. Tourist arrivals and retail sales collapsed in August, and expectations are now for a more prolonged period of weakness that will also start to impact the larger banking and property stocks.

Consensus forecasts are, as usual, looking for double-digit earnings growth again next year. This is predicated on further monetary stimulus and as some rebound in the technology sector feeds through. However, in our view, this looks optimistic, currently, given the headwinds from trade uncertainties and weak corporate confidence in most economies. In the near term, this leaves the market hostage to the continued swings in macroeconomic sentiment regarding US rates and trade. If the Fed continues to cut, while the US growth outlooks does not deteriorate sharply, and the current nervous stand-off on trade is maintained (that is, with no further increases in tariffs), then markets may be supported. There are positive factors for investors in healthy equity yields relative to bonds and hopes for improved growth next year. However, if the Fed does not deliver rate cuts, if the dollar rallies sharply, or if US President Trump looks to escalate the trade war again, then the market is likely to retest its recent lows.

Against this very unpredictable near-term backdrop, we are not attempting to trade the month-to-month swings in markets. Instead, we are focused on those companies within the portfolio whose futures are less reliant on 'macroeconomic assistance' but rather have a clear growth path based on something more unique to their own market position. 'Value' as a factor has been a very poor performer globally in recent years, and we remain cautious of many 'nominally cheap' stocks. There is a risk that they will remain 'value traps' as their fundamentals continue to deteriorate in the face of accelerating disruption of their business models. Aggregate valuations for the market are by no means stretched – continued volatility in markets is throwing up interesting opportunities to accumulate strong businesses for the longer term.

We remain focused on selective areas of longer-term secular growth that offer opportunities for attractive compounding of returns in what could be a dull environment for broader economic growth. As interest rate expectations have moderated, the attraction of growing dividend yields has also become more apparent again.

The fund exposure is balanced between those companies that have footprints outside the relatively mature Hong Kong economy and are delivering attractive growth from their regional or global franchises – banks, insurance companies, conglomerates, manufacturing businesses, among others – and those more mature domestic stocks that offer exceptional value to shareholders.

On a medium-term view, we continue to see reasonable value in some of the more traditional Hong Kong property names, particularly those concentrated in the commercial rather than residential markets. A lack of supply in the residential market is putting upward pressure on rents and rising recurring income can drive strong dividend growth over the longer term.

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.

Investments in small companies can be difficult to sell quickly which may affect the value of the fund and, in extreme market conditions, its ability to meet redemption requests upon demand.

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

Emerging markets will generally be subject to greater political, legal, counterparty and operational risk.

The fund may hold indirect short exposure in anticipation of a decline of prices of these exposures or increase of interest rate.

Changes in China's political, legal, economic or tax policies could cause losses or higher costs for the fund.