



Breaking down borders in corporate bond markets

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The global corporate bond market spans hundreds of issuers. Yet, when it comes to portfolio construction, fixed income investors often overlook overseas investing. The benefits of moving abroad include diversification and better risk-adjusted returns, but investors need to tread carefully. In light of this, we believe that a flexible investment approach is likely to add the most value, as it can capitalise on changing market environments and generate more efficient portfolio returns.

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Introduction

Over the last twenty years, the investable global corporate bond market in the developed world (as reflected by the BofA Merrill Lynch (BAML) Global Corporate Index) has risen eight-fold and become more diversified. This has been fuelled by the acceleration of globalisation, declining interest rates and increased capital flows. Yet, over the same period, investors have maintained their home-country bias. For example, domestic bonds still accounted for 77% of the average pension fund bond portfolio in 2016, a fall of just 11 percentage points from 1998¹. Why might this be the case? Many investors prefer to use local markets to match their liabilities for currency reasons and/or they see overseas markets as riskier. Some of these reasons may be valid, but by no means all.

This paper compares and contrasts the fundamental characteristics of global and local corporate bond universes and analyses the value of a global portfolio. We highlight three features of overseas investing that investors often get wrong:

- First, currency and country exposures are not equivalent: a balance between the two can lead to better diversification.
- Second, beware of foreign yield comparisons: investors should not simply look at yields in different markets, as currency hedging will tend to equalise any differences.
- Third, long-term benefits can vary: foreign markets can offer higher returns and/or lower volatility, but the benefits will depend on an investor's home market.

Although there are pros and cons, taken together these characteristics suggest there are benefits to be gained from moving abroad. Indeed, our research suggests a global portfolio that dynamically allocates to different global markets can generate better risk-adjusted returns than one that hugs the domestic universe.

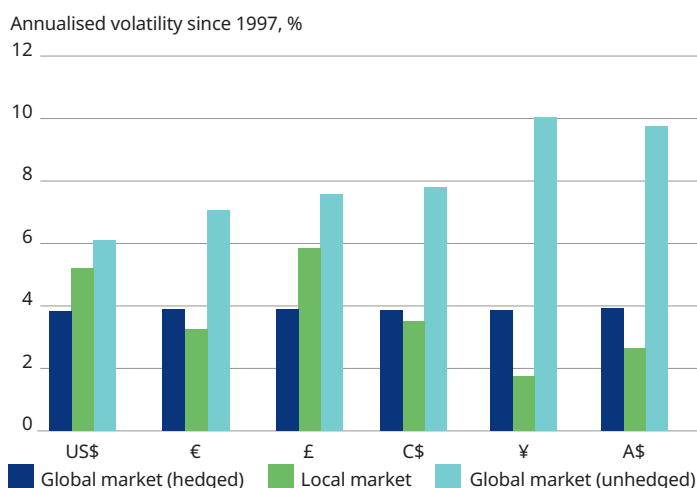
The impact of currency moves

Investors typically buy corporate debt because they expect to earn an additional return over maturity-equivalent government debt. This additional return is related to the

probability of default and is often reflected in a bond's credit spread. The actual return an investor receives can be lower than the initial credit spread suggests as default and downgrade losses eat into gains. The difference between the credit spread and credit-related losses is sometimes referred to as the risk premium.

While government yields and credit spreads are the main return components for domestic investments, currency moves will often have a considerable impact on a global portfolio's risk profile. Any diversification benefits will depend on ensuring that currency exposures are hedged (see box on next page for more details). As Figure 1 shows, the volatility of the unhedged global market has historically been much higher than the hedged version for all investors. For this reason, unless an investor holds a long-term strategic view on a currency pair, they should prefer to hedge foreign currency exposures. All analysis throughout this paper is in fully hedged local currency terms, in line with market practice, and based on market data as at 30 September 2017.

Figure 1: Portfolio volatility intensifies when currency exposures are left unhedged



Global market = BAML Global Broad Market Corporate Index.
Local market = respective currency component of the Global Broad Market Corporate Index. Source: BofA Merrill Lynch and Schroders. Data to 30 September 2017.

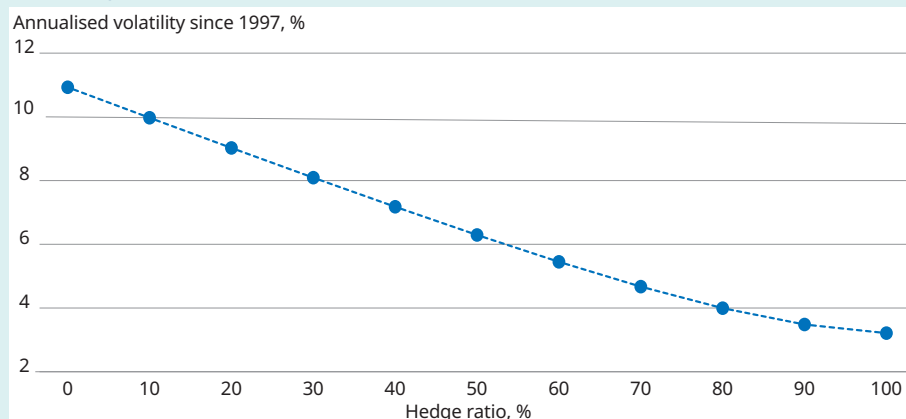
¹ Average across US, UK, Switzerland, Netherlands, Japan, Canada, Australia, according to Global Pension Assets Study, Willis Towers Watson, 2017.

How much should you hedge?

The extent of the volatility reduction from hedging will depend on the proportion of the value of the portfolio that is covered, or the “hedge ratio”. The chart illustrates this concept using the euro corporate bond market from the perspective of a US dollar investor. As the hedge ratio increases, volatility decreases. Some investors may strategically hedge less than 100% for practical reasons or because of the costs involved, but a discussion on this topic is beyond the scope of this paper.

The higher the hedge, the lower the volatility

Euro corporate bond market in US dollars



Euro corporate bond market = BAML EMU Corporate Index. Source: BofA Merrill Lynch and Schroders. Data to 30 September 2017.

Surveying the global landscape

Figure 2: Features of the largest, most liquid investment grade corporate bond markets

Market	Global	US\$	€	£	C\$	¥	A\$
Market value (US\$ bn)	10,400	6,441	2,483	498	340	160	73
Number of issuers	2,602	1,476	728	336	199	98	129
Global weight (%)	-	64	25	5	3	2	1
Domestic exposure (%)*	-	71	67	49	89	70	59
Sector split (%)							
Industrial	58	63	52	47	48	40	53
Financial	32	29	36	33	41	42	40
Utility	9	7	11	20	10	18	6
Hedged yield (to US\$)	3.1	3.2	2.9	3.7	3.4	2.0	2.9
Spread (basis points)	106	107	98	126	116	34	104
Duration (years)	6.7	7.3	5.3	8.7	6.4	4.7	3.7
Average rating	A-	A-	A-	A-	A-	A	A

*By domicile of issuer. US\$ = BAML US Corporate Master Index, € = BAML EMU Corporate Index, £ = BAML Sterling Corporate Securities Index, C\$ = BAML Canadian Corporate Securities Index, ¥ = BAML Japan Corporate Index, A\$ = BAML Australian Corporate & Collateralised Index. Global weight of US dollar market excludes eurodollar debt. Sector weights for Australian corporates have been scaled to exclude securitised and collateralised debt. Weights may not add up to 100% due to rounding. Source: BofA Merrill Lynch and Schroders. As at 30 September 2017.

The global investment grade corporate bond market encompasses a huge universe (Figure 2). The market is valued at over US\$10 trillion, involving 2,602 issuers in six currencies. US dollar debt dominates the index, representing 64% of the total value, and also accounts for the greatest number of issuers. The second-largest part of the market is euro corporate debt, representing 25% of the index (up from 14% in 1996). Against a background of

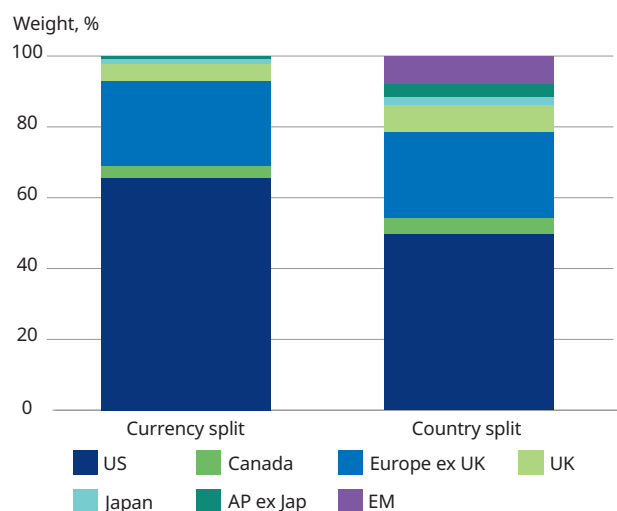
anaemic Japanese economic growth, yen corporate debt is the only segment to have shrunk, dropping from a high of 25% in 2000 to just 2% today. On a sectoral basis, the US dollar market has the largest allocation to industrials at 63%, whereas the sterling and yen markets have nearly 20% in utilities, double the weight of the global index. Yen markets also have the heaviest tilt towards financials at 42%, a proportion that was even higher a few years ago.

1. Currency and country exposures are not equivalent

One of the misconceptions of investing abroad is that buying local currency debt is the same as buying into the local economy. In fact, given today's globally interconnected economies, it is almost impossible to avoid international exposure, even if the debt is denominated in a local currency. As a consequence, there is a significant difference between the currency and country exposures of the global corporate bond market. This is evident from Figure 3, which shows how much more diverse it is in its country than its currency representation. It is also worth noting that a passive investment will expose investors – possibly unwittingly – to risks in emerging markets. For example, nearly 8% of US dollar debt comes from emerging market issuers, including the Chinese internet company Baidu and the Mexican oil company Petroleos Mexicanos.

This underscores how easy it is to fall into the trap of talking about the UK or US corporate bond market. The markets in which investors invest are defined by the currency of the bond and not the location of the issuer. Indeed, it is hard to argue that the UK and sterling corporate bond markets are synonymous when just over 50% of issuers are not actually UK companies. Similarly for the US dollar market, nearly 30% of issuers are from overseas.

Figure 3: The global market is more diversified by country than currency



Source: BofA Merrill Lynch and Schroders. As at 30 September 2017.

These findings may surprise some investors who believe that their local market is entirely domestically-focused when there is actually a significant overseas exposure. Nevertheless, when it comes to market performance, much of it is still driven by changes in local interest rates and credit cycles, regardless of where corporate revenues originate from. Therefore, striking a balance between currency and country exposures can achieve a better diversification mix.

In terms of credit risk, the average credit rating across global markets is A-, with around 47% of global bonds rated BBB. Hardly any companies are rated AAA, reflecting a trend for riskier companies to issue more debt. The local yen and Australian dollar markets fare slightly better, with an average rating of A as a result of their lower BBB exposure. They also have the lowest duration and so are less sensitive to local interest rate changes.

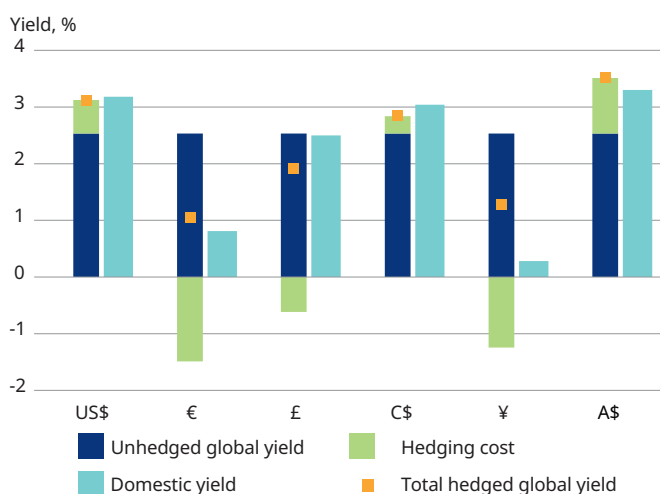
Clearly, the global corporate bond market covers a broad range of currencies, countries and companies. Portfolios diversified across these components can reduce dependence on one particular company or sector and limit exposure to potentially unfavourable domestic conditions.

2. Beware of foreign yield comparisons

Investors tend to pay a lot of attention to starting yield levels because they serve as an approximate guide to long-term future returns. There is empirical evidence for this relationship as initial yields in the US corporate bond market have on average explained around 84% of the variation in returns over the following five years². Inevitably, yields in some bond markets look superficially more attractive than others. For instance, the US dollar market generates more than triple the yield of euro and yen markets, in local currency terms. This may encourage investors to divert assets to US corporate debt. But, as we previously suggested, overseas bonds are almost always invested on a currency-hedged basis which can affect yields. Therefore, what really matters to global investors is the yield after allowing for the impact of currency hedging.

Such hedging often involves the use of forward contracts. These allow investors to effectively “lock in” a forward exchange rate and remove the volatility of currency movements from their portfolio. The key driver of the forward exchange rate is the prevailing difference in short-term local interest rates. The assumption is that higher yielding currencies depreciate relative to lower yielding currencies. However, although yields are not identical on a hedged basis, a significant portion of these differences are eroded once we adjust for hedging costs (Figure 4). So investors should not be fooled into thinking that markets with higher yields in local terms offer higher return prospects. Currency hedging will neutralise much of this advantage, rendering comparisons of yields between domestic and overseas markets less meaningful.

Figure 4: Currency hedging will erode foreign interest rate differentials



Unhedged global yield is the weighted average effective yield across the different components of the BAML Global Broad Market Corporate Index. Domestic yield is the effective yield of each respective component of the BAML Global Broad Market Corporate Index. Total hedged global yield is the weighted average effective yield across regional components, adjusted for currency hedging. Hedging cost is the difference between the total hedged yield and domestic yield. Source: BofA Merrill Lynch, Datastream and Schroders. As at 30 September 2017.

² Source: BofA Merrill Lynch and Schroders. Data from 2006-2017. Based on a linear regression between the initial effective yield and the subsequent 5-year annualised return of the BAML US Corporate Master Index, measured in US dollars.

Nonetheless, there are some caveats. Although the effect of hedging usually results in a broad equalisation of interest rate differentials, it can still leave differences as a result of the supply of or demand for funding in each currency. The deviation of forward exchange rates from interest rate parity is known as the “cross-currency basis”. Also, not all corporate bond markets will trade at similar credit spreads and so investing overseas can still increase yields. For example, yen investors can earn a 1% pick-up in yield by going global, even after adjusting for currency hedging. This is primarily because the credit spread of the global index is three times that of the yen market.

3. Long-term benefits can vary

Investors are often led to believe that they can achieve higher total returns by investing abroad. Although this may be true on a tactical basis, long-term global hedged returns for most investors have not strayed far from those in their home market (Figure 5). Historically, only Japanese and Australian investors have significantly enhanced their returns by investing overseas. This suggests that on a hedged basis there are limited structural return advantages that global investors have been able to capture through a strategic asset allocation. Investing is not easy and a simple passive exposure to a global index may not lead to better performance.

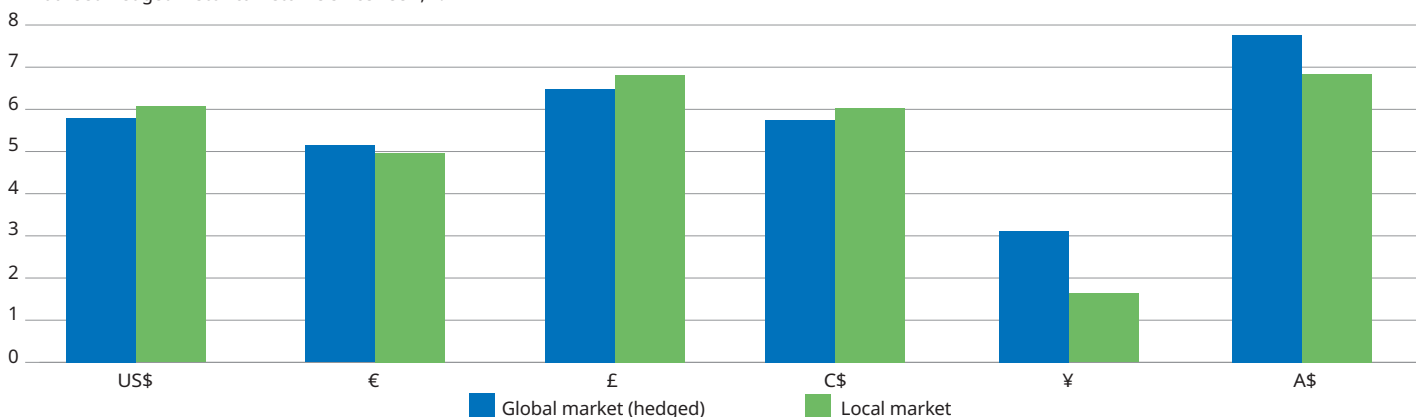
In light of this track record, some investors may argue that since currency hedging brings global bond returns into line with local bond returns, then why bother with global diversification at all? We would argue, however, that performance is not the only consideration for investors. Volatility, portfolio efficiency and sharp valuation moves are just as important and moving abroad can help with all three.

Looking at volatility first, choppy markets can make entry and exit opportunities difficult, while holding investments in such circumstances can be hard to stomach. The diversification benefit from investing in overseas markets with lower volatilities can decrease portfolio risk over the long term and generate a smoother return profile. Historically, US dollar and sterling investors have achieved lower volatility by going global (recall Figure 1). This suggests that going overseas can sometimes be safer than sticking exclusively to local markets.

Most of the regional differences in volatility profiles arise as a consequence of their differing duration. Duration, by definition, is a measure of the sensitivity of bond prices to changes in interest rates. Therefore, once we adjust for duration across regions, we should expect some of the discrepancies between global and local markets to decrease (for unadjusted volatilities, see Figure 1). For instance, Australian investors experienced lower volatility per unit of duration in the global market compared to their local market, even though the global market was more volatile in absolute terms (Figure 6).

Figure 5: Over the long term, few investors have improved their total returns by going global

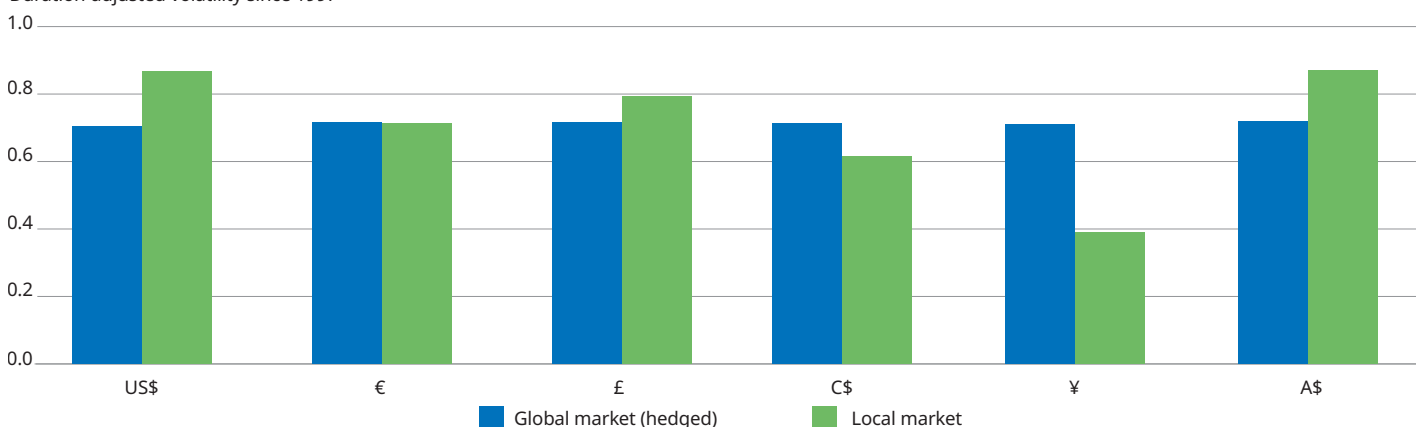
Annualised hedged historical returns since 1997, %



1997 starting point chosen to coincide with inception of BAML Merrill Lynch Corporate Indices. All data are in hedged currency terms from the perspective of an investor's home market. Past performance is not a guide to future performance and may not be repeated. Source: Datastream, BofA Merrill Lynch and Schroders. Data to 30 September 2017.

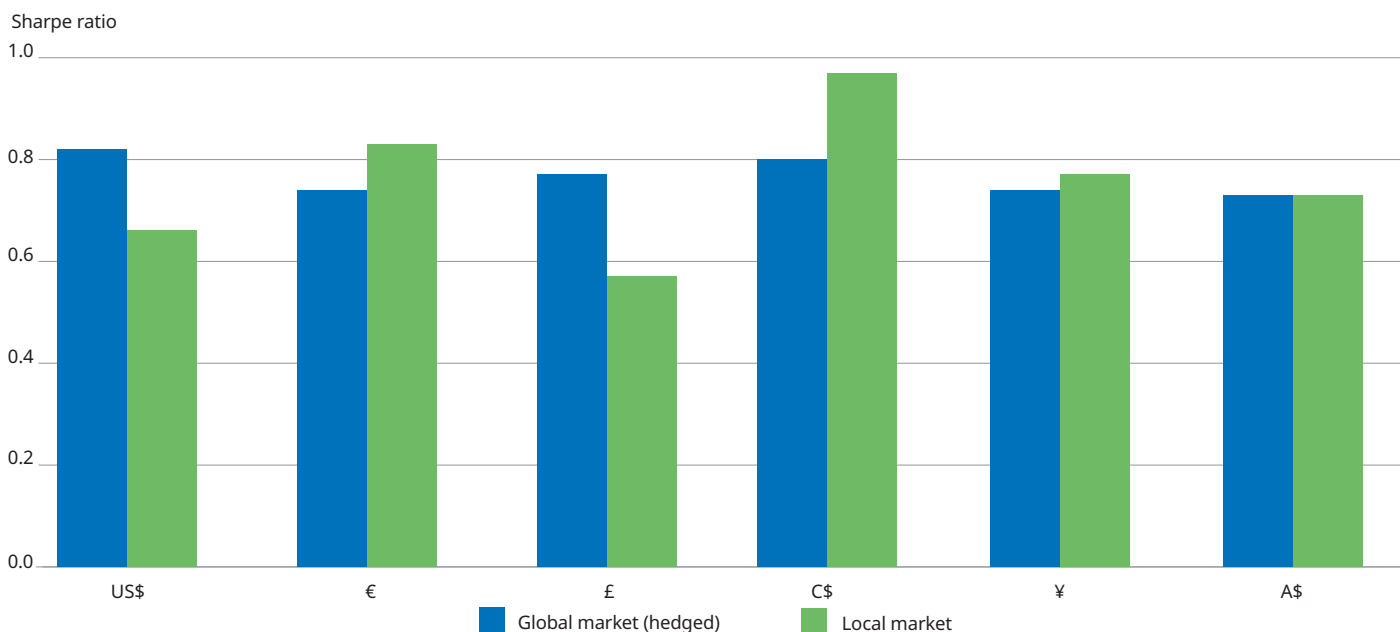
Figure 6: Measuring volatility against duration explains some of the differences between markets

Duration-adjusted volatility since 1997



Source: BofA Merrill Lynch, Datastream and Schroders. Data to 30 September 2017.

Figure 7: Going global has improved risk-adjusted returns for some investors



Sharpe ratio is a measure of risk-adjusted returns where a higher number is preferred. Source: Bloomberg, BofA Merrill Lynch, Datastream and Schroders. Data to 30 September 2017.

Spread levels can also influence volatility. Generally, the larger the credit spread, the more uncertainty there is surrounding cash flows. Hence, bonds trading at higher credit spreads are also more volatile. In order to isolate this relationship, we analysed the correlation between spreads and excess returns (the portion of returns not explained by changes in the risk-free yield curve). Although not perfect, average spread levels in the US dollar market have historically explained around 86% of the volatility in excess returns³. Since US dollar and sterling spread levels have been on average higher than other markets, it is not surprising that a global portfolio has lowered volatility over the long term for US dollar and sterling investors.

An important consequence of experiencing lower volatility is its impact on risk-adjusted performance. While some local markets may offer higher long-term returns, these returns may be accompanied by higher volatility. Overseas markets can, therefore, still be attractive if they improve risk-adjusted returns, even if absolute returns are lower. This has certainly been true for US dollar and sterling investors, who have achieved higher risk-adjusted returns by investing in a global portfolio (Figure 7). In contrast, although Australian dollar investors achieved higher returns by investing abroad, volatility also increased, leaving risk-adjusted returns practically equivalent to the local market.

³ Based on a linear regression between the average five-year option-adjusted spread and the five-year annualised volatility of excess returns of the Merrill Lynch US Corporate Master Index. Source: BofA Merrill Lynch and Schroders. Data from 1997-2017.

In addition to improving risk-adjusted returns, overseas markets can add value to a portfolio as a result of their lower correlations with the local market. If all markets do not move up and down in perfect harmony, then a globally diversified portfolio will display less volatility than the weighted average volatility of its parts. Historically, the US dollar, euro and sterling markets have all been strongly correlated with each other (Figure 8). But they have shown much lower correlations with the yen and Australian dollar markets. This suggests that more efficient portfolios can be constructed by spreading investments across multiple bond markets.

Figure 8: correlation matrix since 1997

	US\$	€	£	C\$	¥	A\$
US\$						
€	0.8					
£	0.7	0.8				
C\$	0.7	0.6	0.6			
¥	0.2	0.2	0.1	0.2		
A\$	0.4	0.4	0.4	0.5	0.3	

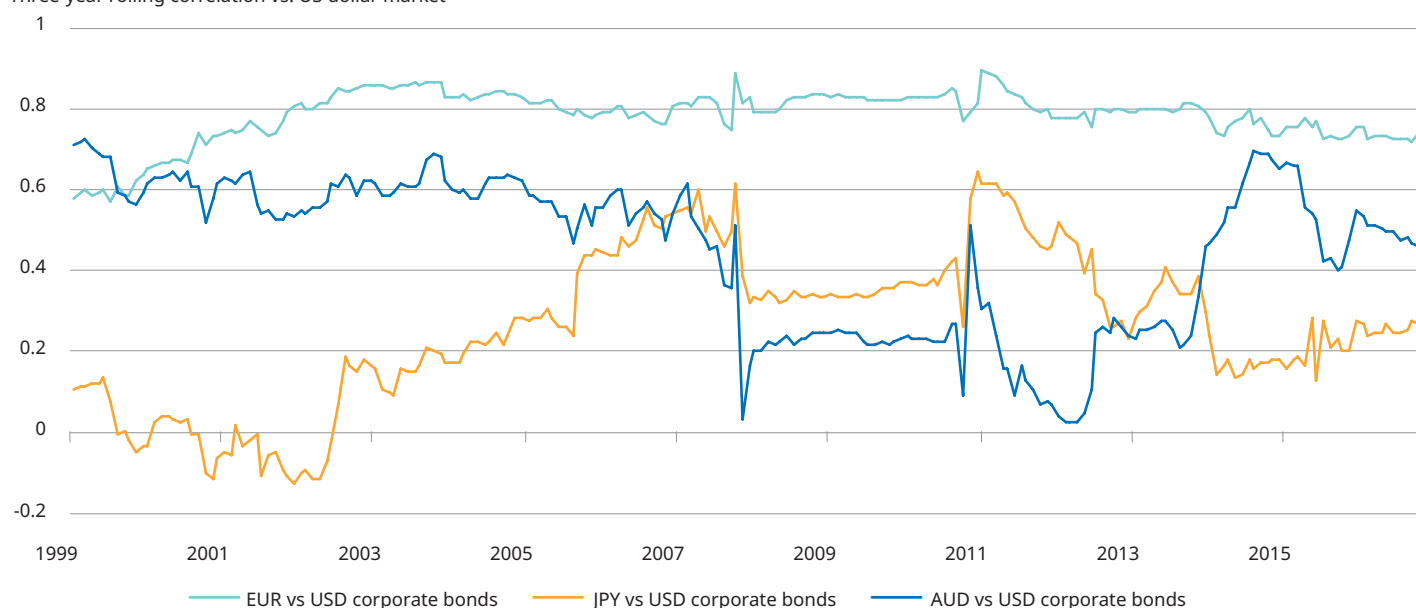
All data is in hedged USD terms. Source: BofA Merrill Lynch and Schroders. Data to 30 September 2017.

Although average correlations have remained stable over the long run, they have varied quite substantially over shorter time frames. In the run-up to the Global Financial Crisis, for instance, yen vs US dollar correlations strengthened from 0.1 to 0.6 (Figure 9, orange line). In contrast, over the same period, Australian dollar vs US dollar correlations weakened from a high of 0.7 to almost 0 (dark blue line). In the light of these changes, it is clearly important to know what has driven markets in the past and decide whether these drivers will continue, as the diversification benefits of a global portfolio can vary over time.

Another way in which diversifying overseas can improve portfolio outcomes is by reducing sharp dips in valuation, or temporary losses. For example, the worst peak-to-trough losses suffered by US dollar and sterling investors in the last 20 years exceeded 16%, whereas a global market portfolio would have cut these falls to just 10% (Figure 10). Even so, some global investors have had to shoulder greater losses. The experience of the yen investor is notable here in that their worst loss would have been four times greater in a global portfolio than a local one. Thus, as with volatility, discretion is important where losses are a primary concern: a global portfolio can provide additional downside protection, but not for everyone. It is important to have an understanding of the past before deciding who might benefit.

Figure 9: Correlations can move up or down over time

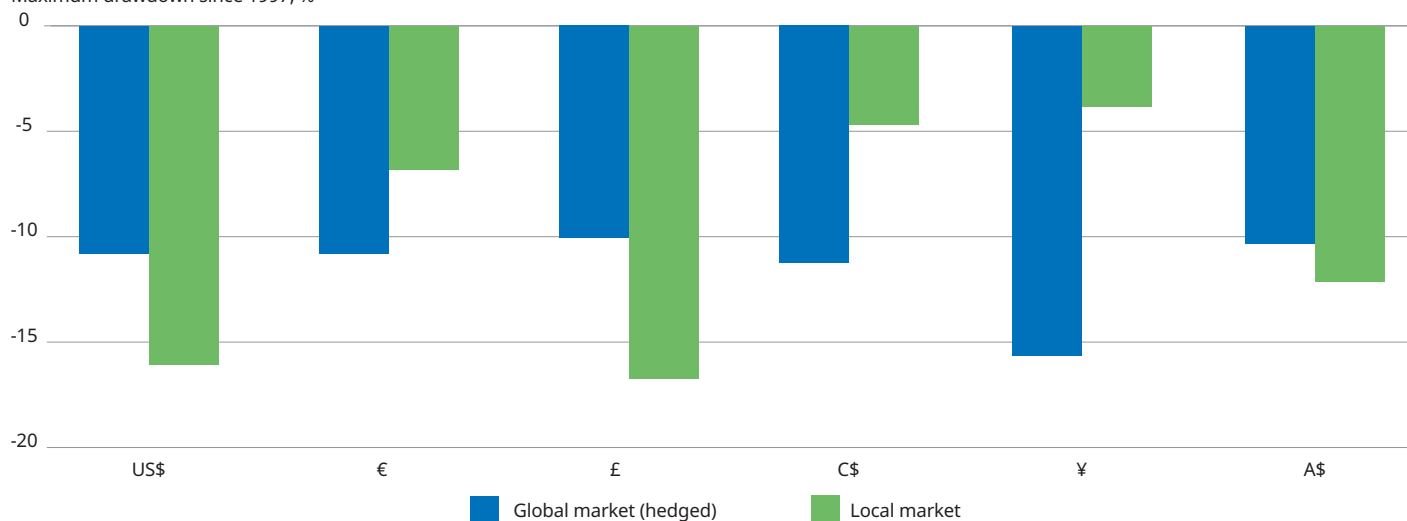
Three-year rolling correlation vs. US dollar market



All data is in hedged USD terms. Source: BofA Merrill Lynch and Schroders. Data to 30 September 2017.

Figure 10: US dollar and sterling markets suffered more severe drawdowns than global markets

Maximum drawdown since 1997, %



Source: BofA Merrill Lynch and Schroders. Data to 30 September 2017.

Figure 11: Performance leadership rotates significantly year to year

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
USD	7.0%	5.4%	7.3%	6.9%	19.8%	9.5%	7.5%	15.6%	2.5%	12.2%	1.9%	12.4%
EUR	6.9%	5.4%	4.6%	3.1%	16.2%	8.7%	7.0%	13.3%	2.0%	8.2%	0.9%	6.3%
GBP	5.2%	4.4%	2.1%	-0.5%	15.6%	7.0%	5.9%	10.4%	1.8%	7.5%	0.9%	6.0%
CAD	4.0%	2.9%	1.6%	-3.7%	14.8%	4.8%	4.9%	7.3%	1.6%	6.5%	-0.1%	3.9%
JPY	3.6%	2.8%	1.3%	-6.8%	4.5%	2.9%	1.6%	5.7%	0.0%	5.9%	-0.2%	2.6%
AUD	2.0%	1.4%	0.1%	-10.4%	3.2%	2.9%	-1.0%	1.7%	-1.5%	2.0%	-0.6%	2.2%
Dispersion	5.0%	4.0%	7.2%	17.3%	16.6%	6.7%	8.5%	13.9%	4.0%	10.1%	2.5%	10.2%

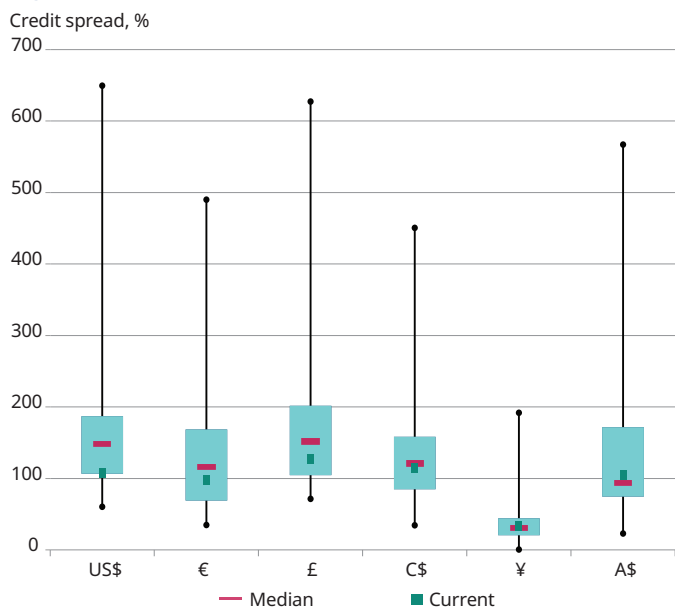
All data is in hedged USD terms. Past performance is not a guide to future performance and may not be repeated. Source: Schroders, BofA Merrill Lynch and Schroders. Data to 30 September 2017.

Performance leadership is cyclical

Long-term trends should not be the only factor affecting the decision to diversify globally, as there can be substantial differences in regional performance over the short term. The potential diversification benefits can be seen in the wide dispersion of returns over time (Figure 11). For instance, in 2008, the difference between the top (AUD) and bottom (GBP) performer in US dollar terms was as high as 17%. Moreover, different markets do better at different times: the US dollar market was consistently the top performer for three years from 2009 until 2011, but it then started dropping down the table and by 2013 it was in last place. So investors need to be flexible in their asset allocation, as performance leadership can suddenly change.

As we discussed earlier, while some local markets have outperformed global markets over longer horizons, it can be dangerous to assume that this will continue. One way to establish whether historical returns are sustainable is by looking at valuations. Figure 12 shows where spread levels are (as at 30 September 2017) relative to both their long-term average and their historical distribution.

Figure 12: Valuations look stretched in several markets



Blue bar represents interquartile range. Black dots represent minimum and maximum spread. Spread levels adjusted to take account of change in rating distribution over time. Historical data cover the period December 1996 – September 2017. Current data as at 30 September 2017. Source: BofA Merrill Lynch and Schroders.

On this basis, we can observe that several markets are looking relatively expensive compared to their history. The US dollar market is the most extreme of the six we look at in the chart, being 28% more expensive than its long-term median. On the other hand, the yen and Australian dollar markets look slightly cheap relative to history. If we believe that valuations will revert to median levels, then global diversification can potentially help investors overcome lower returns in their local markets.

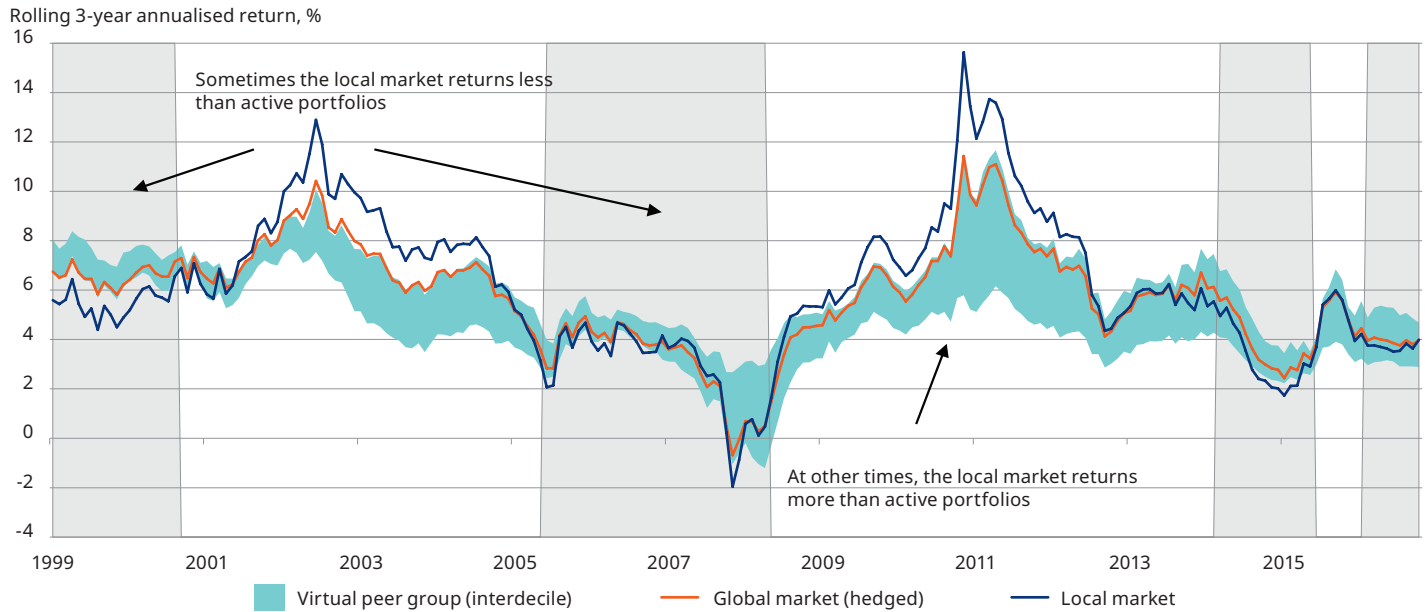
From benchmark-relative to outcome-oriented

Thus far, we have relied on a traditional, market-cap weighted benchmark to evaluate the attractiveness of overseas markets relative to local markets. However, the type of benchmark can heavily influence the decision to diversify or not and hugging a global benchmark can sometimes worsen portfolio outcomes. Since market-cap weighted indices over-emphasise the largest markets, we do not believe they capture the full range of outcomes an investor can achieve. A better way to benchmark local markets is to compare them to a range of simulated global portfolios chosen from the same opportunity set. We have defined a “virtual peer group” representing theoretical outcomes that an active investor could have historically achieved simply using different weightings of the six markets. For instance, one portfolio might hold 50% in the euro market, 30% in the US dollar market and 20% in the yen market. To be clear: each portfolio ignores any security selection decisions. Even so, such a framework should still allow us to show how an active investor might perform if they are given the flexibility to dynamically allocate across regions. (See box for the methodology used in creating our virtual peer group portfolios.)

Methodology

To construct the virtual peer group, we calculated all the possible portfolio combinations of the various regional indices that comprise the global market. Using 10% weight increments from 0% to 100%, we found that there were 3,003 possible portfolios that a manager could deploy. We then calculated the portfolio return of the bottom 10% and the top 10% each month to derive the interdecile range of outcomes.

Figure 13: The optimal portfolio can change over time



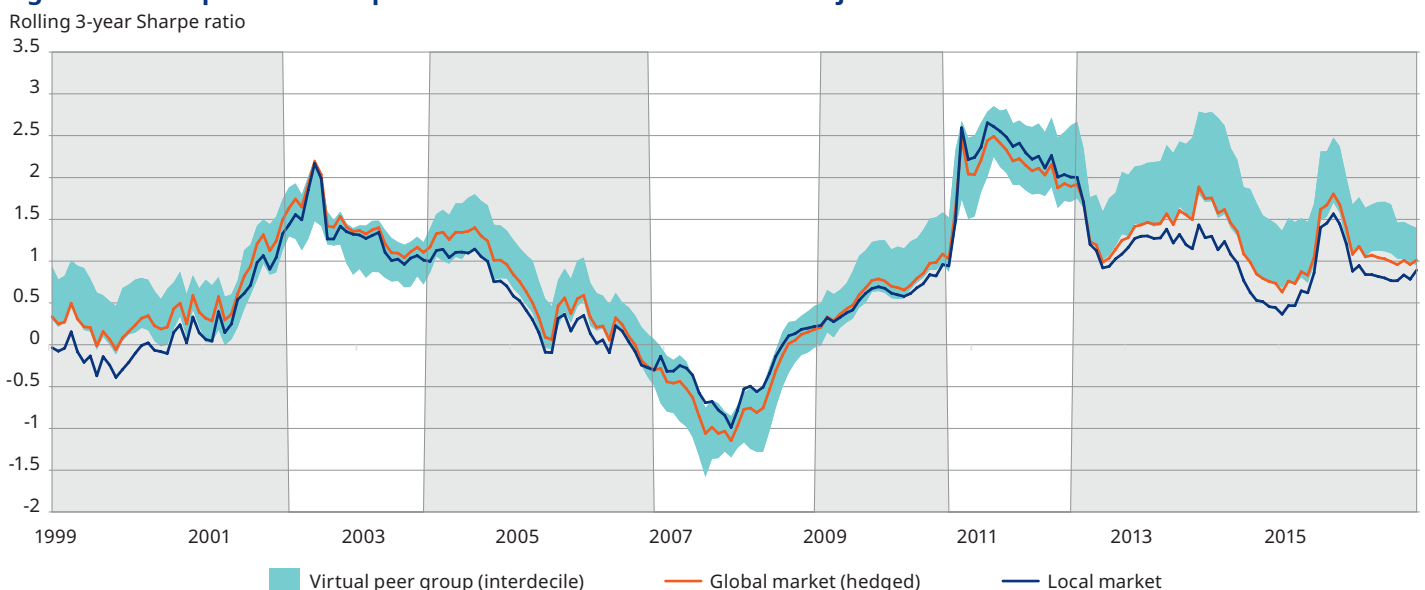
Local market = BAML US Corporate Master Index. The periods where the local market underperforms (outperforms) most global portfolios is shaded in grey (white). All data is in hedged USD terms. Past performance is not a guide to future performance and may not be repeated. Source: BofA Merrill Lynch and Schroders. Data to 30 September 2017.

Figure 13 shows the range of outcomes for a US dollar investor over a rolling three-year period. The pale blue shading represents the range of potential returns (excluding the bottom 10% and top 10% of portfolios). It is clear that there are occasions when some active portfolios outperform the local market (dark blue line), such as in the run-up to the Global Financial Crisis (2005 to 2009), while in the post-recovery period (2008-2014), the local market tends to perform better than the global markets, whether active or passive. On the other hand, in the years preceding the dot com bubble (up to 2000), the passive global market (orange line) easily outpaces the local market, but investors could have done even better with active allocations. So, while it is fair to say that a manager with a global mandate is unlikely to be able to invest on a fully unconstrained basis, short-term trends do matter and an allocation to a flexible

global portfolio should allow a skilful investor to capture some of the performance variability.

This is even more evident if we use risk-adjusted returns, as represented by the Sharpe ratios plotted in Figure 14. Both the local and passive global market score poorly on this measure relative to the range of simulated potential portfolios. For example, over the last twenty years, the local market achieved a higher Sharpe ratio than the median simulated portfolio only 24% of the time (although the ratio improved slightly for the global market at 34%). Indeed, over the last three years, it has done worse than the 10th percentile of simulated portfolios. This suggests that global portfolios can be constructed to generate more efficient returns than the local market. Further testing of this model from the perspective of non-dollar-based investors results in similar conclusions.

Figure 14: Most portfolios outperformed the local market in risk-adjusted returns



Local market = BAML US Corporate Master Index. Sharpe ratio is a measure of risk-adjusted returns where a higher number is preferred. The periods when the US dollar market underperforms (outperforms) most global portfolios is shaded in grey (white). All data is in hedged USD terms. Past performance is not a guide to future performance and may not be repeated. Source: BofA Merrill Lynch and Schroders. Data to 30 September 2017.

Conclusion

Overseas corporate bond markets make up a significant portion of the investable universe, yet many investors still ignore them. We think that is a mistake. There are significant benefits to going global, but investors need to be aware of certain key considerations:

- Currency fluctuations can overwhelm the diversification benefits that overseas markets may bring to a portfolio. Hedging (at least some) foreign currency exposures can mitigate these effects.
- Country and currency exposures are not equivalent in the global market. Investors who do not have strong views on either should benefit by diversifying across both, thereby limiting their exposure to unfavourable influences.
- Currency hedging will tend to equalise differences between foreign and domestic returns, so comparing starting local yields across markets is not meaningful.
- The benefits of investing abroad can include higher returns, lower volatility, improved risk-adjusted returns and less severe drawdowns. However, these benefits will vary depending on an investor's home market.

In light of this, investors need to be ready to be far more tactical and flexible in their asset allocation approach if they want to generate the superior portfolio outcomes available from the global market. We believe that the only way to do this effectively is to use a manager with the necessary discretion to range across different markets.

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