Schroders

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Schroder Emerging Markets Sustainable Fund (Wholesale Class)

Fund commentary

Bucking pessimistic expectations at the beginning of the year, global equity markets recovered strongly over the course of 2023, accelerating into year-end as inflation pressures eased and labour markets softened. A definitive Fed pivot in December buoyed a risk on Santa Claus rally led by unprofitable tech stocks, heavily shorted and highly leveraged companies. Within EM, China remained the dominant story as the market declined 4% during the quarter despite a strong up market, ending the year down 11% in US dollar terms. Persistent headwinds in the real estate industry overwhelmed the milder than expected post Covid economic recovery. The portfolio outperformed the MSCI EM index during the quarter as lower quality expensive growth and expensive cyclical stocks outperformed most, while quality defensive value and deeper value stocks were more challenged in a risk-loving environment during the period.

At the portfolio level, positioning in EM EMEA, China and Taiwan added most value during the period. Extending upon favourable contributions over the course of the year, an overweight and strong stock selection in attractively valued quality Polish financials was supportive of relative performance as the market rallied post elections in October. Select sectors in India continued to outperform the broader EM index during the quarter, and the portfolio benefited from notable contributions within financials and technology (e.g., structural growth software holdings). Finally, favourable positioning in a selection of mid cap, quality cyclical Taiwanese semis contributed positively as the group rallied following strong Q3 results from US mega cap tech (e.g., Nvidia), which continued to highlight secular industry level demand.

Positioning in EM Asia was the primary headwind during the period, punctuated by positioning in South Korea; Latin America also detracted. South Korea rallied sharply and was an outperformer in the region, led by cyclical sectors. Defensive value healthcare names paired with an underweight to materials weighed on relative performance. Continued central bank easing in Brazil sparked a low-quality rally during the period and our underweight stance within inferior quality banks and mining was a slight headwind. Lastly, a new regulatory airport tariff methodology in Mexico fuelled near term uncertainty which impacted sentiment on the portfolio's airport operator holdings.

We continue to maintain breadth within the portfolio and are well diversified across various measures of value and quality. 2023 was another reminder that the benefits of diversification by sourcing ideas from a broad opportunity set can be substantial over the long run – a time tested pillar to our investment approach.

As equity returns in broad segments of emerging markets were robust in Q424, we remained diligent in harvesting gains where select holdings had rallied sharply. In particular, across semiconductors, we trimmed exposure to notable winners and capitalized on wide performance dispersion in the group to add to names that rank favourably on our measures of Value and Quality (e.g., Innodisk).

India was a bright spot on an absolute and relative basis over the past year and another area where we have taken profits in key outperformers, particularly stocks that possess mean reverting characteristics (e.g., autos and utilities). Here too, performance dispersion has created compelling entry points for opportunities with attractive characteristics (e.g., banks and select chemicals). Broadly speaking, the market remains an exceptional source for quality, albeit with the trade-off of higher valuations.

Market review

After a shaky third quarter, global stocks enjoyed a strong end to 2023 (+11.4% in Q4) to round out an exceptional year for equities with the MSCI World index gaining almost 24% over 2023 as whole. Equities returned to form by climbing a wall of worry amid concerns around sticky inflation and the Fed's response, whilst also brushing off a mini-banking crisis along the way. However, the strong gains were largely driven by the index heavyweights and the newly resurgent "Magnificent Seven" (i.e., Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia and Tesla), particularly in the first half of the year. This was initially fuelled by AI hype but strong earnings and, in some cases, cost cutting initiatives provided further catalysts as the year progressed.

The stellar performance of these behemoths also had huge implications for market breadth as two thirds of global stocks underperformed last year and almost 3 in 4 S&P500 stocks, one of the lowest levels of market participation in decades. The wide chasm between the returns of the MSCI Value and Growth style indices (-25% for MSCI World Value vs. Growth) was also attributable to the Big-7 stocks rather than a broad-based revulsion against cheaper companies.

Away from this cohort, the MSCI ACWI ex-US Index still posted a respectable 15.6% gain for the year, driven by Japanese and Continental European stocks, whilst the MSCI Emerging Markets benchmark delivered a more modest 9.8% return, weighed down by China's poor performance (-11.2%) following a lacklustre post COVID re-opening and an ongoing real estate crisis.

As confidence in a Fed pivot increased, the year concluded with a "Santa rally", which favoured lower quality speculative areas (unprofitable tech stocks, heavily shorted and highly leveraged companies). Some deeper value laggards also enjoyed a recovery in December due to their perceived economic sensitivity as fears of a recession rapidly receded. From a sector perspective, technology remained dominant in Q4, followed by real estate, industrials, and financials while higher quality defensive sectors (e.g., health care, consumer staples) lagged well behind amid the exuberance.

Outlook

2023 will be etched in investors' memory as a year where almost everyone got the big picture wrong. A simple interpretation of the unexpectedly strong returns to most equity markets during the year is that a global recession was avoided, thanks to a resilient US consumer and China's re-opening, even if the latter was rather half-baked. By the end of the year, the Fed appeared to be pivoting and a soft landing had been widely discounted, leading to a strong rally into year end.

Looking ahead, the key question for 2024 would appear to be whether the Fed has indeed pulled off a soft landing and what this means for rates. Despite attempts from the Fed to reign back enthusiasm for early and swift interest rate cuts, the bond market appears convinced that this is on the cards. Investors seem to be of the view that interest rate cuts are good for global equities but this is unlikely to be the case if they are driven by the need to stave off recession rather than disinflation. It is too early to tell as we are now entering the peak impact phase of prior tightening and even hard landings appear soft at first. The bar is high for those who are in the recession avoided camp, requiring some form of "this time will be different".

As for emerging markets (EM), going long the asset class was every strategist's favourite place to be at the start of 2023. It may pay to be sceptical again, but the value story is still there (especially for China and Latin America/Non-Asia EM). In addition, we need to factor in potential rate cuts in the US, potential for further dollar weakness and pessimism on EM assets as tailwinds.

The buy case for EM remains that they are expected to be more resilient against the backdrop of a weaker global economic environment. The EM-DM GDP growth differential is forecast to widen to a 5 year high with earnings growth almost double that that anticipated in developed markets. Solid EM macro fundamentals should provide a buffer in the event of a less benign 2024 US scenario. Rate cuts are also coming to emerging markets and probably more quickly than in DM as EM Central banks started the tightening process earlier. China's approach will prioritise stimulating production rather than consumption, although deflation is still likely to end this year. Investors have shied away from China amid the economic uncertainty and real estate market turmoil. The government will need to delicately manage a reduction in construction and housing development to align with collapsing demand. However, many of the risks are now well flagged and we may be close to the point of "peak pessimism". A combination of a mild cyclical recovery and positive EPS growth, cheap valuations and underweight positioning could set up a tactical rally in Chinese equities which may gain momentum. However, we are always cautious of market timing and see a better bottom-up opportunities that straddle countries (e.g. Asian tech).

Indian equities have been a standout performer in recent years. The economic outlook remains robust with c.7% multi-year GDP growth likely and Nifty earnings growth should remain well into double figures this year and next. Coupled with light foreign investor positioning, we suspect that any corrections will most likely be met with new flows, particularly since India is regarded as a safe-haven relative to China.

The summary would be that emerging markets offer a range of good candidates for diversification from developed markets. That said, Latin American markets may face more headwinds. They have run hard in recent years and the commodity price trends are unlikely to be as supportive going ahead.

The key risks to EM are geopolitical with significant elections (Taiwan, Mexico, South Africa, India, Brazil) and the ongoing threat that China will follow through with its stated intentions towards Taiwan. Ahead of Taiwanese elections in mid-January, President Zi used his annual new-year address to reiterate that the "reunification" of Taiwan and China was a "historical inevitability". We are not military strategists but it's easy to fall into the trap of down weighting low probability but extremely high impact scenarios. That said, there are no obvious hedges but we would expect increasing investor interest in separate allocations to China as a result.

At the time of writing, there are several known unknowns, and few strategists, after being humbled by their poor forecasting abilities during 2023, are willing to stick their necks out again. From our perspective, the risks would seem modestly skewed to disappointment, but our key observation is that the sheer breadth of valuations across emerging markets at present has set the stage for bottom-up rather than top-down calls. This favours good stock selection and effective risk management. Given our diversified approach, this suits us well and our focus will primarily be on high quality stocks that are well suited to navigate economic uncertainty, particularly since the wide range of valuation opportunities does not require us to pay a premium.

Active Stewardship

The QEP investment team works in close collaboration with Schroders' Sustainable Investment team to facilitate our engagement activity. Company engagement continues to play an important role in our process, with the information gained helping us to understand the sustainability issues corporations face and the strategies in place to address them. It also allows us to promote change and make clear our transition expectations for the companies in which we invest. The central store of engagement information available to us, covering all Schroders firmwide engagements, also provides useful qualitative information on issues that are otherwise difficult to capture from traditional ESG data sources. Schroders' engagement blueprint includes six priority engagement themes capturing issues relating to environmental (climate change, natural capital & biodiversity), social (human rights, human capital management, diversity & inclusion) and corporate governance.

Several climate engagements focussed on decarbonisation were initiated during the fourth quarter across a range of companies. For example, we engaged with Hon Hai Precision to better understand their energy transition plans. With the company aiming to be net zero by 2050, including across its supply chain, and targets to move to 50% green energy by 2030 we requested detail on how they planned to achieve these aims. We also asked for an update on any developments relating to the company's previous communication that it was setting up a green fund to help support suppliers with their renewable energy goals. Midea Group was also engaged with as we questioned their green roadmap and plans to be carbon neutral by 2050. We encouraged the firm to set and publish more quantitative GHG (greenhouse gas) emissions targets as well as targets focussed on green product use and recycling. The company replied to acknowledge our expectations and will share additional information on the progress being made in these areas.

Social engagements centered on human capital were also carried out in the final quarter of 2023. Taiwanese semiconductor firm MediaTek was reached out to understand how they are dealing with the issue of retaining talent, considering poaching from Chinese competitors. MediaTek confirmed talent retention has improved, with increased profitability allowing them to offer more competitive compensation packages. The company has also increasingly moved to a global talent strategy to combat the impact of low birth rates in Taiwan. MediaTek have a significant employee base in India with close to 40% of it's research & development capabilities outside of Taiwan. We also followed up with Baidu given our previous engagements with the company, seeking an update on their plans to improve board diversity. There remains a lack of female board members, and we want to understand the company's aspirations relating to improving diversity.

Our stewardship process extends to a proactive voting programme, a mechanism we can leverage using the weight of Schroders' asset base and associated voting rights to drive our engagement priorities. We make considered use of our voting rights, acting in line with our fiduciary responsibilities in what we deem to be the best interests of our clients. As a firm, Schroders votes on all resolutions unless we are specifically restricted from doing so, with all voting carried out by Schroders' corporate governance specialists. We voted at 117 meetings on almost 600 resolutions for companies held within the QEP emerging market strategies in the final quarter of the year. Within these votes, around 18% were not with management. Votes against management were focussed on compensation plans, the election of directors or board related. We voted against Eicher Motors' director nomination given concerns of overboarding with the nominee sitting on several other external boards. We also voted against similar proposals with respect to Sanofi India and against Zhejiang Supor's proposed remuneration plan. The long-term vesting period is less than 3 years, a period we see as too short. Furthermore, performance hurdles are proposed in the second half of the year meaning that targets are influenced by performance from the first half of year, which may impact fairness.

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