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September 2024

Schroder Global Equity Alpha Fund – Wholesale Class

Performance overview

The MSCI World (NDR) Index rose by 0.76%, while the Schroder Global Equity Fund Wholesale class fell by 0.34% (post-fee), underperforming by 1.10% (post-fee) during September.

Market Review

Global equities were broadly higher for the period since the fund launched. Notably, returns were helped by Chinese stimulus policy easing measures brought in to support its flagging economy. The People's Bank of China (PBoC) cut banks' RRR by 50 bps and trimmed the 7D reverse repo rate by 20 bps to 1.5. The Chinese Central Bank also cut rates on existing mortgage loans effective immediately and slashed the minimum down payment ratio for second homes to 15%. The fiscal pledges made at China’s Politburo meeting held in the month were also a positive.

The stimulus announcements provided much relief to a Chinese market that had previously been underperforming global markets, but there is still debate as to whether the amount of stimulus required was sufficient to materially shift the economy or property market. Nevertheless, peripheral markets adjacent to China such as emerging markets and Asia ex Japan benefited from the uplift in September. Hong Kong and Thailand were the best-performing markets in the MSCI AC Asia ex Japan Index. Emerging market equities also moved higher and outperformed developed markets in the month.

In the US, the S&P 500 gained, supported by the Federal Reserve’s (Fed) announcement of a 50 basis point (bps) reduction to interest rates. Eurozone shares also moved higher in the month and the European Central Bank cut interest rates by 25 bps. UK equities, however, moved lower in the month. This weaker performance was mirrored in Japan, where shares fell amid a surprise outcome to the LDP leadership election. Shigeru Ishiba emerged as the victor and called a snap general election, with investors fearing he may hike business taxes.

Cyclically orientated sectors such as Consumer Discretionary, Materials real estate and financials were standout performers, with defensive sectors such as Healthcare on the weaker side. Energy was the worst performing sector in September. Whilst pressure from the Middle East war threatens to push oil prices up, Saudi Arabia is reportedly ready to abandon its official price target of $100 a barrel for crude as it prepares to increase output.

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Performance Review

For the short period since inception, the portfolio recorded a negative performance and underperformed the benchmark. Our stock selection within Healthcare detracted, while selection in industrials contributed. Underweight exposure to Emerging Markets and more specifically to China was a notable detractor.

In Healthcare, Danish pharmaceutical company Novo Nordisk underperformed on analyst fears that the company's third-quarter results may reveal slower-than-expected sales its weight-loss drug Wegovy as a result of competition from rivals. The company is also witnessing quarterly volatility of US realised pricing. In February 2025, Semaglutide will get added to the next list of drugs set for Medicare price negotiation and the company's arithmetic driven growth is being put under pressure to overcome quarter to quarter volatility. The potential global market for anti-obesity drugs is, however, sizeable with around 40% of the US population classified as obese (as defined by body mass index). While the company will undoubtedly continue to see increased competition and greater focus from rivals in developing treatments within this class of drugs, we believe that Novo Nordisk remains well positioned to benefit from this growth due to its early leadership and strong market position.

Energy holding Shell also underperformed following Saudi Arabia's announcement to increase oil production capacity. The company also reported a fall in second quarter profit as refining margins and oil and gas trading weakened. Shell continues to benefit from ongoing capital discipline and a focus on high return projects. We believe that the company is managing its energy transition risk in a manner that is not short-term dilutive to returns but we continue to engage with Shell, encouraging it to strengthen its transition plan to help reduce longer term business risk. In the longer term, the company should benefit from its significant investments in electrification, hydrogen, wind, and alternative energy assets and would like to see more capital being allocated toward these investments.

US energy services and equipment maker GE Vernova (GEV) outperformed during the period. The US electricity grid has seen little capacity expansion in recent years and weak interstate transmission infrastructure means local increases in demand will have to be met with local production. GEV is in great position to take advantage of this demand inflection. The company's wind business is also seeing a dramatic improvement in its margins. GEV's management has said it expects earnings per share (EPS) to grow from $5 in 2024 to $9 in 2026, and we remain confident that the company will continue to grow thereafter.

Swedish music streaming platform Spotify also outperformed following the confirmation by rival TikTok that its standalone music streaming app would cease operating in November 2024, providing Spotify with a potential opportunity to expand its market share in a number of territories. The company is also gaining market share in audiobooks (a strong growth market that generally earns higher margins than music streaming) after launching its offering in 2022. The company is increasing its gap between peers in terms of engagement which has proved very positive for its medium-term pricing power. Spotify is very capital light and, as a result, generates strong free capital flow. Moreover, as both Spotify and the music streaming industry gradually increase paid subscription fees, we believe it will generate very attractive returns.

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Trades

We initiated a new position in US technology and computational software company Cadence Design Systems (CDNS) in the third quarter. Revenue growth has gradually and consistently accelerated and we believe this can sustained in the medium term. CDNS is a quality business and because this is a capital light software business, growth has been able to drive operating leverage and ever higher return on invested capital (ROIC) in addition to excellent free cash flow (FCF) conversion.
We initiated a new position in Boston Scientific in the third quarter. The US biomedical/biotechnology engineering company is currently in a product cycle sweet spot, which should generate organic revenue growth in the teens. The biomedical/biotechnology engineering company's new product launches also have the potential to deliver strong margin expansion in addition to strong revenue growth.

We sold our position is US financial services company Charles Schwab in the third quarter. Higher interest rates have led to weaker profits as clients moved funds to higher yielding money market funds with the company having to pay much higher rates on deposits. While these pressures are gradually abating, this is happening at a slower pace than expected. The company's management has also guided for a slower growth outlook, reducing the chance for a positive growth gap to materialise.
We sold our position in US energy company ConocoPhillips in the third quarter. This was an opportunistic purchase and our investment thesis for holding the stock has now largely played out, with current oil prices now back to normal levels. With ongoing weak Chinese economic growth, leading to negative oil demand revisions, it is hard to sustain this positive opportunistic thesis.

Market Outlook

Global economic growth has been remarkably stable, though there are growing signs of spending exhaustion by segments of the US consumer combined with low confidence amongst European and Chinese consumers. Global inflation is firmly on a downward trajectory allowing central banks to embark on a relatively synchronised easing cycle which should begin to provide support to business confidence in some of the more interest rate sensitive parts of the global economy. Many western housing markets, and green infrastructure projects, for example, have been hit hard by the materially higher interest rate environment of 2022-2024. These end markets can expect considerable relief as monetary policy normalises.

Both market breadth and volatility have remained at extremely low levels within markets over the past year as a narrow set of stocks have accounted for the vast majority of market gains. The "Magnificent 7" stocks have, in aggregate, benefitted from both relevant thematic exposures and strong fundamentals. In contrast, the reminder of the market has been contending with a still 'tough' operating environment, which has dampened top- and bottom-line growth for much of this time. We are already seeing signs of the market anticipating potential changes in this dynamic with substantial profit-taking and rotation toward more underappreciated parts of the market, with improving expectations. As valuations in some of the narrower parts of the market are now looking fuller and some parts of the market more vulnerable, we expect the drivers of markets to broaden out and volatility will likely also increase. Both of which are more favourable tailwinds for active stock pickers.

Things are more concerning in China where the country is flirting with outright deflation (PPI is already very negative) as a consequence of persistent overinvestment and the massive overbuild in residential property units. Authorities have recently adopted a much greater sense of urgency, combining more aggressive monetary and fiscal policy support to boost the economy and fight deflation. With tens of millions of unsold vacant homes in China, the property market overhang will take years to fully clear. Nevertheless, we need to watch carefully for the size and impact of the current stimulus measures, as the market implications of a China economic recovery in 2025 would be very different from a continued deflationary slump.

Japan remains an outlier in this disinflationary global picture that adds good diversification to portfolios. The governance reforms championed by the Tokyo Stock Exchange (TSE) have been the catalyst for an acceleration in corporate governance reform, unwind of crossholdings, and return of excess cash. A number of our holdings have good exposure to these positive developments. Finally, after three decades of low inflation, and even deflation, the current return of mild inflation is very welcome in Japan and is allowing the Bank of Japan to raise interest rates. As this modest tightening occurs against the backdrop of falling rates elsewhere, the backdrop for the Japanese Yen looks quite different from a year ago.

Artificial Intelligence (AI) has been a dominant theme for much of the last 12 months, though more recent performance shows some signs of exhaustion. AI technologies and applications undoubtedly have the potential to transform industries, giving disruptive power to challengers and competitive advantage to companies that are faster to capitalise on its potential for their specific businesses. The portfolio has good exposure to a range of AI enablers including semiconductor companies, data centre infrastructure suppliers and even utilities companies. The latter companies may seem relatively loosely correlated to the theme, but increased power demand and the related infrastructure required to support it are a clear consequence of the surge in AI and cloud computing volumes. This drives higher power prices and higher grid investment needs, which provided that the companies can achieve good rates of return on this investment is an opportunity for shareholders. In the coming year we expect there to be above average levels of volatility in AI related stocks, reflecting uncertainty over the pace of adoption and monetisation of AI applications. This will continue to present opportunities to add value through trading in some of our core positions in the space, as we have done with Arm Holdings over the course of the year.

The portfolio is well-diversified by region and sector, comprising equites where we have good long term growth gaps, sustainable competitive advantage, and exposure to long term structural growth trends. As always, we remain focused on watching for potential market dislocations and carefully weighing the trade-offs between risk and reward, as we assess opportunities for unanticipated growth.

Engagements

Company	Activity
Microsoft	The Global & International team hosted an engagement with Microsoft in Q3 2024. The engagement touched upon environmental, social, and governance matters, with specific focus on environmental sustainability and artificial intelligence (AI) responsibility. Company representatives highlighted their commitment to climate and emissions reductions, albeit acknowledging challenges in achieving these, particularly in relation to energy use in buildings and the carbon impact of data centre construction. Efforts to advocate for changes to energy policy and improve renewable energy capacity were also discussed. On the topic of responsible AI, the representatives discussed safety measures, product review processes, and regulatory compliance. They also highlighted the company's efforts to ensure that their products meet responsible AI standards, with specific processes in place for sensitive use cases and rigorous contracts for enterprise customers. Furthermore, they mentioned that tools are used to identify potential risks in their AI products.
Procter & Gamble Co	The Global & International team sent a follow up email to Procter & Gamble focused on responsible purchasing practices and deforestation efforts. The company representatives discussed their human rights due diligence strategies, including their supplier Code of Conduct, audit processes, and grievance lines. They also explained their support for smallholder farmers and their efforts to help them increase yields and meet RSPO standards. The company acknowledged traceability challenges for palm kern oil, which is why they have lower overall palm oil traceability that similar peers who source less kern oil. They are working on satellite monitoring capabilities for palm oil, however challenges remain for forestry/pulp commodities. As a next step, we agreed to follow up with more detailed questions on purchasing practices via email.

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