Schroders

Schroder Global Recovery Fund

Summary Statement

Uncertainty tends to be good for our investment style. When the market operated in an artificially buoyed and protected QE market, with lower for longer rates, and low volatility, few new investment opportunities are created, and performance can suffer as a consequence. However, when emotions reign, when uncertainty increases, when fear (or greed) takes over, shares prices move by more than is justified by fundamentals and opportunities are created. That is why our funds have tended to perform well after periods of uncertainty. Periods like the tech crash, the Great Financial Crash and the Covid Crisis all created the conditions for strong subsequent returns for our unit holders. Unfortunately, there is no play book for what stocks or sectors we will buy, or stocks that we will sell. We promise simply to be guided by valuation, and to build diversified portfolios not beholden to one sector, to one theme or to one macroeconomic outcome. Over time, we believe that simple promise and simple process will compound to deliver strong returns for our clients.

Performance overview

The portfolio outperformed the MSCI World index over the first quarter. On a relative basis, the fund's positioning in the consumer discretionary and financials sectors were a key contributors to the fund's positive returns, while not holding tech heavyweights Apple and Nvidia, which performed well, detracted from relative returns.

Rolls-Royce shares moved higher after it released its full-year results, which include significant improvements in its revenues, profits, cash flow and new orders. Underlying operating profit was £652m, £238m higher than the prior year, with the increase driven by Civil Aerospace and Power Systems, while free cash flow from operations was bolstered by a recovery in flying hours as the travel industry has reopened post-pandemic. Improved cash flow and the proceeds of strategic disposals have improved the balance sheet a little as well, with c.£2bn reduction in net debt (now £3.3bn). Management were also able to update investors on the company's transformation programme. We will get more detail on this later in 2023, but for now management have said that from benchmarking Rolls-Royce against its peers, they believe there is significant scope for the business to deliver materially higher profit, cash flows and shareholder returns. This is corporate management speak for saying *'we are considerably behind our peers'* , with the Civil Aerospace and Power Systems divisions the laggards. Overall, the risks have reduced and while the shares have performed well, we believe they remain undervalued. That said, we trimmed back our overall holding in the wake of recent share price strength, as Rolls-Royce remains relatively high-risk turnaround and we want to control the position size given the abundance of cyclical opportunities available today.

UK telecommunications firm **BT Group** performed well over the first quarter, recovering some of the poor performance in 2022. We continue to believe that BT is a business with decent pricing power in an inflationary environment and a strong incumbent market position. It will have to spend a lot of money on the roll-out of full-fibre broadband in the near-term, but the improved regulatory backdrop should enable them to earn a reasonable payback on that investment and improve free cash generation in the medium term. We believe the shares offer plenty of upside from today's level on a conservative multiple, and with the c.5% dividend yield we are being paid to wait.

A number of our banking sector holdings were among the top positive contributors, including Italian bank **UniCredit**. Banks continue to benefit from the rising interest rate environment and are supported by valuations that remain undemanding. During the quarter, UniCredit reported record profits for 2022 and announced plans to return €5.25 billion to shareholders this year. This is part of the company's plan to return €16 billion by 2024, with the healthy dividend distribution unaffected.

US technology company **Intel** performed well over the quarter, but viewed though a longer term lens it remains a disappointment. Its 2022 results were poor and the near-term outlook for revenues and gross margins is much weaker than expected. Intel's key end markets are currently experiencing painful falls from Covid highs, with both the PC and data centre segments recording sharp revenue declines. While management are keen to portray the current pain as an unusually sharp inventory correction following an exceptionally strong period of sales during the pandemic (when a sudden boost to demand and constrained supply chains pushed PC and server customers to stock-up on inventory), we are concerned that the severity of the downcycle is being amplified by Intel-specific issues linked to their loss of manufacturing leadership in recent years. Reappraising today, we concede a meaningful step-down in the fair value of the business and an increase in the risks due to the deterioration in cash generation and higher forecast leverage over the next couple of years. However, given the tendency for a confluence of cyclical and structural fears to create some of the most attractive contrarian recovery opportunities, we are wary of over-extrapolating from short-term numbers that undeniably make for bleak reading. If margins can return to anything close to what they've consistently done historically (excluding the 'super-normal' pandemic years), the shares look very cheap here. So we are minded to take a contrarian stance and assume things might not be quite as apocalyptically awful as current sentiment would suggest.

Elsewhere, German cement maker **Heidelbergcement** and tyre manufacturer **Continental** also supported portfolio performance. Both are energy intensive businesses and so worries over high European power prices, and possible gas shortages, have dented sentiment towards these stocks since Russia's invasion of Ukraine. However, reductions in overall usage, plus generally mild winter weather, have allayed concerns over power cuts and seen gas prices fall significantly.

Japanese watch and machine tools maker **Citizen Watch** performed well. The watch business has been under pressure for years from increasing smartwatch penetration, but over time management have been able managed to pivot the business towards its much more profitable machine tools division. This is now the biggest part of the company in terms of profits and, it is a very profitable (albeit cyclical) niche business that underpins the bulk of the valuation in our view. Citizen Watch also serves as an interesting case study for how much corporate governance has changed in Japan, to the benefit of shareholders. Historically, the business had been run with an extremely strong, inefficient balance sheet stuffed full of latent cash, financial assets and cross-holdings. In February, it announced an aggressive share buy-back – tantamount to 25% of the market capitalisation – which the stock market has taken extremely well.

On the negative side, our lower-than-index allocation to information technology was a detractor, as was not owning some of the more expensive US large cap tech companies which performed well in the quarter.

Of the fund's holdings, **Western Union** performed poorly. Fears around disintermediation of their physical network by cheaper online money transfer offers have been heightened by weaker revenues over the last 12 months. The profits and cash generation are lower than where they were 20 years ago, but if current sales and margins are sustainable it's very undervalued today and management have a shareholder friendly focus. The disposal of the Business Solutions business was well-timed and for an excellent multiple, and the balance sheet remains very strong.

US pharmaceutical company **Viatris** also detracted from returns. Viatris was formed as a result of the spin-off by Pfizer of its global, off-patent branded and generic medicines business, Upjohn, which merged with Mylan to form Viatris in late 2020. Viatris is a higher risk recovery investment given the balance sheet risk, but for patient long-term value investors we continue to believe the potential rewards are compelling.

Portfolio Activity

In the banking sector we have sold **HBSC** and **Intesa Sanpaolo**. Both shares have performed very well and we are conscious of controlling the overall banks weight in the fund. We used some of the proceeds to establish a position in US banking giant **Citigroup**, which we believe is now more attractively priced and diversifies the fund's exposure to banks outside of Europe. Citigroup is one of two genuinely global universal banks (alongside HSBC). And while Citi's historical return on equity has lagged that of US peers, it is still someway ahead of many European banks that now trade at similar or lower multiples. Capital generation has been impressive, enabling a 50% increase in CET1 (a capital measure of a bank's health introduced post Global Financial Crisis) over 10 years, while at the same time returning its entire market cap in dividends and buybacks. Tangible book value per share has doubled since 2011 and it made an average 9% return on equity over the last 5 years. Today it trades at a deep-discount to tangible book value and the 5% dividend yield ensures we are paid to wait.

We sold out of the position in **Genting Singapore** as the shares have performed well and reached our estimate of fair value. We had initiated the position back in April 2020, after shares tumbled following the start of the Covid-19 pandemic and associated restrictions on travel. It has taken the best part of three years for tourists to return to Genting's resorts but finally, in Q3 2022, we saw something close to a return to normality. The market now seems to be pricing a return to pre-pandemic earnings. That was the assumption underpinning our fair value and so it appears there is little upside left. Given the healthy opportunity set for global equity investors, we have exited and will recycle the proceeds into positions with more recovery/upside potential.

We sold out of metals & mining firm **South32**. The shares have performed well amid an increase in key commodity prices and profits. Looking ahead, we see a risk that capital expenditure may have to rise in order to increase reserves. Given the healthy opportunity set for global equity investors, we have exited and will recycle the proceeds into positions with more recovery/upside potential.

We also exited **Saipem**. We purchased shares in Saipem in September after the rights issue, which was not fully subscribed. The market had become concerned about the deterioration in the Italian oil service company's financial position. A new CEO joined in summer 2022, and in October, Saipem announced a $4.5 billion contract in Qatar, representing the largest single offshore contract win in its history. The shares have since experienced a strong recovery and hit our estimate of fair value.

Market Outlook & Positioning

It's supposed to be a bumpy ride

There are people a well into their investment careers (yours truly included) that are yet to witness value outperforming the market for a sustained multi-year period. However, value has had the upper hand since late 2020 and the portfolio's returns over 3-years now reflect what a deep-value active investment strategy is capable of delivering.

So it seems appropriate to offer a timely reminder that within any period of strong performance there will be ups and downs. A heady cocktail of hindsight bias, emotional filtering, cognitive dissonance and memory reconstruction mean human beings will emphasise the good times and do our very best to block out the bad.

> *"Objects in the rear-view mirror may appear smoother than they actually are"*

But the reality is life is always a lot messier when you're living through it than looking back at it. Return series are never as smooth as they appear in the mirror when you're living them day-to-day, week-to-week, month-to-month.

So, what does 3-years of stellar outperformance feel like? At times, really tough. Chart 1 looks at the two biggest secular value rallies in modern market history – the mid-70s and the early 2000s (in the period following the dotcom boom). These were multi-year periods of extremely strong relative performance for value. Looking back, it is easy to see them through rose-tinted lenses as truly wonderful times to have been a value investor. However, if we zoom in on those great secular value rallies, something very interesting emerges. Those strong value rallies were also home to some of the worst relative monthly returns for value vs. growth in stock market history! No less than six of the 10 worst months for value vs. growth on record occurred during those periods of stellar outperformance – periods that we all now all look back on as golden periods for value strategies.

Monthly returns of US large value vs. growth 1971–2019

Source: Russell Investments, GMO, Compustat.
From 1980–2019 performance is for Russell 1000 Value less Russell 1000 Growth. From 1971–79 performance is for cheapest 50% of price/book versus most expensive 50% of price/book in top 1000 US stocks.

Our conclusion is that – in the short-term at least – the market is really noisy. Trying to extrapolate what is going to happen over the next 3-5 years based on monthly swings in sentiment is a dangerous game because it is hugely misleading. Value has undoubtably had a more difficult month in March 2023 – but history shows this is par for the course.

Let's talk about banks …

We have to talk about the elephant in the room. What is going on in the banking sector, and is this the beginning of a 2008-style banking crisis?

Long-term readers will already know our answer. The future is unknowable, and only time will tell if this is the beginning of something, or not. But before we get to that somewhat unhelpful answer, we can say many things that may help with an understanding of the probabilities of such an event.
Since the Federal Deposit Insurance Corp started publishing records, a little over two decades ago, there have been 563 US bank failures. While strictly speaking, the average is two per month, the monthly average is more than a little misleading as more than 80% of bank failures occurred during the Great Financial Crash (starting in 2008).

In an attempt to curb some of the behaviours that contributed towards the crash, and to build a more resilient financial sector, the Dodd-Frank act was passed into law in 2010 under the Obama administration. Coming to a whopping 848 pages, it was designed to protect US banks from failing, and to protect the system when banks did fail. Banks with over $50bn of assets had to undergo stringent capital requirements, enhanced disclosures, increased supervision and improved liquidity protections.

"Regional banks unsurprisingly did not like the new rules - after all who likes being told what to do?"

It is also true to say the new regulations did not stop banks failing, as between 2012 and 2017 banks continued to fail at the rate of just over one per month. As an aside, we would argue the fact that if banks failed and neither the economy nor financial system noticed, the regulations clearly worked. Nevertheless, in 2018, following intense lobbying from the regional banks, then president Donald Trump signed-off on a rare bipartisan bill to reduce regulatory restrictions on banks, increasing the threshold for enhanced supervision from $50bn of assets to $250bn.

Following the reductions in restrictions from the Dodd-Frank act, the incidence of bank failures declined significantly. From a rate of one per month in the five years leading up to Trump's new rules, to 0.1 per month in the five years afterwards – and that's despite the best efforts of a Covid economy to wreck businesses and create bad loans. It turns out that if you don't look for bad things, you don't find them. Unfortunately, not finding bad things is not the same as bad things not happening. Weaknesses that have been building for the past couple of years have come to the fore in the last 30 days, causing two of the three largest bank failures in US history, and leading to an intense discussion about the nature of banking.

"It is worth stating explicitly that what happened in the US cannot happen here."

By that, we are not saying that European banks can't fail. But that with 'only' $211bn of assets, Silicon Valley Bank (the larger of the two) was too small to be dealt with under the revised Dodd-Frank legislation. As such, it operated in ways impossible under UK and EU legislation; liquidity was too low, critical investments were unhedged, with capital buffers below market norms and with no regulatory stress-testing. Banks fail for one of three reasons; insufficient capital, problems with their assets (either bad lending or bad investments), or illiquidity. Silicon Valley and Signature had issues with all three. Perhaps totally coincidentally, if the $50bn threshold had been adhered to, SVB would have come under Dodd-Frank's more stringent US legislation at the end of 2017 (assets at Dec '17 were $51.2bn); we can but wonder what might have happened if the 2018 legislation hadn't passed.

But we only get one run of history. The legislation passed, and the weakened oversight contributed directly to the failure of SVB and Signature. The failure of those banks created an environment of suspicion, an environment that directly led to Credit Suisse's failure. We need to be humble and state explicitly that what happened to Credit Suisse **can** happen here. Of the three issues that get banks into trouble, Credit Suisse exhibited none of them a year ago. That's not to say that Credit Suisse was a totally innocent by-stander in the banking drive-by. A continual failure of their internal risk controls (money laundering, tax evasion, Greensill and Archegos to name but four), serial acquisitions, continual restructuring, operational losses, capital destruction, rights issues, delayed accounts, espionage, Covid breaches and business model questions gave plenty of reasons for investors to point the finger. But an imperfect storm of internal issues, combined with an external environment of distrust, conspired against Credit Suisse, and ultimately led to its collapse. In today's modern connected world, where it is easy to move money with the tap of an app, question marks around the sustainability of a company, combined with a high proportion of uninsured (and therefore flighty) deposits, can be terminal for any bank. Ultimately, banks rely on the confidence of the depositors. That is why banks are highly regulated, why regulators insist on high levels of capital, on living wills, and most importantly, why the central bank operates as the lender of last resort.

The intra-bank is working as it should, and our favoured banks are highly profitable

At the time of writing, there are few signs of stress in the European intra-bank market. Intra-bank lending continues, signifying that, unlike in 2008, large banks trust each other. There are some signs of a slowing consumer, but not yet the significant recession forecast by central banks last year, and certainly nothing sufficient to prompt asset quality concerns. There are no signs of deposit flight, nor yet of significant numbers moving deposits to gain access to higher interest rates. Lastly, the banks we own are highly profitable, generating significant capital which further improves their buffers against bad news and external shocks as each day passes. While it may not be of any comfort, neither the Bank of England nor European Central Bank believe there are any systemic issues arising from the demise of Credit Suisse for European banks.
But there are undoubted strains out there. Increasing interest rates and inflation are a new investment paradigm, putting unforeseen pressure on business models previously seen as robust.

> *"The end of an era of free money will cause some business models to fail."*

We have potentially seen the start of the issues that a more difficult liquidity environment can cause through the failure of bitcoin exchanges (FTX), US regional banks (SVB and Silvergate), and issues with non-quoted holdings held within daily dealt investment funds (no comment ...). They are unlikely to be the last.
Interest rates haven't been above 1% since 2009; anyone working in finance lucky enough to be in their mid 30's (or younger) hasn't operated with any meaningful level of interest rates. Inflation hasn't been above 10% since 1981, meaning there are very few people still working in finance who have experience of impactful levels of inflation. There will almost inevitably be some people making mistakes that don't realise it today. Perhaps it's in the tech space, where less liquidity causes funding rounds to be more difficult, compounded by the tech industry's lender of last resort (SVB) failing. Perhaps it's simply the idea of meme stocks, of NFTs or of Bitcoin. More likely it's something we don't even realise is going on in some dark corner of the financial world – which are typically associated with the most recent fashionable investment themes and fads.

Higher rates mean interest cover is relevant again

For our portfolios, we need to think about one general and two specific areas where a changing paradigm may negatively impact our investments. The general area is to ensure that companies where we choose to invest can service their debt at 'the old normal' interest rates. For a long period of time when thinking about corporate health, net debt to EBITDA has been pretty much the only balance sheet ratio that needed to be considered. The importance of interest cover has been largely forgotten. But as we see from SVB et al, liquidity can be the most pernicious of problems. Assessing corporate health in terms of interest cover, of understanding which companies have unhedged debt, and who will struggle to service that interest in an environment of interest rates thought impossible a year ago, is likely to be crucial to performance.

What next for banks?

In terms of the specific areas, the first to consider is the banks. Following another headline grabbing issue, it would be easy to give up on our long-standing position in the banks. But before doing so, we should note a couple of things. The first is that despite the headlines, most (but not all) UK and European banks have performed well year to date – a sharp spike upwards (which is easy to forget) was followed by a sharp downdraft (which is not). The second is following significant upgrades to their earnings forecasts, banks as a whole now trade at half the market multiple, close to the 20-year low set during Covid.
That said, our funds have significantly lower exposures to banks today in comparison to the onset of the covid pandemic. Banks are the only global sector that has seen consistent positive earnings revision over the last two years.

The majority of bank shares we own have rebounded very strongly off the lows, and our bespoke risk/reward framework – using risk scores, fair values and required upsides – has led us to reduce our weighting to the banks over time. Reducing this exposure has been facilitated by the broadening out of the overall opportunity set for value investors. In practical terms, this means that as bank shares have performed well, we have taken profits and recycled the proceeds into other undervalued areas of the market. However, Banks remain a significant position because we continue to believe in the long-term attractiveness of the unloved sector from both a valuation and from an income perspective.

A value portfolio is far more diversified today than is often appreciated

On the eve of Covid pandemic in 2020, Global Recovery Fund had a combined weight of 40% in Banks, Energy and Materials. Today the combined exposure to these sectors is less than 20%, and they account for the three largest reductions in sector weights over the last three years. Conversely, the areas where we have increased exposure the most at the sector level include Telecoms & Pharmaceuticals; two traditionally defensive sectors.

The point that we would like to make here is the global universe is big enough and wide enough that the value opportunity set is extremely healthy today. We have been able to increase the number of holdings in the portfolio the low 30s to the mid-50s as the opportunity set for value investors has broadened out. This also means that our portfolios are as diversified as they have ever been.

Volatility is a good thing for value investors

Uncertainty tends to be good for our investment style. When the market operated in an artificially buoyed and protected QE market, with lower for longer rates, and low volatility, few new investment opportunities are created, and performance can suffer as a consequence. However, when emotions reign, when uncertainty increases, when fear (or greed) takes over, shares prices move by more than is justified by fundamentals and opportunities are created. That is why our funds have tended to perform well after periods of uncertainty. Periods like the tech crash, the Great Financial Crash and the Covid Crisis all created the conditions for strong subsequent returns for our unit holders. Unfortunately, there is no play book for what stocks or sectors we will buy, or stocks that we will sell. We promise simply to be guided by valuation, and to build diversified portfolios not beholden to one sector, to one theme or to one macroeconomic outcome. Over time, we believe that simple promise and simple process will compound to deliver strong returns for our clients.

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