

# Schroder Global Value Fund

## (Wholesale Class)

### Fund commentary

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Markets continued their upwards momentum in the opening quarter of 2024, building on 2023's strong finish to the year on increasingly bullish sentiment. The outlook for the global economy was bolstered on multiple fronts.

The QEP Global Value strategy underperformed its reference index, the MSCI AC World, over Q2 but finished comfortably ahead of the Value index, extending year-to-date gains against the relevant style index. The narrowness of the market and the dominance of a handful of ultra mega cap US Growth stocks was the key headwind during the quarter given our diversified approach along with the strategy's strong Value focus. The largest 5 stocks in the index (Microsoft, Apple, Nvidia, Alphabet, Amazon) accounted for over three quarters of the strategy's underperformance in the second quarter.

Offsetting this performance headwind was strong stock selection within the health care sector, where an avoidance of lower quality names in health equipment supported relative returns as they lagged. Similarly, stock selection within financials was positive as our favoured names within insurers, asset managers and complex banks contributed over the second quarter.

At a high level, the portfolio continues to seek the best value opportunities without compromising on business quality. It is also well diversified across a range of themes and our four value pillars (earnings, cash flows, assets, yield).

With markets exceptionally narrow and many stocks failing to keep up with the index, we took the opportunity to increase the strategy's allocation to attractively valued stable defensives, predominantly through neutralising the underweight to the health care and consumer staples sectors. Within deeper value areas we have identified a diverse set of opportunities in materials with attractive quality cyclical characteristics that trade on very attractive valuations, spanning precious metals, metal refiners and specialty chemicals. Helping fund this was a rotation out of European and Japanese banks as we took profits in selected names on good performance but maintain our overweight to the banking industry, albeit to a lesser extent.

The strategy remains underweight technology considering elevated valuations. Where possible, the strategy holds structural growth opportunities in more affordable names within Asia (e.g. semiconductors & hardware) while also capitalising on select stocks in the US that are more reasonably priced. Finally, balance sheet leverage in the real estate sector remains unattractive from a risk/return perspective and we maintain our underweight stance.

From a regional perspective, the strategy maintains a broad overweight to all regions outside of the US. Our significant underweight allocation is largely driven by a lower exposure to US tech on valuation grounds. The strategy has also increased its allocation to Emerging markets, particularly Emerging EMEA where we hold a diversified exposure across a range of compelling positions.

### Market review

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Risk assets remained in favour during the second quarter as markets continued their march upwards to round out a solid first half overall. Initial concerns around sticky inflation and dissipating hopes of US rate cuts abated over the course of the quarter, with equity markets regaining their confidence thanks to another solid reporting season.

Whilst the economic data blew hot and cold, the expectation is increasingly that the US economy will achieve a soft landing, but the dominant theme was the ongoing dominance of the big US index stocks which are all regarded as AI beneficiaries. Market breadth was extremely narrow globally, but particularly in the US where almost three quarters of the universe lagged the index, the highest proportion since at least the late 1990s. Nvidia, Apple and Alphabet all posted gains in excess of 20% with Nvidia once again leading the pack, rising by almost 37% during the quarter and is now up 150% over the year.

Elsewhere, equities were a mixed bag. Eurozone shares weakened amid uncertainty caused by the announcement of parliamentary elections in France and dwindling expectations for steep interest rate cuts. Notably, the technology sector gained with semiconductor-related stocks performing particularly well, while the consumer discretionary sector saw declines amid weakness in automotive and luxury goods stocks. UK equities rose with the FTSE 100 achieving fresh all-time highs driven by financials, health care and resources. Performance of small and mid-sized companies was also helped by a flurry of new bids as underperformance has seen many of these areas floundering on low valuations, making them ideal targets for overseas or private equity bids. Japan also gained in local currency terms but returns were negative in USD terms due to the continued depreciation of the Japanese yen.

Emerging market equities edged ahead of developed markets in the second quarter despite the headwind of a firmer US dollar. While softer US macroeconomic data helped ease concerns about the timing of US interest rate hikes, a rebound in China during the first two months of the quarter also supported EM returns. Optimism about the authorities' support for the housing sector and President Xi's reform rhetoric was beneficial.

In Asia, Taiwan and India led the way over the quarter. Taiwan posted double-digit return in US dollar terms against a backdrop of continued investor enthusiasm for technology stocks (particularly artificial intelligence-related names), while in India political developments supporting equity market returns over the quarter. Prime Minister Modi's Bharatiya Janata Party (BJP) led National Democratic Alliance retained its parliamentary majority although the BJP lost its single party majority.

Within European markets Turkey was the best performer over Q2 helped by optimism that economic policy will remain orthodox while Hungary, Czech Republic and Poland also posted decent gains. South Africa was another top performer, as investors welcomed the results of the country's general elections.

Other markets lagged, including Korea and some of the energy-related markets such as Kuwait, UAE, Colombia and Saudi Arabia. Brazil and Mexico posted the biggest losses in US dollar terms.

## Outlook

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As we enter the second half of 2024, many investors are finding it hard to jump off the momentum bandwagon. In truth, there have been few reasons to change course. The current extended market rally which began in late October 2023 was initially fuelled by the expectation that falling inflation would allow the Fed to cut rates aggressively this year and flawlessly engineer a soft landing. Instead, inflation has proved sticky and economic growth has been uneven, limiting the space for policy easing. Nevertheless, equities have firmly shrugged this off, thanks to a disconnect between the lacklustre macro cycle and buoyant corporate earnings. Historically, this has been a supportive environment for stocks, but the gains posted since last October have been extremely narrow, which increasingly belies the health of the rally.

This "higher for longer" backdrop has rewarded quality stocks but particularly those linked to AI themes to a point where momentum crowding and stock concentration have reached multi decade highs. According to the latest Bank of America global fund manager survey, being long the Magnificent 7 remains the most crowded trade for the 15<sup>th</sup> consecutive month and there have only been a handful of times when a single trade was more crowded in the history of the survey.

One way to quantify the dispersion between the average stock and the chosen few is to compare the performance of the equally weighted S&P500 and the standard index. Over several decades, the ratio of the two has trended firmly upwards, highlighting the impact of creative destruction at the top of the index. Simply put, it's rare for the biggest stocks to sustain their dominance. However, the recent sharp underperformance of the equally weighted index relative to this longer-term trend is on a par with the depths of the TMT bubble and the Nifty-fifty boom in the early 1970s. Both periods were followed by exceptionally strong performance for the average stock and the onus on those expecting the momentum trade to continue is that this time things are different.

There are certainly reasons to believe this may be the case as all the big stocks share a common trait of strong business franchises in fast growing areas, particularly now that Broadcom has replaced Tesla in the Magnificent-7 cohort. Their valuations look elevated but not particularly egregious and, in the case of the posterchild of the group Nvidia, whilst earnings continue to roll in, there seems little reason to take the career risk of calling the top.

The outsized return of the big index stocks is however masking weakness in other areas of the market. Just as the

average stock has trod water for the past 2 ½ years, their earnings have also been unspectacular over the same period. This may be about to change as current analyst forecasts for next year and 2026 suggest a broadening out of the contribution to market earnings growth beyond the Ultra Mega Caps, which would be a healthy development if it is matched by broader participation.

The second quarter earnings season will most likely be key to deciding the next phase of this market, particularly in the US. Even with earnings support, it may be increasingly hard for the Mag-7 to sustain their recent performance with expectations so elevated and both valuation and investor positioning either at or near the highs of this cycle.

Outside of the US, the case for Value is more compelling. The performance gap between the standard MSCI ACWI ex US Growth and Value indices year to date is narrow with Value outperforming during the second quarter, albeit thanks to the bounce in energy stocks during the period. On a relative basis (i.e. vs the US market), valuations are more attractive and central banks are responding more quickly than the Fed in easing. European political risk is unlikely to be promptly resolved but, following the strong outperformance of European cyclicals between mid-2022 and April which has only partly unwound since, there remain plenty of attractively priced quality defensives within the region.

Elsewhere, it is difficult to get overly bullish about emerging markets, particularly given the likelihood of a strong USD due to its ongoing yield advantage, but robust EM earnings growth and cheap relative valuations are supportive. Lastly, Japan could easily perform well in the second half of the year but this outcome most likely requires a stabilisation in its currency which currently remains elusive. More generally, with investor sentiment buoyant and cash levels low, the most diversifying trade away from momentum tail risk is to allocate more to defensive value (e.g. staples such as home products and pharmaceuticals) as well as cheap insurers. These stocks are also attractive as a potential hedge in the event of a market setback.

Meanwhile, the US election continues to edge closer. The polls are still close but the Trump camp appears to marginally have the upper hand which could also lead to investor uncertainty given the potential for significant changes to trade policy, foreign relations and regulation, not to mention a looser fiscal stance. The long end of the US yield curve is already responding accordingly.

From our perspective, the risks would seem modestly skewed to disappointment, but our key observation is that the wide dispersion of valuations across the market at present, caused by the extremely narrow breadth of recent years, continues to set the stage for bottom-up rather than top-down calls. It seems less likely that beta will drive returns, meaning that alpha generation will be even more important. Given our diversified approach, we are very comfortable with a more range bound environment and our focus remains on identifying attractively valued high quality stocks that are well suited to navigate a multi themed market.

## Active Ownership

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The QEP investment team works in close collaboration with Schroders' Sustainable Investment team to facilitate our engagement activity. Company engagements play an important role in our process, with the information gained key in helping us understand the sustainability issues corporations face and the specific 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.

Climate change and biodiversity continue to be key subjects of engagement, with several engagements focused on environmental topics conducted during the second quarter. Banks JP Morgan Chase & Toronto-Dominion Bank were both engaged with on their climate alignment practices. The engagement with JP Morgan Chase centred on the bank's green bond framework to understand how the proceeds from green bond issuance were being used. We also sought further information around their financed emissions framework, asking for more robust financed emissions disclosures and the methodology employed to set their new energy targets.

With regards to Toronto-Dominion Bank our focus was on their climate strategy and transition readiness. The bank openly discussed their approach to assessing their transition readiness, communicating how they employ several tools to help in their assessment, such as their Transition Plan Assessment Framework. The bank's focus remains on

delivering on the targets that they have already set versus extending these further. Toronto-Dominion Bank also confirmed that climate risk is integrated within their credit assessment processes to identify potential transition risks in their lending book. Finally, the company has increased their focus on utilising sustainability metrics in the remuneration policies for senior-level executives, including financed emissions targets which is a step we welcome to help drive improvements moving forward.

Our stewardship process extends to a proactive voting programme, a mechanism we 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 over 800 meetings on almost 12,000 resolutions for companies held across the QEP desk in the second quarter of 2024. Within these votes, around 15% were not with management. Votes against management were focussed on compensation plans, the election of directors or auditor related. We voted against ASML's remuneration proposal as the metrics used to set targets within the long-term incentive proposal were below expectations. We also voted against AstraZeneca's proposed new director given the overboarding of the company's board presently. The nominee already sits on a number of external boards which could also impact their ability to appropriately carry out the role if elected.

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