Schroders

March 2025

Schroder Global Value Fund Hedged (Wholesale Class)

Fund commentary

The portfolio significantly outperformed the MSCI ACWI index during the period. At a high level, cheap cyclical and defensive areas outperformed as markets rotated out of growth stocks. The portfolio's lower exposure to the big index stocks (e.g. Nvidia, Tesla, Apple) supported relative performance as market participation broadened in the US. Elsewhere, solid stock selection within quality cyclical financials in the UK and Continental Europe also contributed. After a period of lagging performance, the health care sector proved resilient in a volatile market environment. Favourable stock selection in select stable quality European pharma holdings contributed to relative performance (e.g. Roche).

Detractors were muted, but a lower than index exposure to UK and European defence contractors weighed on relative performance. Profit taking in select deep value and quality cyclical US construction supply holdings and a lack of exposure to tobacco were also modest headwinds during the period.

At a high level, the overall balance across our four value areas remains slightly in favour of Shareholder value (dividend, share buyback, surplus free cash flow) versus more cyclical value exposure from Book and Earnings value. Sources of Shareholder value are broad rather than concentrated in the typical defensive sectors and we are finding compelling opportunities across financials, high quality cyclicals and defensives.

The strategy maintains its diversified exposure, with broad overweights across a range of sectors and regions funded by the strategy's longstanding underweight to US tech given extended valuations. We are, however, able to gain exposure to structural growth opportunities in more affordable areas, predominantly within Asia where valuations are more reasonable.

At a regional level, we maintain our preference for value in Europe and the UK where shareholder yield features prominently. We have taken some profits here across banks and infrastructure-related names after some exceptional returns. However, valuations remain cheap overall with a depth of opportunity and remain overweight these areas. We moderately trimmed exposure to the US, taking profits across select names in health care, technology and consumer discretionary which was redeployed more broadly.

Within defensive areas, we added to our overweight position in utilities where we identified some compelling entry points in Europe during the quarter. Elsewhere within defensives we expanded our overweight posture in health care with a preference for select European pharma stocks with near term catalysts for business improvement and compelling quality characteristics.

Market review

Even before the stark initial adverse reaction to Trump's tariffs in early April, it had been a challenging start to the year for global equity markets, particularly in the US where both the S&P500 and Nasdaq experienced their worst quarterly performance since 2022. The S&P also trailed the rest of the world by the widest quarterly margin in over a decade. The pro-growth trades that emerged around the US election went into reverse, as initial hopes for deregulation and tax cuts gave way to increasing concerns about tariffs and their potential economic impact. Guided by Trump's first term, this was not the order of policy priorities that investors had expected from the new administration.

The prior market darlings were at the forefront of the selling in the first quarter. All but Meta out of the Mag-7 stocks suffered double digit declines amid growing concerns about a slowdown in AI-spend. They were clearly the obvious source of profit taking as uncertainty spread. As such, market breadth continued to recover with around 60% of stocks outperforming in both the US and developed markets whilst the equally weighted S&P500 outperformed the standard cap weighted index by 3.6%.

The main beneficiary of the apparent reversal in American exceptionalism was Europe, particularly after Germany changed its constitution to permit a significant ramp up in defence spending. According to MSCI, European equity markets gained by 10.5% in the first quarter in dollar terms compared to a 4.6% decline in the US. Emerging markets benefitted from a significant retreat in the US dollar but only managed to eke out a gain of 2.9% as China's strong performance was offset by weakness heavy Taiwan (TSMC) and, to a lesser extent, India.

Whilst the period was notable for significant short-term swings in sentiment, the preference for defensiveness was clear. Staples, utilities and health care performed well but it would be wrong to characterise the first quarter's price action as a rush for the hills as cheaper cyclical stocks in financials and resources also gained. The broader trend was a rotation away from the dominant themes of last year (AI/tech), which were rich for profit taking, towards better value areas which also offered diversification. MSCI's World Value index gained by as much as 4.8% whilst its sister Growth index declined by almost 8%. It was also a poor quarter for sustainability focused investors as aerospace & defence stocks rallied by over 15% whilst tobacco was up by 21%.

Bond yields declined at an orderly pace whilst the VIX index averaged 18.5%, not materially higher than the average for 2024, albeit the trend was clearly upwards. Similarly, typical haven currencies such as the Swiss franc gained but not to the extent that indicated panic. The consensus was that that the quarter was more of a correction and that investors were still hoping that Trump's bark was worse than his bite when it comes to a potential trade war. This turned out not to be the case following the punitive tariffs subsequently announced on "Liberation Day" (2nd April) but as the quarter drew to a close, US growth forecasts were already being revised downwards (led by exports and investment) and the probability of recession was rising sharply.

Outlook

Global equity markets appear to be at an important turning point with much now depending on the impact of Trump's tariffs on global growth. The tariffs announced after the end of the quarter (2nd April) were far more punitive than expected which is clearly a significant negative for risk appetite in the near term. The consensus had been for an effective US tariff rate in the low teens whereas the announced rate appears to be closer to 25%, the highest US average tariff rate since the early 1900s. Whilst the tariffs were described as reciprocal in nature, they were devised using an unconventional approach based on the US trade deficit with its trading partners.

Assuming that the tariffs were pitched at the high end of expectations to induce negotiations, the final tariffs could be lower. However, there is also the chance that they also are ratcheted up if countries decide to retaliate. China has already moved down this path. The focus has been on trade in goods, but this hides the fact that the US has a substantial trade surplus in services with most of its trading partners which regions such as the EU may choose to target. Unfortunately, we are braced for months of back and forth as trading partners seek to reduce the damage and engage in specific negotiations for different industries. The process is likely to be both intricate and challenging.

The probability of a recession in the US has jumped sharply due to these tariffs with the major Wall Street banks already quoting numbers as high as 60%. However, judging the impact on global growth by country is incredibly difficult as it will be determined by the respective economy's overall goods exports to GDP, the negotiated outcomes (if any), the availability of substitutes, and, crucially, currency movements. Perhaps even more importantly, the wider damage to corporate and consumer confidence will reinforce the existing downward momentum to global growth expectations and Treasury yields. This may explain the initial adverse move in the US dollar. Other things being equal, tariffs should have boosted the greenback due to the expected weaker demand for imports, resulting in fewer dollars getting swapped for foreign currencies.

Needless to say, it remains very uncertain what the year ahead holds. Before the reaction to "Liberation Day", the S&P500 had ended the first quarter struggling to regain its 200-day moving average, which it had traded above for more than 330 consecutive sessions. There have only been a dozen occasions since the second world war when the US index had dipped below this average but then recaptured it and even then, the subsequent market outcome has on average been at best muted. It's also worth noting that over half of the S&P500's constituents were below their 200-day moving averages at the end of March.

Prior to the negative market reaction to the tariffs in early April, the size of the drawdown in the US index since it peaked in late Feb was not out of kilter with the median annual drawdown of 10% experienced over the past four decade. However, a "correction" does not imply that the market is now fair value. Markets have clearly fallen significantly in early April but as at the end of Q1, the US was trading on a forward PE multiple of 20.5x compared to 13.7x for Europe and 13.3x for ACWI ex US. The same is true for equally weighted versions of these indices with the US ending the first quarter at a 35% premium to Europe and 38% premium to the rest of the world. The recent enthusiasm for non-US equities may well continue but it's hard to shake off the likelihood that European markets will also struggle as the global growth outlook is revised lower.

All bear markets start with a correction (i.e. the index falling by more than 10% from its peak) but not all corrections turn into a bear market (a decline of more than 20%). Historically, a third of the over 30 corrections in the US market since 1945 have turned into bear markets. The key differentiator was the subsequent path of the US economy. We don't expect it to be any different this time. At a high level, we can characterise the first quarter as a correction from overbought levels (the catalyst this time was uncertainty due to a potential trade war), and the likelihood that this evolves into a bear market will depend on whether a US recession can be avoided in the wake of Trump's tariff announcements.

The initial omens do not look promising, particularly given that the Fed may not be able to come to the rescue due to stubbornly high inflation. Expectations for more rate cuts this year are increasing but monetary policy has not proved to be an appropriate weapon in the face of stagflation. Soft economic data turned down in the first quarter, but this has not yet been evident in the harder data. How the announced tariffs impact the mix between growth and inflation is also highly uncertain so our best guess is that the path of least resistance for the Fed will be inertia.

That all said, the current doom and gloom is not necessarily a bad platform for a short-term relief rally. Investor cash levels ahead of the tariff announcement were already elevated and global growth expectations falling rapidly whilst global equity allocations had also declined sharply, all of which skew the potential reaction to “good” news to the upside. One potential catalyst for a rebound is the announcement of a raft of trade deals, or at least signs of US flexibility, leaning into the prior market thinking that Trump is using tariffs as a bargaining tool. Other market friendly candidates are a swift announcement that revenues will be used to fund significant tax cuts and as well as a refocus on deregulation. However, it’s worth stressing that it’s not unusual to observe sharp relief rally’s even in a midst of a bear market.

There is also the performance of the Magnificent-7 to consider given their dominant weight in the US index. Excluding the GFC period, the 10.4% drop in the Nasdaq in the first quarter of 2025 represents the 5th worst quarter since the dot.com bubble burst. Despite Goldman’s rebranding them as the Maleficient-7, their earnings revisions remained robust in the first quarter but their reliance on non-US supply chains (Apple in particular) means that they are far from immune to the tariff fallout. This will be of particular concern to those who like to draw parallels between the recent AI driven market with the dot.com boom and bust as the S&P500 fell by nearly 50% between March 2000 and October 2002 whilst the NASDAQ lost almost 80% of its value over the same period.

In terms of what all of this means for the market, all we can say is that there has clearly been a dramatic shift in the market’s tone so far in 2025 and the only prediction we can make with a high degree of confidence is that volatility will remain elevated. Everything is likely to hang on whether the US and other major economies slip into recession. Much has been written about the potential for either or of both a Trump-Put or a Fed-Put to come to the rescue, but Trump seems less concerned about equities so early in his term whilst, as noted, the Fed is caught in the headlights.

Being value conscious and looking for more opportunities outside the US seems sensible for diversification reasons but few areas will remain untouched by an escalating global trade war, and it is always best to remain focused on bottom-up stock fundamentals. Against the backdrop of scarcer growth, company quality will be prized, particularly for those with robust balance sheets that are also able to demonstrate margin stability. As such, we dialled up our defensive positioning during the first quarter across all our strategies. And of course, diversification will remain even more important during periods of elevated volatility. The increased likelihood of market overreaction, in either direction, is another source of opportunity that we intend to harvest.

Active Ownership

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 to 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 may otherwise be 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.

A range of companies held across the QEP investment desk were engaged with on various environmental, social and governance topics over the course of the first quarter. Social issues continue to be an important area of focus and we engaged with Howmet Aerospace on their supply chain and human rights risks. The company confirmed they use Ecovadis, an independent sustainability risk consultant, for supplier audits to help mitigate such risks. The company is also broadening its product safety disclosures and will be incorporating a new materiality map in their ESG reports to improve communication of their sustainability risks. We encouraged the company to continue expanding their disclosures but welcomed current developments which emphasize improving safety standards. Finally, Howmet confirmed they have grievance mechanisms for stakeholders and actively report on community grievances raised, primarily related to dust and noise pollution as a result of its operations.

We also engaged with Toyota on our blueprint theme of climate change as well as select governance topics. We discussed the company's increased move into hybrid and electric vehicles given growing demand in this space and their efforts towards achieving carbon neutrality. Toyota confirmed that they have already met their SBTi 2030 targets in their heavy freight trucks division and continue to focus on improving carbon emission reductions across their broad supply chain. The company noted the constant communication in place with suppliers regarding achieving their emission reduction targets. They also highlighted their commitment to reskilling their R&D staff, with a particular focus on software reskilling to further improve automation. We took the opportunity in this engagement to discuss the transformation of the Board of Directors and implementation of a new corporate governance model at Toyota. The company reduced the Board of Directors from 16 to 10, with an increased presence of outside directors and we will continue to monitor further developments in this area.

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 230 meetings on almost 2,500 resolutions for companies held across the QEP desk in the first quarter of 2025. Within these votes, around 11% were not with management. Votes against management were focussed on compensation plans, the election of directors or auditor related. For example, we voted against Italian bank Unicredit's remuneration proposal given another significant increase without reasonable justification to support this. We also voted against Costco's board proposal on gender diversity grounds with the Costco board lacking women on their executive committee.

Important Information

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