Schroder Sustainable Global Core Fund (Wholesale Class)

Fund commentary

The portfolio outperformed the benchmark over the first quarter against the backdrop of buoyant global markets which continued to benefit Growth stocks, although on an equal weighted basis, Value outperformed across a range of areas. The Core strategy's balanced approach, which focuses on better value and higher quality, held up well over the period with broad based positive contributions.

Positioning in cyclicals was a positive contributor over the quarter as our focus on quality was rewarded. Stock selection was positive within financials and select industrials as our favoured names in insurers and banks outperformed, as did our holdings in construction related industries. Elsewhere, positioning across US technology aided as the sector enjoyed broad based gains. We find compelling structural growth opportunities across hardware and semis which contributed as they moved higher on expected strong revenue growth driven by AI-demand. Additionally, our longstanding avoidance of real estate on poor quality characteristics provided a tailwind over the month as the sector lagged on the back of news of a hawkish pivot from the Fed. Detractors were relatively muted over the quarter, with the strategy seeing modest headwinds to performance from exposure within higher quality European energy players which lagged.

The portfolio continues to have exposure to a wide range of themes across our pillars of Quality and Value. Our focus in portfolio construction at this juncture is to maintain a balanced exposure to help diversify the strategy and manage for a range of potential market outcomes. While at a high level, allocations across sectors have not changed materially over the quarter, with positioning balanced across structural growth, cyclical and defensive positions, with markets rising strongly, we remained diligent in profit taking where the opportunity arose, rotating into more compelling options particularly in higher quality cyclicals.

We continue to be overweight within technology, though to a lesser degree, as we have been disciplined around profit taking with strong performance across the sector. Here we remain focused on stocks demonstrating stronger growth characteristics with still affordable valuations within semis and application software. Attractive value opportunities continue to reside within financials as well as select cyclical areas across both consumer discretionary and industrials. Within financials we maintain our diversified overweight allocation to both payments and banks while we have continued to find new opportunities within insurers where we have increased our allocation to the industry broadly. Across these areas our focus remains on those companies with higher quality characteristics, and a range of prospects exist globally to buy such names on attractive valuations. In consumer discretionary, we retain a preference for online retail and homebuilders, partly funded at the expense of autos and apparel where valuations are less appealing.

Meanwhile an exposure to defensive areas persist to provide a hedge against potential downside risks. Our preference is for staples (e.g. home products and drinks) and global telco stocks that are priced cheaply, while our longstanding overweight to pharmaceuticals remains.

Regional allocations have not changed materially. We continue to hold a higher than index allocation to the US while maintaining an underweight to the UK, Japan and Continental Europe where we do find some deeper value opportunities.

Market review

Global stock markets continued their march upwards in the first quarter, buoyed by resilient macroeconomic data globally. Whilst the strong gains posted in Q4 were driven in large part by expectations of a dovish US Federal Reserve (Fed) pivot, the continued global rally this year has come on the back of expectations turning hawkish, with stickier inflation and resilient economic activity. Although Growth stocks were again dominant over the quarter on the back of continued AI-related optimism, Value also saw gains with more traditional areas such as financials and energy participating.

US equities continued to lead the advance, helped by healthy corporate earnings with the S&P 500 index enjoying its second consecutive quarter of double digit returns for only the 9th time in the last 80 years. Ten of the eleven GICS sectors finished higher led by communications, energy, technology and financials while real estate was the only sector in the red. Eurozone stocks were also strong with technology again leading while improvements in the economic outlook boosted more economically sensitive stocks. UK equities meanwhile saw more modest gains with the UK economy officially entering a mild recession in the second half of 2023.

The star performers over the quarter were Japanese equities, particularly in local currency terms, with the TOPIX Total Return index reaching an all-time high. This surge was fuelled by foreign investment and optimism about Japan's economic cycle. The Bank of Japan (BOJ) took significant steps to overhaul its monetary policy, including abandoning negative interest rates and yield curve control, although this was widely discounted and led to yen weakness.

Elsewhere, emerging markets also saw gains but underperformed developed market peers as China's struggles dragged on returns and delays in the Fed cutting impacted rate sensitive markets like Brazil. Asian markets generally delivered modest gains over the quarter with India, the Philippines and Taiwan being the bright spots with the latter particularly strong due to its technology heavy index. Central bank policy drove returns in key markets with both Colombia and Peru benefitting from easing monetary policy whilst Turkey also posted strong returns as the central bank continued its orthodox monetary policy approach by increasing interest rates over the quarter. Meanwhile, South Africa was a poor performer against a backdrop of political uncertainty in the run-up to its general election while Egypt generated the worst returns over the quarter on the back of its c. 35% currency devaluation.

Outlook

Equity markets are usually described as climbing a wall of worry during turbulent times but the resilience of stocks this year suggests that investors are firmly focused on the good news rather than the potential for adverse tail events. Admittedly, despite the ongoing conflicts in Ukraine and the middle east, there has been much to take comfort from. Most importantly, a widely expected global recession appears to have been averted. Some indicators even suggest tentative signs of reacceleration, although it's too early to say whether this will gain traction. Inflation is proving sticky, but the door remains open for rate cuts around the world with the US Fed and ECB still expected to ease in the northern summer. The fact that rate cuts have been delayed (and are likely to be fewer in number than previously discounted) is less of a concern for equity investors as the shift in view is being driven by positive macro momentum. Bond markets are less sanguine but such a divergence of opinion with equities has not been unusual in the recent past.

Our best guess is that the Fed will not want to create unnecessary turbulence in an important election year which should support equities in the absence of a negative shock. Under the surface, it is also encouraging that the narrowness of last year's gains has broadened out beyond the big index stocks. There also appears to be increasing demand for economic sensitivity, which aligns with the re-acceleration argument, but as investors already seem lowly exposed to defensives, this does rather feel like putting all the eggs in one basket. But it may not matter, any rotation in leadership between cyclicals, defensives and structural growth stocks this year will probably be more muted than has historically been the case given that central banks are unlikely to surprise.

It is hard to find historical parallels of other low risk premia periods that rhyme with the current market backdrop, but three possibilities are the mid-1990's, the early stages of the dotcom bubble and the pre-GFC euphoria. Investors currently appear to be discounting the perfectly orchestrated soft-landing of the mid-1990s. AI fuelled sentiment is not yet matching the frenzy which characterised 1999/2000 whilst leverage is clearly not as excessive as it was in 2007/8.

We would not rule out the potential for a bubble developing in big-Tech but a degree of scepticism does seem to be emerging, most evident in their late Q1 consolidation and the performance dispersion between the big-7 index stocks this year. This dispersion is driven by earnings dynamics at the stock level, which is another healthy development but does flag the need for strong earnings momentum to continue. Rather than worrying about the macro or geopolitics, in our minds the key risk to manage today is earnings expectations versus reality at the stock level. As we enter the first quarter earnings season, downgrades have been slightly less than is usually the case which further highlights the risk of disappointment.

With the average pairwise correlation between MSCI ACWI constituents being close to its lowest level in at least two decades, this still feels like a stock pickers market. Our response is to ensure a well-balanced portfolio that is hedged on the market where possible (i.e. a beta close to one) whilst allocating to a broad range of stocks with Value and Quality credentials. This is not requiring us to take significant sector or style tilts as we are not finding it difficult to identify good prospects across the market at present. It also reduces our vulnerability to the macro noise. Given the potential for outsized relative stock gains, it is also important to remain very disciplined regarding profit taking when things have gone well and looking for overreaction where there has been disappointment. In summary, the current market backdrop is offering the opportunity to exploit excess volatility at the stock level without having to make a top-down call, which suits our process well.

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 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.

Several engagements focussed on climate change were initiated in the quarter. Dutch semiconductor equipment company ASML was engaged with to obtain an update on their climate transition objectives. ASML have committed to achieving net zero by 2025, with this ambition covering the company's scope 1 & 2 emissions as well as a proportion of their scope 3 emissions. Their strategy focusses on reducing emissions through energy efficiency while concurrently increasing renewable energies use. The company confirmed energy efficiency has already significantly improved and plans are in place for this to be improved further. Regarding scope 3 emissions specifically, ASML is addressing supply chain emissions via increased supplier commitments to sustainability as well as collaborations with customers, for instance TSMC on renewables adoption. The company's investments to reduce emissions are included within their R&D budget and ESG metrics are now linked to 20% of long-term remuneration for executives. ASML has made considerable progress towards their stated climate ambitions, and we will continue to monitor their progress.

With corporate governance forming an important pillar of the Schroders engagement blueprint, governance engagements were also carried out in the opening quarter of 2024. Remuneration policy was one topic engaged on, and our central Sustainable Investment team contacted Swedish manufacturing firm Assa Abloy. We encouraged them to diversify the metrics used in their remuneration methodology. At present, earnings per share determines all of their long-term incentive programme and almost all of their short-term programme. This is overly simplified and does not capture a broader range of measures that might be useful when assessing the performance of management. As part of this engagement we also requested the company improve the level of their disclosures, particularly around human capital metrics such as fatalities, training hours, turnover and the result of engagement surveys.

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 over 270 meetings on almost 3,000 resolutions for companies held across the QEP desk in the first quarter of the year. 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 Inpex's director election proposal due to a lack of gender diversity on their board at present and did similarly for D.R. Horton also. We also voted against Applied Materials' executive compensation proposal given certain targets set below median performance and a lack of sufficient disclosure on the broader set of targets used for justifying awards. In addition, there is high-level of remuneration inequity among named executive officers.

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