Schroders

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Schroder Global Recovery Fund

Fund Managers: Liam Nunn and Simon Adler | Q3 2024

Performance overview

- The MSCI World Index delivered a total return of 0.2% over the quarter. The portfolio delivered an absolute return of 6.1% (Z Acc), outperforming the index.

Drivers of fund performance

- The leading individual contributor to returns was the world's leading flooring manufacturer **Mohawk Industries**. This leading business has a short-term problem: weak demand in its end markets. However, business conditions are improving, and the latest quarterly results showed its cost-cutting is feeding through to the bottom line as profits beat the market's expectations. The balance sheet remains strong, and there is significant upside to fair value.
- It's a similar story with quality US power tool business **Stanley Black & Decker**. US real estate investment remains under pressure, but the market responded positively to the group's quarterly results, which saw it raise its earnings per share guidance range for the full year. Management has emphasised their focus on making the supply chain more efficient to expand profit margins.
- **Bristol Myers Squibb**, the US pharma giant, was the top performer after reporting better-than-expected second-quarter results. Management disclosed good numbers driven by new products such as Reblozyl and Camzyos, as well as its top-seller Eliquis. CEO Chris Boerner expressed confidence in navigating the impact of upcoming Medicare price negotiations on Eliquis and raised the company's earnings forecast for the full year. The company still faces potential challenges from upcoming changes in Medicare drug pricing in 2026, although we feel these risks are more than discounted by the valuation today. At purchase, we also assumed that a decent chunk of free cash flow will be allocated to M&A to plug the gap as its drugs roll-off patent, and still saw plenty of upside. As the shares have done well, we have taken profits to keep the position size in check.
- Japanese advertising agency **Dentsu** rebounded, with the shares now up a third year-to-date. The business had a very challenging year in 2023, with organic growth falling well behind peers for several self-inflicted reasons including unintended consequences from the organisational changes made in 2021 (which led to less collaboration within the business) and a botched IT systems roll-out. Management say these issues have been addressed, and they expect the business to be back on track by the end of 2024 (with an aim to achieve 1% group organic growth and a 15% operating margin). While this falls well short of its own medium-term targets announced a few years ago, and even if we use this poor year as 'normal' there is significant upside to fair value.
- Another strong performer was **Standard Chartered**, the emerging markets focused bank. The bank announced its largest-ever share buyback of $1.5 billion, as well as upgraded income growth guidance for 2024. A reported 5% increase in pre-tax profits for the first half of the year also exceeded expectations, with shares up 12% over the quarter as a result. The business continues to face challenges, such as China's slowing growth and its property market crisis, nonetheless management remain optimistic about its prospects in Asia.
- Chinese retail and technology giant **Alibaba** also added value in the quarter, with the shares moving sharply higher after the Chinese government announced its so-called 'bazooka' stimulus in an attempt to rouse lacklustre GDP growth. Focusing on the company, revenues continue to grow, and margins have started to move in the right direction again (albeit not as fast as the market would like). We remain mindful of the geopolitical risks, but the bottom-up valuation remains very appealing – particularly considering that 'core' group profits are currently depressed by various early-stage investment business lines. The balance sheet is also very strong, which is allowing management to return cash to shareholders through both value-accretive share buybacks and dividends.
- On the negative side, **Walgreens Boots Alliance** weighed on relative returns. We wrote about Walgreens last quarter, and having reviewed the business again, we have not made any material changes to our normalised assumptions. The risks to this business remain very high – a potent mix of structural issues and balance sheet stress – but any medium-term recovery in core US Retail-Pharmacy

profits would leave the shares looking extremely undervalued, and we continue to believe that the International and Healthcare assets should be sufficiently valuable to offset the bulk of the gross debt outstanding. Our biggest concern is the weakening fixed charge cover given guidance for further erosion of core US Retail Pharmacy profits next year; albeit plans to close circa 1200 stores over the next few years could help in that regard. We believe we are compensated for the risks, and the position size in the portfolio also reflects these.

– **Intel** performed poorly. The US chip giant's strategy requires a substantial increase in investment levels, as they attempt to regain their process leadership position while also building a third-party foundry business. The near-term impact of that is increased leverage, lower capacity utilisation and lower margins, and this year the evidence of both technological and financial progress has been disappointingly limited. In July, Intel announced material cost-saving measures that included a 15% reduction in its workforce and cancelling the dividend. We've done a significant amount of work reviewing the position and it remains our belief that Intel can recover to a degree that is not priced in by the current valuation. We believe the shares offer significant upside today but will continue to monitor the business closely.

– **Macy's** also detracted from returns following news that discussions with a private equity firm over a potential takeover offer had been terminated. The company continues to work through its organic turnaround plan with several cost control initiatives; and while the macroeconomic environment is weighing on current trading, the balance sheet remains in good shape, with significant cash flow also being generated from the sale of their non-core real estate.

Portfolio activity:

– We initiated a new position in UK telecoms group **Vodafone**. This is a stock that has been a laggard for 20 years, but we believe the company has done a lot of the heavy lifting to transform itself. The Spanish and Italian businesses have been sold for quite attractive multiples, improving the balance sheet and simplifying the business model (which is now largely focused on their core markets of Germany & the UK). With the balance sheet in much improved health, Vodafone is using some of the sale proceeds to buy back shares, and the dividend yield of c.5% means we are being paid to wait while the transformation benefits come through.

– Another new position is **Burberry**. July brought a profit warning, the dividend cut to zero and a new CEO. In the near-term, the picture is far from rosy. Sales trends are very negative in every channel and every region ex-Japan. Burberry has significant operating leverage, so profit forecasts have collapsed. The company has guided to a potential loss in its first half, but the truth is that a full year loss isn't out of the question. The luxury backdrop is clearly worsening for all but a handful of super premium brands, with the likes of De Beers, Swatch, Kering and LVMH also issuing profit warnings on the back of weakening appetite for discretionary purchases. But Burberry has compounded these woes by dropping the ball operationally and botching their attempts to rejuvenate the brand. To assess the base rates for margins we created 2 custom peer groups, one comprised of luxury goods peers and the other of higher end but more affordable brands, such as Michael Kors and Coach (which incidentally the new CEO has on his CV). If we assume some mean reversion even to the more conservative, 'affordable' end of that margin spectrum, the shares appear undervalued today. And if Burberry can ever get back to prior peaks and deliver margins in-line with genuine luxury peers, the upside in the shares is likely to be very attractive indeed.

– We also initiated a position in Chinese online automobile platform **Autohome**. The company offers interactive content and tools to car buyers as well as a wide range of marketing services to automakers and dealers. Autohome delivered outstanding revenue growth from 2014 to 2020; but in the last 4 years, sales have flat lined amid a slowdown in the Chinese auto market and rising competition from alternative advertising platforms. The shares have de-rated as a result, but we believe the company's fundamentals remain strong and it has a superb balance sheet, with cash and short-term investments equivalent to nearly the entire market cap of the company when we purchased the shares. While we cannot know when a Chinese auto demand and corresponding carmarker advertising recovery might occur, in the meantime we get to invest in a materially undervalued and profitable business.

– We have sold out of US consumer discretionary businesses **Best Buy** and **eBay** after they performed well and reached our assessments of fair value. We also sold our position in **Nordstrom** in order to add to our position in Macy's; as the collapse in Macy's bid interest opened up a large fundamental valuation gap between the two US department stores.

Global Value policy – September 2024

When a crystal ball isn't enough to make you money

– A fun and fascinating paper caught our eye in September. The research was conducted by Victor Haghani and James White of Elm Partners (you can read the paper here). They start with a quote from Nassim Taleb, posted on X:

- "I conjecture that if you gave an investor the next day's news 24 hours in advance, he would go bust in less than a year"
- In the 1989 blockbuster Back to the Future II, time travel enables Michael J. Fox's nemesis, Biff, to become a gazillionaire by bringing an almanac with sports match outcomes back from the future.
- This was the basis for Haghani and White's experiment, which they called 'The Crystal Ball Challenge'. They gave each participant $50 and the opportunity to grow that stake by trading in the S&P 500 index and 30-year US Treasury bonds with the information on the front page of the Wall Street Journal (WSJ) one day in advance, but with stock and bond price data blacked out.
- As you might have guessed, it did not end well for the participants. About half of them lost money, and one in six actually went bust. The average payout was just $51.62 (a gain of just 3.2%), which is statistically indistinguishable from breaking even.
- The poor results were a product of: 1) not guessing the direction of stocks and bonds very well, and; 2) poor trade-sizing (a mixture of excessive risk taking and positions that bore no relation to their propensity to guess the price moves of stocks or bonds correctly.
- Let's take the first of these. Sometimes the markets don't react to the news as even seasoned experts expect. I'm reminded of what happened in 2016. Brexit and the US election results foxed the pollsters. But even if you had known the result of the EU referendum and the US election in advance and with absolute certainty, what good would it have done you as an investor?
- It was widely believed that both eventualities would be bad news for equities. However, the market took just a couple of weeks to bounce back from its post-referendum losses, and not even a day to account for Trump's impending residency in the White House before resuming its march towards all-time highs. This should serve as a reminder that not only is political and macro-economic forecasting very difficult, even if you get it right the market can move in the opposite direction to what you believe is appropriate.
- The second reason for the poor results in the experiment is interesting because it points to the fact that the excessive risk-taking by some of the players is at least partially explained by the finding that most investors tend to overestimate the predictive value of news on market outcomes.
- But not knowing what the future will bring does not mean that we cannot prepare for it. Instead of relying on subjective forecasts, we base our investment decisions on long-term historical data and robust processes to determine instances where the upside potential exceeds the downside risk.
- First and foremost, stocks must trade at a large discount to fair value. More than a century's data shows that value investing outperforms on average and over time. Assuming a stock is sufficiently cheap, we then spend a lot of time studying accounts to give us a clear picture of how a company performs across the business cycle. To what extent is a profit recovery within the company's own control or dependent on external conditions, and what are the major risks associated with it? Finally, we look closely at balance sheets to ensure companies have sufficient capital strength to see them through short and medium-term challenges; a robust balance sheet provides a 'margin of safety' against unknowable risks.
- Were we to choose to ignore these principles and do something different each time – like clinging to the latest economic forecast – then we would just be individuals doing whatever took our fancy. That is not repeatable. What separates the Benjamin Grahams of this world from the average fund manager is an investment process that is repeatable, process-driven and based on history. That is value investing – and only by being disciplined and consistent can we deliver its long-term performance advantage.
- History suggests that the resulting outperformance of the portfolio from today's level should be significant on a 10-year view, but performance is always lumpy, and it is not possible to predict when sentiment will wax or wane for our investments.

Boring old UK Banks or the most exciting US tech?

- Believe it or not, UK banks have delivered higher returns than the Nasdaq-100 since the end of 2020 (!), with total returns of 102% and 60% respectively, in local terms.
- Before we continue, we need to strongly caveat the fact that value investors haven't exactly covered themselves in glory over the past decade. However, operational performance has been strong, and, in some cases, we are even seeing that coming through (albeit reluctantly) in share prices.
- Take NatWest for example. In the last three years, NatWest has done everything that we could have hoped for operationally. Pre-tax profits have grown from £4bn to £6bn, return on equity has increased, the cost-income ratio has decreased, the only thing that had been lacking is an improvement in the share price. Earlier this year, we wrote that if we aggregate the dividends and the buybacks, over the past three years NatWest has distributed £12.5bn to shareholders. This was equal to half its prevailing market capitalisation! We felt patience, and the continued judicious use of share buybacks should deliver next leg of recovery for shareholders. Year-to-date, the share price has increased by almost 70%.

- Barclays shares have also performed well this year. The bank is returning at least £10bn to shareholders over the next three years, which is 40% of its market cap, and management say it will do so without weakening its capital ratios. This commitment follows the £9bn returned to shareholders since 2019, which has resulted in a 13% decline in the shares in issue. Barclays has proven to be effective in cutting costs in the retail business, which is exemplified by the number of UK branches declining from 666 in 2021 to 306 today. This focus is why Barclays UK business is currently making a 20% return on equity, which justifies the entire market cap by itself. The shares remain undervalued and are very attractive from both a capital growth and an income perspective.

Gently rotating the portfolio

- To ensure our portfolios do not have style drift, and to ensure they represent the best opportunities today, we have been taking money out of some of the financials and selected consumer-facing cyclicals. These are areas which have done very well over the past year. We are rotating the proceeds into the areas most out of favour, where people are most pessimistic, and where valuations are lowest. We are not doing so oblivious to the difficulties that lie ahead, instead choosing to only buy the ones where balance sheets are strong, and which can be sustained through whatever the future may hold.

Past performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get back the amount originally invested.

Calendar year performance (%)

Year	Fund	Target	Comp. 1	Comp.2
2023	13.8	16.8	5.2	12.6
2022	1.6	-7.8	5.3	-11.3
2021	23.9	22.9	23.1	17.5
2020	-7.3	12.3	-4.2	14.8
2019	17.9	22.7	17.0	22.0
2018	-8.1	-3.0	-5.2	-5.7
2017	10.9	11.8	7.0	13.9
2016	37.1	28.2	34.0	23.9
2015				
2014				

Source: Schroders, net of fees, bid to bid, with net income reinvested. GBP Z Acc as at 31 December 2023. The fund's performance should be assessed against its target benchmark, being to exceed the MSCI World (Net Total Return) Index, and compared against the MSCI World Value (Net Total Return) Index (comp. 1) and the Investment Association Global sector average return (comp. 2). The investment manager invests on a discretionary basis and is not limited to investing in accordance with the composition of the benchmark.

Risk considerations

Currency risk The fund may lose value as a result of movements in foreign exchange rates.
Derivatives risk Derivatives may be used to manage the portfolio efficiently. A derivative may not perform as expected, may create losses greater than the cost of the derivative and may result in losses to the fund. The fund may also materially invest in derivatives including using short selling and leverage techniques with the aim of making a return. When the value of an asset changes, the value of a derivative based on that asset may change to a much greater extent. This may result in greater losses than investing in the underlying asset.
Emerging markets & frontier risk Emerging markets, and especially frontier markets, generally carry greater political, legal, counterparty, operational and liquidity risk than developed markets.
IBOR risk The transition of the financial markets away from the use of interbank offered rates (IBORs) to alternative reference rates may impact the valuation of certain holdings and disrupt liquidity in certain instruments. This may impact the investment performance of the fund.
Liquidity risk In difficult market conditions, the fund may not be able to sell a security for full value or at all. This could affect performance and could cause the fund to defer or suspend redemptions of its shares.
Operational risk Operational processes, including those related to the safekeeping of assets, may fail. This may result in losses to the fund.
Performance risk Investment objectives express an intended result but there is no guarantee that such a result will be achieved. Depending on market conditions and the macro economic environment, investment objectives may become more difficult to achieve.

Important information