Schroders

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Schroder ISF* Asian Total Return
Fund Update
October 2024

Fund Performance

Performance of Schroder ISF Asian Total Return ('C' Class Accumulation Units)
Since inception on 16 November 2007, indexed returns in USD

Calendar year returns (%)

	Fund	Index	Comparator
2023	13.9	7.4	5.0
2022	-22.9	-17.5	1.5
2021	4.7	-2.9	0.1
2020	31.0	22.4	0.7
2019	18.5	19.2	2.4
2018	-14.6	-13.9	2.4
2017	40.2	37.0	1.3
2016	7.2	6.8	0.8
2015	-2.5	-9.4	0.3
2014	7.1	2.8	0.2

Index: MSCI AC Asia Pacific ex Japan, USD terms.
Comparator: USD 3 Month T-Bill (or an alternative reference rate).
Source: Schroders, bid to bid, with net income invested.

Past performance is not a reliable indicator of future results, the prices of shares and the income from them may fall as well as rise, and investors may not get back the full amount originally invested.

%	Oct 2024	YTD	1 Year	3 Years (p.a.)	5 Years (p.a)	Since Inception (p.a.)	Standard Deviation (p.a.)	Sharpe Ratio (RFR = USD 3M T-Bill)
Schroder ISF Asian Total Return (C Class USD)	-4.9	11.8	27.3	-0.2	7.1	8.8	16.7	0.4
MSCI AC Asia Pacific ex Japan index	-5.0	14.0	28.1	-0.5	5.0	3.4	20.3	0.1
USD 3-month T-Bill	0.4	4.4	5.4	3.6	2.4	1.2	0.5	--
Lipper Equity Asia Pacific ex Japan universe	-4.7	10.9	22.3	-3.5	3.0	2.5	20.2	0.1
Quartile Ranking (Fund Ranking)	Q3 (315/513)	Q3 (271/508)	Q2 (140/507)	Q2 (136/472)	Q1 (51/420)	Q1 (1/200)	Q1 (6/200)	Q1 (2/200)

Lipper universe annualised standard deviations and Sharpe ratios are calculated for the period since the fund's inception, and annualised returns are calculated based on number of days since inception. For illustrative purposes only and should not be construed as a forecast, prediction, or projection of the future or likely performance of the fund. The fund is not managed with reference to any specific benchmark(s), but its performance may be measured against one or more.
Source: Bloomberg, Lipper IM, Schroders, as at end of October 2024. Quartile data source: Lipper universe.

*Schroder International Selection Fund referred to as Schroder ISF throughout this document

OCTOBER PERFORMANCE

Asian markets were down in October, with the fund's reference benchmark, the MSCI AC Asia Pacific ex-Japan Index, decreasing by 4.9% in US dollar terms.

Expectations of strong Chinese stimulus initially led the China and Hong Kong markets higher, ending the first week up nearly 9% and 6.5%, respectively, in US dollar terms. However, a lack of concrete details and consensus that the stimulus would be lower than initially hoped meant both markets quickly reversed their gains and finished the month down just shy of 6%.

India was the worst-performing big market, decreasing by 7.7% in US dollar terms. Weak results across the board met with lofty valuations and heightened expectations. We discuss India in detail in this month's report.

Taiwan was the key outperformer in the region, as TSMC reported another excellent set of results, confirming it as a core recipient of Nvidia GPU demand and its outlook highlighting the company's position as an effective monopoly in leading-edge foundry services.

Against this backdrop, the fund (C share class) was down by 4.9%, marginally outperforming the benchmark.

RISK CONSIDERATIONS

- Capital risk / distribution policy: As the fund intends to pay dividends regardless of its performance, a dividend may represent a return of part of the amount you invested.

- Counterparty risk: The fund may have contractual agreements with counterparties. If a counterparty is unable to fulfil their obligations, the sum that they owe to the fund may be lost in part or in whole.

- Currency risk / hedged share class: The hedging of the share class may not be fully effective and residual currency exposure may remain. The cost associated with hedging may impact performance and potential gains may be more limited than for unhedged share classes.

- Derivatives risk: Derivatives may be used to manage the portfolio efficiently. The fund may also materially invest in derivatives including using short selling and leverage techniques with the aim of making a return. 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.

- Emerging markets & frontier risk: Emerging markets, and especially frontier markets, generally carry greater political, legal, counterparty, operational and liquidity risk than developed markets.
- Higher volatility risk: The price of this fund may be volatile as it may take higher risks in search of higher rewards.

- 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.

- Market risk: The value of investments can go up and down and an investor may not get back the amount initially invested.

- Onshore renminbi currency risk: The fund can be exposed to different currencies. Changes in foreign exchange rates could create losses. Currency control decisions made by the Chinese government could affect the value of the fund's investments 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.

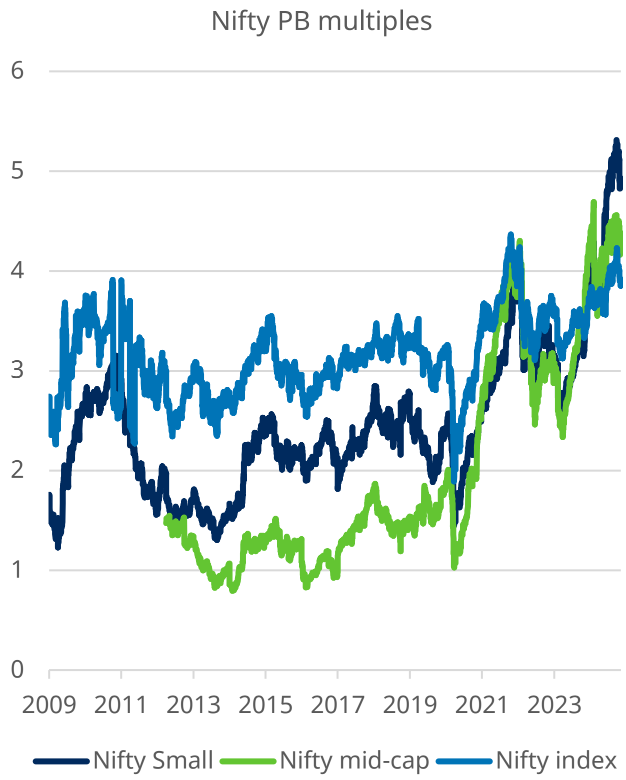
- Stock connect risk: The fund may be investing in China "A" shares via the Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect which may involve clearing and settlement, regulatory, operational and counterparty risks.

- Sustainability risk: The fund has environmental and/or social characteristics. This means it may have limited exposure to some companies, industries or sectors and may forego certain investment opportunities, or dispose of certain holdings, that do not align with its sustainability criteria chosen by the investment manager. The fund may invest in companies that do not reflect the beliefs and values of any particular investor.

STRATEGY REVIEW AND FUND STRATEGY

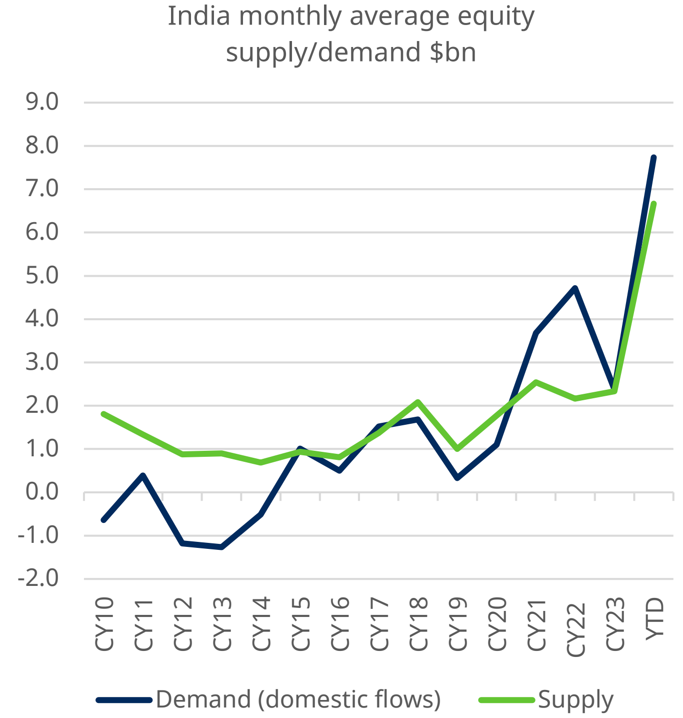
India

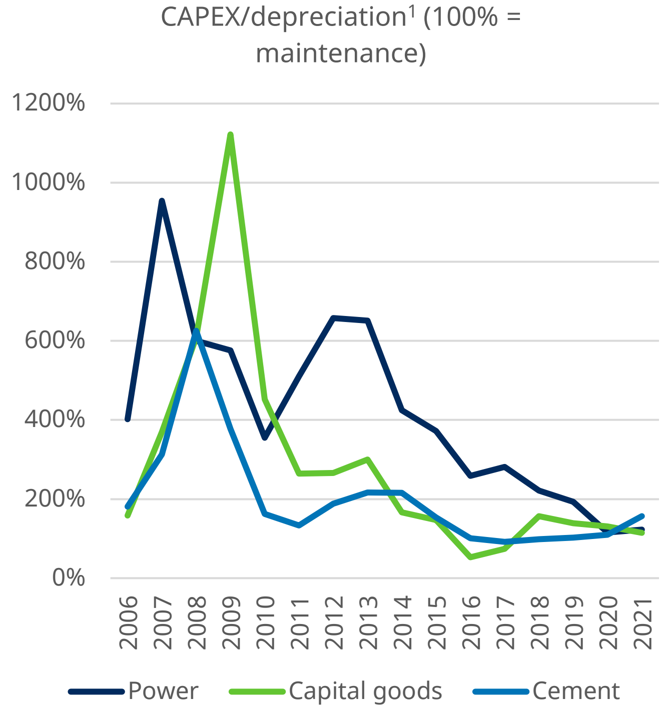
Your fund managers have written a couple of times this year about our concerns on the Indian market, highlighting valuations increasingly diverging from their fundamentals and the stock market overlooking the impacts of fiscal consolidation, demand that in areas is cyclical not structural, and an unsecured credit cycle that is likely to play through. With Q2 fiscal year 2025 (September period-end) starting, we believe our thesis is starting to play through, and the Indian market is likely to de-rate given elevated multiples.



Source: CLSA, IBES, Refinitiv

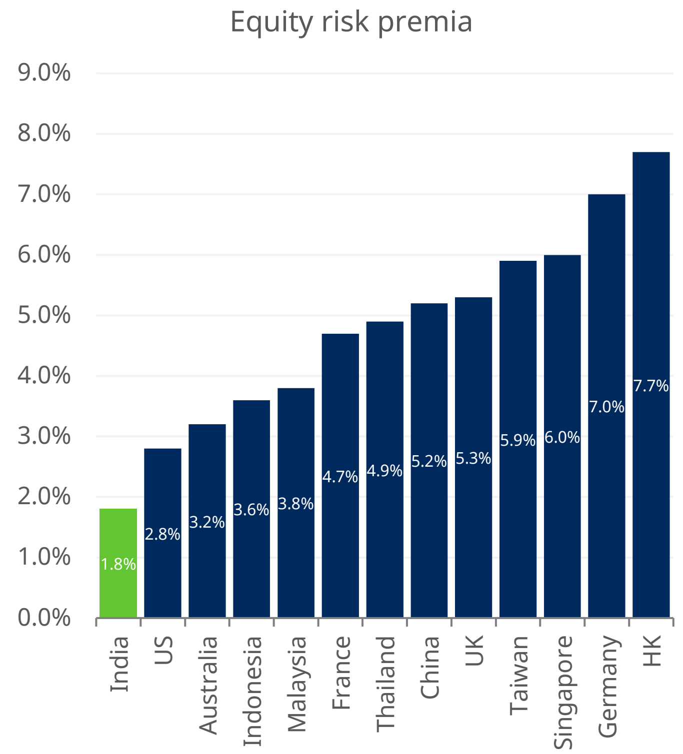
What principally drove the market over the past 5 years has been a constrained supply-side environment that was overwhelmed with resurgent demand. At an aggregate index level, India's equity supply is restricted by large promoter ownership, and the demand-side in recent years has been buoyed by strong retail flows. Similarly, in many asset-heavy industries – real estate, capital goods, utilities, cement, hospitals – there was a significant dearth of investment from 2012-2019 as Indian corporates dealt with the excesses of the 2005-2012 cycle. This has met strong demand in recent years as India reaped the benefits of Modi's economic reforms coupled with strong fiscal stimulus.

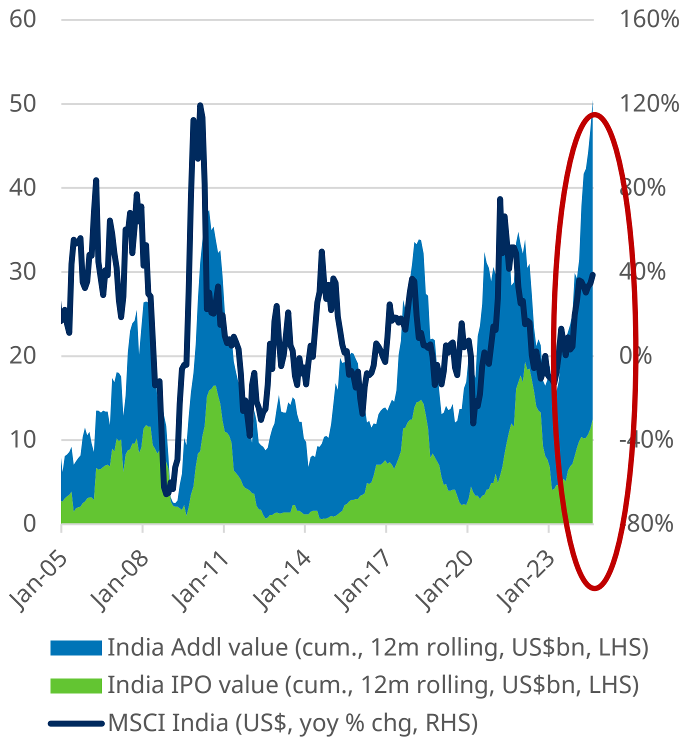




Source: Jefferies; Bloomberg[1]

Demand returning to a constrained supply-side environment led to meaningfully better returns on capital as depressed utilisation rates increased and margins expanded. However, the issue your fund managers have is that significant retail participation in the Indian equity market has pushed valuations to record highs and the implied cost of capital to record lows. As such, equity financing has become too cheap. In a market where return on capital has historically been high due to the scarcity of capital, we are now seeing record equity raising, not a day goes by without a new IPO prospectus or equity raise coming across our desks.

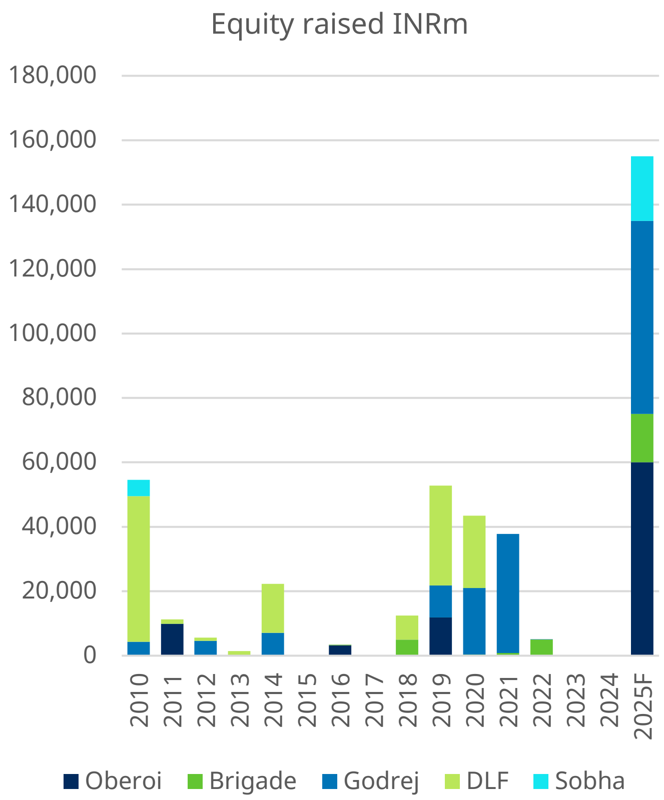


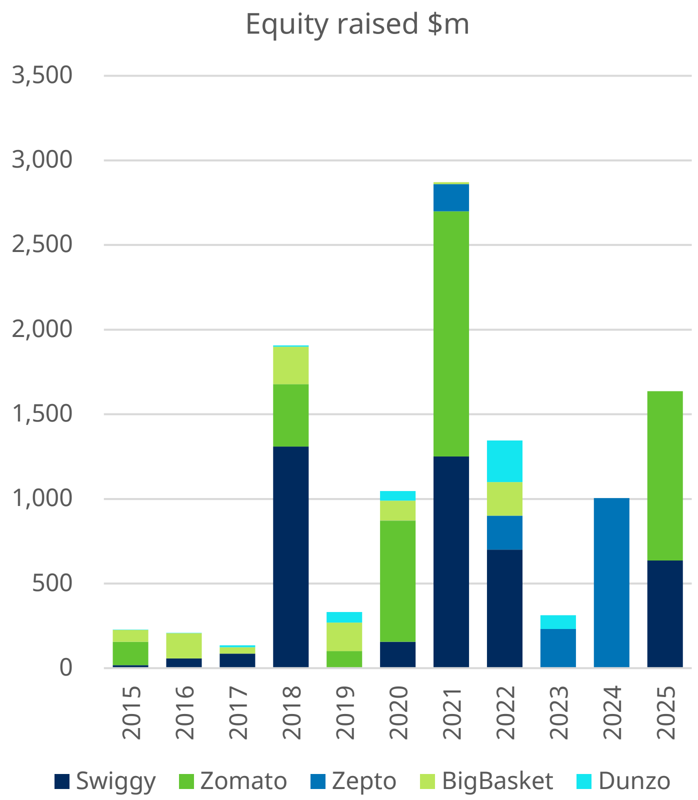


Source: http://www.market-risk-premia.com; CLSA, Bloomberg, MSCI, August 2024

[1] Power = leading four power companies (Torrent Power, Power Grid, NTPC, Tata Power); Capital goods = Titagarh, Voltamp and Transformers & Rectifiers; Cement = Ambuja, UltraTech and ACC Ltd.

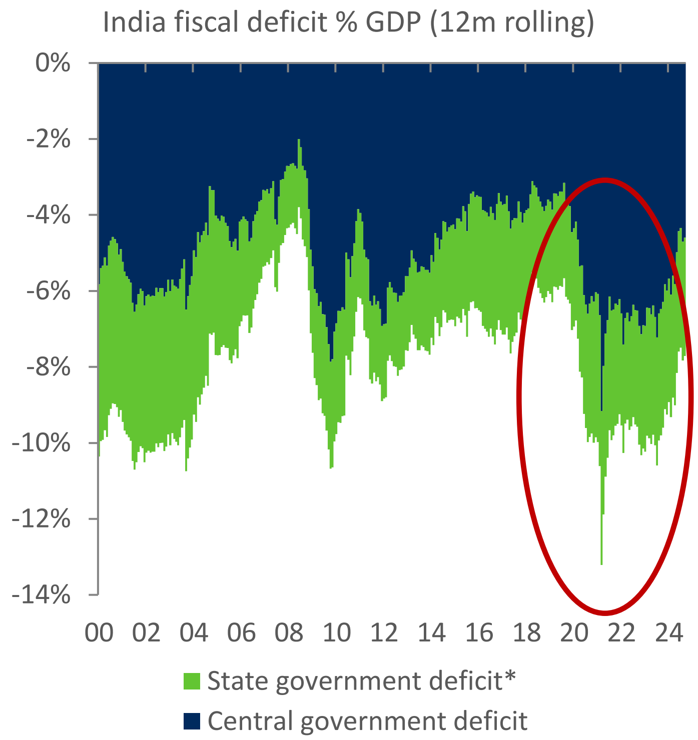
To highlight what this looks like at a micro-level, take for example the property industry or quick commerce industry. Both have excellent outlooks: property is three years through a likely six year upswing, pre-sales remain strong, and affordability remains strong at an aggregate level even if there is some overheating in select micro-markets. But record high valuations have seen many companies raising equity, including Oberoi which has a net cash balance sheet. Quick commerce is no different: the business model has worked in India leveraging lower per unit labour costs, and Blinkit (owned by Zomato) has led the way with very strong growth rates. Again, record high valuations implying fast growth and higher returns have caught the eye of other players in the market, who now are tapping into this cheap finance and going after the large TAM ("total addressable market") in tech speak. Zomato's board has approved a $1bn capital raised on top of $1.2bn existing cash on balance sheet and a food business that is set to generate meaningful free cash flow. Competitors, as shown below, have also recently raised $1.6bn. Naturally, we struggle to see how returns are likely to rise in this market with six to seven well-funded competitors.





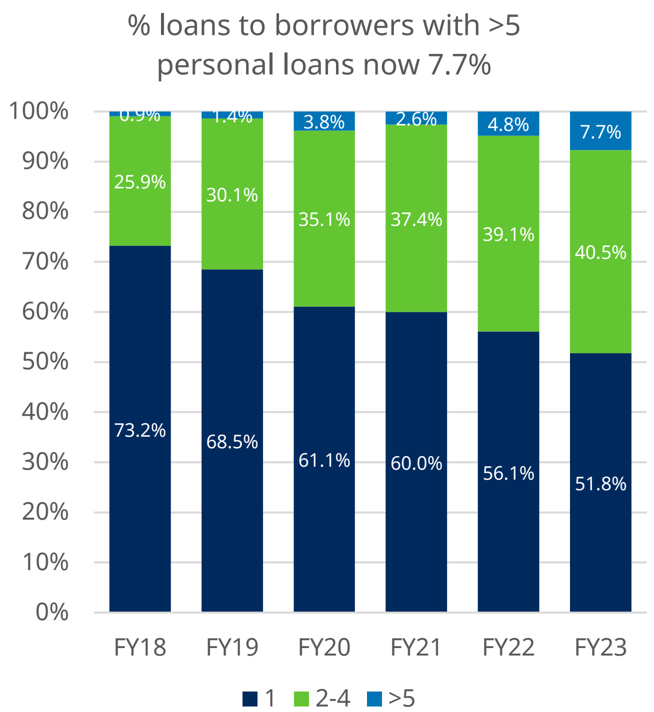
Source: Bloomberg; Goldman Sachs;

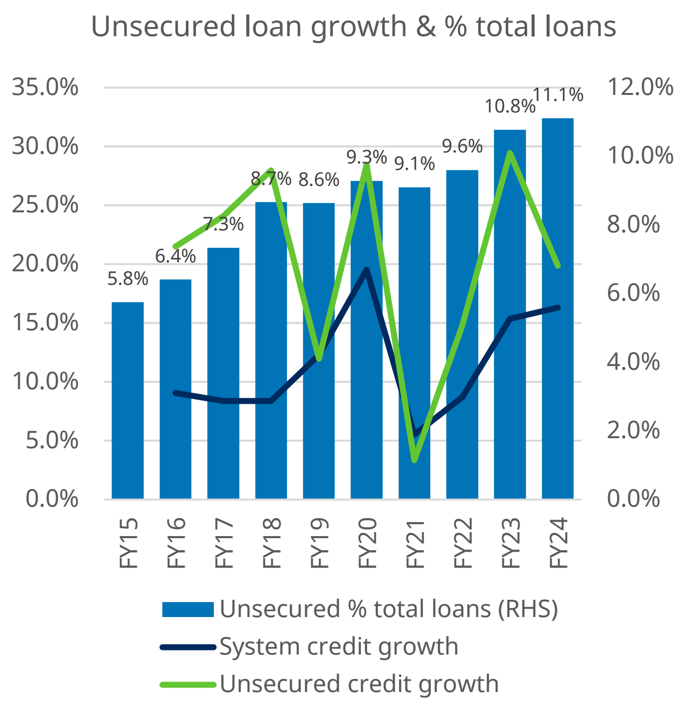
An elevated supply-side response has come at a time when the demand-side is cyclically moderating. System loan growth is normalising as the banking system struggles with higher funding costs after three years of loan growth exceeding deposit growth. As mentioned in the June update, India does not have infinite fiscal headroom. With interest rates at 6.5%, nominal growth slowing, and gross public debt moving above 80%, we are noting fiscal consolidation with the fiscal impulse now negative.



Source: RBI; CEIC; Autonomous

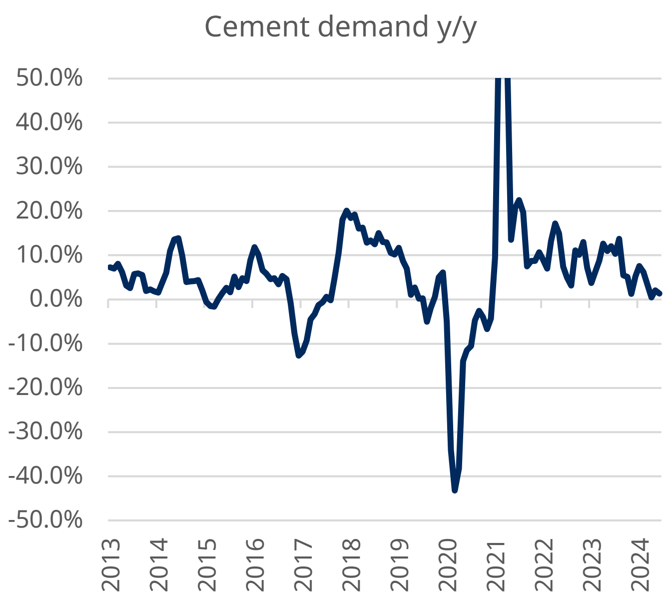
Where we will see even more moderation in loan growth is within unsecured lending where the RBI has rightly cracked down on excessive leverage being taken on by individuals. This reporting season has seen considerable increases in provisions in select banks and NBFCs as India experiences a mini credit cycle from excessive lending into personal loans, credit cards, and microfinance during the good times. Your fund managers would applaud the RBI for being counter-cyclical here and isolating this issue before it spread to other loan categories. We do not think this is systemic.

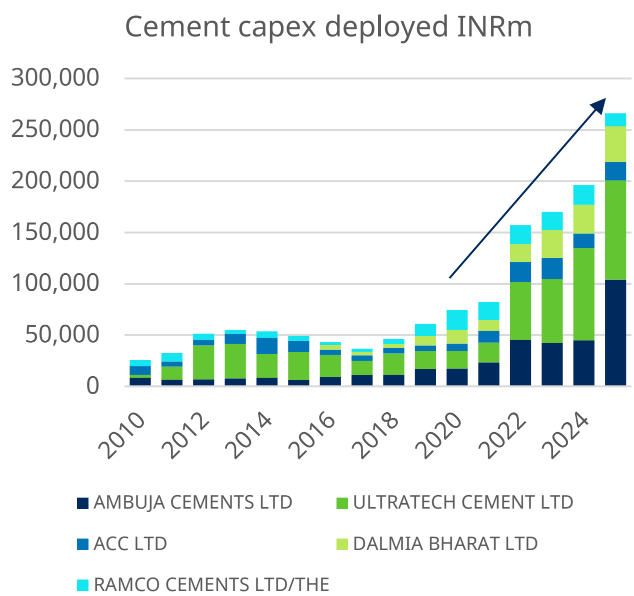




Source: UBS; RBI; CRIF High Mark

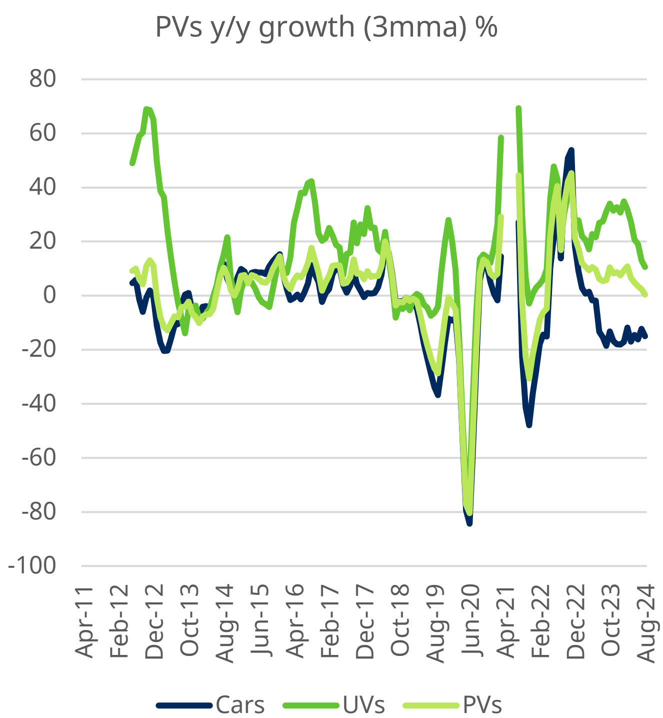
Showing this at an industry level - take the cement industry. Demand is clearly moderating yet the companies in the market have been taken in by 3-years of 10%+ demand. The result has been a significant increase in capital expenditure with more forecast in FY25. To put this further into perspective, companies from 2012-2019 spent capex equal to depreciation – a rough proxy for maintenance capex. Ambuja cement owned by Mr. Adani is now deploying capex 5x higher than depreciation into a clearly weakening macro backdrop. A reduction in gross profit margins and utilisation rates will naturally follow reducing returns.

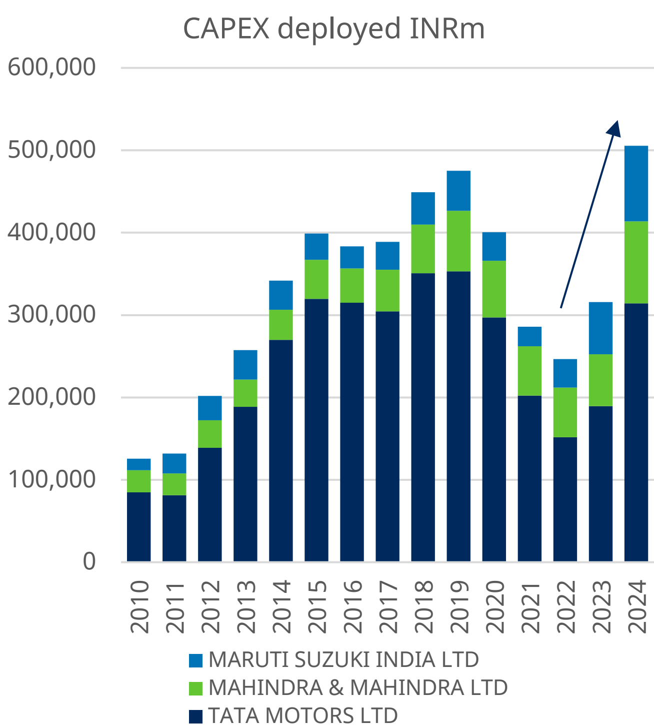




Source: Bloomberg

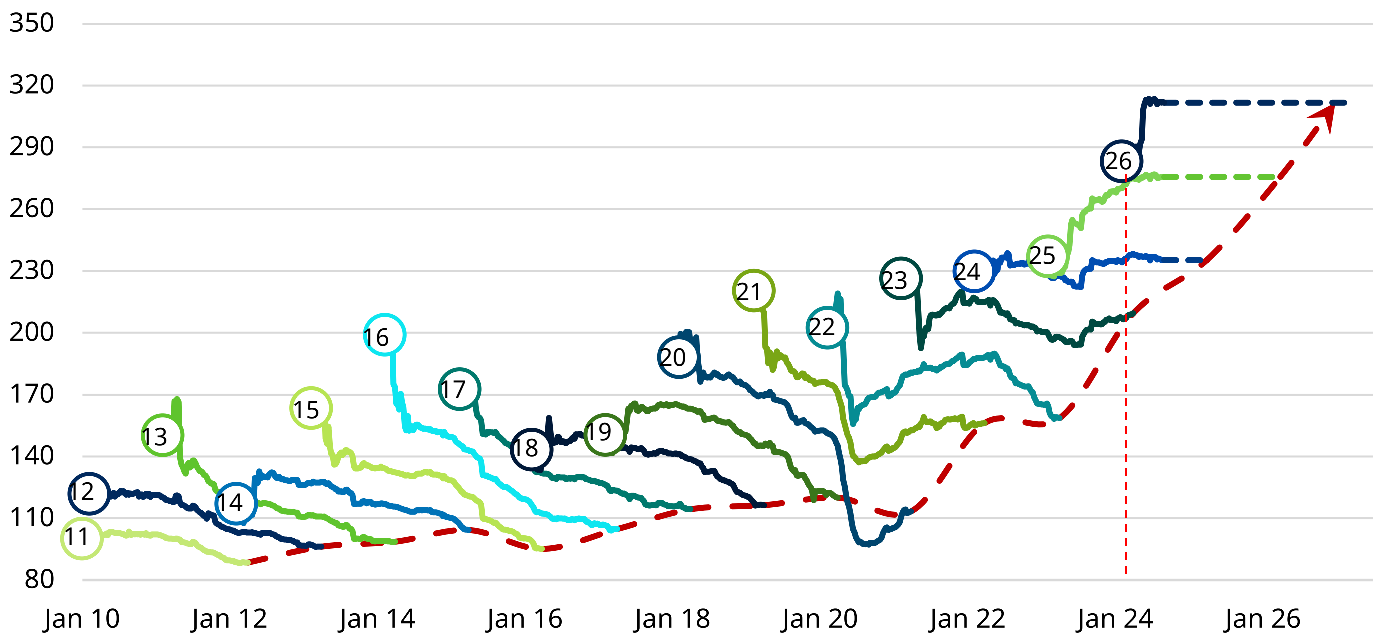
Similarly, in the auto industry, a strong cyclical recovery occurred post-COVID against a constrained supply-side as OEMs hadn't invested during the downturn and faced a scarcity of auto supplies. This constrained supply-side met with strong pent-up demand, and OEMs enjoyed higher utilisation rates, returns, and valuation re-rating. Companies are now at risk of extrapolating this as the new normal: one company we recently met is now guiding to a 40% increase in production over the next 3 years when the industry data suggest to us that a slowdown is occurring.





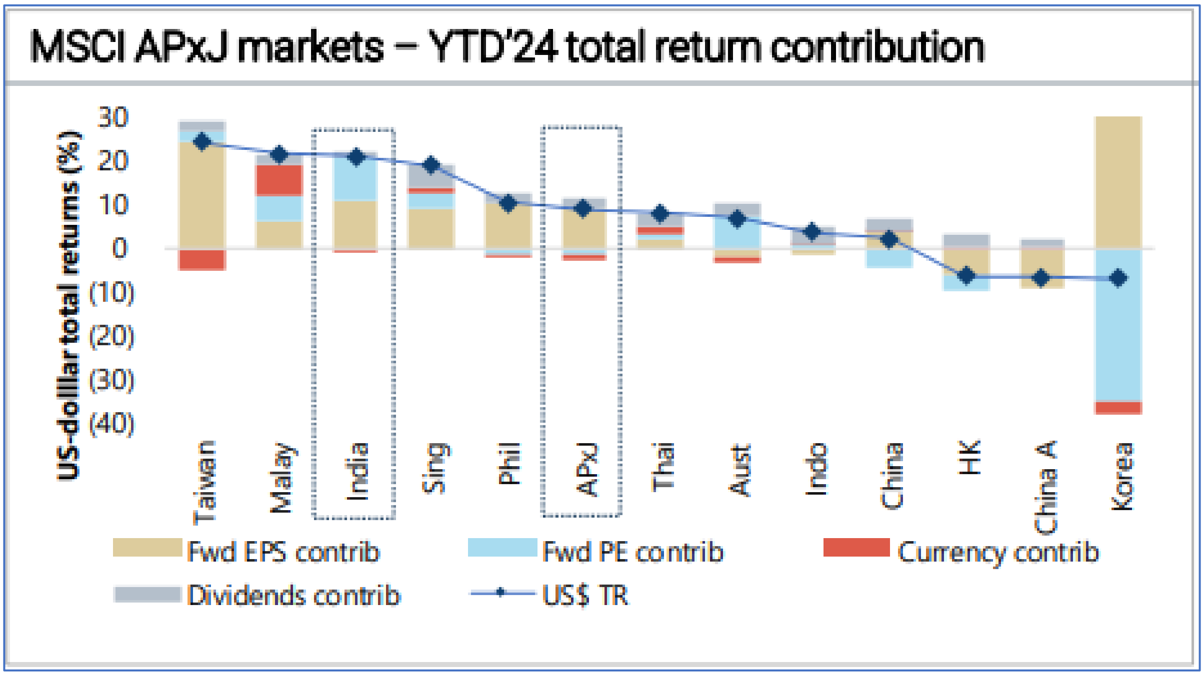
Source: Bloomberg, Jefferies

Deploying more capital into a weakening demand environment will naturally lead to returns coming under pressure. However, your fund managers scratch their heads when we look at IBES consensus estimates that appear heroic and are in need of considerable moderation. We note a number of misses relative to consensus in Q2 2025 (September period-end) and expect this to continue into next year.



Source: CLSA, IBES, August 2024

Indeed, as the Jefferies quant team points out - in a market that has been driven more than any in Asia year-to-date by re-rating (expectations of higher future earnings increases) rather than actual earnings delivery, we naturally feel that there is likely to be a healthy correction in valuations coming.

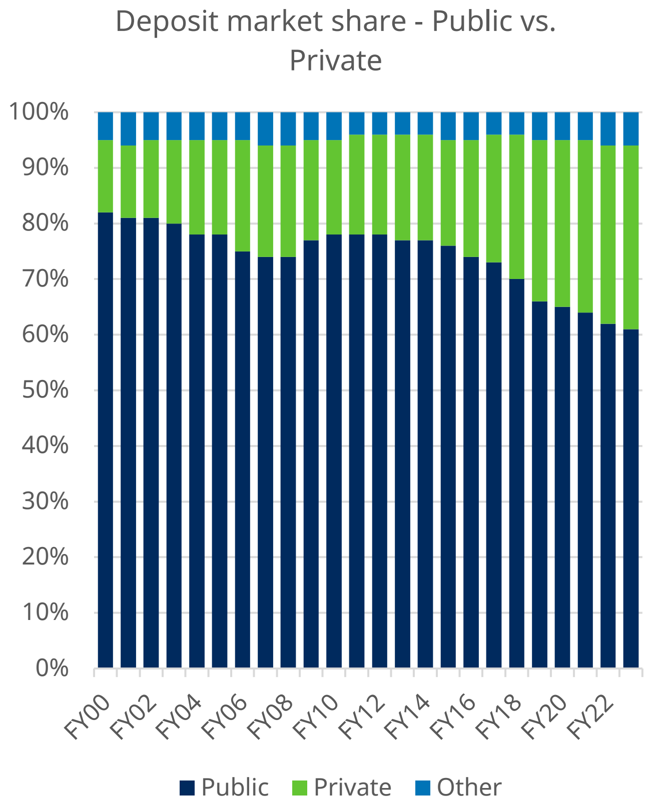


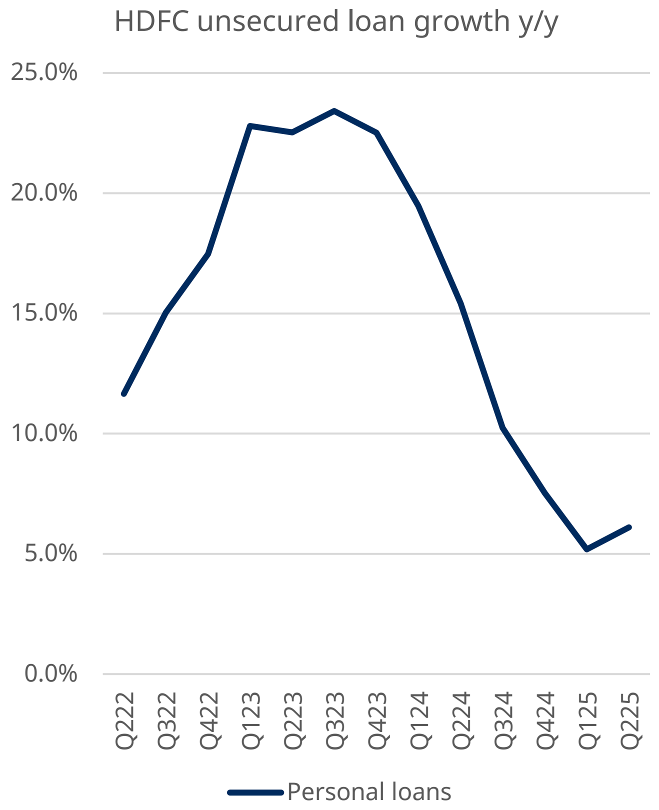
Source: Jefferies, September 2024

Against this backdrop, how are your fund managers positioning their portfolio?

It won't surprise readers to note we currently have only 12% of our portfolio invested in India, relative to an index weighting of 18%.

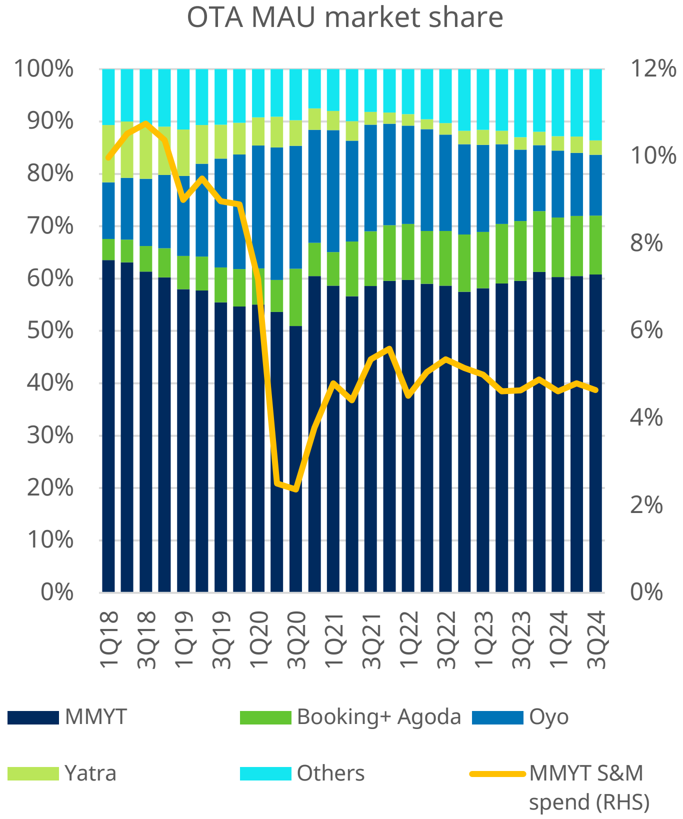
We remain invested in the two biggest Indian banks – HDFC and ICICI – which we don't think have underwritten a lot of the problematic areas and are enjoying much better credit costs this reporting season relative to peers. Nothing has changed in the medium-term picture that private Indian banks are likely to outcompete their state owned enterprise peers for low-cost deposits, enabling them to lend into the economy at high risk-adjusted returns. We'd call out HDFC in particular, which has been significantly ahead of its peers in moderating unsecured loan growth and explaining why it's now our biggest Indian financial overweight.

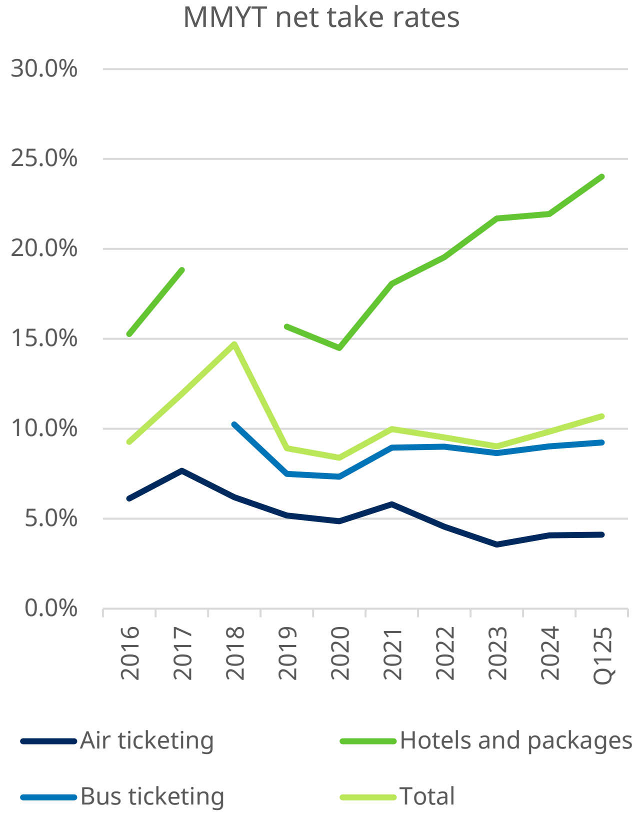




Source: Autonomous; RBI; Company financials

We are also happy to continue investing in areas where returns are high, there remains a dearth of capital raised, and moats around the businesses are strong. Our core belief is that access to capital isn't a durable barrier to entry, rather it's the long-term moat or intellectual property around a company's business model. Take Make My Trip, which spent many years running elevated sales and marketing spend as it consolidated the hotel supply chain onto its platform and transformed into the dominant online travel agent in India. This created a very strong network effect, and when COVID hit, competition further shied away. It has now reduced its incentive spend and is continuing to scale profitability, principally led by higher net take rates from the hotel business.



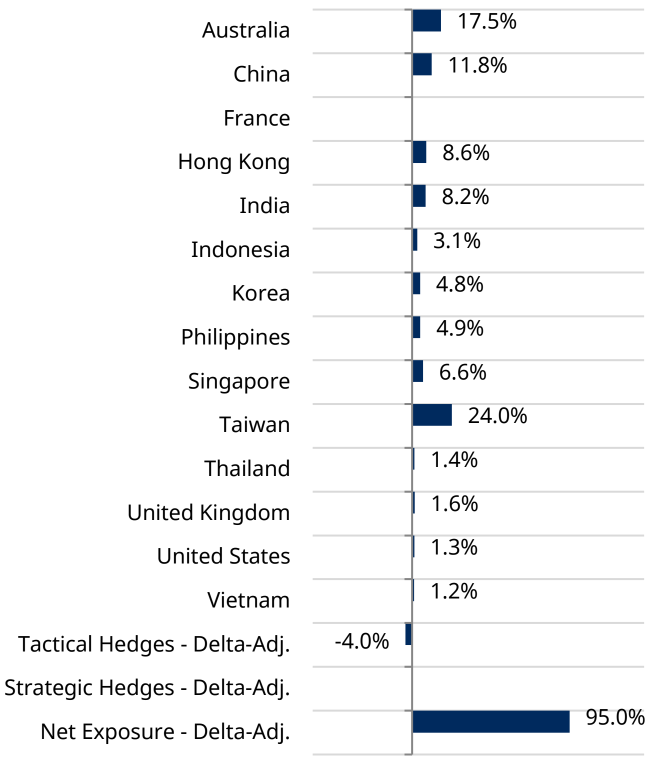


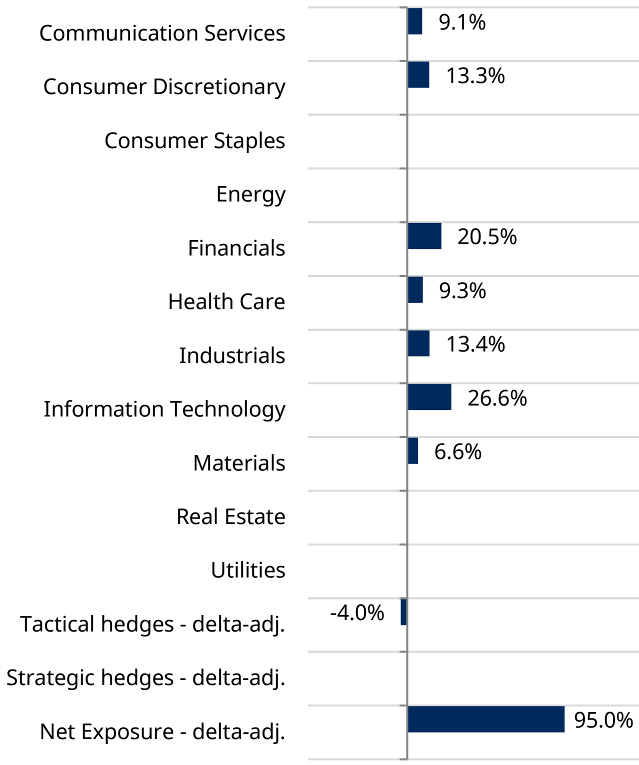
Source: Goldman Sachs

In conclusion, we remain very selective in a market where the supply-side no longer looks constrained and the demand-side is cyclically weakening. We remain of the view that valuations will normalise downwards in India as elevated expectations subside and this, in turn, will increase the cost of equity and stop the flood of capital issuance. Should this occur, there are several Indian equities that we have on our watchlist, which operate in areas where we believe durable high returns of capital are available, and we would be happy to acquire them at sensible multiples.

Tom Clough, Lee King Fuei and Robin Parbrook
7th November 2024

FUND POSITIONING





Source: Schroders, as at end of October 2024.

For illustrative purposes only and does not constitute any recommendation to invest in the above-mentioned countries.

TOP 10 HOLDINGS

Stock	Fund (%)
TSMC	9.9
Tencent	5.3
Mediatek	3.4
Samsung Electronics	3.4
DBS Group	3.3
Bank Mandiri	3.1
HDFC Bank	3.1
AIA	2.8
Resmed	2.4
Aristocrat Leisure	2.3
Total	**39.0**

Source: Schroders, as at end of October 2024.

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