

# Schroder ISF\* European Alpha Absolute Return

Fund Managers: Nick Kissack and Bill Casey | Fund update: May 2024

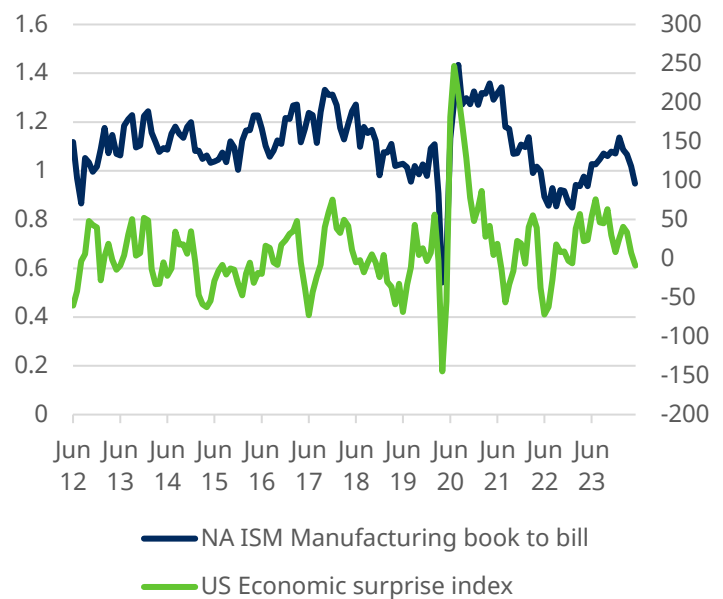
## Performance overview

- Markets recovered somewhat in May after a softer April, as central bankers continued to flip-flop between hawkish and dovish commentary. Significantly high inflation levels are in the rear-view mirror for now, and central banks are cautiously moving towards cutting interest rates in the summer. Liquidity conditions remain relatively loose, which is helping to support asset prices.
- We are seeing weak, albeit modestly improving, leading economic indicators in Europe, but less encouraging signs in the US (see Chart 1) which has been the engine of the global economy in recent years. The two months of positive ISM (Institute for Supply Management) new orders that drove cyclical stocks higher this year have reversed. We wonder whether the US economy is as strong as the market consensus believes, especially now that the anticipated rate cuts earlier in the year are unlikely to materialise in 2024. It is our view that weaker economic conditions will continue to keep a renewed inflation surge under control and probably bring more rate cuts in 2025. High rates will eventually bring down inflation, but probably not before we see a slowdown. We are looking closely at the commercial real estate and private equity markets for signs of real pain from higher-for-longer interest rates. We think 2024 will gradually offer us more insight on this, as the debt refinancing needs will be much higher in 2025/26.
- There is also a significant risk that inflation will climb from here and central banks, particularly the US Federal Reserve, will not be able to cut rates. This would lead to a significant tightening of financial conditions through higher real yields and credit spreads, in our view. Equity and credit markets are currently ignoring this risk and focusing on the hope of economic growth driving an earnings recovery from the second half of 2024. That said, the irony is that rate cuts have been given as the

primary reason for a second-half recovery in many corporate outlook statements.

- The liquidity and positioning metrics that we track are pointing to euphoric or near-euphoric levels for equity and credit markets. We had picked up some signs that liquidity was peaking, at least in the short term. These included a strong dollar, falling prices in liquidity proxies such as Bitcoin and a rise in bond market volatility. However, they have all stabilised recently, suggesting liquidity remains ample.

Chart 1. US economy is slowing



Source: Schroders, Bloomberg as at 31 May 2024

## Drivers of fund performance

- In May, the fund's return was +1.4%, compared to +3.3% for the MSCI Europe Net TR index, and 0.3% for the Euro Short Term Rate. Our average gross and net exposures were 212% and -13.1%. Our long book added 3.3% and our

- short book subtracted 1.8% in gross terms during the month. Cash and forex subtracted 0.02%.
- We have maintained a cautious position with regard to our net exposure, as we are seeing euphoric liquidity and positioning data across a range of metrics.
- We exited the month with a net exposure of -14.3% and a gross of 214%. The fund's volatility is at the lower end of our 5-8% target range, the majority of which is stock-specific risk.

Past performance does not predict future returns. 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	Comparator 1	Comparator 2
2023	-6.3	15.8	3.3
2022	-1.3	-9.5	-0.0
2021	-4.0	25.1	-0.6
2020	6.0	-3.3	-0.4
2019	-7.1	26.0	-0.3%
2018	-6.6	-10.6	-0.4%
2017	1.3	10.2	-0.3%
2016	0.0	2.6	-0.3
2015	8.4	8.2	0.0
2014	-	-	-

Source: Schroders, net of fees, bid-bid, with net income reinvested. EUR C Acc share class as of 31 December 2023. The fund's performance should be assessed against its objective of providing a positive return over a 12-month period in all market conditions and compared against the MSCI Europe (Net TR) index and the Euro Short Term Rate (or an alternative reference rate). The comparator benchmarks are only included for performance comparison purposes and do not determine how the investment manager invests the fund's assets. In relation to the MSCI Europe (Net TR) index, the fund's investment universe is expected to overlap materially, directly, or indirectly, with the components of the comparator benchmark. The investment manager invests on a discretionary basis and there are no restrictions on the extent to which the fund's portfolio and performance may deviate from the MSCI Europe (Net TR) index. The benchmark(s) does/do not take into account the environmental and social characteristics or sustainable objective (as relevant) of the fund. Please see appendix III of the fund's prospectus for further details.

### Top stock contributors:

- **Future**, a digital media business, was a very strong contributor in May. This followed a

robust set of results which helped to dispel fears that changes to the Google search algorithm and threats from AI searches will impact web visits and advertising revenues. The company was trading at a very depressed valuation for a business with such strong margins and cashflow generation. Despite the recent rally in the shares, this continues to be the case.

- **Berkeley Group**, the London-based housebuilder, was a strong performer, due to an improvement in housing indicators related to demand and pricing. A rapid fall in UK inflation in April has encouraged the belief that the Bank of England will begin cutting rates this summer. Berkeley is one of the few builders with the scale and resources in London to navigate the difficult planning and regulatory regime that has led to a dramatic decline in new building in the city. This drop has pushed up rental prices and helped to stem the nine-year real price decline in London property.
- Shares in **Veolia**, the water, waste and energy solutions provider, bounced strongly in May on the back of impressive results. These demonstrated a strong operating performance, featuring growth in its key water technology and hazardous waste management divisions.
- **A short position in a chemicals distribution and logistics provider** benefited the fund's returns in the month. This company continues to manage its profitability guidance downwards, following three years of over-earning after the global pandemic and energy crises. It had boosted its margins and pricing well beyond historic peak levels, taking advantage of its global sourcing at a time when European chemical manufacturers had shut capacity due to high energy costs. Its mid-term guidance was set during this period of supernormal profits, and has had to be ratcheted down, bit by bit, ever since.

### Top stock detractors:

- **Entain**, a global sports betting and iGaming business, detracted in May following a tax hike proposal from the State of Illinois in the US. While it did not particularly impact Entain itself, the narrative has been that other US states could begin to raise gaming taxes. Aside from this, monthly data in the US (the key growth market for the group) is seeing some improving trends in market share for the

company after its recent product upgrades.

- **Just Eat** detracted, despite stable earnings expectations and an expansion of its Amazon partnership in the US with Grubhub. The stock has a high sensitivity to interest-rate cut expectations and consumer confidence, which eased in May.
- Shares in **Hiscox** weighed on returns, giving back some of their strong prior performance. In early May, results were reasonably strong, but a resetting of its broker channel in the US is taking a little longer than hoped, a small blemish on otherwise stellar results.
- **A short position in a hearing-aid manufacturer** detracted in the month as the stock was squeezed on results that were broadly in line. The company confirmed its guidance in what has been a weak hearing-aid market, offering some short-term relief.

## Outlook/Positioning

- Inflation and expectations of interest-rate cuts moderated in the first five months of 2024.

Global disruption has not fully disappeared, but monetary stimulus to the real economy has lessened meaningfully, which is leading to a moderation in aggregate demand. Whether this results in a global recession depends on: 1) The incremental fiscal stimulus from governments (especially in the US and China), and 2) The eventual impact of much higher rates during 2022-24 on the real economy as businesses and households refinance debt.

- We started 2024 with tight credit spreads, very low volatility in the equity market and expectations for good earnings growth. In our view, this is at odds with what many leading indicators are signalling, including the bond market. Additionally, we have almost two-thirds (in GDP terms) of the democratic world facing, or having faced, general elections this year, which will no doubt keep things lively.
- We believe negative real interest rates and real money supply growth are key ingredients for positive equity performance in the medium term and await their return before we become much more constructive on the market.

## Risk considerations

**Concentration risk:** The fund may be concentrated in a limited number of geographical regions, industry sectors, markets and/or individual positions. This may result in large changes in the value of the fund, both up or down.

**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:** The fund may lose value as a result of movements in foreign exchange rates.

**Currency risk / hedged shareclass:** 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.

**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.

**Issuer risk:** The fund is permitted to invest more than 35% of its scheme property in transferable securities and money market instruments issued or guaranteed by an EEA State / governments of the following country: France.

**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.

**No capital guarantee risk:** Positive returns are not guaranteed, and no form of capital protection applies.

**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.

**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.

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