

Schroder ISF* European Alpha Absolute Return

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

Performance overview

- European equity markets continued to drift upwards in March, driven by positive liquidity conditions and a surprisingly dovish US Federal Reserve (Fed) meeting.
- While inflation has remained benign, the recent increases in oil prices and global purchasing managers' index data are driving bond yields and one-year inflation expectations higher, particularly in the US. The swap market is now pricing in one-year US inflation above 4%, compared with the Fed's target of 2%. Fed fund futures are currently predicting fewer rate cuts than the three that the central bank has suggested are likely for this year. The message the market has taken from recent Fed meetings is that the 2% inflation target has been pushed out to make way for economic growth in an election year. For now, this is driving risk asset prices – such as gold, bitcoin and equities – higher. There is a significant risk that, in a world where inflation begins to reaccelerate, central banks, particularly the Fed, will not be able to cut rates. This could lead, in our view, to a significant tightening of financial conditions through real yields and credit spreads.
- Equity and credit markets are ignoring this risk and focusing on hopes of economic growth driving an earnings recovery from the second half of 2024. European markets' aggregate 2024 earnings estimates have continued to be cut in the past few months. Since the October lows, equity and credit markets have been driven higher almost entirely by a re-rating in multiples and spreads to levels historically deemed as expensive or tight. Loose financial conditions have encouraged this, allowing animal spirits to gather momentum.
- One measure of equity risk premium, the earnings yield relative to global bond yields (See Chart 1), hit a 20-year low in recent days. This signals the global equity market is pricing in positive global growth momentum and

expects multiple interest-rate cuts in the coming years. This stance is now more vulnerable than at any time in the past few years to inflation coming in higher than expected; that is, if central banks are serious about their inflation mandates. If they are not, that is another debate. Ballooning fiscal deficits, ongoing wars involving petrostates, and de-globalisation are increasing risks.

- Liquidity and positioning metrics that we track are pointing to euphoric, or near-euphoric, levels for both equity and credit markets.

Chart 1. Global equity earnings yield relative to Government bond yield - lowest risk premium since 2003.



Source: Schroders, Bloomberg as at 31 March 2024.

Drivers of fund performance

- In March, the fund's net return was 0.1%, compared to 3.9% for the MSCI Europe Net TR index, and 0.3% for the Euro Short Term Rate. Our average gross and net exposures were 205% and -14.2%. Our long book added 3.0% and our short book subtracted -3.1% in gross terms during the month. Cash and forex added 0.2%.
- 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. The fund generated alpha in the month, which was partially offset by a negative beta contribution.
- Our positioning had been contrarian in 2023,

with a tilt towards China and away from the US. This has been a drag on performance since the summer as the Chinese consumer / economy has recovered more slowly coming out of the pandemic, and the US consumer has remained resilient. We have narrowed this positioning gap in the fund.

- We exited the month with a net exposure of -17.5% and a gross of 208%. The fund's volatility is at the lower end of our 5-8% target range, the majority of which is stock-specific risk.

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.

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.

Top stock contributors:

- **DS Smith**, the paper and packaging firm, had a positive month after rival Mondi agreed an all-share offer for an implied 373p acquisition price. However, we have subsequently seen another rival, International Paper, signal its intentions with an indicative all-share offer for DS Smith of 415p. This has brought about the possibility of a bidding war for one of the largest remaining assets in the global paper and packaging market. April is a key month as both Mondi and International Paper have deadlines to submit final bids for the business.
- **Zalando**, the online apparel platform, performed well, driven by full-year results that saw it exceed adjusted EBIT forecasts for 2023 and revise higher its targets for growth through to 2028. In addition, its core German market showed signs of recent improvement, giving the market comfort about the company's ability to capture growth as consumer demand recovers.
- **Next**, the UK-based fashion retailer contributed positively after its full-year results beat estimates and the company's management maintained its guidance for 2025. This was supported by the positive mood of CEO Simon Wolfson, who commented on a consumer environment that seems more benign than it has been in several years.
- **Hiscox**, a Lloyd's of London insurer, had another strong month in March as recent results showed the business continues to trade very well.

Top stock detractors:

- **Entain**, the global sports betting and iGaming platform, contributed negatively. While 2023 earnings were solid and 2024 year-to-date trading was in line with expectations, management flagged a potential £40 million hit to 2024 EBITDA from regulatory changes in the UK and the Netherlands. Its key US joint venture is making good progress at stabilising market share and it is on track to generate \$500 million in EBITDA in 2026. The new interim CEO, Stella David, has begun making positive changes to group operations and signalled her confidence in prospects with further share purchases.
- **A short position in a European investment**

bank produced a negative contribution as the CEO made positive comments at an industry conference on cost targets and investment banking revenues for the year to date. The sector continues to outperform as soft-landing expectations for the global economy have become the base case. Additionally, expectations for the European Central Bank's (ECB) first rate reduction remain settled on June, with nearly 100 basis points of cuts priced in by year-end.

- **A short position in a European fashion retailer** detracted in the month, following reasonable trading results year to date. The shares gave back some of this move in early April.
- **A short position in a UK-based investment bank** was a negative contributor as its strategic update was well received. The update mentioned a strong improvement in revenues and return on equity and a commitment to large capital returns over the next few years.

In terms of revenues, the plan relies on driving strong investment banking revenue growth, while reducing risk-weighted assets in the segment – a tough task, in our view. In addition, and in a similar fashion to the ECB, the markets are pricing in the first Bank of England rate cut between June and August, with several more to follow into 2025.

Outlook/Positioning

- Inflation and interest-rate expectations moderated in the first few months of 2024.
- Global disruption has not fully gone away, but monetary stimulus to the real economy has lessened meaningfully, which is leading to moderating aggregate demand. Whether this leads to 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 over 2022-24 on the real economy as businesses and households refinance their debt.
- We have started the year 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. We then have almost two-thirds (in GDP terms) of the democratic world heading for general elections in 2024, 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 mid-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.

Important Information: Marketing material for professional clients only. This document does not constitute an offer to anyone, or a solicitation by anyone, to subscribe for shares of Schroder International Selection Fund (the "Company"). Nothing in this document should be construed as advice and is therefore not a recommendation to buy or sell shares. An investment in the Company entails risks, which are fully described in the prospectus. Subscriptions for shares of the Company can only be made on the basis of its latest Key Investor Information Document and prospectus, together with the latest audited annual report (and subsequent unaudited semi-annual report, if published), copies of which can be obtained, free of charge, from Schroder Investment Management (Europe) S.A. Schroders may decide to cease the distribution of any fund(s) in any EEA country at any time but we will publish our intention to do so on our website, in line with applicable regulatory requirements. For Luxembourg, these documents may be obtained in English, free of charge, from the following link: www.eifs.lu/schroders. For the UK, these documents may be obtained in English, free of charge, from the following link: www.eifs.lu/schroders. This fund does not have the objective of sustainable investment or binding environmental or social characteristics as defined by Regulation (EU) 2019/2088 on Sustainability-related Disclosures in the Financial Services Sector (the "SFDR"). Any references to the integration of sustainability considerations are made in relation to the processes of the investment manager or the Schroders Group and are not specific to the fund. Any reference to sectors/countries/stocks/securities are for illustrative purposes only and not a recommendation to buy or sell any financial instrument/securities or adopt any investment strategy. 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 amounts originally invested. Exchange rate changes may cause the value of investments to fall as well as rise. The views and opinions contained herein are those of the individuals to whom they are attributed and may not necessarily represent views expressed or reflected in other Schroders communications, strategies, or funds. Information herein is believed to be reliable but Schroders does not warrant its completeness or accuracy. Schroders will be a data controller in respect of your personal data. For information on how Schroders might process your personal data, please view our Privacy Policy available at www.schroders.com/en/privacy-policy/ or on request should you not have access to this webpage. A summary of investor rights may be obtained from <https://www.schroders.com/en/lu/professional-investor/footer/complaints-handling/> For your security, communications may be recorded or monitored. Issued by Schroder Investment Management (Europe) S.A., rue Höhenhof, L-1736 Senningerberg, Luxembourg. Registration No B 37.799. Distributed in the UK by Schroder Investment Management Ltd, 1 London Wall Place, London EC2Y 5AU. Registration No 1893220 England. Authorised and regulated by the Financial Conduct Authority. Information for Switzerland: Schroder Investment Management (Switzerland) AG is the Swiss representative («Swiss Representative») and Schroder & Co Bank AG is the paying agent in Switzerland of the Luxembourg domiciled Schroder International Selection Fund. The prospectus for Switzerland, the key information documents, the articles of association and the annual and semi-annual reports may be obtained free of charge from the Swiss Representative.