

Schroder ISF* Strategic Credit

Fund Manager: Peter Harvey | Fund update: June 2024

Market overview

- Although credit markets generated positive returns, the performance of corporates lagged government bonds, with spreads widening across the board. European bond markets particularly were unsettled by the announcement of elections in France. Amongst European high yield bonds, credit spreads widened, apart from the interest rate sensitive real estate sector which saw a further significant compression. In the US market, spreads widened across most sectors, although there was further compression amongst autos, consumer, leisure and retail issuers. Overall, high yield markets outperformed investment grade credit in June.
- June was generally a positive month for government bond markets. With only a few exceptions, bond yields fell as concerns about inflation lessened slightly. US Treasury yields fell across the curve on anticipation that the Federal Reserve (Fed) would still cut interest rates this year, following a series of generally weaker economic indicators. However, the Fed struck a more hawkish tone while keeping interest rates on hold. The accompanying revised forecasts suggested just one rate cut over the rest of 2024.
- As expected, the European Central Bank (ECB) announced a 25bp cut in the deposit rate - the first since 2019. The major market-moving event was around political developments in France, where government bond yields rose over the month after President Macron unexpectedly called parliamentary elections. The first round of voting at the end of June highlighted strong support for the hard right National Rally (RN). Additionally, the formation of a left-wing alliance generated greater political uncertainty, and also highlighted concerns about France's already unstable fiscal position.

Drivers of fund performance

- Fund performance was positive and outperformed the benchmark during the month of June.
- Allocations in the financial services, energy and media sectors was additive.
- Within financial services, our allocation to high quality banks contributed positively as they continue to benefit from the higher interest rate environment.
- In the media sector, our holding in a German cable TV and internet provider performed well following an encouraging trading update.
- Elsewhere our allocation healthcare, namely a large US pharmaceutical company also contributed positively as the sector continued to see credit spreads tighten particularly in the high yield segment.
- Allocations in the real estate sector detracted. Our holding in a French property services group weakened on negative market sentiment in credit following the announcement of parliamentary elections. However, we consider that the business is in a favourable position to weather challenging conditions with strong recurring revenues.

Portfolio activity

- The portfolio remains well diversified with our main sector exposures remaining as healthcare, automotives, senior banking, and financial services.
- We continued to add to our investment grade allocation in the fund as valuations look attractive. As such, we continued to reduce exposure to BB-rated issues during June, as credit spreads in this segment of the high yield market are now very tight historically on a 10-year view.

- We also participated in the new issue of one of Europe's largest radiator companies which also have a growing business in underfloor heating and heat exchangers. This issue came to market with a very attractive yield premium.
- We also established a position in a European provider of packaging products, including capping systems and aluminium metal covers for the beverages industry.

Outlook/Positioning

- Looking at the outlook for credit markets, the macroeconomic backdrop is supportive, with recent data showing ongoing resilience in the US and a gradual cyclical pickup across Europe. We are encouraged by the latest signs of disinflation, with the increased likelihood of a 'soft landing', but we expect the path back to central banks' inflation targets will be slow and uneven, with service sector prices in particular remaining sticky.
- Bond markets continue to be driven by evolving expectations over the possible timing of interest rate cuts. The start of an easing cycle is an important juncture, both for sentiment and market direction. There are a growing number of central banks that are now cutting interest rates, even though the pace of easing is slower than widely anticipated at the beginning of the year.
- Nevertheless, the 'soft landing' outlook is already well-priced across many sectors of the bond market, so we are mindful that valuations are already stretched. Accordingly, we have become more cautious on the near-term prospects for credit markets over the summer months.
- In the high yield sector, BB-rated issues particularly are trading at expensive valuations relative to history, with B-rated issues in contrast offering more investment opportunities from a risk/return perspective. In Europe in particular, debt refinancing is progressing at a pace which continues to run ahead of maturity schedules, presenting several opportunities to participate in new issues on attractive yields. We remain particularly mindful of credit risk amongst CCC-rated issues and exposure to this segment of the high yield market is likely to be kept at low levels. As a buffer against near-term market volatility, we continue to hold a proportion of the portfolio in off-benchmark exposure to investment grade bonds, focusing mainly on BBB-rated corporate issues.

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 (%)

	C Acc	Target
2023	11.3	2.8
2022	-7.7	1.3
2021	3.7	0.0
2020	3.8	0.3
2019	8.8	0.8
2018	-1.8	0.7
2017	4.3	0.4
2016	5.9	0.5
2015	3.4	0.6
2014	3.0	0.6
2013	4.7	0.5

Source: Schroders, as at 31/12/2023. All performance net of fees (where applicable), NAV to NAV (bid to bid), GBP returns. Target : ICE BofA Sterling 3-Month Government Bill Index.

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.

Contingent convertible bonds: The fund may invest in contingent convertible bonds. If the financial strength of the issuer of a contingent convertible bond falls in a prescribed way, the value of the bond may fall

significantly and, in the worst case, may result in losses to the fund.

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.

Credit risk: A decline in the financial health of an issuer could cause the value of its bonds to fall or become worthless.

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

Derivatives risk – efficient portfolio management and investment purposes: 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.

Event risk: The fund will take significant positions on companies involved in mergers, acquisitions, reorganisations and other corporate events. These may not turn out as expected and may result in losses to the fund.

High yield bond risk: High yield bonds (normally lower rated or unrated) generally carry greater market, credit and liquidity risk.

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.

Interest rate risk: The fund may lose value as a direct result of interest rate changes.

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.

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.

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