

Schroder ISF* EURO Credit Conviction

Fund Manager: Patrick Vogel | Fund update: June 2024

Performance overview

- June was generally a positive month for global bond markets. With only a few exceptions, government bond yields fell over the month as concerns about inflation lessened slightly. US Treasury yields fell across the curve on anticipation that the Federal Reserve (Fed) would still cut rates this year, following a series of generally weaker economic data. The latest release of the Consumer Price Index (CPI) showed a marked improvement. However the Fed struck a more hawkish tone while keeping rates on hold. The accompanying revised forecasts suggested just one cut over the rest of 2024, scaled back from three cuts that were anticipated back in March.
- As expected, the European Central Bank (ECB) announced a 25bp cut in the deposit rate - the first since 2019. The accompanying statement and upgrade to inflation forecasts were construed by the market as relatively hawkish. However, 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 was dominated by the hard right National Rally (RN). The formation of a left-wing alliance generated greater uncertainty, not only about the outcome of the parliamentary elections, but also concerns about France's already unstable fiscal position.
- Spreads on European investment grade corporate bonds widened over the month following the announcement of elections in France. After the initial rise in spreads, there was some buying on weakness with higher beta sectors of the market surprisingly resilient.
- The 10-year US Treasury yield declined from 4.50% to 4.41% at the end of the month. The German 10-year bund yield fell from 2.65% to 2.49%. In contrast, equivalent French yields rose from 3.15% to 3.29%, while fiscal concerns also impacted in Italy, where the 10-year government bond yield rose from 3.99% to 4.06%.

Drivers of fund performance

- The fund underperformed the Markit iBoxx BBB Euro Corporate Index during June.

- The main factor that detracted from performance was the relatively long spread duration of the portfolio in comparison with the benchmark, as credit spreads widened over the month.
- Security selection in healthcare and services also detracted.
- In the services sector, our holding in a global testing company weakened on concerns over its accounting policies. Our holding in a leading auction house also detracted on continuing ownership concerns.
- A large underweight position in French banks was additive.
- Security selection amongst senior banking issues and in telecommunications was also positive for relative returns.

Portfolio activity

- Ahead of the French elections, and further anticipated market volatility, we reduced our high beta banking exposure which had performed very well over the first half of the year. We took profits on several holdings in Spanish and Italian Tier 2 issues.
- Moreover, we have been underweight in French credit exposure for a while even before the unexpected announcement of the elections in France.
- More broadly however, we did participate in new issues from French companies after the bond market sell-off, capitalising on attractive yield premiums. These comprised a new tranche of bonds from a utility group, and a Tier 2 issue from the leasing unit of a leading autos manufacturer.
- As the month progressed, we acquired holdings in new issues from several Eastern European banks. These issues provide significant carry and solid credit fundamentals. Accordingly, the allocation to emerging market investment grade credit rose over the month, although we consider these holdings are more comparable with the broader European banking sector.
- Amongst utilities, we added a new position in an Italian renewable energy provider. A substantial proportion of group revenues are derived from power purchase agreements, providing stable cash flows and ensuring low revenue volatility. The issue

was also priced at an attractive yield premium in comparison with peers.

- In the services sector, we added to holdings in both senior and hybrid securities issued by a global testing company, as we considered that concerns over its accounting policies were unfounded.

Outlook

- Looking at the outlook for European credit markets, the macroeconomic backdrop is supportive with Eurozone growth on a gradually improving trajectory while the corporate sector is in a healthier financial shape. Nevertheless, we have become more cautious on the near-term prospects for credit given both the speed and the extent of spread compression, with the European investment grade market now trading at its tightest level since 2021.
- We have seen peak tightness of financial conditions and the European Central Bank is expected to loosen its monetary policy, however less than expected at the beginning of the year.
- After delivering its first interest rate cut in June, we concur with market expectations for only two further rate cuts from the ECB over the second half of this year as services sector inflation remains sticky.
- The technical backdrop for the market remains favourable, with inflows into investment grade credit funds continuing while the pipeline of new issues is slowing. With supply front-end loaded this year, our expectation is that the second half of 2024 will be much quieter in the primary market.

- Going forward a combination of positive carry and idiosyncratic opportunities should underpin total returns from the European investment grade market.

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 (%)

| | A Acc | I Acc | Target** |
|------|-------|-------|----------|
| 2023 | 10.6 | 12.0 | 9.0 |
| 2022 | -16.7 | -15.7 | -14.8 |
| 2021 | -1.1 | 0.2 | -0.6 |
| 2020 | 4.8 | 6.1 | 3.0 |
| 2019 | 9.8 | 11.1 | 7.7 |
| 2018 | -3.6 | -2.4 | -2.0 |
| 2017 | 6.2 | 7.5 | 3.4 |
| 2016 | 6.8 | 8.1 | 5.4 |
| 2015 | 1.5 | 2.8 | -0.9 |
| 2014 | 9.1 | 10.5 | 8.0 |

Source: Schroders as at 31/12/2023 net of fees (where applicable), NAV to NAV (bid to bid), EUR. **iBoxx EUR Corp BBB. The fund's performance should be assessed against its target of exceeding the iBoxx EUR Corporates BBB (TR) index. The fund's investment universe is expected to overlap to a limited extent with the components of the target benchmark.

Risk considerations

- **ABS and MBS risk:** The fund may invest in mortgage or asset-backed securities. The underlying borrowers of these securities may not be able to pay back the full amount that they owe, which may result in losses to the fund.
- **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.
- **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.
- **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.
- **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. Therefore, the fund may underperform other funds that do not apply similar criteria. The fund may invest in companies that do not reflect the beliefs and values of any particular investor.

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