

# Schroder ISF\* Global Convertible Bond

Fund Managers: Dr. Peter Reinmuth & Chris Richards | Fund update: June 2024

## Performance overview

- Global stock markets resumed their upward trend in June. The overall market breadth remained low and once more it was down to a few stocks to drive the positive performance.
- The European Central Bank (ECB) cut interest rates despite sticky inflationary pressure. And they were not the only central bank to do so. Canada, the Czech Republic, Denmark, Hungary, and Switzerland all cut rates in June.
- Most of the rate moves were well telegraphed to market participants and did not come as a surprise.
- Oil was up in June which could signal inflationary pressure. However, base metals such as aluminium or nickel cheapened in June. Gold showed some volatility but closed the month above USD 2,300 again.
- The Vix which measures volatility continues to show a calm reading of under 14%. This is still low on a historic level and shows a degree of complacency.
- In the US, the Nasdaq and the S&P 500 advanced a strong 6% and 3.6%, respectively. Once more, few heavyweight stocks drove these equity benchmarks higher. The broader Dow Jones gained a mere 1.2%.
- European markets were dragged down by the upcoming French elections. The Eurostoxx was down -1.7% in June, the French CAC fell by a full -6.2%.
- Still, June turned out to be a negative month for most of the other European bourses. Germany's Dax noted a loss of -1.4%, UK's FTSE was down -1%. Italy and Spain saw losses of -3.6% and -3.1%, respectively. The Swiss Market Index was flat in June.
- Asian stock markets showed a more heterogeneous picture. The overall MSCI Asia ex Japan was up 4.3%.
- Taiwan's and South Korea's stock markets saw the biggest moves with the TAIEX up 9.3% and the KOSPI up 6.1%. Hong Kong's Hang Seng and China's CSI300 closed the month with a loss of -1.1% and -2.5%, respectively. Singapore stated a small loss of -0.1% for June.
- In Japan, the Nikkei saw a positive reaction of +2.9% after the Japanese yen came under further pressure.
- The global MSCI equity index advanced 2.3% in June. Once more, convertibles lacked in traditional upside participation. Still, the equity tailwind moved the FTSE Global Focus to a plus of 0.5%.

## Drivers of fund performance

- The fund outperformed its benchmark in June.
- Our attribution analysis shows a negative allocation effect from our overweight to materials. However, we could compensate that with a contribution from our underweight to utilities.
- Turning to single names, **Rivian** leads the list of detractors. **Volkswagen** announced a USD 5 billion investment in the struggling electric vehicle (EV) maker. The Rivian stock reacted with a significant plus to the news. Since then, the stock has lost some of the gains again, but our underweight has cost us about 0.2% against the benchmark.
- On the other end of the spectrum, we outperformed with overweights in **Zscaler**, **Sarepta**, **MKS Instruments** and **Alnylam Pharma** to finish the month of June with a plus against our benchmark.

## Portfolio activity

- We only gently rebalanced our portfolio in June and kept the general settings in line with the last few months.
- In terms of regional positioning, we remain underweight in convertible bonds from Europe and the US. At the same time, we remain positive on Asian and Japanese convertibles.
- At the sector level, we continue with an overweight to IT, materials, and energy. We remain underweight to communication, consumer names, utilities, and real estate.
- The primary market in convertibles remained active in June and we saw good activity as well as good demand for new convertibles in the market. Amongst others, we participated in **Schneider Electric** and **Zijin**.
- The upward valuation trend in convertibles turned in June and converts cheapened on a broad basis. In our experience, valuation moves are usually positively correlated to stock moves. The universe of convertibles is already in a down trend. Hence, the valuation losses are not much of a surprise. Overall, broad parts of the convertible market are trading below fair value.

## Outlook

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- Markets have come to terms with postponing rate cuts as some parts of the inflationary pressure seem stickier. It is interesting to note that the rate cut argument carried a lot of weight in the early part of the rally which started in October 2023. Now that the argument seems to have dissolved, there is no negative impact on the equity market – we note that for the current exuberance in markets, rates seem to have an asymmetric footprint.
- We still hold the view that lower interest rates are on the horizon and that central banks will enter a rate cut cycle in 2024. Switzerland's SNB was out of the blocks, but the ECB followed in June. Rhetoric from the US Federal Reserve (Fed) signals a higher-for-longer period in rates. The last hike was 10 months ago.
- In the last fund updates, we discussed macro indicators which have had a very high prediction accuracy in the past. The inversion of yield curves, the downtrend in the quit rate, the labour market Sahm rule, the historic uniqueness of decreasing M2 monetary supply in the US between April 2022 to October 2023, the difference between real and nominal consumption in the US. We could also add lacklustre consumer numbers from fast food restaurants and coffee shops and lower turnover figures from grocery stores as well as rising delinquency from credit card and auto loans. Timing and time lags of these indicators are anything but precise. Still, the frequency of these leading indicators flashing alarm signals should make investors more risk averse than they currently are.
- Turning from macro-economic, recessionary indicators to more financial, market bellwethers we have repeatedly highlighted the narrow market breadth – which has significant effects on the upside participation of convertibles. Lately, Hindenburg warning signals show that the overall positive equity performance comes with a high proportion of stocks hitting new lows. Something is at odds, and we do not believe in a “this time it's different” scenario.
- At the same time, we believe that US rates will remain high unless something finally breaks and forces the Fed to move.
- In an election year, the US continues to spend its way out of a crisis with significant fiscal deficits. Of course, the government deficits are not sustainable. This is especially true for the US, where a full 31% of outstanding government debt needs to be refinanced in 2024.
- The ECB looks trapped. On the one hand, lagging economies such as Germany could use a monetary boost. On the other hand, deficit spending remains strong with 11 states now in breach of EU deficit limits. Amongst them are larger economies such as Spain, France, and Italy. On top, European politicians are already asking for a new round of EU debt issue as part of a debt union.
- Ideally, the ECB would like to follow the Fed with lower interest rates. But the Fed seems to stick to its higher-for-longer mantra.
- Perhaps more interesting than short-term rates is a look at the central bank balance sheets. The Fed has already tapered its Quantitative Tightening. The ECB's balance sheet shows a less constant trend with maturation of LTRO packages. There are at least two similarities, though. Current financial conditions are anything but overly tight and central banks are ready to provide sudden monetary backing if and when liquidity will evaporate.
- And so will the convertible bond market. We will see high demand for refinancing from companies who will not be able to attract liquidity on traditional corporate markets – and they will offer cheap equity on top of high coupons by issuing convertibles. Converts have always been the market that stayed open in days of illiquidity and there are first signs that the high yield (HY) refinancing market has already started to stutter.
- The global high yield bond market has increased by a factor of five since the Global Financial Crisis while the converts market remained almost on the same capitalisation. There is a lot of refinancing coming up – and it is coming up at significantly higher interest rate levels and with much tighter credit conditions.
- Before the golden times though, convertibles have to deliver on protection against stock market losses. Given that a significant part of our convertible universe remains balanced to slightly defensive, we remain constructive on our asset class and believe that a good degree of protection against equity market losses is inbuilt into the asset class.
- The most crowded trade on the market is to be long big tech names – especially the remaining Magnificent Five. It is worthwhile to note that these companies do not have converts outstanding. Our asset class cannot provide its traditional upside participation. The good news is that a reversal of this trend, and a setback of the large cap IT names will not impact our universe.
- Finally, parts of the convertibles market remain cheap and continue to trade under their fair value. Given the performance in global equity markets since October last year, this looks like a historic anomaly.

- In summary, we are looking at a highly convex asset class, with a good 50% equity loss protection, that has started to pay a handsome running yield and is trading at a discount. Our favourite asset class remains overlooked and oversold.

Past performance is not a reliable indicator of future results. The value of investments and the income from them may fall as well as rise and investors may not get the amount originally invested. Some performance differences between the fund and the benchmark may arise because the fund performance is calculated at a different valuation point from the benchmark. Please see the respective fund factsheets for the performance of other share classes.

## Calendar year performance (%)

Year	Fund (A Acc)	Fund (I Acc)	BM
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## Risk considerations

- **Currency risk:** The fund may lose value as a result of movements in foreign exchange rates.
- **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.
- **Interest rate risk:** The fund may lose value as a direct result of interest rate changes.
- **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.
- **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.
- **Credit risk:** A decline in the financial health of an issuer could cause the value of its bonds to fall or become worthless.
- **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.
- **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.
- **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.
- **Market risk:** The value of investments can go up and down and an investor may not get back the amount initially invested.

2023	7.01%	8.66%	9.84%
2022	-18.9%	-17.6%	-16.0%
2021	-3.3%	-1.8%	-1.1%
2020	24.0%	25.0%	22.8%
2019	12.4%	14.1%	13.1%
2018	-5.1%	-3.6%	-3.0%
2017	7.4%	9.0%	6.0%
2016	1.6%	3.2%	1.6%
2015	3.1%	4.8%	3.8%
2014	4.0%	5.7%	4.7%

Source: Schroders, NAV to NAV (bid to bid), net of fees (where applicable), USD, as at 30/12/2023. The fund's performance should be assessed against its target benchmark being to exceed the FTSE Global Focus Hedged Convertible Bond Index (USD). 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 target benchmark.

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