

Schroder ISF* Global Convertible Bond

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

Performance overview

- The rally on global stock markets showed no signs of slowing down in March. Overall, it was a month without great surprises. The major central banks kept rates on hold and postponed any hopes for fast interest rate cuts. The latest CPI figures from the US indicate a pause in falling inflation figures. Investors now do not expect a first cut before the US Federal Reserve's (Fed) June meeting. Not so in Switzerland, where the SNB reacted to Swiss inflation falling to 1.3% and cut rates by 0.25%.
- Economic data did not surprise either. The US published 3.4% final GDP growth after revisions for Q4 2023. The economic growth in the Eurozone remains stale with Germany stuck in a recession and France's deficit reaching a staggering 5.5% of GDP.
- Gold continues to react more to inflationary fears and lax financial conditions than to higher for longer rates, and reached new highs in several currencies.
- In the US, the Nasdaq and the S&P 500 advanced by 1.8% and 3.2%, respectively. The Dow Jones ended March with a plus of 2.2%
- European bourses also showed positive moves in March. The overall Euro Stoxx gained 4.4%. Despite recession fears, Germany's DAX stated a gain of 4.6%. France's CAC also posted a gain of 3.6%. Southern Europe saw a very strong month with Italy's MIB advancing 6.8% and the Spanish IBEX gaining a full 11.1%. The Swiss Market Index finished the month on a plus of 4% and the UK's FTSE advanced 4.8%
- Positive momentum also lifted stocks in Asia. The overall MSCI Asia ex Japan was up 2.6%. Hong Kong's Hang Seng and China's CSI 300 were only just in positive territory with a plus of 0.6% each. Taiwan's TAIEX stated 7.2% and Korea's KOSPI finished the month on +4.3%
- Japan's Nikkei accelerated further with a plus of 3.7%.
- The Vix which measures volatility remained low with a reading of under 14% at the end of March. The fear and greed index regularly moved between greed and extreme greed. Investors are still not pricing in too much risk on the horizon.

- The global MSCI equity index gained 3.2% in March. Convertibles benefitted from the equity move. Global Focus finished the month with a gain of 1.8%.

Drivers of fund performance

- The fund outperformed its benchmark in March.
- Our attribution analysis shows a positive allocation effect from our overweight to energy names. We also gained relative performance with good convertible selection in both, the health care and materials sector.
- Turning to single names, **China Hongqiao**, **Saipem** and **Dexcom** lead the list of contributors. We also gained with our underweight to **Nio**. The underweights to **NRG Energy** and **Western Digital** detracted in March.

Portfolio activity

- In March, we used good equity performance to trim some positions and lock in profits. **Rheinmetall** and **Saipem** were on our sales list after a good run. We also slightly reduced our position in Japanese converts.
- 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, industrials, and energy. We remain underweight to communication, utilities, and real estate. We have not shifted our regional or sectoral allocation over the last few months.
- Convertible primary markets were very active in March. We saw USD 11.9 billion in new converts coming to the market. Amongst others, we participated in **Infroneer**.
- Valuations, however, remain subdued. The stock market rally has generated interest in convertibles and valuations in the US and in Europe have been enriched. Overall, broad parts of the convertible market are still trading below fair value.

Outlook

- 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. The move of the Swiss National Bank to come out first and cut rates this month is a good indication. Besides some domestic points (rents had risen as these are coupled to higher mortgage rates) the main backdrop is subdued economic activity abroad, especially in the Eurozone, Switzerland's main trading partner.
- Furthermore, PMI numbers from Germany and France came in weak. Especially Germany's manufacturing sector continue to be under extreme pressure,
- A stronger cooling off is by no means a European problem. Export orders in Taiwan are a bellwether of potential problems. Here, February export order fell a staggering -10.4% on a 12-month basis against Reuters expectations of +1.3%. The sharp drop was triggered by low orders for electronic components and chips especially from Europe and Japan, but also from the US.
- Turning to the US, where the Fed unsurprisingly kept rates at 5.25%-5.50%, we note that similar to early February, the Fed's balance sheet reduction seems to have taken a breather – numbers show a week of quantitative easing. Still, it was more rhetoric than numbers which drove markets. Fed Chair Jerome Powell's comment that somewhere, sometime rate cuts were still on the agenda was enough to keep the stock market rally alive: "I think they [the latest figures] haven't really changed the overall story, which is that of inflation moving down gradually on a sometimes bumpy road toward 2%"
- Traditionally, a diversion between US real consumption and consumption in nominal terms indicates a serious problem in the economy. Hence, we continue to believe the economy may be on the verge of entering a classic boom and bust cycle.
- The US continues to spend its way out of a crisis with significant fiscal deficits. Looking at the overall global economic cooling off and first major economies drifting into recessions, we don't believe in a US decoupling of the global economy.
- US presidents tend to lose election campaigns if the economy is in a recession, has just gone through a recession, or if there is the fear of a recession. Clearly, the re-election of the Biden administration is at risk – in simple words: "It's the economy, stupid!". Hence, there is a clear political tug of war, Democrats will want to delay a recession until after the November elections and the Republicans would prefer a fast (and perhaps shallow) recession in early 2024.
- Moreover, 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.
- As we come to the start of a new rate cycle, we believe it is important to put the previous hikes into historic context: We have seen one of the fastest interest rate hiking cycles in history – and surprising to many analysts, the economy stayed strong, the labour market stayed resilient, and the US consumer kept spending. This goldilocks scenario may now come to an end.
- While it is not our base scenario, we believe the risks on inflation may not be fully priced in and that central banks could be forced to keep rates higher. This scenario could receive tailwinds from the lax financial conditions in the US. If a severe economic slowdown – perhaps combined with a credit or illiquidity event – does not move inflation lower, the case for such a development strengthens further.
- Fast forward to a more long-term view for our favourite asset class: 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 HY refinancing market has already started to stutter.
- The global high yield bond market has increased by a factor of five since the Great 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.

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

Calendar year performance (%)

| Year | Fund (A Acc) | Fund (I Acc) | BM |
|------|--------------|--------------|--------|
| 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.

- 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.

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