

## Schroder ISF\* Global Convertible Bond

Fund Managers: Dr. Peter Reinmuth &amp; Chris Richards, CFA | Fund update: December 2024

### Performance overview

- Global stock markets finished the year on the downside and gave up some of the strong annual gains. General market developments made it increasingly difficult to justify stocks reaching new all-time highs, implying that the market had been overbought and a pullback might have been anticipated.
- Longer-term interest rates in the US are up to 4.6% which also is a good indicator of some market stress. The fear and greed indicator has quickly moved to fear and the market looks short-term oversold. It is a sign of the times that greed and fear seem to take turns even after rather small market swings.
- December was a challenging month for the Dow Jones, which recorded its poorest performance since 2018 and its largest monthly percentage decline since September 2022. The S&P 500 shed -2.4% while the tech heavy Nasdaq index ended the year on a slight plus of 0.6%.
- All three major indices experienced notable declines after the Federal Reserve (Fed) meeting. Although the Fed implemented another rate cut, Chair Jerome Powell projected only two rate cuts of 25 basis points each in 2025 and expressed concerns about persistent inflation into the next year. This outlook likely unsettled investors, resulting in a sharp downturn in stock prices that day.
- European markets fared a bit better. The Euro Stoxx finished the year on a plus of 1.9%, mainly driven by positive performance in Germany (Dax 1.4%) and France (CAC 2.1%). The Italian MIB was up 2.3% while Spain reported a small loss of -0.2% for the IBEX. The UK's FTSE and Switzerland's SMI both stated negative performance figures for December.
- Asian stock markets also presented a mixed bag. The overall MSCI Asia exJapan finished on a gain of 0.2%.
- The Hang Seng was up 3.3%. China's CSI300 gained 0.6%. Singapore stated some gains of 1.36%. Taiwan was up 3.6%. In Japan, the Nikkei was up a strong 4.5%
- The global MSCI equity index shed -2.3% in December. Convertibles protected reasonably well against the equity market headwinds.
- The FTSE Global Focus hedged in USD ended the month on a loss of -1.8%.

### Drivers of fund performance

- The fund underperformed its benchmark in December.
- In a downward month, our attribution analysis of course shows a positive allocation effect from our underweight positioning to the US. We also gained relative to our benchmark by being overweight to Asia.
- On a sector level, our overweight to IT as well as our underweight to consumer names detracted from relative performance.
- **Northern Oil, Jetblue Airways, and Snowflake** are among the detracting positions for December.
- At the same time, we added relative performance with **Terawulf, Bloom Energy** and **Lenovo**.

### Portfolio activity

- The stock market down-move in December resulted in an automatically lower equity exposure for convertibles. We have therefore increased our active exposure against the benchmark very slightly.
- At the same time, we took some profits in our positions in **Coinbase, Snowflake, or Saipem** and used the proceeds for adding to **SK Hynix** and **Exact** amongst others.
- 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, financials, and energy. We remain underweight communication, utilities and real estate.
- The market rally in the US has resulted in more expensive valuations for US convertibles. Other main convertible regions are trading well below fair value.
- The overall investment year 2024 has seen a very active primary market for convertibles, and this trend did continue into December. We saw USD 12 billion of new paper being launched in December. This brings the overall 2024 IPO volume to USD 128 billion. Growth oriented Information Technology (IT) and – certainly a trend in 2024 – bitcoin and crypto

biased company led the way. This month, we participated in **Datadog and Bill**.

## Outlook

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- Despite the set-back in December, global stock markets remain convinced of an ongoing Goldilocks scenario. Inflation has decreased significantly from highs, energy and oil prices remain subdued despite international conflicts, and the US labour market shows limited signs of weakness in line with a soft landing scenario – no clouds on the horizon.
- Historically, strong interest rate hikes have triggered a sharp cooling off in the economy, leading to significant negative repercussions for stock markets. But this time, it seems to be different. However, recent developments in inflation expectations, 10-year USD yield figures and of course bitcoin and gold prices may all tell a different story.
- Starting rate cuts with a full 0.5% move has traditionally signalled that the Fed realised they were behind the curve, the economy was slowing down faster than previously thought, and that an element of panic steered the committee to a big and sudden rate cut.
- We also identified first cracks in the US labour market as a harbinger of economic slowdown as early as mid-year. The Fed's economists needed a few months to digest harbingers from the labour market such as the Sahm rule, the lower quit rates, or the upside move through the 24-month average.
- Obviously, the labour market is a lagging indicator and hence a turndown here has traditionally signalled the arrival of a recession. The history play-book of central bank rate hike cycles is pretty clear: the economy usually takes a turn to the worse and consumption is hit hard. Several macro leading indicators confirm that consumption is waning with rising credit card and auto loan delinquencies.
- The 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. For the markets, a recession would come as a surprise – from a historic perspective the absence of a recession is the surprise.
- In contrast, Europe, particularly its former economic powerhouse, Germany, is already confronting recessionary fears. Recent news from its energy-dependent automotive industry only reinforces these concerns. It looks as if at least a regional hard landing is clearly on the cards. Additionally, one of the most significant recession indicators for anyone in Switzerland is, of course, Swiss watch exports – which have decreased by a full 20% (in number of watches) year-on-year.
- In Asia, we are particularly focused on China. We believe more economic stimulus is essential to re-establishing a robust growth trajectory. Persistent weakness in private sector credit demand stems from a downturn in the housing market. September's government stimulus packages provided some relief, but their effects were largely short-lived. In essence, after each stimulus package, we await the next. This presents an ideal market condition for convertible bonds, as investors are paid a good coupon income to wait for China to step up and surprise the markets.
- Generally, market participants have mainly priced in a no-landing or soft-landing scenario; we still need to be convinced that the overall global macro picture is really that rose-tinted.
- Cutting rates usually is not a good sign for the stock market. This holds especially when rates are cut because of recessionary fears. Hence, a combination of lower rates, a weak labour market, consumption spending taking a dive and the economy heading for a harder than expected landing will be detrimental to the stock markets.
- While we continue to rate the global economic picture as non-sustainable in the long-run, it is difficult to spot concrete triggers of a potential reversal.
- Current financial conditions are not remotely tight. Here, it is important to see that while the Fed finally lowered rates, they are still actively reducing their balance sheet by USD 50 billion of monthly quantitative tightening.
- Recent history teaches us that the central banks have a big toolbox of monetary instruments. Currently, the Fed is still on course for quantitative tightening.
- Any reduction, stop, or indeed reversal of quantitative tightening is a blunt and effective instrument as we have seen in the 2023 banking turmoil. It could well be that central banks, led by the US Fed, accept longer-term inflation figures above their current 2% target. History teaches us that the liquidity is there until it suddenly evaporates and a risk-off environment of distrust and fear sets in.
- If and when a recession, or rather a sharp sector and regional rotation comes into play, equity investors could feel the pressure. There is, of course, the convertible bond market for providing extra liquidity in such market environments. We will see high demand for refinancing from companies that 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. Convertibles have always been the market that has stayed open

in days of illiquidity, and there are first signs that the high-yield (HY) refinancing market has already started to stutter.

- Before the golden times, though, convertibles have to deliver on protection against stock-market losses.
- Due to their in-built equity exposure, convertibles increase in value as the underlying stock increases. Simultaneously, when the underlying stock drops, the convertible loses some value but still offers protection thanks to their bond floor, the bond part of the convertible.
- 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. We have seen efficient downside protection in the volatile summer months, and we are confident that convertibles will also protect in case of future stock market setbacks.
- In addition, parts of the convertibles market remain cheap and continue to trade under their fair value. Given the performance in global equity markets since 2023, this looks like a historical anomaly.
- Finally, 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. Still, our favourite asset class remains overlooked and oversold.
- When talking to clients and discussing their tactical allocation, I often hear the following: Equity exposure, but not full-on risk, please.
- A good underweight in the overcrowded trade in big IT companies especially the Magnificent Seven and a bias towards small and mid-cap where we see an

opportunity for some catch up potential – this wish list matches pretty much what global convertibles offer. And if our investors are right, 2025 could turn out to be a great year for converts.

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
2024	5.4%	7.0%	8.6%
2023	7.0%	8.7%	9.8%
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%

Source: Schroders, NAV to NAV (bid to bid), net of fees (where applicable), USD, as at 30/12/2024. 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.

## 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 macroeconomic 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.

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