Schroders

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Schroder ISF* EURO High Yield

Fund Manager: Hugo Squire | Fund update: March 2024

Performance overview

- Corporate bonds continued to outperform government bonds amid stronger economic data and robust corporate earnings. Despite heavy supply, credit spreads tightened further in March on the back of strong investor demand for new issues, and spreads in both US and European investment grade markets declined to the tightest level for two years. Although high yield markets generated positive total returns, the European market lagged with spreads widening on the month. This was attributable to the weakness of the technology and financial services sectors. In contrast, spreads tightened considerably in the real estate sector.
- At its meeting in early March, the ECB lowered forecasts for inflation, and is now expecting the consumer price index to decline to its 2% target next year. Accordingly, bond markets are anticipating that the ECB will cut interest rates in June. Economic indicators for the Eurozone released last month highlighted that business activity, as measured by the Purchasing Managers index (PMI), is being lifted by a rebound in the services sector. While business activity in both the German and French economies continued to contract, the picture was brighter elsewhere. Notably, southern European economies have been outperforming, benefiting from a recovery in tourism, while they have less exposure to the manufacturing cycle.
- Against a relatively benign economic and market backdrop, yields fell across the major government bond markets in anticipation of interest rate cuts commencing in June.
- The US 10-year Treasury yield fell from 4.24% to 4.2%, while the 10-year German bund yield fell from 2.41%. to 2.3%. Equivalent yields in both the Italian and Spanish markets fell further.

Drivers of fund performance

- The fund outperformed the ICE BofA Euro High Yield Constrained index in March.
- Exposure to the real estate sector was a key contributor as the rebound from last year's sell off continued. We saw strong performance from a leading European operator which reported high occupancy rates and steady rental growth, while reducing net debts in 2023. Our holding in a Scandinavian group also performed well on the announcement of a proposal to buy back its debt.
- In the telecoms sector, our position in a Latin American carrier that has strengthened profitability and cash generation from subscriber growth was additive.
- Positioning in the banking sector made a significant contribution last month as credit spreads continued to tighten. Holdings in several European and UK issuers performed well.
- Security selection in the insurance sector was also additive.
- Within financial services, our holding in a European credit management company detracted on continuing concerns over exposure to non-performing loans.

Portfolio activity

- We selectively invested in the new issue market during March, as several companies took the opportunity to refinance debts.
- In the telecoms sector, we added a holding in a European geostationary satellite operator, priced on an attractive yield and a solid position in the company's capital structure. We also established a position in a new issue from a leading European producer of recycled cardboard.
- In the secondary market, we increased our holding in a fibre-optic network operator on completion of a debt restructuring programme, while securing a cash payment of accrued interest.
- We continued to reduce the risk profile of the portfolio in response to further spread compression over the month, switching into investment grade bonds.
- In the investment grade market, we increased our position in a Scandinavian digital services provider and added a new holding in a French auto parts supplier.

*Schroder International Selection Fund is referred to as Schroder ISF throughout the document.

- We also switched from unsecured debt into secured bonds placed higher up the capital structure, issued by European telecoms operator.
- Overall, the allocation to B-rated issues declined over the month, while the allocation to off-benchmark investment grade bonds and BB-rated issues increased.

Outlook/Positioning

- Consistent with our central thesis of a 'soft landing', firming goods demand has driven an upturn in the global manufacturing cycle. The US has led the way, but the Eurozone has been a more recent beneficiary of this cyclical uplift, with a more accommodative interest rate outlook offering additional support. Not only does it appear that the region's manufacturing cycle has turned, but the services sector also seems to be recovering, feeding through to the labour market. Leading indicators are signalling a clear improvement and given the weakness of growth expectations for the region, the hurdle for positive surprises is easy to beat.
- However, an improving global growth backdrop presents an upside risk to inflation and there has already been a flurry of surprises in recent data releases. Although favourable base effects mean year-over-year core inflation should continue to decline in the immediate future, continued stickiness in underlying prices could pose challenges further out, without marked improvement.
- The resilience of labour markets is also a potential headwind to the depth of the forthcoming interest rate cutting cycle. This continues to warrant close scrutiny, particularly in the US.
- With credit spreads having tightened significantly in parts of the high yield market, there is some clear evidence of bifurcation between quality and capital structure. BB and B-rated issues are no longer cheap relative to history. However, in Europe debt refinancing is progressing at a pace which is running ahead of maturity schedules, presenting investment opportunities in new issues on attractive yields. While CCC-rated credit remains cheap in a historical context, given the subordinated status of these issues in the capital structure we are particularly mindful of credit risk.

Calendar year performance (%)

	A Acc	I Acc	Target
2023	11.8	13.1	12.0
2022	-13.9	-12.9	-11.5
2021	4.5	5.8	3.3
2020	4.2	5.6	2.7
2019	9.8	11.1	11.2
2018	-5.5	-4.4	-3.6
2017	6.7	8.0	6.7
2016	10.0	11.4	9.1
2015	3.5	4.8	0.7
2014	5.0	6.3	5.4

Source: Schroders, as at 31/12/2023. All performance net of fees (where applicable), NAV to NAV (bid to bid), EUR. Target : ICE BofA Euro High Yield Constrained Index.

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 back 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

- **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 share class:** 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. 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.
- **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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