

Schroder ISF* EURO High Yield

Fund Manager: Hugo Squire | Fund update: December 2024

Performance overview

- Within high yield bond markets, December heralded a reversal of the previous month, with European high yield gaining ground in contrast to the weakness of the US market. Spread tightening in European high yield credit was meaningful, with the most significant compression in the technology, basic industries, capital goods and insurance sectors. In contrast, US high yield lost ground partially as the equity market sold off from record highs. Furthermore, inflationary pressures and concerns surrounding the proposed economic policies of the Trump administration are leading investors to consider more defensive strategies.
- There were some tentative signs of stabilisation in European economic indicators released during December. The closely watched composite purchasing managers index (PMI) for the Eurozone picked up driven by the services sector activity, which managed to offset some of the continuing contraction in manufacturing. However, it remains below the 50 mark, suggesting the eurozone economy is contracting as activity in both Germany and France remains sluggish.
- As expected, European Central Bank (ECB) cut interest rates in December to 3% from 3.25%. This was the fourth time this year the ECB made the decision to lower its deposit rate, but the market was disappointed as the tone was less dovish than expected. Concerned with the potential for new US tariffs, among other factors, hampering economic growth, some policymakers had been pushing for 50bp rate cut. The ECB lowered its growth forecast for the Eurozone economy to 1.1% in 2025 and cautioned that as yet this did not reflect the impact of proposed US tariffs on exports.
- Government bond yields rose across European markets in December, with the 10-year German bund yield rising by 28bps to close the year at 2.35%. Ratings agency Moody's downgraded France's credit rating, citing political instability and cautioning it will be difficult for the incoming government to tackle the country's fiscal deficit. Unease over deteriorating public finances have pushed the yield spread for French bonds over benchmark German debt to its highest level since the Eurozone debt crisis.

Drivers of fund performance

- The fund posted a positive total return but underperformed the ICE BofA Euro High Yield Constrained index in December.
- Positioning in the telecoms, autos and capital goods sectors detracted from performance over the month.
- Several single B-rated holdings underperformed. In the healthcare sector, our holding in pan European group Cheplapharm, which outsources its production, detracted on reports of supply chain difficulties.
- Our holding in Amara, a global distributor of solar panels, detracted on concerns that potential US trade tariffs would weaken demand as well as the likely shift in energy policy away from renewables.
- Credit selection in the banking, insurance and energy sectors was additive.
- A major contributor was our holding in a financial services group as a debt restructuring extended existing bonds on enhanced legal protection and improving credit fundamentals.

Portfolio activity

- Although the primary market was relatively quiet during December, we participated in several new issues. These included senior secured short-dated debt from Spanish pharmaceutical group Grifols that was priced on an attractive yield. This was a private placement structured as a refinancing of existing short-dated maturities.
- In the real estate sector, we participated in an issue of short-dated bonds from Emirates REIT, which is focused on the Dubai financial services sector. The issue carries a low loan to value (LTV), while Dubai is growing rapidly as a financial services hub, particularly for wealth management businesses.
- Other acquisitions included a new holding in Var Energi, a Norwegian upstream oil and gas exploration group, which was recently granted a licence to drill in the North Sea.
- We also added a holding in Apcoa, a leading car park operator in Europe.

- Disposals included Israeli group Teva Pharmaceutical, while we took profits on our holding in Italian banking group Intesa San Paolo, as spreads throughout the sector continued to tighten.
- We maintained a significant allocation to investment grade corporate bonds, focused on BBB-rated issues. The narrowing differential in credit spreads between BB and BBB-rated securities shifts the risk/return profile in favour of the latter, while also acting as a buffer against market volatility.
- Within the investment grade market, we added a new holding in French diagnostics and testing group Eurofins, while increasing our holding in Danish wind turbine manufacturer Vestas.
- from the central bank is required to support any sustainable recovery in economic activity.
- There is a continuing disparity in valuations within the European high yield markets. Credit spreads in some parts of the market, notably BB and B-rated issues, measured over government bonds, are at historically tight levels. In contrast, amongst issuers lower down the credit spectrum there is greater disparity with European markets offering more value than in the US.
- However, we remain mindful of duration risk particularly in view of tighter spreads and generally more demanding valuations. preferring to focus on shorter-dated credit. Nevertheless, the dispersion in valuations should continue to present idiosyncratic opportunities in areas of the high yield market that have been overlooked.

Outlook/Positioning

- The economic recovery in Europe is struggling to gain any momentum with recent indicators highlighting further weakness in manufacturing as the continuing decline in new orders is driving businesses to reduce output. In addition, concerns about job security with the announcement of further redundancies in the autos sector have significantly weakened consumer confidence in Germany, as well as in France.
- The outlook is clouded further by the risk of trade tariffs on exports to the US, as well as ongoing political uncertainty in France and forthcoming elections in Germany following the collapse of the coalition government.
- Against this background, pressure on the ECB to sanction further monetary easing has intensified. In total, investors are discounting five additional rate cuts over the next 12 months. Furthermore, pressure on the EU to implement proposed structural reforms aimed at boosting the region's competitiveness is likely to grow.
- While the Eurozone CPI is running above its 2% target, inflation is likely to moderate as service sector inflation should decline further driven by a weaker labour market.
- We continue to believe growth in Europe will remain subdued and that further significant monetary easing

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
2024	10.9	12.3	8.6
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

Source: Schroders, as at 31/12/2024. All performance net of fees (where applicable), NAV to NAV (bid to bid), EUR. Target : ICE BofA Euro High Yield Constrained Index.

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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