Schroders

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Schroder ISF* EURO High Yield

Fund Manager: Hugo Squire | Fund update: January 2025

Performance overview

- High yield markets gained ground in January with credit spreads, as measured over government bonds, tightening further over the month. US high yield outperformed European markets, as robust investor demand was driven by the continued strength of US economic indicators in marked contrast with Europe. Accordingly, spreads tightened across all sectors of the US market. In Europe, the real estate, retail and insurance sectors exhibited the most significant spread compression, although there was a notable widening of spreads in the services, basic industries, and energy sectors.
- The fourth quarter GDP figures, published at the end of the month, highlighted the Eurozone economy stagnated last quarter. Germany faces the headwind of a severe manufacturing slowdown as well as political uncertainty with federal elections scheduled for February. The French economy unexpectedly contracted, while output was flat in Italy. The exception was Spain, where growth exceeded expectations driven by the services sector.
- As expected, the European Central Bank (ECB) cut interest rates by a further 25bps to 2.75% in January. ECB president Lagarde issued a cautious assessment of the economic outlook, highlighting the risk of global trade tariffs and uncertainty as to whether the impact would be inflationary or deflationary. The latest consumer price indices for December revealed that inflation remains above the ECB's 2% target, with persistent inflationary pressures in the services sector. Nevertheless, the ECB expects inflation to return to its target over the course of this year.
- With investors already discounting the most recent ECB interest rate cut, government bond yields in most European markets were broadly unchanged. However, the benchmark 10-year bund yield ended the month 11bps higher at 2.46%, having retreated from a six-month high in mid-January as weaker economic indicators strengthened the case for further interest rate cuts.

Drivers of fund performance

- The fund posted a positive total return and outperformed the ICE BofA Euro High Yield Constrained index in January.
- Exposure to the European real estate sector was a key factor that contributed to performance over the month. Our holding in French group Foncia was a leading contributor. Cash flows have become more sustainable, providing an improving credit outlook over the next two years. The company also completed a small disposal last month.
- The holding in US healthcare REIT MPW, which operates in the private hospital sector in the US, UK and Germany, also performed well. The company's finances are now stabilising after a period when revenues were impacted by tenancy-related issues.
- Within the energy sector, Energean was a key contributor. The oil exploration and production business operates off the coast of Israel, with the bonds gaining ground on the ceasefire in the Middle East.
- Amongst telecoms, the holding in German fiber-optic network operator Tele Columbus was additive as the bonds rose on improving investor sentiment on the company's credit outlook.
- In the healthcare sector, our holding in pan European group Cheplapharm, which outsources its production, detracted on concerns over supply chain difficulties.

Portfolio activity

- While the fund remains underweight in most cyclical sectors, we increased exposure to the chemicals sector through adding a holding in a BB-rated euro-denominated new issue from Ineos. While the sector is still in recession, there is recovery potential in the high yield bond market as the impact of capital expenditure should be positive in the longer term.
- In the retail sector, we added a holding in the UK restaurant chain Wagamama. The business is outperforming peers in the retail format, and we

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consider the prospects for sustainable earnings growth are positive. The bonds carry a single-B rating and offer an attractive yield.

– On the disposals, side we took profits on our holding in healthcare REIT MPW.
– Our holding in German real estate group Adler was called on redemption of the bonds.
– We sold down the fund's position in Cheplapharm as the investment case had failed to materialise.
– We continue to hold a significant underweight position in the autos sector, as European vehicle manufacturers are particularly vulnerable to the imposition of US trade tariffs on exports.
– We maintained an 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.

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 imminent elections in Germany.
– Against this background, pressure on the ECB to sanction further monetary easing has intensified. In total, investors are discounting further interest rate cuts over the coming months with the ECB's key deposit rate reduced to 2% by the summer. 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 gradually decline, driven by a weaker labour market.
– We continue to believe growth in Europe will remain subdued and that further significant monetary easing from the central bank is required to support any meaningful 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. Going forward, a combination of positive carry and idiosyncratic opportunities should underpin total returns from the European high yield market.

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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