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Schroder ISF* Sustainable EURO Credit

Fund Manager: Saida Eggerstedt | Fund update: January 2025

Market review

- Credit spreads in the European investment grade market, as measured over government bonds, tightened further during January. A combination of low issuance volumes and strong inflows into European investment grade credit, with institutional investors particularly active around the 10-year part of the curve, pulled yields lower. So far, the quarterly results season in Europe has been broadly encouraging, particularly amongst banks with interest margins peaking combined with an upturn in fee income boosted by M&A activity.
- 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 delivered positive returns over the month but slightly underperformed (net of fees) relative to the reference index. Meanwhile, the fund continues to deliver on Sustainability performance metrics including a high SustainEx™ overall impact score and MSCI ESG rating.
- Overweight sector allocations to subordinated insurance and banking sectors was positive for relative returns, as was security selection in European services and the fund's underweight duration stance versus the Index.
- In contrast, the underweight allocation to automotives and senior banking, as well as selection decisions, was negative for relative returns. Off-benchmark sovereign exposure also detracted.

Portfolio activity

- Throughout the month, we increased our exposure to senior banking, automotive and transportation. In contrast, we marginally reduced our exposure to AT1 banking, utilities and consumer goods.
- Our investment strategy focuses on a broad range of sustainable themes and bonds, including waste recycling and biodiversity, sustainable infrastructure, the circular economy, and responsible consumption. We also prioritize opportunities in decarbonizing technology and health and education. In alignment with our commitment to sustainability, we exclude investments in fossil fuels, weapons, alcohol, tobacco, and companies that violate the UN Global Compact.
- Over the month, we increased our allocation to a German utility energy company through new green bond issues. The proceeds will be used towards electricity networks, renewable energy, improving energy efficiency and clean transportation.
- Also of note, included new issues from a company that owns and operates business and industrial parks and flexible workspace across Germany and the UK. The company has strong, diverse, and independent governance. The group has a policy in place to achieve net zero emission by 2045, with interim targets and good early progress through the uptake of renewable energy.
- We remain invested in our preferred responsible finance names, including green, social, and sustainability-linked bonds issued by UK and European companies.
- The fund's carbon emissions intensity, as measured by tonnes CO_2e per $mn sales (scope 1 and 2 emissions), is less than half that of the reference index. Additionally, our overall SustainEx™ impact score remains significantly higher, as we strive to identify improvers, limit laggards, conduct ESG research, utilize tools, and focus on positive sustainability themes.

Outlook

- 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.

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

- 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.
- After a quiet start to the year, we would expect to see a sustained upturn in new issuance volumes over the coming months and while credit spreads are at tight levels historically, we anticipate the primary market should offer opportunities to deploy cash currently parked in short-dated government bonds. Moreover, with further interest rate cuts in the pipeline we expect the demand for credit to remain high over the course of 2025, supporting tighter spreads at broad market level.
- We are looking for opportunities in the single A rating segment, as it is historically cheap to go up in quality. Non-cyclical sectors, notably healthcare and business services, also selectively provide attractive real income.
- Going forward, a combination of positive carry and idiosyncratic opportunities should underpin total returns from the European investment grade market.

Calendar year performance (%)

Past Performance is not a guide to future performance and may not be repeated.

The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested. Exchange rate changes may cause the value of investments to fall as well as rise.

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.

	C Acc	A Acc	I Acc	Target**
2024	5.6	5.2	6.3	4.7
2023	8.3	7.8	8.9	8.0
2022	-12.4	-12.7	-11.8	-13.9
2021	0.7	0.3	1.3	-1.0
2020	5.6	5.2	6.2	2.6
2019	-	-	-	-
2018	-	-	-	-
2017	-	-	-	-
2016	-	-	-	-
2015	-	-	-	-

Source: Schroders, as at 31/12/24. All performance net of fees (where applicable), NAV to NAV (bid to bid), EUR. ** ICE BofAML Euro Corporate TR.

Risk considerations

ABS and MBS risk: The fund may invest in mortgage or asset-backed securities. The underlying borrowers of these securities may not be able to pay back the full amount that they owe, which may result in losses to the fund.

Contingent convertible bonds: The fund may invest in contingent convertible bonds which are bonds that convert to shares if the bond issuer's financial health deteriorates. A reduction in the financial strength of the issuer 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: If a borrower of debt provided by the fund or a bond issuer experiences a decline in financial health, their ability to make payments of interest and principal may be affected, which may cause a decline in the value of the fund.

Currency risk: If the fund's investments are denominated in currencies different to the fund's base currency, the fund may lose value as a result of movements in foreign exchange rates, otherwise known as currency rates. If the investor holds a share class in a different currency to the base currency of the fund, investors may be exposed to losses as a result of movements in currency rates.

Currency risk / hedged share class: The currency 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, which are financial instruments deriving their value from an underlying asset, may be used for investment purposes and/ or 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.

Emerging markets & frontier risk: Emerging markets, and especially frontier markets, generally carry greater political, legal, counterparty, operational and liquidity risk than developed markets.

High yield bond risk: High yield bonds (normally lower rated or unrated) generally carry greater market, credit and liquidity risk meaning greater uncertainty of returns.

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, meaning investors may not be able to have immediate access to their holdings.

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 the objective of sustainable investment. 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 chosen by the investment manager. The fund may invest in companies that do not reflect the beliefs and values of any particular investor.

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The Company is a Luxembourg-based Société d'Investissement à Capital Variable (SICAV) with unlimited duration which is coordinated with regard to the European regulations and meets the criteria for Undertakings for Collective Investment in Transferable Securities (UCITS).

The total net asset value is published on the website of the Belgian Asset Managers Association (BEAMA) on www.beama.be. In addition, the tariff schedules are available from distributors in Belgium. The fee on the stock exchange transactions of 1.32 % (with a maximum of € 4,000 per transaction) is payable on the purchase or conversion of capitalisation shares if they are carried out by the intervention of a professional intermediary in Belgium. Dividends paid to natural persons who are Belgian tax residents are subject to a Belgian withholding tax at a rate of 30% if they are paid by the intervention of a financial intermediary established in Belgium (this information applies to all distribution shares). If the dividends are received by such natural persons without the intervention of a financial intermediary established in Belgium, they must indicate the amount of the dividends received in their tax return and will be taxed on that amount at a rate of 30%. In the event of the redemption or sale of shares of a sub-fund investing, directly or indirectly, either (i) more than 25% of its assets in receivables with regard to shares acquired by the investor before January 1, 2018, or (ii) more than 10% of its assets in receivables with regard to the shares acquired by the investor from 1 January 2018 (provided, in each of these two cases, that certain additional conditions are met), the interest component of this redemption or sale price is subject to a 30% tax in Belgium.

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