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Schroder ISF* US Small & Mid Cap Equity

Fund Manager: Robert Kaynor, CFA | Fund update: March 2024

Performance overview

- US equities performed well again in March, with all the major local indices making gains.
- The fund underperformed the benchmark during the month.

Drivers of fund performance

- Stock selection and sector allocation both detracted over the period.
- The top detractors were industrials and information technology. Stock selection within industrials was one of the main factors behind the fund's relative weakness, particularly in the aerospace & defense and commercial services sub-sectors. Both stock selection and sector allocation detracted from returns in information technology. Communications equipment also weighed notably on performance, as the overweight to the group and the stocks held in it did not perform well. **Ciena Corporation**, which provides network and communication infrastructure, was down over 13% for the month after the company forecast fiscal 2024 revenue will fall on a year-on-year basis.
- The top contributors from a sector perspective were healthcare and real estate.
- Within healthcare, stock selection was the leading contributor, particularly in healthcare equipment. **Haemonetics Corporation** and **Masimo Corporation** were the fund's top contributors for the month. The fund's underweight to biotechnology also added value. Real estate was led by stock selection, notably in the specialised REIT group, with **Lamar Advertising** performing well.
- In terms of the alpha sources[1], all three groups underperformed for the month.
- Major contributors included **Masimo Corporation**, **Haemonetics Corporation** and **Burlington Stores**.
- Major detractors included **Sotera Health, Ciena Corporation** and **WNS (Holdings)**.

Portfolio activity

- We added **iRhythm Technologies** and **Terreno** Realty.
- We exited **Sotera Health** and **Global Life**.

Calendar year performance (%)

Year	Fund	Target	Comparator 1	Comparator 2
2023	12.2	11.3	18.4	15.0
2022	-13.3	-18.5	-20.4	-13.0
2021	21.6	17.8	19.4	24.4
2020	6.8	20.4	22.4	13.0
2019	28.9	28.6	29.9	26.7
2018	-12.4	-11.5	-10.8	-12.9
2017	15.2	17.2	16.1	15.9
2016	17.6	16.4	13.6	19.4
2015	0.7	-3.2	-2.6	-2.7
2014	11.6	7.8	8.3	10.8
2013	35.0	38.4	37.7	34.6
2012	9.1	14.7	12.0	15.0

Source: Schroders, net of fees, NAV to NAV, with net income reinvested. USD C Acc share class as at 31 December 2021. The fund's performance should be assessed against its target benchmark being to exceed the Russell 2500 Lagged (Net TR) index and compared against the Morningstar US MidCap Equity Category and the S&P Mid Cap 400 Lagged (Net TR) Index. The fund's investment universe is expected to overlap materially with the components of the target benchmark and the S&P Mid Cap 400 Lagged (Net TR) Index. The comparator benchmarks are only included for performance comparison purposes and does not determine how the investment manager invests the fund's assets. 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 or the S&P Mid Cap 400 Lagged (Net TR) Index. The benchmark(s) does/do not take into account the environmental and social characteristics or sustainable objective (as relevant) of the fund. Please see appendix III of the fund's prospectus for further details.

Past performance is not a reliable indicator of future results, prices of shares and the income from them may fall as well as rise and investors may not get the amount originally invested.

[1] We target three types of opportunities: "mispriced growth stocks" – stocks where we think the market continues to undervalue a company's growth prospects; "steady eddies" – strong companies with recurring revenues and/or cashflows; and "turnarounds" – firms that are addressing their problems, often with new management, which are likely to outperform over time.

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

Outlook/positioning

- US small and mid-cap stocks are suffering their worst performance relative to large companies in more than 20 years. There was a brief period of outperformance in 2020 during the preliminary stages of Covid, but since then, small and mid-cap stocks have continued to lag their larger peers. This highlights how much investors have chased mega-cap technology stocks.
- The US Federal Reserve's interest-rate hikes and the ripple effects from Silicon Valley Bank's collapse made 2023 an especially difficult year for small-cap stocks. Small and mid-cap companies could not offer the same AI-related growth dynamics, and appear more at risk from the impact of higher interest rates. However, the reality is that small and mid-caps' company balance sheets are much more robust in the current cycle than in the past.
- Consensus Wall Street estimates for 2024 indicate small and mid-caps will deliver better earnings as the year progresses. A reduction in interest rates, however small, will make a difference to sentiment. The cost of refinancing debt is especially expensive for small-cap companies in periods of rising interest rates. Given that much of their debt is structured with shorter-term and floating-rate instruments, this also makes a period of declining interest rates particularly favourable for small caps.
- Apart from a reduction in financing costs, there is another quite significant structural reason to hope for a prospective improvement in small and mid-cap earnings: support for the domestic US economy from a major increase in fiscal stimulus sponsored by the Inflation Reduction Act, as well as the Chips and Science Act, which is now providing major investment across multiple sectors.
- We have concerns about how much spending has been pulled forward to invest in AI, especially as the returns are not currently visible. The current investment in generative AI infrastructure is largely driven by venture capital, which is funding start-ups that are training AI models. However, there are concerns about the sustainability of this funding, especially given the challenges and costs associated with implementation. Generative AI could be a significant phenomenon over the next three-to-five years, but we expect its rollout to be slower due to these challenges.
- Over the long term, the market has always been cyclical, and leadership has changed. There are good reasons to believe there will eventually be a resurgence in the performance of small-cap stocks, at some point this year.

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.

Concentration risk: The fund may be concentrated in a limited number of geographical regions, industry sectors, markets and/or individual positions. This may result in large changes in the value of the fund, both up or down.

Currency risk: The fund may lose value as a result of movements in foreign exchange rates.

Currency risk / hedged shareclass: 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.

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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.

Smaller companies risk: Smaller companies generally carry greater liquidity risk than larger companies, and they may also fluctuate in value to a greater extent.

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