Schroders

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Schroder ISF* European Sustainable Market Neutral

Fund Managers: Nick Kissack and Bill Casey | Fund update: July 2023

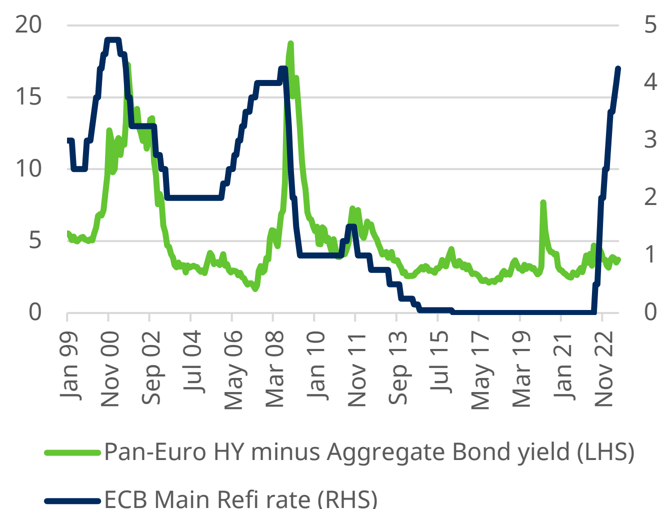
Market overview

– Markets have continued to remain resilient through July. Since March, whilst being net short the market, we have underestimated market positioning and its response to falling inflation, rather focusing on metrics that tend to be very early leads such as money supply growth and lending standards. Monetary tightening clearly plays out with long and variable lags, but we find it difficult to ignore the monetary data and see an inevitable impact on economic growth and earnings. This is playing out more quickly in Europe than in the US for now, and is increasingly evident as we move through the Q2 earnings season. We note a number of the sentiment indicators are now signalling positioning and risk appetite are the highest since 2021.

– Following the various liquidity an monetary metrics that we track, such as central banks balance sheets (flat lining), bank lending surveys (tightening), and money growth (globally negative in nominal terms), the excesses of the pandemic era are gradually being drained out of the system. The excesses were so large however, they have acted like a cushion to for the economy thus far. For example, many corporates and households in the Western world locked in mid term fixed rates at rock bottom levels, and it is not until 2024 that the refinancing wall and hence the true tightening commences. Excess savings at households are also being worked off. This has culminated in a consensus expectation of a "soft landing" or rather "no landing".

– We believe there is a false sense of security priced into markets, and the share prices of particularly the cyclical parts of the market will have to adjust to the realities of a higher cost of capital and softening activity. We see some of the clearest signs of complacency in the corporate bond market where for example in Europe, investment grade spreads are near zero vs sovereigns, the lowest levels since EU was formed. Also, the gap between High Yield (HY) and Investment Grade (IG) rates is extremely low for the current rate environment (Chart 1), despite sharply tighter lending standards and poor economic momentum.

Chart 1. Limited risk premium in HY debt for current rate environment



Sources: Bloomberg, as at 31 July 2023.

Drivers of fund performance

– In the month of July, the fund's net return was -0.4% compared to 2.0% for the MSCI Europe Net TR index, and +0.3% for the Euro Short Term Rate. Our average gross and net exposures were 212% and -18.8%. Our long book added 3.4% and our short book subtracted -3.6% in gross terms during the month. Cash subtracted 0.1%.

– The fund had a positive month in July, despite the continued strong move up in markets. Particular strength in our UK based mid caps drove performance, after a period where the geography / factor has had a difficult time due to persistent high inflation. We are seeing a number of strong idiosyncratic situations play out in this space given the very cheap valuations on offer, such as share buyback launches, activist investors taking stakes, and divisional disposals.

– Our positioning continues to be tilted away from the US economy (consumer / housing) towards the Asian / Chinese economy (consumer) particularly around the themes of

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

peak vs trough consumption. We also see earnings particularly vulnerable for several cyclical industries that have taken a lot of pricing above cost inflation or have built up a very large but cancellable orderbook (over ordering risk), which has been a very strong earnings driver in recent years.

– We exited the month with a net exposure of -18.1% and a gross of 219%. The fund's volatility remains at the mid of our 5-8% target range, the majority of which is equity specific risk.

Calendar year performance (%)

Year	Fund	Comparator 1	Comparator 2
2022	-5.4	-9.5	-0.0
2021	0.2	25.1	-0.6
2020	1.1	-3.3	-0.4
2019	1.6	26.0	-0.4
2018	-5.0	-10.6	-0.4
2017	9.1	10.2	-0.4
2016	0.3	2.6	-0.3
2015	10.0	8.2	0.0
2014	0.4	6.8	0.2
2013	14.1	19.8	0.2

Source: Schroders, net of fees, bid-bid, with net income reinvested. EUR C Acc share class as of 31 December 2022. The fund's performance should be assessed against its objective of providing a positive return over a 12-month period in all market conditions, and compared against the MSCI Europe (Net TR) index and the Euro Short Term Rate (or an alternative reference rate). The comparator benchmarks are only included for performance comparison purposes and do not determine how the investment manager invests the fund's assets. In relation to the MSCI Europe (Net TR) index, the fund's investment universe is expected to overlap materially, directly or indirectly, with the components of the comparator benchmark. 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 MSCI Europe (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.

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 amount originally invested.

Top stock contributors:

– **Future** had a strong month, following a prolonged period of derating, as they announced a £45m share buyback programme (5% of market cap) and scope to go up to 10% of share capital. Online advertising trends have mean reverted after a very strong pandemic era, but Future has been particularly hard hit this year after the surprise loss of a star CEO. We have been close to both the Chair and new CEO, and are happy with the actions being taken with regard capital allocation and investment.

– Unite Group, a UK based student accommodation business, contributed well in the month after a very strong trading update, increasing rental growth and EPS guidance. As a real estate business, trading at book value despite high growth prospects, Unite should benefit from any moderation in UK inflation in H2.

– **Swatch** reported a very strong set of results in July, particularly on the profit margin line. Swatch is over-indexed to the Chinese market where a strong recovery is underway. Aside from China, however, improved global travel flow is benefitting growth. Even in European and US markets where luxury goods trends are softening, Swatch performed well. Swatch is trading well in a number of its price points, but particularly for the MoonSwatch. Innovation at the group is firing on all cylinders, and the stock is far too cheap as compared to its earnings growth prospects.

– **Grifols**, a blood plasma therapeutics and diagnostics manufacturer, had a strong move in the month following a strong set of Q2 results and guidance upgrade (again). Despite having great assets and market position in a highly concentrated sector, the business had suffered tremendously through the pandemic with supply cost issues and a high debt burden. We can see a clear path now for both of these issues to be resolved in the next 18 months, and we are pleased with the recent governance reshuffle – leaving the sensible industry veteran Mr Glanzmann as CEO/Chairman to drive the self-help and restructuring of the group.

Top stock detractors:

– **St James Place** was a key detractor in July, primarily due to the announcement of a cut to fees for clients with the company >10yrs. This was in response to a piece of legislation in the UK called Consumer Duty, where financial services businesses need to prove they are offering value for money to clients. STJ decided to get well ahead of the regulator and cut aggressively, which was unexpected. The long

term growth drivers and leading market position is left unchanged, despite this reset.

- **Short position in global auto manufacturer** detracted, as the stock benefitted from the continued cyclical / risk rally in July. The short thesis is based on two major themes – 1. Peak pricing and margin in Western markets as supply chain issue cease and dealers finishing restocking their forecourts just as demand cools with rapidly rising lease rates for consumers. 2. Rising competition in Europe from Chinese EV manufacturers, which will impact the future profitability of the industry in the mid term.
- **Short position in temp staffing agency** benefited from the broader rally in cyclical stocks as well as sector trading updates that continued to see weak trends but with no major sequential deterioration versus Q1.
- **Short position in glass packaging manufacturer** rose in the month due to a strong set of H2 results. We reduced the position following this. Deflation in the supply chain (namely gas prices) has yet to play into their pricing, and the business continues to egregiously over-earn.

Outlook/Positioning

- As the world economy recovers from the worst global shock of a generation, the pandemic problems have shifted to an energy and inflation crisis. With Central banks having been woefully behind the curve on fighting inflation, the sharp response to tighten liquidity is threatening a global recession. Predicting what happens in the next phase will depend on one's view of how deep the coming recession will be and how quickly inflation will come down. Historic precedent from the 1970's doesn't bode well for those expecting a sharp correction in inflation, but the world is very different 50 years on. It is clear to us now that the post pandemic global economic recovery is being replaced with a global recession as we head through 2023, and we would expect a potential cooling in inflation expectations through this period, allowing central banks some room to ease rate expectations.
- In the interim, we must navigate the liquidity / stimulus hangover of the pandemic years, and until this normalises, we struggle to see the restoration of the bull market. We believe negative real interest rates and real money supply growth are key ingredients for positive equity performance mid term and await their return before we become much more constructive on the market.

Risk considerations

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.

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

Derivatives risk: Derivatives may be used to manage the portfolio efficiently. The fund may also materially invest in derivatives including using short selling and leverage techniques with the aim of making a return. 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.

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.

Issuer risk: The fund is permitted to invest more than 35% of its scheme property in transferable securities and money market instruments issued or guaranteed by an EEA State / governments of the following country: France.

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.

No capital guarantee risk: Positive returns are not guaranteed and no form of capital protection applies.

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 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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