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# Schroder ISF* Asian Convertible Bond

**Fund Managers: Dr. Peter Reinmuth & Chris Richards, CFA | Fund update: July 2024**

## Performance overview

- July was a game of two halves for global equity investors. Stock markets continued on an upward trend for the first two weeks, then changed direction, and we witnessed the start of a rotation out of a rather crowded trade.
- The US Federal Reserve (Fed), as anticipated, did not cut interest rates as inflationary measures headed in the right direction. The Consumer Price Index (CPI) came down more than expected, and the Personal Consumption Expenditures index came in line. Moreover, GDP numbers came in much stronger than expected, showing no signs of weakness in the second quarter.
- In line with this, rates moved further down as the 10-year rate dropped more than 0.4 percentage points to just above 4%. One caveat was the unemployment numbers, which came in slightly higher than expected.
- Oil was down in July, completing the picture of slowing prices, alongside base metals such as copper, aluminium and nickel. Gold showed some volatility and closed the month higher at above USD 2,400 again.
- The VIX, which measures volatility, steadily increased in July and reached a level of over 18%. The VIX has continued to increase since then.
- In the US, the Nasdaq lost -0.7% as large-cap information technology (IT) names came under pressure in the second half of July. On the other hand, the S&P 500 showed a solid positive performance of 1.2%. The broader Dow Jones gained an astonishing 4.5%.
- European markets were middle of the road in July. The Euro Stoxx was down -0.3%, and France's CAC recovered to 0.7% after a disastrous June.
- Still, July turned out to be a positive month for all the other European bourses. Germany's Dax noted a gain of 1.5%, and the UK's FTSE was up 2.5%. Italy and Spain saw gains of 2.2% and 1.9%, respectively. The Swiss Market Index was also strong in July, up 2.7%.
- Asian stock markets showed a more heterogenous picture. Taiwan's TAIEX and South Korea's KOSPI were dragged down by -2.6% and -1.0%, respectively. Hong Kong's Hang Seng closed the month with a loss of -1.0%. On the other hand, China's CSI 300 gained 0.6%. Singapore was very strong and ended the month of July with a gain of 3.7%.
- In Japan, the Nikkei saw a negative reaction of -1.2% after the Japanese yen rallied sharply.
- The global MSCI equity index advanced 1.4% in July. Asia's large cap index, the S&P Asia 50 decreased by -1.7%. The broader MSCI Asia ex Japan was flat in July. The FTSE Asia ex Japan convertible index lost -2.4% this month.

## Drivers of fund performance

- The fund slightly underperformed its benchmark.
- Our overweights in higher-delta semiconductor and materials names had a negative effect in July. While these overweights contributed strongly in Q2, they underperformed during the tech pullback that took place in the second half of July.
- On a single-name basis, our overweights in **Vinpearl**, **Yageo Corp** and underweight to **Singapore Airlines** all contributed to performance.

## Portfolio activity

- The strategy seeks to maintain good upside exposure to Asian stocks, balanced by 'bondfloor' protection. As a result, we maintain an equity exposure positioning above benchmark.
- China remains our largest investment country (though significantly reduced from a year ago and below benchmark), followed by South Korea and Taiwan (both above benchmark).
- Turning to sector, we are risk overweight in IT, Consumer and Financials where we find more attractive structures. Our only underweight sector is Industrials.
- We quite aggressively sold down low delta/low yielding positions in July (where optionality had deteriorated), raising cash from names such as Posco and Anta Sports, Postal Savings Bank and LG Chemical. These were all in truth disappointing underliers in the Asian universe in terms of equity performance, though all provided good bondfloors, allowing us to sell near par despite their weak stocks.

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

With this cash we added to balanced new issues such as **Ping An Insurance** and **Zinjin Mining**.

- In the higher delta space, we took profits in Yageo, and bought back China Hongqiao and Lenovo on weakness.
- The primary market in convertibles remained active in July and we saw good activity as well as good demand for new convertibles in the market. With USD 4.55 billion in Asian convertible bonds, July has surpassed the previous month and has been the strongest IPO month this year.
- Despite the solid issuance market from July, convertibles remain cheap. In line with typical valuation behaviour, convertibles became more attractive with falling stock markets. July saw further cheapening in all regions, with European convertibles now being the most undervalued.

## Outlook

- Chinese names still play a large role in our convertible bond universe in Asia. Hence, economic growth and investor sentiment in China remains a crucial driver of our asset class's performance. This is especially true after blockbuster new issues such as Alibaba and JD.com revived the primary market for Asian convertibles.
- We had previously pointed out that China looked oversold and undervalued.
- The combined market capitalisation of stocks in China and Hong Kong has experienced a significant decline of USD 4.8 trillion since 2021. This amount exceeds the value of the Indian stock market. This decline raises concerns for both China and Hong Kong, particularly when compared to the continuous growth observed in the National Stock Exchange of India during the same period.
- Macro-economic news out of China is mediocre at best. China shows economic growth, but this is feeble and slowing down. The Caixin services purchasing managers' index (PMI) fell to 51.2 in June. The People's Bank of China left interest rates unchanged. We believe there is some room for some more support from China's central bank. At the same time, China is looking for the Fed to cut in order to avoid too much downside pressure on the Chinese yuan.
- Looking at US imports as an indicator for Chinese exports, we see downside price pressure for nearly all product categories.  Whether we look at textiles and apparel, raw materials or, the largest import category, computers and electronics, prices in the yuan are falling. Similar to monetary policy, China seems to turn into a US price taker with little pricing power.
- Broadening the picture to other Asian economies, there is positive news that international air travel figures are up in the region and that overall consumer spending remains robust. Still, it remains an uphill struggle to reach pre-COVID-19 levels in terms of GDP.
- The real estate market in China had acted as a millstone to the economy. Chinese housing construction has now reached a level of around 50% compared to its 2021 high days. There is clearly less new supply. Absorbing the oversupply in the housing market could easily take another two years.
- It is important to note however, that real estate has also long been seen as a store of value for Chinese households. While real estate developers had been severely over-leveraged, households usually had to fully pay for second homes. Hence, there is some hope that at least higher quality projects can be sold to less leveraged developers and will be delivered in the end.
- We had stated before that we need political intervention to rekindle growth and hence global investment interest in the region.

  Looking further into 2024, it's also clear that the negative economic forecast for China is well encompassed into equity prices. For Asian converts, there is an additional discount in terms of valuation.
- In summary: we are left in an investment environment where monetary and fiscal policy are needed as triggers for renewed interest in China. However, Asian convertibles pay coupons, and we can earn a positive running yield. Hence, the market is paying convert investors to wait for this trigger.
- We continue to hold to our long-term conviction that convertible bonds offer great access to exploit equity upside participation in Asian stocks, with a safety net attached.



## Calendar year performance (%)

| Year | Fund (A Acc) | Fund (I Acc) | BM |
|---|---|---|---|
| 2023 | 7.8% | 9.5% | 10.7% |
| 2022 | -13.31% | -11.96% | -8.95% |
| 2021 | 0.49% | 2.11% | -0.07% |
| 2020 | 18.1% | 19.94% | 17.43% |
| 2019 | 9.08% | 10.81% | 9.82% |
| 2018 | -5.65% | -4.16% | -2.30% |

| | | | |
|---|---|---|---|
| 2017 | 9.29% | 10.98% | 7.93% |
| 2016 | 0.63% | 2.24% | 3.12% |
| 2015 | 6.22% | 7.96% | 6.76% |
| 2014 | 1.48% | 3.11% | 2.92% |

Source: Schroders, NAV to NAV (bid to bid), net of fees (where applicable), USD, as at 30/12/2023. The fund's performance should be assessed against its target benchmark being to exceed the FTSE Asia ex Japan Hedged Convertible Bond Index (USD). 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.

## Risk considerations

– **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.

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

– **Interest rate risk**: The fund may lose value as a direct result of interest rate changes.

– **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.

– **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.

– **Credit risk**: A decline in the financial health of an issuer could cause the value of its bonds to fall or become worthless.

– **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.

– **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.

– **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.

– **Market risk**: The value of investments can go up and down and an investor may not get back the amount initially invested.

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