

Schroder ISF* Asian Convertible Bond

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

Performance overview

- The rally on global stock markets showed no signs of slowing down in March. Overall, it was a month without great surprises. The major central banks kept rates on hold and postponed any hopes for fast interest rate cuts. The latest CPI figures from the US indicate a pause in falling inflation readings. Investors now do not expect the first cut before the US Federal Reserve's (Fed) June meeting. Not so in Switzerland, where the SNB reacted to Swiss inflation falling to 1.3% and cut rates by 0.25%.
- Economic data did not surprise either. The US published 3.4% final GDP growth after revisions for Q4 2023. The economic growth in the Eurozone remains stale with Germany stuck in a recession and France's deficit reaching a staggering 5.5% of GDP.
- Gold continues to react more to inflationary fears and lax financial conditions than to higher for longer rates, and reached new highs in several currencies.
- In the US, the Nasdaq and the S&P 500 advanced by 1.8% and 3.2%, respectively. The Dow Jones ended March with a plus of 2.2%
- European bourses also showed positive moves in March. The overall Euro Stoxx gained 4.4%. Despite recession fears, Germany's DAX stated a gain of 4.6%.
- Positive momentum also lifted stocks in Asia. The overall MSCI Asia ex Japan was up 2.6%. Hong Kong's Hang Seng and China's CSI 300 were only just in positive territory with a plus of 0.6% each. Taiwan's TAIEX stated 7.2% and South Korea's KOSPI finished the month on a plus of 4.3%.
- The FTSE Asia ex Japan convertible index advanced 3.7% in March, outperforming equities as measured by the MSCI Asia ex Japan on the upside.

Drivers of fund performance

- The fund slightly underperformed its benchmark in March.
- On a single name basis, overweights in **China Hongqiao** and **SK Hynix** contributed once more. Both investments belong to our higher delta names.

- However, our underweight to Hon Hai cost us relative performance as the underlying equity jumped by a full 45% in March.
- Similar to last month, our underweight in IT names had a negative allocation effect. At the same time, our selection calls within consumer discretionary and industrials generated outperformance.

Portfolio activity

- We have kept the overall exposures of the portfolio rather constant in March.
- China remains our largest investment country, followed by South Korea, Hong Kong and Taiwan.
- Turning to sector, we remain risk overweight in most sectors. In line with the recent past, we see too little overall equity risk in our benchmark and are structurally overweight to find more convex convertibles.
- Global convertible primary markets were very active in March. We saw USD 11.9 billion in new converts coming to the market. We still need to see solid issuance in Asia though. The overall share of Asian converts has decreased to a low 13% of the global investment universe.
- Valuations of convertibles, however, remain subdued. Converts, especially in Asia, are trading below fair value. This is very much in line with the general market sentiment for the region. Convertibles, and especially Asian convertibles remain out of favour and overlooked.

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.
- 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.

- Unfortunately for convertible investors, the originators have not picked up on India. We had seen a wave-like issuance pattern in India 10 years ago. As is often the case in convertibles, performance was solid for a time, and we could make good profits – though several converts had to go into technical defaults at the end.
- What we have seen though is a fast shift in the Asian market. At highs, Chinese convertibles dominated the FTSE Asia ex Japan index with more than 60%. This figure has come down to the mid-forties now in favour of South Korea and Taiwan. We see this as good news as macroeconomic figures from China remain gloomy.
- China's National People's Congress did not result in any wide reaching measures for the economy or for the stock market. The overall growth target of around 5% was expected – even though it could be widely regarded as unrealistic. There is some governmental support though, as China announced to issue around USD 140 billion on ultra-long bond issues to boost special projects.
- Not all is gloom and doom, though. The latest February reading for the Caixin purchasing managers' index was up to 52.7%.
- The real estate market in China continues to act like a millstone to the economy. The downturn in the property market can be attributed to both cyclical factors, such as the slowdown in income growth during the pandemic, and structural factors, including a decline in the working-age population in China, diminishing returns on investments, and slower growth in total factor productivity.
- It is important to note however, that real estate has 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.
- Further rate cuts could of course help, although China's consumer price index turned slightly positive after several months in deflationary territory.
- We had stated before that we need political intervention to rekindle growth and hence global investment interest in the region.
- The January stimulus package with direct intervention in the stock markets, showed that Chinese communist politicians seemed to panic in line with a significant sell off on Chinese stock

markets. We clearly need further measures so that China can dig itself out of this hole.

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.

- Elsewhere in Asia, growth figures look more promising. Generally, the region is showing lower inflation rates and solid consumer spending.
- 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.

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

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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