Schroders FundFocus

Schroder ISF* Strategic Bond

The era of passively investing in bonds is dead, but Schroders' innovative approach means this is an alpha-rich environment for Schroder ISF Strategic Bond. Fund manager Bob Jolly explains why.

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'For investors able to invest tactically and strategically across the whole spectrum of global fixed income sectors and FX, this is a market rich in alpha-generating opportunity'

With government bond yields at low levels, isn't this a difficult environment for fixed income investing?
For passive investors it will be tough. Unlike recent years when investors could just buy exposure to the bond market then sit back and watch the returns roll in, it is clear that nobody is going to get rich by investing passively in fixed income in the near future. Bond beta is dead, but for investors like us, who with Schroder ISF Strategic Bond are able to invest tactically and strategically across the whole spectrum of global fixed income sectors as well as foreign exchange (FX), this is a market rich in alpha-generating opportunity.

Schroders' fixed income team is large and I can use the skills and specialist knowledge of more than 100 investment professionals based around the world. This gives us a significant edge and enables us to exploit the full opportunity set available: duration positioning, country allocation, yield curve positioning, credit, FX, and emerging markets.

The fund has had a solid start to 2013 – what has been driving returns?
Since the final months of 2012 and so far this year, much of our risk budget has been focused on FX markets. We were early to build a short exposure to the Japanese yen in the final quarter of 2012 when it seemed likely that Shinzo Abe would be elected Prime Minister of Japan. His election campaign was based on his intention to enforce an aggressive programme of monetary easing with the goal of ending the deflationary cycle in the country. Since his election success the yen has depreciated significantly versus the dollar and the fund has profited as a result. We have also benefited from a short exposure to the Australian dollar in recent months.

Also making positive contributions to returns so far this year have been our holdings in Portuguese and Irish government bonds, which we have since reduced, and our relative value strategies in credit. More recently, our interest rate positioning has also contributed and we were able to profit from a selloff in bond markets.

What other FX trades are you targeting?
Having recently reduced our short exposures to the yen and the Australian dollar, one of our key FX trades now is a short position in the euro, versus long positions in Scandinavian currencies such as the Norwegian krone. These Nordic currencies should perform well, partly because their strong budgetary positions provide them room to manoeuvre with conventional fiscal policy to boost economic activity.

On the long side we also favour the US dollar. The US economy has been improving and growth is likely to pick up. Also, we think the end of quantitative easing (QE) is likely to arrive slightly earlier than the market expects, which will provide further support for the dollar.

Where else are you finding opportunities in global fixed income?
Interest rates are likely to become an increasing focus for the fund. For example, in recent months we have been building a short exposure to the US Treasury market. There are positive signs emanating from the US, particularly from its property sector, and we will see the US economy gradually accelerate through the remainder of 2013 and so we expect Treasury yields to rise. Indeed, we already saw a significant rise in yields in May and the fund was able to profit from this. However, we do not expect a major bear market in sovereign bonds given central banks would likely be forced to intervene should rising government yields threaten to destabilise improvements in the real economy.

Another interest rate trade we are focusing on is in Australia, where we initiated a short exposure to short-term government bonds. We think current valuations have moved too far and markets are now discounting too many rate cuts from the Reserve Bank of Australia. The central bank recently cut rates primarily to ease the strength of the currency and we do not expect further cuts unless the domestic economy deteriorates significantly, particularly considering the signs of stabilisation in the housing market. On the other hand, we have a long exposure to Japanese government bonds in the belief that the recent volatility has been excessive in response to the Bank of Japan policy announcements. In the longer term we expect the BoJ to become a major buyer of Japanese government bonds and demand could start outweighing supply.

What is your view on corporate bonds?
Corporate bond valuations in general may look fairly unappealing compared to history at the moment, but when you dig down a little there are gems in the rough. Identifying the companies that will prosper and those that will struggle will be crucial in corporate bonds this year. Using the in-depth research from our extensive team of credit analysts located around the world we are looking to profit from both sides using our long/short credit strategy, exploiting opportunities where we think corporate bonds have been mispriced.

As we expect the yields on core sovereign bonds to rise in the near future, we have been targeting corporate bonds which are not too closely correlated with sovereign bonds as they may, to some extent, provide a cushion against rising yields. In recent months the corporate bond market has been driven largely by investors seeking out sources of yield, and we expect this trend to continue, albeit at a slower pace. In addition, the abundant liquidity in global markets is helping to keep corporate default rates low

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

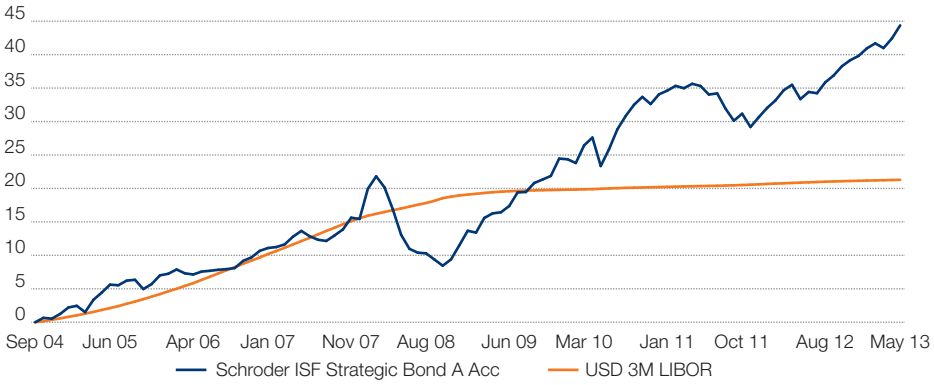
as companies are able to keep their borrowing costs low. We are mindful, however, that central banks will at some point slow the flow of liquidity being poured into the market. The beginning of that process may prove a difficult environment for riskier assets in the short-term, but ultimately we expect the stronger growth dynamics in the US to supersede these concerns.

Are you invested in the eurozone periphery?
Until recently we were investing in Portuguese and Irish government bonds. Their yields looked very attractive compared to the low offerings from most other government bonds and the countries had implemented many of the structural reforms needed to put their economies back on track. In return for making these changes the European Central Bank (ECB) has provided a backstop to the country's bonds in the form of the bond buying programme known as OMT. However, following the strong rally in these bonds in recent months we took profits from these positions and have reduced our exposure.

Do you think talk of the 'Great Rotation' from bonds to equities has been overdone?
So far we have not seen evidence of a wholesale rotation out of fixed income. On the contrary, money continues to come into the asset class. The main rotation we have been seeing is investors moving out of cash and government bonds into corporate bonds and emerging market debt. With a narrowing of the choices in the bond world for finding income, investors are finding that they need to take on greater risk in order to get the equivalent income of the past.

What role does emerging market debt play in the portfolio?
Emerging markets will become an increasingly significant focus for the fund. We have an experienced and successful emerging market debt team based in New York, headed up by James Barrineau, whom we are in regular contact with. The Schroders global fixed income team is always looking to utilise the broad expertise we have around the world and across different sectors, and we will always seek to implement the best ideas that the different specialists put forward. The attractive fundamentals of some emerging markets are hard to ignore and in some ways the traditional notions of what constitutes a safe haven have been turned on their head. If you think about the deterioration of sovereign credit quality in the West's core markets and compare them with the deficits and debts of most emerging markets, it is clear that the metrics of emerging markets are generally far better. Some emerging markets are likely to deteriorate, however, amid a slowdown in the commodity supercycle. As a result, emerging market investing will be increasingly driven by actively seeking alpha-generating opportunities through relative value trades, rather than by relying on market beta for returns.

Cumulative performance since inception[1]



Portfolio return statistics

3 year annualised return	5.4%
3 year volatility	3.3%
3 year Sharpe ratio	1.6
3 year Sortino ratio*	2.1
3 year Maximum drawdown	-4.8%

Source: Schroders
1 Cumulative performance since inception to 31 May 2013, net of fees. Return is calculated on the A Acc USD share class. Past performance is no guarantee of future returns. Please refer to the Fund's offering document for more detailed information.

Fund Manager Biography, Bob Jolly – Head of Global Macro

Bob joined Schroders' Fixed Income Team in September 2011 as Head of Global Macro. Prior to joining Schroders, Bob worked for UBS Global Asset Management where his more recent responsibilities were Head of Currency, UK Fixed Income and Global Sovereign. Prior to UBS, Bob spent two years with SEI investments developing customised solutions for institutional pension fund clients. The majority of Bob's investment career was spent at Gartmore Investment Management where he held various positions, the most recent being Head of Fixed Income Portfolio Construction. Bob is a CFA Charterholder.