Schroders
Monthly Fund Update

Schroder ISF* Asian Bond

Fund overview:

Schroder ISF Asian Bond invests in debt instruments from a diverse range of Asian countries, each with very different economic structures and credit fundamentals. While the Asian bond asset class is relatively young, it is one that is growing rapidly, presenting a multitude of opportunities for investors. In recent years, Asian governments have embarked on a process of structural improvements, which have resulted in increased foreign reserves, healthier banking systems and improved trade balances. Asian bonds thus have the potential to benefit from healthier economic growth, in addition to the current favourable environment of stable inflation and longer term Asian currency appreciation.

Risk aversion eased during April, boosting many of the fund's positions. We were short duration as government bond markets fell, while our exposure to the rising US dollar also supported returns. The selloff in many bond markets should present more attractive buying opportunities ahead, and the portfolio will capitalise on such opportunities as they arise.

In-depth:

What have been the main drivers of recent fund performance?

As risk aversion eased during April, credit markets staged a rebound globally, particularly in the Asian high yield corporate sector, boosting the fund's performance. While G3 and most Asian local bonds fell over the month (very sharply in the case of the Philippines and Indonesia), the fund's overall short duration strategy, as well as minimal exposures in the Philippines and Indonesia, helped the fund to weather these volatile conditions very well. The fund's timely hedging of its non-US dollar exposures last month also helped performance given the US dollar's recovery against many Asian currencies.

What have been the key market events affecting the asset class recently?

US economic data continued to point to a sluggish economy, but perhaps not as dire as many had earlier feared. Similarly, major US corporate earnings turned out better than expected, lifting broad equity indices and tightening corporate credit spreads in the process. Undoubtedly, amidst sustained housing deflation and record low consumer confidence, aggressive US monetary and fiscal policy measures played a key role in calming risky asset markets. Concurrently, reduced flight-to-quality flows, lower expectations of further Fed easing as well as rising/sticky inflation (especially in Asia) caused G3 and many Asian local bond yields to rise sharply. In currency markets, the US dollar finally regained some of its footing against major currencies while signs of economic weakness started to surface elsewhere, particularly in Europe. Amongst Asian currencies, the notable outperformers during the month were the Singapore dollar and the Malaysian Ringgit, underpinned by hawkish central banks which are relying on a strong currency framework to manage rising inflation pressures.

What have been the key trades recently?

Our defensive portfolio posture was unchanged during the month as duration was kept short and non-US dollar currency exposures were minimal. With improved liquidity in the credit sector, the fund took the opportunity to trim selected less attractive corporate bond exposures.

What are the main themes running through the portfolio in view of the outlook for the market?

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Interest Rates: The continuation of the credit crunch, as reflected by further tightening in lending standards in the latest Fed Senior Loan Officer Survey, points to latent risks in the broader US real economy despite tentative signs of stabilisation recently. With crude oil prices hitting record highs and stoking inflation worries; the FOMC effectively signalling a pause in its policy response after 325bps of cumulative rate cuts; and risk assets clawing back their recent sharp losses, the environment could remain hostile to government bond markets for a while longer.

However, we do expect US economic momentum to fizzle out, perhaps after the temporary fiscal-induced boost, with downside pressures to risk assets reappearing at some point. Further rises in government bond yields ahead would hence be regarded as opportunities to raise our duration from current low levels.

In Asia, countries continue to battle inflation on the back of higher food/energy prices amidst still resilient (but slowing) growth. Certain local bond markets which had sold off sharply recently, such as Indonesia and the Philippines, should present more attractive buying opportunities ahead as appropriate policy measures are being introduced, and the portfolio will capitalise on such opportunities as they arise.

Currencies: Protracted slow US growth versus more resilient growth in the rest of the world, low US interest rates versus sticky interest rates elsewhere, and more intense inflationary pressures in the rest of the world (especially Asia) versus the US, should support a continuation of the weak US dollar trend. However, from deeply oversold levels, the US dollar is currently staging a tactical recovery as we had expected, in line with the pause in Fed policy. Expectations of a spill-over of US economic weakness and financial sector concerns, particularly into EU, together with a rebound in risk assets, could help prolong the US dollar bounce ahead. We are thus maintaining our current defensive currency posture in terms of minimal non-US dollar exposures, and will look to reinstate selected Asian currency exposures on weakness ahead.

Credits: Better than expected US economic data and aggressive policy measures to help the economy suggest that credit markets globally could extend their gains in the near term. In Asia, while current spread levels suggest good long-term value, buying interest is countered by expectations of heavy new issuance and uncertainties over the strength of the US economy and financial markets. We hope to participate in selective good quality new issues that come at meaningful concessions, but retain an overall defensive bias. Credit spreads globally could widen again given continued tightening in global banks' lending standards and still fragile investor sentiment, especially if the US real economy struggles to grow and inflation globally remains sticky, as is expected.

Could you explain the investment process/strategy?

We use a mix of top-down macroeconomic analysis and bottom-up security selection seeking to add value in three core areas: interest rates, currencies and credits. Our approach is unconstrained by a benchmark, which enables active management within risk parameters. Our investible universe comprises 14 Asian countries (excluding Japan), each with very different economic structures, credit fundamentals and a relatively low correlation to each other. We can diversify into cash/G7 bonds (up to a maximum of 30%) to provide greater flexibility for capital preservation and interest rate/currency management. As a result, by investing across different Asian countries in debt denominated in both major and regional currencies and selected diversification outside of Asia (where permitted), we seek to reduce overall portfolio volatility.

30 April 2008

*Note: Schroder International Selection Fund may be referred to as Schroder ISF throughout this document.

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