Fund Focus
Schroder ISF*
– Emerging Markets
– Global Emerging Market Opportunities

Allan Conway, Head of Emerging Market Equities

Although emerging markets have delivered impressive returns over the last 12 months, we believe that they continue to offer strong upside potential. Their excellent growth prospects and robust fundamentals compared to the developed world are increasingly attracting investors and we would expect valuations to move to a premium to developed markets over time. Schroder ISF Emerging Markets offers diversified exposure to the asset class, while Schroder ISF Global Emerging Market Opportunities takes an innovative, highly flexible approach, targeting absolute returns.

We spoke to Allan Conway, Head of Emerging Market Equities, about the two funds and how he sees the emerging markets story unfolding in the coming years.

After such strong gains in the past year does the rally have further to go?

Yes, we believe these markets continue to offer strong upside potential on a medium-term view. Despite the excellent performance we have seen over the past year, emerging markets are on a prospective price-to-earnings ratio (P/E) of around 12 times, which is in line with the long-term average, and therefore not expensive. These markets were massively oversold in the turbulent market conditions of 2008 and all the rally has done is take them back to long-term average valuations. Taken together with their excellent growth prospects, we believe this is a very attractive picture.

What is behind the strong growth in emerging economies?

Emerging markets are increasingly driving their own growth, with domestic demand and trade between emerging countries becoming much more important – in recent years, the emerging economies have been growing 4% to 5% faster than the developed economies. These economies are also, broadly speaking, unencumbered by the huge private and public debt problems of the developed world – unlike the most advanced economies they do not face the drag on GDP growth of a prolonged deleveraging process.

We are living through a period of important structural change in the global economy in which power is shifting from the developed to the emerging world. The emerging economies are now the drivers of global growth and we would suggest that they will account for 70-75% of global growth every year for the foreseeable future.

Furthermore, the superior economic performance of emerging countries is translating into company profits – earnings growth is expected to be around 30% in these markets this year. Given their attractions, we are expecting emerging market valuations to move to a premium to the developed world in the coming years. There is a huge amount of liquidity in the financial system and it is unlikely that this will be withdrawn in haste, as central banks will not want to endanger the anaemic recovery we are seeing. These favourable liquidity conditions are likely to fuel asset price bubbles and in our opinion, emerging market equities are the most likely beneficiary. We are already seeing huge amounts of money flowing into these markets and we could well see valuations being pushed up to much higher levels over the next couple of years.

Do you see any risks to these markets on the horizon?

While the medium to long-term prospects for emerging markets are very strong, we are more cautious on the near-term outlook. US economic data is pointing to stronger-than-expected growth in the near term and as a result, the US dollar is strengthening. Taken together with the modest tightening of monetary policy underway in some emerging economies (in particular, China and India) and uncertainties over the fiscal difficulties in some eurozone countries, this creates the potential for a degree of near-term profit taking. However, we have already seen some of this playing out this year and we would expect the potential downside to be relatively limited. Overall, we believe the short-term risks should not detract from what is a highly positive medium to long-term outlook.

How can investors tap into this investment potential?

Schroders offers several products which aim to take full advantage of the investment opportunities available in this asset class, and these include Schroder ISF Emerging Markets and Schroder ISF Global Emerging Market Opportunities.

Schroder ISF Emerging Markets provides diversified exposure to global emerging markets and aims to achieve 50% of its value added through country allocation and 50% from stock selection.

Where are you finding the best opportunities for this fund?

We are finding some of the best opportunities in terms of valuation in Korea, Russia and Turkey, and these markets represent our largest overweight positions. Furthermore, earnings growth in Korea is strong and this market is likely to continue to benefit from global economic recovery. In Russia, liquidity conditions are supportive and economic fundamentals are improving, while the growth outlook in Turkey is reasonably good.

In contrast, we are cautious on markets like India and Taiwan where valuations look expensive. In addition, we have concerns over inflation and interest rates in India. We are also underweight South Africa as the earnings growth picture is unattractive.

How has the fund been performing recently?

Despite achieving an impressive absolute return during the market rally over the last 12 months, the fund has underperformed the benchmark. One of the features of the strong market conditions has been what we have termed a 'trash rally'. During the period between the end of February and the end of July last year, many of the stocks that led the market rally typically had weak fundamentals – characteristics such as high operational leverage, very weak balance sheets, large downward revisions to their earnings estimates in the three months prior to the rally, extremely weak performance over the six months prior to the rally – and were typically small, illiquid stocks. Our investment approach means that, broadly speaking, we were underweight in these types of stocks. We generally had a preference for defensive stocks with low operational leverage and for large caps over small caps. These stocks underperformed in the rally and hence relative performance was impacted, although this was also a tough market environment for many of our competitors.

The extremely volatile market conditions we have seen so far in 2010 have also made outperformance difficult. However, we would expect that once market conditions normalise and the level of general uncertainty declines the fund will return to outperformance.

Schroders

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

Fund Focus Schroder ISF Emerging Markets & Global Emerging Market Opportunities

You mentioned you have another fund investing across emerging markets – how does this differ?

As well as our core global product, we also offer a fund investing in global emerging market assets which targets absolute returns and has a much higher level of investment flexibility – **Schroder ISF Global Emerging Market Opportunities**. This is an innovative product in the emerging markets sphere and we know of no similar competitor product.

How does the fund work?

Schroder ISF Global Emerging Market Opportunities is an unconstrained fund and can be positioned aggressively to maximise growth potential when market conditions are favourable and can also be very cautiously positioned when stockmarkets are expected to be weak.

The fund can have up to 60% in cash and global bonds in order to protect returns during such periods. This was of particular benefit during the market sell-off of 2008 in shielding the fund from the full extent of the market falls.

The majority of the portfolio is typically invested in emerging market equities as we believe these are likely to deliver strong returns over the longer term. The fund provides focused exposure to the best investment ideas generated by our global team of emerging market experts. It aims to have at least 60% of its equity content in a shortlist of core markets which we believe offer the best 'top-down' investment potential. The remainder of the fund's equity content is invested in our strongest stock-specific ideas from other emerging markets. Our best ideas can include selective exposure to emerging markets fixed income.

How is the fund currently structured?

The portfolio has exposure to six core markets at present – Korea, Russia, Turkey (for similar reasons to our relatively high exposure to these markets in Schroder ISF Emerging Markets) Thailand, Indonesia and Egypt. Valuations are at attractive levels in Thailand and Egypt. Furthermore, the growth outlook in Thailand is improving, while we like Indonesia as return on equity is relatively strong. We also have exposure to several markets where we have identified a number of strong stock-specific opportunities, including China, Brazil and Taiwan. Finally, the portfolio has substantial exposure to cash to guard against the potential for near-term market volatility. Overall, the fund's approach has worked very well, enabling it to deliver strong absolute returns over one and three years.

Emerging Market Equities – Investment Process

Schroders has a balanced approach to investing in emerging markets. We use a mix of top-down analysis and bottom-up stock selection, looking to derive added value from both country allocation and stock selection. Our core investment process does not target any particular style bias and aims to outperform in most market environments.

Country Selection

We believe that selecting the right countries to invest in within the emerging markets universe is a key decision. We use a proprietary quantitative model to drive country allocation. The model uses five groups of factors, which are scored to produce a ranking of countries across the global emerging market universe.

The output of the model is reviewed at the monthly strategy meeting to determine if there are any reasons not to follow its recommendations. This judgmental overlay is based on three groups of quantifiable factors (equity, macro and sector) and other non-quantifiable factors (politics, for example).

Stock Selection

We do not believe quantitative tools can replace a good, well incentivised analyst conducting fundamental research in generating successful stock ideas. The primary research universe consists of all stocks in the MSCI Emerging Markets Index, although we also aim to find good investments from the wider emerging market universe. Our team of over 20 emerging markets analysts is located in eight offices. Through their extensive programme of company visits, we evaluate a company's management team, obtain key inputs for earnings models, assess the company's strategy and review its operations.

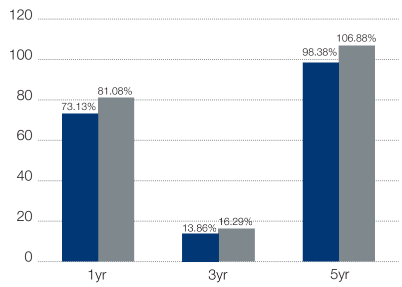
Portfolio Construction

At the country level, allocation decisions are driven by the quantitative model suggestions with controlled judgmental overlay from the team. The monthly strategy meeting is attended by all members of the emerging markets team and the whole team contributes to the discussion on countries. However, the final allocation decision is owned by five key investment professionals: Allan Conway, Head of Emerging Market Equities, the three global fund managers (Robert Davy, Waj Hashmi and James Gotto) and Nicholas Field, Emerging Markets Strategist / Fund Manager. At the stock level the global fund managers, in conjunction with the relevant analysts, construct a country portfolio for each country they are responsible for. We take an extremely pro-active approach to managing risk in our portfolios through rigorous risk budgeting both at the overall portfolio level and right down to the stock level. We adjust each individual manager's risk budget depending on performance and we apply a stop-loss rule to limit the damage that mistakes can do to the portfolios.

Biography – Allan Conway

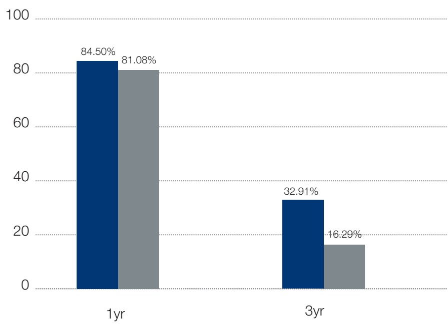
Allan joined Schroders in October 2004 as Head of Emerging Market Equities. His investment career began in 1980 and he has worked at companies including WestLB Asset Management (where he was Head of Global Emerging Markets and later Chief Executive Officer of WestAM (UK) Ltd) and LGT Asset Management (where he was Head of Global Emerging Markets). He is a Fellow of the Securities Institute (FSI), Member of the Institute of Chartered Accountants (ACA) and has a BA (Hons) Degree in Economics from York University.

Fund performance (cumulative returns)



Schroder ISF Emerging Markets
(Managed by Allan Conway and Robert Davy)

- A shares
- MSCI Emerging Markets



Schroder ISF Global Emerging Market Opportunities
(Managed by Allan Conway and Nicholas Field)

- A shares
- MSCI Emerging Markets**

**The index performance is for information only as this fund is benchmark unconstrained.
Source: Schroders. Based on A shares, bid-to-bid, US dollar terms to 31 March 2010.