Schroder ISF* Emerging Europe
Monthly Fund Update

In summary

Emerging European markets delivered a positive overall return in April, as did the fund. Looking forward, the key reason for investing in emerging European markets is to access their excellent long-term potential. Over the medium to long term, these economies are expected to achieve faster rates of growth than the more developed countries. Russia has huge reserves of oil, natural gas and metals, putting it in a strong position to supply more developed countries, where many natural resources are becoming increasingly scarce. Turkey is another of the region's larger markets. It has an attractive domestic market due to a large and growing population and is highly competitive as a manufacturing hub for western Europe.

The market and the drivers of fund performance

The MSCI World index delivered a positive return in euro terms over the month. The improvement in investor sentiment seen in the previous month continued into the early weeks of April. However, markets gave back some ground in the latter part of the month as concerns over fiscal difficulties in the eurozone resurfaced, with rating agency Standard & Poor's downgrading the sovereign credit ratings of Greece, Portugal and Spain. Overall, emerging European markets outperformed developed markets against this background although they lagged broader emerging markets. Turkey was the strongest performing market in the region as it continued to rebound from weakness earlier in the year. Local currency appreciation boosted performance in euro terms. Data was also released showing industrial production growing by 18.1% year-on-year in February, which was ahead of consensus expectations. The Czech market also outperformed after lagging in March. Over the month, data was released showing Czech industrial production increasing by 7.0% year-on-year in February. Hungary and Poland underperformed, following the strong returns delivered in March. In Hungary, the centre-right Fidesz party won the country's parliamentary elections, while the central bank reduced interest rates by 25 basis points. The energy-dominated Russian market also underperformed, despite an increase in oil prices over the month, with the central bank cutting interest rates by 25 basis points.

Stock selection and asset allocation both had a positive impact on fund performance in April. Stock selection in Turkey added most value, while stock selection in Poland was also beneficial. Our overweight in Turkey added value (we are overweight as valuations are attractive and the growth outlook is improving) as did our underweight in Poland (we are underweight as we have concerns about the level of potential equity issuance in this market).

The market outlook and portfolio strategy

We remain overweight Russia/CIS. We expect a strong recovery in Russian growth in 2010, which we believe will be driven by the combination of base effects, the improved financing environment and improvements in wages, pensions and commodity prices. Liquidity conditions are supportive and valuations are at attractive levels. We remain overweight Turkey. Growth is expected to rebound relatively strongly and valuations are attractive. However, concerns over inflation (we are expecting interest rates to be increased during the year to combat inflationary pressures) and continued political uncertainties mean we have only a modest overweight in the market. We remain neutral Hungary. Growth is set to remain subdued in 2010, although expected further reductions in interest rates would provide some support to the economy. A key positive is that many necessary structural reforms to improve Hungary's attractiveness as an investment destination have already been implemented. Furthermore, a large amount of pain on the fiscal side has already been taken due to IMF constraints on spending. However, we are finding better opportunities elsewhere in the region in terms of valuation. We remain underweight the Czech Republic. Valuations look attractive, but relative earnings growth versus the region is notably poor and we can see limited catalysts for the market to re-rate. Poland remains our largest underweight. Our main concern is that the level of forthcoming equity issuance due to government privatisations could result in a very large overhang for the market to absorb.

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