

Quarterly Fund Update

Schroder ISF* Emerging Markets Debt Absolute Return

Fund Overview

The Schroder Emerging Markets Debt team manages global emerging market debt funds using a variety of instruments and techniques in an effort to enhance overall risk-adjusted returns. The funds aim to achieve high, long-term absolute returns while keeping volatility to a minimum. Specifically, the team aims to make positive returns in any 12 month period. The team manages 'absolute return' EMD funds of over **US\$8,939 million*** (as at 30 June 2010) on behalf of private clients, institutional and retail investors worldwide.

*Source: Schroders

Cumulative Gross Returns to 30 June 2010

US\$ %	3 months	2009	1 year	2 years	5 years	10 years	Since inception annualised
Schroder ISF Emerging Markets Debt *	0.48	19.72	11.20	17.33	52.76	174.44	10.77
JPM EMBI+	1.44	25.95	17.44	20.29	49.03	174.59	9.39
JPM ELMI / ELMI+ **	-4.42	11.69	2.31	-4.28	41.06	119.52	8.47

€uro Hedged %	3 months	2009	1 year	2 years	5 years	10 years	Since inception annualised
Schroder ISF Emerging Markets Debt *	0.34	19.00	10.62	16.24	44.51	162.49	9.93
JPM EMBI+	1.25	25.36	17.07	17.07	39.98	161.05	8.58
JPM ELMI / ELMI+ **	-4.79	10.65	1.80	-6.89	31.13	105.96	7.42

Since Dec 1998*** in US\$	Fund	EMBI+	ELMI+ **
Annual Rate of Return %	12.30	12.15	8.41
Annual Volatility %	6.75	10.94	7.03
Sharpe Ratio	1.40	0.88	0.80
Sortino Ratio	2.88	1.10	0.92
Correlation	1	0.63	0.63
Positive Quarters %	89.13	76.09	71.74
Maximum Drawdown %	-9.26	-19.71	-19.93
Best Month %	8.84	8.52	5.52
Worst Month %	-3.71	-13.79	-8.73

Source: Schroders

* SISF EMD C Nav Gross 31 August 1997

** ELMI used until 31/01/02 (index discontinued)

*** Dec 1998 – Geoff Blanning became the Lead Fund Manager for the fund

Review

Schroder ISF EMD Absolute Return maintained a very defensive positioning during the quarter under review. This positioning was characterised by high cash exposure, low positions in external debt while the local debt exposure is mostly currency hedged. As a result, the fund has managed to weather, during the quarter, the recurrent pressures on most EM bonds and currencies.

The defensive positioning was justified by unattractive valuations, heavy investors' positioning and poor chart patterns. We also believe that the second half of this year is likely to bring more bad surprises in terms of economic activity. We think that the effects of the credit squeeze in China, the ongoing disorder in the Eurozone and the fading fiscal and monetary support in the West have yet to severely propagate to the real economy.

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



In Emerging Markets, the poor performance of some currencies during the quarter (notably in Eastern Europe and in trade or commodity sensitive countries) is an early warning of what's to come in terms of global economic and trade activity. While these exchange rates are discounting to some extent the unfolding slowdown, most EM credit spreads have not yet widened meaningfully.

The exceptions are Venezuela and Argentina where sovereign spreads have widened by 430 bps and 220 bps respectively from their lows of the quarter. We have always considered these weaker and less liquid credits as a leading indicator for the sector as a whole. In other words, unlike the reassuring comments from a variety of EM investors, we do not view this as a "healthy differentiation". Indeed, during major market downturns, pressures tend to first affect the most vulnerable credits and then spread more meaningfully to the rest of the sector.

Investment Outlook

Global

- There appears to be little that could reinvigorate global financial markets in the foreseeable future as the key sources of the recent economic recovery have already been exhausted. Indeed, both Western fiscal stimulus and China's credit surge are now in full reverse mode.
- Moreover, the deleveraging of the private sector in key economies has not yet shown any sign of abating, as evidenced by the relentless and broadening slowdown in monetary and credit aggregates. Signs of policy impotence are also appearing; neither a mega European bailout package nor the apparent attempts by Euroland governments to restore fiscal sustainability have sufficed to stabilise markets convincingly. This may be a warning that deflationary forces may have taken hold.
- Global capital flows have to overcome an increasing number of hurdles imposed by more hostile and uncoordinated policy frameworks. New regulations and taxation in developed countries and a variety of capital and credit controls being imposed by some Emerging countries will only worsen an already contracting global financial liquidity.
- Against this challenging backdrop, recurrent dislocations could remain a feature of global financial markets in the near future. The unity of the Eurozone may continue to be challenged. Policy mistakes and investment excesses in China are likely to be fully exposed. The US private sector deleveraging could intensify.
- Consequently, investment opportunities are becoming scarce. Even assets in sound Emerging economies (see below) could suffer from unattractive valuations, heavy investors' participation and poor chart patterns. Absent a meaningful repricing or a major change in the poor trends highlighted above, our fund will remain on the sidelines with high cash balances and with minimal exposure to EM credits and currencies.

Asia

- Extrapolating the recent trend, investor expectations of Chinese growth remain sky-high. However, the key driving forces of growth in the past 10-20 years – the roll-back of the State sector, exports and FDI – have all slowed markedly in the past 12-24 months. Demand-supporting borrowing and spending – notably at local government levels – boosted aggregate demand recently and the property market also boomed; these supports will also now fade. The **coming China slowdown** will be the key theme for investors in Asian assets to recognise in the next 6-12 months.
- Though relative fundamental strengths in Asia remain, the prospect of disappointing Chinese growth tarnishes the outlook for economies which have benefitted most from China's boom – primarily Korea, an investor favourite in currency markets. Sentiment towards commodity-driven Asian economies may also sour a little, especially where political dynamics are poor (Malaysia and, potentially, Indonesia).
- Philippines and India stand out clearly as relatively attractive within the region. Philippines has a sound banking system and a new President with a strong mandate for reform. India's steady progress in deregulation continues to be a key driver of impressive domestically-driven growth.

Eastern Europe

- The Baltic States, Russia and Kazakhstan are amongst the countries that have made good progress in reducing their fiscal and balance of payments vulnerabilities. Therefore, they appear better equipped to confront renewed global dislocations. However, valuations currently offered by assets in these countries are not compelling. The same could be said about Hungarian fixed income assets. These could also suffer from a reform fatigue or from potential policy mistakes that the new and inexperienced government is likely to make. Investments in Romania should still be avoided as the fiscal adjustment that the government has just initiated is unlikely to be implemented in an orderly manner.

- Poland has manageable debt and fiscal dynamics. Buying opportunities could be contemplated when we have enough evidence from chart and sentiment analysis that the ongoing currency depreciation has run its course.

Latin America

- Elections in Latin American countries are taking place with no major surprises so far. Brazil is likely to dominate the headlines as the electoral process should create further political noise. This political paralysis is occurring at what may be a critical juncture for the economy and for domestic capital markets.
- Growth has recently outperformed in Brazil, Peru and Argentina as a result of expansionary fiscal policies. We believe that these growth trends could soon be interrupted as these economies are becoming even more reliant on global commodity prices and on global capital inflows.
- Investment opportunities in the region should be limited to safe credits such as Mexico, where local bonds in particular should remain supported by the long-term structural issues that the economy is facing.

Middle East / Africa

- Dubai's debt restructuring has lately made some progress. However, we remain sceptical about the long-term viability of many private and government owned entities. The low level of yields offered by most GCC corporate issuers does not compensate for the prevalent deflationary trends in the region.
- South Africa and Turkey are witnessing a decent economic recovery supported by lax monetary and fiscal policies. However, such policies are also returning these countries to a position of macro-economic imbalances, characterised by widening deficits and an increasing reliance on foreign financing. Therefore, Turkish and South African assets are due for a repricing.

Quantitative Analysis

- Since the beginning of this year, we have been highlighting that the abrupt deceleration in global monetary aggregates heralds a period of renewed dislocations for global financial assets. Our analysis this quarter of China's credit cycle reinforces this view. Indeed, the "stop and go" credit policies that were carefully orchestrated in the past have been replaced by an uncontrolled surge in credit (2008/2009), followed by a sharp deceleration (2010) which bears the hallmarks of "boom and bust".
- The Quantitative Model shows that the global macro-economic imbalances that prevailed at the onset of the credit crisis have reappeared, as recently implemented policies have prevented or delayed an overdue adjustment. Little has changed with the poor scoring of most Eastern European countries. In contrast, Asian countries such as Taiwan, Philippines, Thailand, Malaysia, Indonesia and Singapore are very highly scored. In Latin America, the poor score of Brazil is noticeable. This can be explained by a large stock of foreign short-term capital (hot money), a credit cycle due for a pause, and growing net foreign liabilities in the banking system.

Chart Analysis

- Long term Chart Analysis identifies a divergence in performance between EM external debt and local debt. Pattern analysis of local government yields concludes that lower yields in Mexico, China, India and core Asian markets should be expected. In contrast, external EM bonds and the EMBI Sovereign spread are forming reversal patterns suggesting higher yields are in the offing. There is even a high risk that these moves for higher yields in EM credits could become aggressive.
- The uptrend in southern European yields is set to continue. G3 bond yields look set to fall accompanied by sharp declines in both EM and developed equity markets.
- Regarding currencies, Chart Analysis suggests that the strong Dollar trend will continue and may broaden out from the European currencies to strengthening against Asian and Latin American currencies. The moves may well be rapid and wipe out most of the gains made by these currencies over the last 12-18 months.

Sentiment Analysis

- The ongoing loss of momentum in the pace of the recovery is widely considered by market participants as normal at this stage of the economic cycle. Recent broad based weakness in global financial assets has yet to lead to a meaningful adjustment in growth expectations or in investors' positioning; negative
- Optimism towards the Emerging Markets remains prevalent, as evidenced by the heavy positioning in all sectors (bonds, currencies and equities). It should be noted that while EMD spreads have been widening lately, mutual funds in this sector have been increasing their beta. This apparent "buy on dip" attitude warrants caution.

- The Consensus Forecast Model suggests that the Euro, US treasuries and some high grade EM bonds could perform strongly in the period immediately ahead, as a result of negative market expectations and low positioning. The exact opposite could be said about Emerging Market currencies.

Abdallah Guezour / Geoff Blanning / Nick Brown / Guillermo Besaccia / Malcolm Melville – 28 June 2010

Asset Allocation as at 30 June 2010

Holdings as at 30 June 2010 %

	Exposure	Duration
Mexico	1.8	1.7
China	0.4	3.9
Malaysia	0.6	1.1
Hungary	0.4	0.6
Poland	1.2	1.9
External Debt	3.4	
Mexico†	6.8	3.5
China	5.9	4.0
Indonesia†	5.0	4.7
Korea†	3.2	4.6
Malaysia†	3.0	3.1
Singapore^	7.4	0.6
Taiwan†	0.8	0.1
Czech Republic†	3.8	0.8
Hungary†	2.0	5.0
Poland†	4.9	3.2
Russia†	0.2	1.7
Turkey†	2.0	0.6
Ukraine	0.1	0.0
Local Debt	42.9	
US Treasury Bonds	15.2	14.4
Cash	38.6	

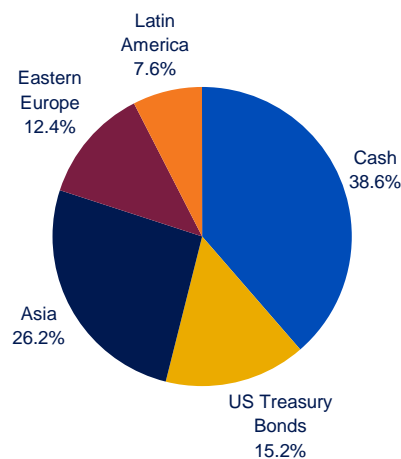
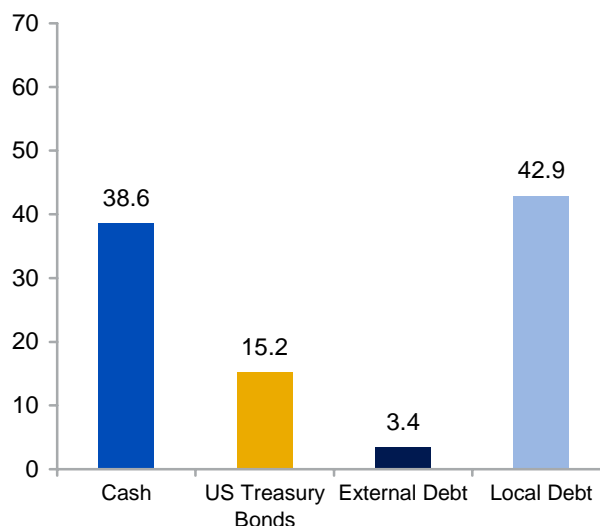
Source: Schroders

^ Partially Hedged

† Fully Hedged

Performance Overview

Sector Allocation as at 30 June 2010 %



Fund Summary	%
Yield to Maturity	1.56
USD Exposure	92.3
EURO Exposure	0.0
EM Currency Exposure	7.7
Duration (years)	3.43
Average Credit Rating	AA
Corporate Bonds	0.68

Fund information	Fund manager	Geoff Blanning
	Managed fund since	31 December 1998
	Launch date	29 August 1997
	US\$ size:	US\$7,728 million
	Annual Management Charge	0.90% (for 'C' class shares)
	Estimated Total Expense Ratio (TER)	Est. 1.24% (for 'C' class shares) as at 31 May 2010
	Number of holdings in fund	75
Source: Schroders		

Investments in emerging markets are subject to market risk and, potentially, liquidity and currency exchange rate risk. Investments in debt securities are primarily subject to interest rate, credit and default risks and, potentially, to currency exchange rate risk.

This fund may use financial derivative instruments as a part of the investment process. This may increase the fund's price volatility by amplifying market events. Investments in absolute return funds are primarily subject to interest rate, market, liquidity, credit and default risks and, potentially, to currency exchange rate risk.

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