

# Schroder ISF\* BRIC (Brazil, Russia, India, China) Fund Update

Covering December 2011

## Performance Comment

On an underlying basis, fund performance was ahead of the benchmark in December. Country selection added to returns while the impact of stock selection was neutral. In terms of country selection, the fund benefited from the underweight in India, which underperformed, and the overweight in China, which outperformed. However, the overweight to Russia, which underperformed, detracted from returns.

## The market and the drivers of fund performance

Global equity markets produced a broadly flat return in December, with the eurozone sovereign debt crisis continuing to impact sentiment. In early December, EU policymakers made some progress towards regional fiscal consolidation, but the lack of a firm commitment for the bailout programme prompted credit rating agencies to warn of potential sovereign downgrades for several eurozone countries. In the US, the Federal Open Market Committee kept policy unchanged at its December meeting and the accompanying statement provided a somewhat more positive tone on US economic growth and labour market conditions. However, US fiscal policy remains subject to political risks, with the House of Representatives rejecting a Senate bill that would have extended the payroll tax cut and long-term unemployment benefits. The MSCI BRIC index underperformed the MSCI World index and also underperformed the MSCI Emerging Markets index, reflecting relatively poor performance from the Russian and Indian markets.

China outperformed its BRIC peers in December and also outperformed broader emerging markets. Early in the month, inflation concerns continued to ease as CPI and PPI came in at 4.2% and 2.7% year on year respectively in November, both below consensus forecasts. Moreover, November's economic activity data releases were broadly consistent with a moderation in growth, rather than a hard landing: industrial production rose 12.4% year on year, only slightly below consensus expectations, while retail sales were stronger than expected at 17.3% year on year. Trade growth slowed further in November, but was more resilient than expected (exports +13.8% year on year, imports +22.1% year on year). On the policy front, the authorities cut the reserve requirement for the banking sector by 50bps on 30 November and confirmed that they would maintain 'prudent' monetary policy and 'proactive' fiscal policy in 2012. In other developments, China and Japan announced that they will promote direct trading of JPY and CNY without using US dollars, in order to reduce currency risks and trading costs.

Brazil performed broadly in line with the MSCI BRIC index, with weakness in the Real weighing on returns. However, market sentiment was supported by the government's decision to cancel the IOF tax on foreign investors trading in Brazilian equities. The government also lowered the IOF tax for household credit to 2.5% from 3.0% and reduced the IPI tax on home appliances in order to help stimulate domestic demand. Data releases in December were mixed, with Q3 real GDP growth slowing to 2.1% year on year (from 3.3% in Q2) while October's IBC-Br (the central bank's monthly real GDP proxy) came in below expectations, falling 0.32% month-on-month on a seasonally-adjusted basis. However, inflation continued to moderate, with annual IPCA inflation easing to 6.6% in November from 7.0% in October, while the unemployment rate declined to 5.6% on a seasonally-adjusted basis in November, a new record low. On the policy front, the central bank left the SELIC rate on hold at 11.0%, having announced a 50bp cut at the end of November. The Q4 2011 Inflation Report pointed to a more favourable balance of inflation risks than in the previous report, supporting the market's expectations of further monetary policy easing in Q1 2012.

India underperformed its BRIC peers in December, with inflation concerns and local currency weakness continuing to provide a drag on sentiment. Economic data releases were largely downbeat, with industrial production much weaker than expected at -5.1% year on year in October, sparking a sell-off in a number of industrial-related names. November's wholesale price inflation came in at 9.1% year on year, marginally ahead of expectations, while September's reading was revised up to 10%. The services sector provided better news however, with the HSBC purchasing managers' index rising to 53.2 in November from 49.1 in October. Turning to policy, the Reserve Bank of India kept all of its key interest rates unchanged, as expected, but softened its rhetoric as it highlighted significant downside risks to growth.

Russia underperformed the BRIC bloc in December. Political unrest led to a market sell-off; the unrest was sparked by allegations of electoral fraud in the parliamentary elections, which saw Vladimir Putin's United Russia party take 49.5% of the vote. In response, PM Putin held a four-hour televised Q&A session in an attempt to defuse the crisis

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and also suggested that video cameras could be installed at polling stations for the presidential elections, which are due to take place in March 2012. The political unrest overshadowed largely favourable data releases: CPI inflation eased to 6.8% year on year in November from 7.2% in October, while industrial production accelerated to 3.9% year on year and retail sales growth held steady at 8.6% year on year. Turning to policy, Bank of Russia surprised the market by cutting the refinancing rate by 25bp. In the accompanying press release, the central bank noted the recent decline in inflation and confirmed its expectations of a further decline in inflationary pressure over the coming months.

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### **The market outlook and portfolio strategy**

We are overweight China. The Chinese market offers attractive valuations. Chinese equities remain subject to fears of a hard landing, with the property sector a key focus of the current concerns, but we view these fears as being somewhat exaggerated. The Chinese authorities have signalled their intent to respond to a moderation in growth with looser policy and have already implemented selective policy easing. Inflation also looks to have peaked, removing a constraint to policy easing.

We remain overweight Russia. The Russian equity market is attractively valued and should respond positively if macroeconomic and debt concerns in the eurozone and US begin to ease. However, the market is sensitive to the outlook for crude oil prices, which may be pressured by fears of a slowdown in developed world growth. Recent domestic political discontent could also provide a drag on sentiment, although this is anticipated to be temporary and the economic growth outlook in Russia remains strong.

We are underweight Brazil. Valuations are reasonable, as is earnings growth. However, recent GDP growth has slowed faster than expected, prompting the government to introduce measures to support domestic consumption. Recent policy action from the central bank shows that it is likely to prioritise growth over inflation targeting in the short term and further interest rate cuts are anticipated in Q1 2012, subject to domestic and external environment pressures.

India remains our largest underweight. Economic growth is slowing from high levels and the equity market is expensive. Inflation remains at elevated levels, and while there is speculation in the market that the interest rate cycle has peaked, recent currency weakness is likely to add to inflation concerns. India's fiscal position is also deteriorating, resulting in concerns that the budget could see some fiscal tightening. India has typically been more insulated from a developed world slowdown than its BRIC peers but we continue to find more attractive opportunities elsewhere.

\*Schroder International Selection Fund.

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