

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

Covering October 2011

Overview

The BRIC equity markets rallied in October as global risk appetite was buoyed by hopes of a resolution to the sovereign debt crisis in the eurozone. The BRIC economies remain free of the debt and de-leveraging problems that are proving so painful in the developed world, and we expect them to deliver better rates of GDP growth than their developed world peers over the long term.

The market and the drivers of fund performance

Global equity markets rallied in October, reflecting hopes that policymakers in the eurozone would announce further measures to address the fiscal and financial challenges facing the region. Enhancements to the European Financial Stability Facility were ratified by all EU member states in October and policymakers in France and Germany proposed a further increase to the size of the fund. However, at the end of month, market sentiment deteriorated due to increasing political uncertainty in Greece, which has continued in November. Meanwhile, US economic data releases remained mixed; housing starts recovered strongly in September but consumer confidence suffered a further decline in October. The BRIC markets performed strongly in October and outperformed both developed and broader emerging markets, supported by strong returns from Brazil and Russia, which rallied after September's heavy sell-off.

Brazil strongly outperformed its BRIC peers in October. In general terms, cyclical and high-beta names performed strongly in October, benefiting from an improvement in risk appetite, while defensives underperformed. Economic data releases continued to point to a moderation in growth, with the central bank's monthly real GDP proxy for August weaker than expected at -0.53% month on month on a seasonally-adjusted basis. On the inflation front, October IPCA-15 inflation rose by 0.42% month on month, slightly below consensus forecasts, aided by lower food and clothing prices. Turning to policy, the central bank cut interest rates by a further 50 basis points, taking the SELIC rate to 11.5%. The minutes of the meeting maintained an overall neutral tone, although some market participants continue to anticipate further cuts before the end of the year.

Russia outperformed the BRIC bloc in October, reflecting strength in the oil price and the rouble, and the Russian market's high-beta nature. The September indicators from Rosstat also helped to boost market sentiment: retail sales growth accelerated to 9.2% year on year from 7.8% in August, real wages climbed 6.2% year on year and unemployment dropped to 6.0%. The improvement in year-on-year figures was partly due to a low base effect, which was triggered by last year's heat wave. Nevertheless, monthly growth momentum remained positive. Encouragingly, inflation also eased to 7.2% year on year from 8.2% the previous month. However, industrial production growth disappointed somewhat, slowing to 3.9% year on year from 6.2% the previous month. On the policy front, the central bank left the refinancing rate unchanged but said it would keep a closer watch on the potential inflationary effects of a weaker rouble, rising prices for consumer goods and increased economic activity.

China modestly underperformed its BRIC peers over the month. Nonetheless, the market enjoyed a strong rally, supported by hopes of selective policy easing. On the economic front, China's Q3 real GDP growth was broadly in line with expectations at 9.1% year on year, while September's official activity indicators also helped to support sentiment; industrial production surprised to the upside, rising to 13.8% year on year from 13.5% in August. Consumer-related releases were also encouraging, with retail sales up 17.7% year on year in September from 17% in August. However, there were further signs of a slowdown in the property sector, reflecting the impact of earlier policy tightening. On the inflation front, September's CPI came in at 6.1% year on year, in line with market expectations. In other developments, Premier Wen said that China would 'fine-tune macro policy at a suitable time and by an appropriate degree' and 'maintain reasonable growth in money and credit'. The market welcomed these comments, viewing them as signals that policy adjustment or easing could be on the way.

India underperformed the BRIC bloc in October, with inflation concerns continuing to provide a headwind for the equity market. September wholesale price inflation came in at 9.7% year on year – largely in line with expectations, but outside the central bank's comfort zone. Core inflation also remained sticky. In response, the Reserve Bank of India (RBI) raised the repo rate by another 25bp to 8.5%. This was its thirteenth hike since March 2010, which has seen the policy interest rate rise by a cumulative 525bp. The RBI maintained its anti-inflationary policy stance, but its



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language indicated that further rate rises may not be necessary if the inflation trajectory conforms to projections. Other economic data releases continued to indicate a further moderation in growth from relatively high levels, with industrial production growth for August slightly below expectations at 4.1% year on year.

On an underlying basis, the fund underperformed the benchmark in October. Country selection had a neutral impact on returns while stock selection was negative. In terms of country selection, the fund benefited from being underweight India, which underperformed, and overweight Russia, which outperformed. However, the underweight in Brazil, which outperformed, detracted in October. Security selection was unfavourable in Brazil (overweight CCR, overweight BR Malls), China (overweight China Mobile, overweight Parkson Retail) and Russia (overweight X5 Retail Group). Selection in India had a broadly neutral impact on returns.

The market outlook and portfolio strategy

We are overweight China. The Chinese market offers reasonable valuations and earnings growth. Chinese markets 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 resources available and scope to unwind tightening measures. Inflation looks to have peaked, removing a potential constraint to policy easing, and the recent decline in commodity prices will also help to ease inflationary pressure.

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 very sensitive to the outlook for crude oil prices, which may be pressured by fears of a slowdown in developed world growth. The investment environment also continues to be negatively impacted by the forthcoming electoral cycle.

We are underweight Brazil. Equity valuations are reasonable but earnings growth is deteriorating and the economic outlook is mixed in our view. Recent policy action from the central bank shows that it is likely to prioritise growth over inflation targeting in the short term.

India remains our largest underweight. The Indian economy is strong but growth is slowing and the equity market is expensive. The RBI has responded to inflation concerns by tightening monetary policy but inflation remains high, although there is some speculation in the market that the rate cycle could be close to its peak. 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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