

# Schroder ISF\* Emerging Europe Fund Update

## Covering October 2011

### Overview

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. The MSCI Emerging Europe index outperformed the MSCI World index and the MSCI Emerging Markets index in euro terms, driven by a strong rebound in the high-beta Russian market. In terms of our country positioning, we remain overweight Russia and retain neutral positions in Turkey and Hungary. In early November, we increased our underweight in Poland, using the proceeds to reduce our underweight position in the Czech Republic. We retain our exposure in Kazakhstan for stock-specific reasons.

### The market and the drivers of fund performance

Russia strongly outperformed its Emerging European peers in October, reflecting strength in the oil price and the rouble, and the Russian market's high-beta nature. The September indicators from Rosstat, released in mid-October, 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%. 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.

Poland performed broadly in line with the regional Emerging Europe index in October, aided by hopes of a resolution to the debt crisis in the eurozone and strength in the zloty following FX intervention by the central bank. On the monetary policy front, the central bank kept benchmark interest rates on hold at 4.5%, as widely expected. However, the governor of the central bank indicated that hikes remain more likely than cuts given ongoing zloty weakness. In other developments, the PO-PSL coalition government was re-elected, with Donald Tusk returning as Prime Minister, helping to ease political uncertainty.

Hungary underperformed its Emerging European peers in October, reflecting weakness in the forint. Nonetheless the market enjoyed a strong rally, with sentiment benefiting from expectations of an EU policy response to the Greek debt crisis. However, Hungarian economic data releases continued to reveal the impact of slowing export demand, with industrial production unexpectedly declining 0.4% year on year in August, well below expectations, while September's PMI declined to 48.2 from 50.8 the previous month. The central bank left benchmark interest rates on hold at 6%, viewing a 'wait and see' approach as being most appropriate, given the continuing problems in the eurozone.

The Czech Republic underperformed its regional peers in October, reflecting the relatively defensive composition of the local market index. As in Poland, economic data continued to show the impact of the problems in the developed world, with the HSBC manufacturing PMI easing to 52.3 in September, the lowest reading since December 2009. On the policy front, the central bank left interest rates on hold at 0.75%, as widely expected, and moved to a neutral stance, reflecting ongoing fiscal drag, continuing uncertainties in the eurozone and a weak consumer recovery.

Turkey underperformed its Emerging European peers in October, having outperformed during the sharp market sell-off in September. As in previous months, concerns over the central bank's unorthodox monetary policy provided a headwind: the bank left benchmark interest rates on hold in October and removed its easing bias on benchmark rates but unexpectedly increased the overnight rate in order to help support the lira. Meanwhile, inflation concerns eased somewhat as annual inflation declined to 6.15% in September. However, the central bank said it expects some acceleration in inflation in Q4 as recent lira weakness is expected to push import costs higher.

On an underlying basis, the fund underperformed the benchmark in October. Country selection had a neutral impact on returns while stock selection detracted. In terms of country selection, the fund benefited from being underweight the Czech Republic, which underperformed, and overweight Russia, which outperformed. Stock selection was positive in Turkey, Hungary and the Czech Republic, but negative in Russia and Poland.

### The market outlook and portfolio strategy

The market volatility seen in September and October has continued into November, chiefly reflecting a marked deterioration in the political environment in Greece, which has led to additional concerns that the EU's proposed rescue of the country could fail. More recently, borrowing costs for the Italian government have increased, raising the risk of a recession in the eurozone. Consumer and business confidence in the developed will have been shaken by recent events,

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which is unhelpful in an environment of low developed market trend growth. Adding to the recent global fears are concerns (somewhat exaggerated in our view) of a hard landing in China. The risk of a near-term recession in developed markets has risen, but this is still not our base-case assumption.

We remain overweight Russia. Equity valuations are attractive although market sentiment remains very sensitive to the oil price; in the short term, oil prices could face pressure from concerns of weaker developed world growth. However, emerging market demand for oil remains resilient and in this light Russian equity valuations continue to stand out in the GEM space. Moreover, fiscal drag should ease in 2012, providing some support to growth. On the downside, there has been a de facto tightening of monetary policy recently, with market rates rising towards the level of the government repo rate. Meanwhile, net outflows of private capital continue, reflecting a somewhat poor investment environment.

We retain a neutral stance in Turkey. Macro risk remains elevated and Turkey remains vulnerable to global liquidity trends. However, to a large extent this has already been priced in: the lira is cheap and we have started to see some moderation in the monthly trade deficit and are likely to see the peak in the current account deficit in November. Foreign equity holdings have declined markedly and there are, selectively, some attractive valuations, irrespective of the currently uncertain global macro environment. Although we remain neutral, we view the market with interest.

In Hungary, we retain a neutral stance. The main argument for Hungary is its valuation, which we regard as cheap versus broader emerging markets. However, recent policy measures, such as the law on FX mortgages, look poorly conceived. The broader market is likely to struggle should the eurozone debt crisis deteriorates further, as exports are the only strong support for the economy, and we are watching events closely.

We remain underweight the Czech Republic, but reduced the magnitude of the position in early November. As is the case in Hungary, the Czech economy is very open and slowing global growth will have an adverse impact. However, the Czech index has a high weighting in more defensive names and benefits from a high yield, meaning that it should outperform if global markets sell off, and valuations are reasonable. Nonetheless, the earnings growth outlook is poor in comparison to other markets.

The fund remains underweight Poland, and we increased the extent of the underweight in November. Valuations in Poland are attractive versus history and the emerging markets average, and the market is underowned. However, privatisation plans (currently on hold) and the associated new equity issuance continue to provide an overhang, and we find more appealing opportunities elsewhere.

We retain our off-benchmark exposure to Kazakhstan for stock-specific reasons.

\*Schroder International Selection Fund.

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