

Schroder ISF* Emerging Europe

Monthly Fund Update

Overview

Emerging European markets posted positive returns in July as risk appetite returned on easing fears on Eurozone growth and the impact of austerity measures. Stronger CE3 currencies vs US\$ and strength in commodities also helped returns. The fund underperformed the benchmark over the month, mainly due to our underweight position in outperforming Poland and our stock selection in Russia. 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 positive returns in July after growth surprises from the euro-zone and concerns about the impact of austerity measures on economic growth subsided. The MSCI Emerging Markets Index also finished July positively. A weaker dollar, strength in commodities and growing expectations of relaxing monetary policy in China next year, all helped returns. Emerging European markets were among the best performers, specifically Poland and Turkey. Positive results from the European stress tests also helped to lift returns.

Poland outperformed the benchmark over the period due to a combination of an appreciating zloty and improving growth expectations. The weak zloty is supporting net exports, while an improving labour market is leading to an improved outlook for the Polish consumer. Net EU transfers are anticipated to increase substantially from 2% to 3-4% of GDP in 2010 which should positively impact investment growth. Turkish equities touched a record high on 20 July on news that Turkey's central bank reduced its year-end inflation forecast. Czech Republic and Hungary performed in line with the benchmark. The Czech market was driven by a combination of currency appreciation and improving macro sentiment – Czech is an open economy and exports are highly correlated with German exports, which were robust this month. Similar to the Czech Republic, a continued recovery in the Hungarian market is contingent on the health of the eurozone. The Hungarian market gained on a supportive export outlook and an improvement in global risk appetite. Elsewhere in Europe, Russia performed well. The country's stocks were lifted by a recovery in commodity prices with oil touching \$80/barrel.

The fund underperformed the benchmark index in July on the back of country allocation. The fund's underweight position in Poland detracted as the country's outperformed the market, while our cash position also hurt relative returns. The impact of stock selection was broadly neutral: positive stock selection in Turkey was offset by stock selection in Russia.

The market outlook and portfolio strategy

While economic fundamentals are improving across emerging Europe, the region remains susceptible to contagion from the eurozone debt crisis. This will continue to lead to volatility in all risk asset markets, but valuations are now at attractive levels.

We maintain our overweight stance in Russia, where the economy is gathering momentum. Real wages, disposable income and unemployment are all showing positive trends and corporate profitability is continuing to improve, in line with expectations. 2010 is seeing a recovery from very depressed levels of activity in 2009, and the region's exports are benefiting from improved cash flows which are likely to lead to a pick up in investment. So far this year, the economy has benefitted from the removal of a large negative inventory drag in 2009 and the reversal of a very negative

credit impulse – we have now firmly seeing growth in both corporate and consumer loans. Across the economy, the liquidity environment has improved and the banking sector is stabilising. Banks have witnessed a substantial improvement in LTD, deposits are growing and the NPL outlook is improving. Our medium-term concerns surround inflation, which remains structurally high, due to excess growth in money supply coupled with the difficult business climate (leading to under-investment and poor productivity growth). Currency appreciation could also reduce the competitiveness of exporters. The country's fiscal position is also a medium-term concern with excessively high reliance on oil and a need to reduce the structural deficit. We are also overweight Kazakhstan where we find very interesting stock specific opportunities.

In Turkey, we maintain an overweight position as 2010 is seeing a healthy recovery in growth. Real rates are at historically low levels, banks are well capitalised and year-to-date loan growth is running at 28%. Employment is improving, while inflation has been surprising positive for four months and rate hike expectations are being pushed back. Political developments will remain firmly on the agenda, with the referendum on the constitutional amendment package in September. The market has performed well and is currently seeing a period of consolidation, but we continue to believe the market is attractively priced given both medium and short term macro outlook.

The fund is neutral Hungary. Hungary is the most open economy in the CE3 and will benefit from improved eurozone export activity. But the lack of other supports for near term growth make Hungary more exposed to global macro trends. Domestic consumption has been hampered due to further fiscal tightening. Public spending needs to be cut further and tax hikes remain a near-term drag on consumer and business spending. Unemployment is likely to continue to rise from already high levels and domestic savings rates are already lower than peers. The aggressive stance of the government towards the IMF and EU, in terms of budget planning for 2011, has prompted concerns of reform fatigue. The government's stance increases the uncertainty regarding the continuation of the IMF fiscal anchor and make Hungary more vulnerable to global risk appetite. On the positive side, the government remains committed to the 3.8% deficit target in 2010. Other positives are benign core CPI, comfortable basic balance of payments and high central bank FX reserves. Hungary has already undertaken several key structural reforms to improve its attractiveness as an investment destination and has taken a large portion of the necessary fiscal pain. If fiscal discipline is maintained then debt dynamics should improve from 2011. The medium-term outlook has also improved: the ongoing economic troubles remain a catalyst for reform and trend growth has likely improved somewhat, although further reform and further cuts in public spend will be necessary.

We remain underweight Poland. Growth expectations have been improving. Exports are more correlated to final demand than to German exports, so the export recovery is more muted compared to Hungary and Czech. The consumer is in reasonably shape and the labour market is improving. The country's fiscal position remains a medium term concern with the need for fiscal contraction. Valuations are reasonable and the overhang risk has eased for H2 2010 due to the completion of the bulk of the privatisation programme, but we continue to find better opportunities in Russia, Turkey and Hungary.

We remain underweight the Czech Republic. Czech has a very open economy and significant auto exposure. Exports are highly correlated with German exports, so the outlook is reasonable given the improvement in export environment in that country. Furthermore, the banking system is in relatively good shape and leverage is relatively low across corporates, government and households. Seasonally-adjusted unemployment has probably peaked and household savings rates have been high at 12%. Monetary policy is loose, and CPI is likely to remain subdued, with any hikes unlikely until mid-2011. However, earnings growth is weak vs other markets and we find more interesting opportunities elsewhere in the region.

Risk warnings: Investments in emerging markets are subject to market risk and, potentially, liquidity and currency exchange rate risk. Investments in equities are subject to market risk 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.

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