

Newsletter – July 2010

Schroder ISF Global Corporate Bond

Size & Holdings	
Fund Size in Base Currency	USD 1,777 mn
Number of Issuers	293

Portfolio Characteristics	
Average YTM	4.1%
Average Credit Rating	A -
Average Duration	5.0 years
% in Investment Grade	86.3%

Credit Quality	%
AAA	19.23
AA	3.58
A	11.24
BBB	52.21
BB	7.68
B	5.15
CCC	0.02
Not Rated	0.89

Market Overview

July saw a strong recovery in credit markets, after the volatility of Q2. Global credit spreads, as measured by the Bank of America Merrill Lynch Global Broad Market Corporate Index, tightened 19bps over the month. Europe, over the past few months the source of much of the markets' anxiety, was in July a catalyst to more positive sentiment: successful bond auctions by peripheral European governments and the results of the European bank stress tests both added to investor propensity to increase risk exposure.

The USD investment grade credit market OAS (Option Adjusted Spread) tightened by 19bps in July, and produced 1.29% of excess return over US Treasuries, driven by a favourable supply backdrop and supportive fundamentals. Although domestic economic data has come in below expectations, equity markets have surprisingly not reacted negatively to this. On the credit side, moderately weaker growth is a positive in that helps delay the cyclical return to re-leveraging while remaining supportive for spreads. The three best performing sectors were consumer cyclicals, basic industries, and consumer non-cyclicals, while the worst three were local authorities, energy and natural gas.

In European credit, July provided 1.22% of excess return, with the financial and insurance sectors both outperforming. The July recovery is mainly attributed to three factors. One, the passing and initial implementation of austerity plans by European peripheral governments helped support sovereign spreads. Amongst the peripheral countries, Spain, Portugal and Greece were all able to issue large bond deals, including reported participation by State Administration of Foreign Exchange (SAFE), the Chinese official sector vehicle, in Spanish Bonos auctions.

Two, the market cheered the release of the European bank stress tests results as it provided some small steps of comfort to investors frustrated with low levels of transparency in the European banking system. However, while the increased granularity and visibility of sovereign holdings in the European bank balance sheets was welcome, we do not believe they were nearly transparent enough: only sovereign holdings were disclosed, with no detail at all on Residential Mortgage-Backed Securities (RMBS) or cross-bank exposures. With some banks having over EUR20bn exposure to Spanish RMBS per bank, this is clearly insufficient. Further, only bank trading books were stressed, thereby substantially understating the required recapitalisation of weaker banks.

Finally, the month did at least see a more open and normally functioning new issue market, with reasonably well subscribed deals, offering some relief from the virtual seizing up of EUR primary markets in May 2010.

In sterling credit markets, month on month total return was 1.12% and average OAS spread on the GBP credit index is back to its end-2009 level of 181bp. Correlations remain very high with other markets globally. Within this rally, financials outperformed and within insurance, Tier 1 issues (where we are overweight) were among the strongest performers.

Portfolio Overview

Overall portfolio performance was strong in absolute terms and also moderately above benchmark, given our overweight credit positioning and the decision to add some credit risk back to the portfolio after the volatility and sell-off of April/May.

In the US, the main positive contributors were overweights to basic industries, communications, energy, banking, insurance, REITS, and natural gas. Overweights to consumer cyclicals and brokerage as well as an underweight to sovereigns offset that outperformance slightly. Nevertheless, we net added alpha in US investment grade over the month.

Presently, our largest overweights are communications, consumers, energy, natural gas, insurance, and banking, with smaller overweights to basic industries, brokerage, and REITS. Our largest underweights are technology, finance companies, electrics, and non-corporates, with a smaller underweight to transportation.

In Europe we added credit across sectors, taking advantage of the cheap deals as the primary market re-opened but nevertheless remaining cognisant of the possible hurdles ahead. We therefore reintroduced out-of-the-money payer options to the portfolio to protect against the potential for renewed volatility as we approach the autumn. Volatility has fallen as spreads have rallied, making this protection a very attractive way to partially immunise the portfolio against any increase in volatility or spread widening.

Outlook

Over the last five weeks we have been more positive on both investment grade and high yield credit than our more tactically defensive positioning in April/May. Specifically, we have seen a marked improvement in two indicators. First, the new issue market has recovered significantly: new deals from high yield, Spanish governments, Spanish banks and subordinated European banks illustrates just how much debt capital markets have healed since April/May.

Second, we believe that Europe's various political, banking and government refinancing issues are far from resolved, and it is highly likely more negative news on this front will re-emerge in the autumn as the government supply calendar begins again. Fanning out to a global level, we think that the recent weakness in US and Chinese macroeconomic data needs a careful eye over the next few weeks. This risk is particularly pertinent now, 18-months after the economic recovery began, given signs that the inventory-led bounce is running out of steam and fiscal stimulus in some countries is beginning to turn to severe austerity. For these reasons, our strategy of being fully invested in duration in the developed markets (ex-Japan) and the re-adding of OTM payers will be important in dampening volatility should the run of macroeconomic data take a continued adverse turn.

Important Information:

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

Any reference to performance refers to the I Accumulation base currency share class of the fund.

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