# Schroders
# Fund Update

## Schroder Alternative Solutions Commodity Fund*

### Fund overview:

Schroders aims to give investors a diversified exposure to commodities primarily through commodity futures. Although index unconstrained, this is an enhanced beta product with the return objectives of outperforming the average of the four main commodity indices, with lower volatility.

| US$ % | May 2010 | YTD 2010 | 2009 | 2008 | 2007 | Since Inception** | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | | Cumulative Performance | Volatility | Sharpe Ratio |
| **Schroder AS Commodity Fund*** | **-8.19** | **-9.76** | **34.03** | **-35.29** | **34.73** | **12.68** | **20.54** | **0.10** |
| **Average of all 4 Indices** | **-9.67** | **-10.31** | **20.57** | **-39.65** | **25.19** | **-18.65** | **23.15** | **-0.18** |
| S&P GSCI TR | -13.19 | -11.58 | 13.48 | -46.49 | 32.67 | -40.17 | 28.07 | -0.33 |
| RJ CRB TR | -8.24 | -10.04 | 23.65 | -35.04 | 22.15 | -9.45 | 21.58 | -0.11 |
| DJ UBS Commodity TR | -6.92 | -9.89 | 18.91 | -35.65 | 16.23 | -15.37 | 20.73 | -0.19 |
| Rogers Int. Commodity TR | -10.33 | -9.92 | 26.23 | -41.35 | 30.01 | -6.86 | 23.66 | -0.05 |

| €uro Hedged % | May 2010 | YTD 2010 | 2009 | 2008 | 2007 | Since Inception** | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | | Cumulative Performance | Volatility | Sharpe Ratio |
| **Schroder AS Commodity Fund*** | **-8.38** | **-10.13** | **32.13** | **-36.66** | **32.48** | **3.73** | **20.84** | **0.01** |
| **Average of all 4 Indices** | **-9.68** | **-10.22** | **21.26** | **-38.67** | **23.97** | **-19.52** | **23.10** | **-0.20** |
| S&P GSCI TR | -13.18 | -11.47 | 14.07 | -45.59 | 31.38 | -40.78 | 28.03 | -0.34 |
| RJ CRB TR | -8.23 | -8.23 | 24.28 | -33.95 | 20.96 | -10.37 | 21.53 | -0.13 |
| DJ UBS Commodity TR | -6.91 | -9.78 | 19.52 | -34.57 | 15.10 | -16.23 | 20.66 | -0.21 |
| Rogers Int. Commodity TR | -10.32 | -9.81 | 26.88 | -40.36 | 28.74 | -7.81 | 23.59 | -0.07 |

| GBP Hedged % | May 2010 | YTD 2010 | 2009 | 2008 | 2007 | Since Inception** | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | | Cumulative Performance | Volatility | Sharpe Ratio |
| **Schroder AS Commodity Fund*** | **-8.32** | **-9.94** | **31.34** | **-36.16** | **34.78** | **9.91** | **20.87** | **0.02** |
| **Average of all 4 Indices** | **-9.67** | **-10.21** | **21.16** | **-38.02** | **26.07** | **-15.61** | **23.10** | **-0.21** |
| S&P GSCI TR | -13.17 | -11.45 | 14.04 | -45.04 | 33.61 | -37.92 | 28.04 | -0.35 |
| RJ CRB TR | -8.22 | -9.91 | 24.25 | -33.30 | 23.02 | -6.07 | 21.54 | -0.13 |
| DJ UBS Commodity TR | -6.91 | -9.76 | 19.48 | -33.92 | 17.06 | -12.19 | 20.67 | -0.22 |
| Rogers Int. Commodity TR | -10.31 | -9.80 | 26.84 | -39.76 | 30.93 | -3.37 | 23.61 | -0.08 |

Source: Schroders; Bloomberg; JP Morgan; Reuters/Jefferies; S&P Goldman Sachs; Dow Jones; Diapason

* A Share Class ** Inception 31 October 2005

### Review

May was a bleak month for commodities; three of the four main indices experienced their largest monthly falls since the height of the bear market in December 2008. Outside the asset class, and with the exception of the dollar and treasury markets, virtually no market was exempt from weakness. During the course of the month it seemed as if every investor across the globe could find something which prompted serious concern, regardless of their location or their investment. Concerns surrounding government debt dynamics and political stability in the European Union adversely impacted stock markets across the continent and proved a catalyst for the weakening of the euro versus its

* Schroder Alternative Solutions is referred to as Schroder AS throughout this document

major trading partners. Elsewhere, Asian markets were troubled by concerns of a hard landing in China, as policy measures aimed at cooling the housing market continued to be implemented and in the United States, many investors, ourselves included, were given to wonder why the positive sentiment which had been generated by first quarter earnings a few weeks previously had been so quick to disappear. Unsurprisingly, not one of the four sub-sectors within the asset class was able to generate a positive return; energy was the worst performing sector with -14.8%, followed by base metals -10.9%, agriculture -6.0%, and precious metals -2.7%. In relative terms, the strategy fared well during May as levels of cash were raised quickly once stop losses in major markets were triggered by mid-month; performance was -8.04% versus the composite benchmark return of -9.67%.

## Energy

During the last several months we have been keeping a wary eye on the global macro situation and the resultant investor sentiment which has played such a large role in driving prices in our asset class. Our reasoning has been that, in a group of markets such as energy where supply is ample and spare capacity is high, investor sentiment and expectations of the extent of the global economic recovery would likely hold sway. Certainly, on a year-over-year basis, demand numbers have been improving in the United States and around the world but we have believed for some time that such improvements have been counterbalanced by record levels of inventory in the OECD and parts of the U.S. The rather extreme levels of contango witnessed during May seemed to suggest that this assessment of market conditions wasn't too far wide of the mark; to place these comments within the context of inventories and market pricing, levels of crude oil inventory reached a record 37 million barrels at Cushing prompting the contango in WTI to hit a lofty $4.80 in mid-May. Little wonder then, that energy markets fared worst of all during the month, as the combination of negative carry ("roll yield") and declining prices combined to such detrimental effect. In a market where spot prices are flat or declining, such conditions are highly disadvantageous to the long-only investor and favour those in the physical market who are equipped to buy spot, pay storage costs and simultaneously sell forward, thereby banking just about as risk-free a profit as it is possible to make these days.

Global demand for oil rose 2.9% on the year for the month of May, to average 85.49 million bpd, and while this is positive news, it also needs to borne in mind that this is still 541,000 bpd below levels of demand seen this time two years ago (year-on-year comparisons are always instructive, but the first half of 2009 was something of special time where energy demand was concerned, and so comparisons versus 2008 and 2007 are also currently just as important). Across the globe, energy demand is recovering as in the United States and demand from emerging economies such as Brazil, India and Gulf States is strong, but yet, the recent financial turmoil in the European Union seems to be affecting energy demand there; European demand contracted -3% in May, signalling that the potential for a further weakening of global demand (should Europe's woes spread beyond its borders) is real and should be taken seriously. For now, however, the saviours of global oil demand are the emerging markets, but for how long they will be able to maintain this position given the risks of their economies overheating remains an open question.

In terms of how these opinions affected positioning throughout the month, we ended April with an energy allocation of approximately 43%, which by the end of May, was cut to our minimum allowable exposure of slightly above 20%. Certainly, after almost a year of erring on the bullish side of the tracks, we have adjusted our viewpoint and our positioning in a radical way in a relatively short space of time and this leaves us exposed to what may be sizeable underperformance if markets rally hard from current levels. However, we are of the view that the vast majority of commodity investors are underestimating the risks of a further, and perhaps very dramatic, fall in most markets. In an environment where spot prices are declining, where the annualised cost of carry is running in the region of 50% and where inventories as well as spare capacity are high, our incentive to be invested is nil. This is to say nothing of the global macro environment which is looking, we believe, more precarious now than it has done since the first quarter of last year. We end the month with the view that until there is some radical change to price, inventories, supply or demand, then weakness is likely in the energy sector for at least the next several months.

## Metals

Base metals markets suffered a second month of weakness during May, as concerns regarding the extent of any potential slowdown in Chinese demand began to become more widespread. The worst performing metals on the month were nickel, lead and zinc which lost -18.8%, -17.0% and 1-5.3% respectively. Exposure to all three of these markets was cut to zero on the first trading day of the month, as stop losses in all markets were triggered. This resulted in our base metals exposure consisting only of aluminium and copper for the month of May, both of which suffered losses: -9.4% and -6.6% respectively. Much of the explanation for these performances lies in the performance of the Chinese stock market which, at the time of writing, has lost almost -24% since last November and currently sits at a 13 month low.

From the standpoint of the fundamentals of supply, demand and inventories, all of these markets have been flashing amber for some time. We would argue that while prices have exhibited something of a V-shaped recovery, the same cannot be said for underlying demand. Yes, there has undoubtedly been cause for optimism where an economic recovery in Europe and the United States has been concerned but this has seemed to be amply reflected in prices for quite some time. In addition, implicit in all forecasts of global economic growth and metals prices has been a resilient and decoupled China. However, with three reserve rate rises already in place this year, an expectation that inflation will be above 3% in May and June and a government which has tightened credit for purchases of multiple homes, increased mortgage rates and down payment requirements, there is now a growing fear that when (not "if") China tightens policy further, base metals markets will hit the windshield. Furthermore, these anxieties are being stoked by those who also maintain a watchful eye on levels of inventory (which are plentiful in every market) and the relationship of prices to the marginal cost of production.

So, with inventories proving plentiful in both absolute and relative terms, supply proving to be relatively unconstrained, demand in China abating somewhat and sentiment rapidly deteriorating, these markets have been proven vulnerable to bearish forces. All of this, it must be argued, should have been enough to cause metals prices to correct, irrespective of any weakness in stock markets or other risk assets. The risk going forward during the next several months is that negative drivers from the bottom up and the top down combine to drive prices much lower from current levels.

In closing, we must also mention precious metals. Despite ripping higher in many other currencies for some time, gold only just managed to eke out a new all-time high of $1249.40 on May 14th. While we have increased our gold holdings in recent weeks and remain bullish on precious metals, we are somewhat perturbed by the recent lack of momentum and the non-confirmation by silver, as well as by gold stocks. From a technical perspective, these markets have looked pregnant with potential for some time, although if our bullish outlook and substantial positioning within the funds is to be justified, prices need to turn around quickly with only brief corrective pauses. At month-end now we await confirmation from the market that our positive outlook for the market is the correct one, should this prove not to be the case during the month of June, these positions will be reduced substantially.

## Agriculture

The corn market continued to decline in May, off the back of a fast planting pace in the US and generally good weather in the main producing countries. We note that the correction in corn prices has however been less pronounced than on other cereal markets. The recent Chinese purchases of US corn are constructive for the export program for the remainder of the 09/10 season and have consequently supported prices. The wheat markets fell to reach new lows last seen in 2007. The long term fundamentals remain negative (large global inventories, generally good weather in the producing countries and the continued export competition from the Black Sea countries). In terms of allocations, we have slightly reduced wheat positions in order to increase the corn allocation.

Oilseeds prices continued on their downward trend in the last month. This weakness is explained by the possibility of a bumper soybean harvest in Latam, competing with the US sources in the export markets, as well as a general decline in commodity and equity markets. The strength seen in the US Dollar also added a serious negative tone. We note that vegetable oils markets continued to outperform beans, seeds and meals markets. Vegetable oils supply/demand balances (notably soybean oil and palm oil) remain very tight and thus continue to explain this relative resilience in prices. The overall oilseed allocation was reduced during the last month, however vegetable oils positions remained unchanged.

Coffee prices ended the month almost unchanged. The current seasonal trend is bearish and the weather looks favourable for the upcoming Brazilian and Columbian harvests, however the recent tropical storm that hit Guatemala and El Salvador fuelled some speculation about possible damage to the crops.

The cocoa market in London reached a 33 year high in May. Uncertainties about the effects of the weather on mid-crops yields in the main producing countries (too dry in Nigeria and too rainy in Ivory Coast) were supportive for prices. Sugar markets fell for the 4th consecutive month. Fundamental news is still relatively bearish for this product (a larger than expected crop in India for this season, a 40% increase in the sugar beet acreage in Russia, a large acreage in China, as well as an expected increase in the Australian crop) and continued to weigh on prices as a result. Finally, we note that the weather is still favourable for crops in Brazil. Our softs positions remained unchanged in May. We continue to favour the cocoa and orange juice markets and remain prudent about the sugar and coffee markets.

Meats markets ended the month sharply down. The continuation of the herd liquidations movements (for hogs and live cattle) increases both the slaughter numbers, the average weight and thus enlarge pork and beef production as a result. On the demand side, the US per capita consumption for beef and pork meats are lower (in favour of poultry meat) and exports are expected to be lower-than-expected, due to the strength of the US Dollar. We can not hope for a durable and strong rally in the meats sector, as long as the herd liquidation movement continues. In terms of allocations, we reduced both our futures and equities meats exposure.

Despite supportive fundamentals, the cotton market ended the month down. This weakness is mainly explained by the strong corrections observed in the other commodity markets, which are closely correlated to the economic cycle. Mounting uncertainties about the global economic recovery and future Chinese policy are negative factors for materials markets in general. We reduced slightly our positions in this sector as a result.

## Commodity Equities

May was a poor month for commodity related equities, with materials and mining indices falling by around -10%.

The performances of the different sectors reflect the risk aversion sentiment:

- Precious metals outperformed with a flattish performance.
- Agriculture equities were weak and the meats were the subsector that held up the best, as they benefit from cheap feed costs.
- Base metals and bulk commodities were the weakest, followed by energy.

The above performance is what one would expect in such times of a negative macro environment; we do not expect a turning point yet. Commodity related equities are mostly trading at 10%-15% discount to their NPVs at spot commodity prices and we do not think the current risks justifies buying yet.

The only exception continues to be gold equities, that are trading at a P/NAV of 1.5x which is at its low historic range. With gold closed to its highs, we expect this multiple to reach to the top of the range at 2.0x, accordingly we expect a re-rating of gold equities on top of the gains from the gold price rally. Over last month we have increased our precious metals equity exposure.

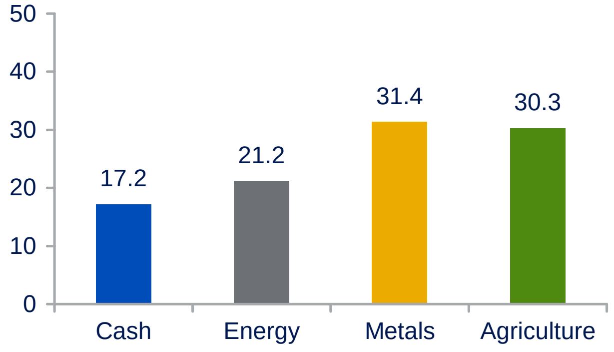
## Asset Allocation as at 31 May 2010

### Top 5 Holdings as at 31 May 2010

| | |
|---|---|
| Gold | 16.8 |
| Brent Oil | 10.1 |
| WTI Oil | 8.9 |
| Corn | 5.5 |
| Copper | 4.9 |

Source: Schroders

### Sector Allocation as at 31 May 2010 %



**Risk Warning:** Indirect investment in commodities and/or real estate may cause the fund to face market risk from the value of the underlying asset together with geopolitical, supply, currency exchange rate and interest rate risks.

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