

Schroder ISF* Emerging Europe

Monthly Fund Update

Overview

Emerging European markets posted a negative return in May (as did the fund) against a background of weakness in developed and broader emerging markets. 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 a negative return in May against a background of heightened concerns about eurozone sovereign debt (although markets recovered some ground towards the end of the period). Investor confidence was also impacted by a unilateral move from the German financial regulator to ban the naked short selling of various securities, while concerns about policy tightening in China contributed to a fall in commodity prices. Emerging European markets underperformed developed and broader emerging markets against this backdrop.

Hungary, Poland and the Czech Republic were the weakest performers in the region. They were impacted by concerns about potential contagion from the eurozone sovereign debt crisis, with weakness in the banking sector weighing on these markets. In other developments, the Czech central bank cut interest rates by 25 basis points to 0.75%, while data was released showing the country's GDP growing by 1.2% year-on-year in Q1. Parliamentary elections were also held at the end of the month in the Czech Republic, with a centre-right coalition government seen as the most likely outcome. In Hungary, data was released showing GDP growing by 0.1% year-on-year in Q1, which was above consensus expectations. The Turkish and Russian markets were also in negative territory but were ahead of the regional index. General weakness among banking stocks had a negative impact on the Turkish market. On the positive side, data was released showing the Turkish economy growing strongly, with industrial production increasing by 21.1% year-on-year in March. A fall in the oil price was a negative for the energy-dominated Russian market. In other developments, data releases showed the Russian economy continuing to recover, with industrial production increasing by 10.4% year-on-year in April.

Stock selection had a negative impact on fund performance in May, while asset allocation had a positive impact. Stock selection in Russia, Turkey and Hungary had a negative impact. Our underweight in Poland had a positive impact (we are underweight as we have concerns about the level of potential equity issuance in this market).

The market outlook and portfolio strategy

Following the end of the month, we slightly reduced our exposure to Russia/CIS although it remains our largest overweight. Recent macro data continues to show evidence of recovering growth. Industrial production came in above expectations in April at 10.4%, real wages grew 6%, real retail sales increased by 4.2%. Manufacturing PMI in May was flat month-on-month at 52 and services PMI was a robust 55.9. We believe consumption will be supported in 2010 by an improving wage and employment outlook and also by material increases in pensions in 2010. The investment outlook has improved due to a better financing environment and better corporate cash flows. The removal of a large negative inventory drag seen in 2009 will also be very positive. Valuations are also at attractive levels in Russia. The main reason for a slight reduction in the scale of the overweight is a scaling back of risk due to the increased uncertainty of the global environment. The outlook for Russia is very tied to the oil price. It is a key driver of the fiscal position, the current account surplus, liquidity conditions and the financing environment. Above US\$65/bbl we are confident in the outlook

for Russia and a fall below this level is not a base case assumption for us – demand growth in the US for distillates is healthy, inventories are high but improving. But current US dollar strength and a reduction in global liquidity may prompt further near term pressure on crude prices.

We used the proceeds to slightly increase our overweight in Turkey, a market which, as a large importer of energy, is a beneficiary of falling oil prices. Economic data is strong: loan growth is robust, Manufacturing PMI for May increased to 56.5, and employment is improving. The release of May inflation data showing a material fall in food prices has served to draw down inflation expectations, although core inflation was static. We continue to be wary about the outlook for inflation and interest rates in the latter part of 2010, but valuations are attractive.

We remain neutral Hungary. The market has suffered recently due in large part to communication failures by the new Fidesz government, notably the statement that the fiscal deficit would be as high as 7-7.5% of GDP. We would be surprised if this was the case. The budget deficit target for 2010 was -3.8% based on -0.9% GDP contraction and with reserves of 0.3% GDP. GDP is surprising positively but the growth surprise is being driven by exports, which carries lower revenue contribution to the budget than consumption. Consequently, budget revenues have proved somewhat disappointing. There has also been a degree of overspend. But Prime Minister Orban's recent trip to Brussels corrected Fidesz expectations that a high degree of flexibility in the fiscal deficit would be tolerated. The government is now planning to implement a series of measures to achieve the original deficit target. This has negative implications for public consumption, and for the corporate tax environment, which leads us to have a more cautious growth forecast for 2011 than previously. But Hungary is in a very substantially better position than Greece and the currency is unlikely to come under further severe pressure. There is an IMF package in place that has not been drawn down since July 2009 but can be used if necessary, reserves are high, Hungary runs a primary surplus and the current account is largely closed and may even be in surplus in 2010. Debt/GDP is high at 80% - but GDP is rising at a very moderate pace of 1-2ppt. The disappointment is that the government has expended a large amount of credibility built by the previous technocrat government and hence pushed up the risk premium on Hungarian assets. Furthermore, growth in 2011 is again dependent on exports, with the contribution from public and private consumption reduced. The market is also adjusting to the new scenario that the tax take from corporates is on the rise. However, much of this has already been factored into currency and equity prices and valuations are sufficiently attractive for us to retain a neutral position.

We remain underweight the Czech Republic. We expect 1-2% GDP growth in 2010, driven primarily by export recovery. The Czech Republic is a very open economy with exports/GDP of 70%. Germany accounts for 32% of exports and Czech exports are more highly correlated with German exports than with German final demand. The outlook for German exports has improved due to the material euro depreciation seen recently and the outlook for Czech exports is thus reasonable – they also have very limited exposure to southern Europe. Furthermore, there is no demand-pull inflationary pressure and rates will likely remain at current low levels through 2010. Public debt/GDP is low at 35% GDP. The consumer is in reasonable shape: employment is beginning to stabilise and the savings rate is higher than CE3 neighbours. However, the market is dominated by electricity company Cez, where earnings were defensive through the crisis and which has sold forward a large proportion of its electricity. As a result, the earnings growth outlook is lacklustre versus peers and so despite reasonably attractive valuations, we remain underweight.

Poland remains our largest underweight. The economy is relatively sound, with 2-3% GDP growth expected in 2010. Investment will remain healthy due to rising EU fund flows and infrastructure investment in advance of the Euro2012 football tournament. The consumer is in reasonable shape with employment stabilising. Politics is likely to improve if Komorowski wins the Presidential elections at the end of June – this will facilitate reform. The currency looks cheap and we believe it will both support exports and provide some potential for appreciation from here. The key negative is that the level of forthcoming equity issuance due to government privatisations produces a large overhang for the market to absorb and is currently eroding the prior premium seen in Polish valuations.

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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