Issued in October 2010

Newsletter – September 2010

Schroder ISF* Global Corporate Bond

Size & Holdings	
Fund Size in Base Currency	USD 1.97bn
Number of Issuers	216

Portfolio Statistics	Fund vs. Index
Effective Duration	4.80 vs. 5.61
Spread Duration	4.27 vs. 5.47
OAS*	192 vs. 157
ASW#	162 vs. 136
Effective Yield	3.26%

*Option Adjusted Spread. #Asset Swap Spread

Credit Quality	%
AAA	5.92
AA	2.05
A	18.19
BBB	37.84
BB	5.18
B	3.82
CCC	0.02
Not Rated	0.71
Cash	27.09
Derivatives	-0.27
Average Credit Quality	A-

Market Overview

Spreads moved tighter during the first half of the month as risk markets responded positively to slightly more upbeat economic data and the increasing certainty of US quantitative easing. A surge in primary activity (more than $111 billion of supply was priced in September) then dominated trading for the remainder of the month. That supply was easily digested and performed well versus secondary bonds, undoubtedly supported by the continued rally in equity markets.

The three best performing sectors were energy, finance companies and insurance; with government guaranteed agencies, supranationals, and local authorities amongst the worst. The three best performing issuers were Anadarko Petroleum (APC), SLM Corp (SLMA), and Transocean (RIG). while Irish Life & Permanent (IPBS), State of Connecticut (CTS), and Bank of Ireland (BKIR) were weakest.

Within European credit, September saw 43bps of excess return versus -39bp of total return as government yields rose. The best performing sector was sub financials, specifically Tier 1, with telecom and utilities as underperformers.

Tier 1 proved very volatile as the market digested news on Basel III. The Basel Committee (with a mandate to strengthen the banks' balance sheets) increased the amount and quality of capital that banks need to hold going forward. By derecognising outstanding bonds in the future, large dynamics in the market were created. However, we continue to only be invested in the strongest banks with the strongest structures.

The other significant move was in peripheral spreads as Ireland and Portugal came under renewed pressure. The dramatically increased cost of bailing out the Irish banking system pushed Ireland spreads to new wides, while spreads in Portugal tested recent wides as the country failed to implement its stated austerity measures.

UK credit performance was muted at the end of the third quarter, while the total return for the month was disappointing following underlying gilt-driven volatility. Most of the support came on the back of a rally in the European banks, which gained following the publication of Basel III.

In the UK, however, the absence of a clear UK recovery has prompted the deputy governor of the Bank of England to encourage the local population to spend more in their domestic market. The second best performing UK sector was insurance as investors sought out high yielding, better quality debt. The worst performing sectors were the least cyclical areas, such as telcos, healthcare and utilities, which were the most compressed sectors to begin with.

Portfolio Overview

US performance was flat relative to the benchmark in September. The main positive contributors were overweights to energy, banking and insurance; and underweights to capital goods, technology, electrics and non-corporates. That outperformance was offset by an overweight to consumer cyclicals, and underweights to basic industries and finance.

Presently, our largest overweights are communications, consumer cyclicals, energy, natural gas, insurance, and banking (and a smaller overweight to REITS). The largest US underweights are basic industries, finance companies, electrics, and non-corporates (and smaller underweights to transportation, capital goods, and technology).

In Europe, we reduced credit, while retaining the long-term structural overweight. High yield exposure came down to 5% as we feel that better opportunities will present themselves in the future. Stocks had their best September since 1939 and, given the uncertain outlook and the less than convincing US data, we feel this looks overdone. As such, there seems to be the potential for a correction should the third quarter earnings season not surprise to the upside.

The fund profited from the widening in Portuguese spreads by buying protection on PORTEL. This credit is the weakest incumbent European Telecom - very exposed to the Portuguese economy and inextricably linked to the sovereign spread since the disposal of Brazilian joint venture Vivo.

The new issue market was disappointing, with the majority of new deals underperforming. The fund only participated in the strongest of these deals and they are now trading around re-offer.

Outlook

As we enter the fourth quarter, credit spreads remain supported by three drivers. First, the fundamentals continue to look good as companies remain conservative with their balance sheets, hoarding cash and paying down debt. At this stage of a ‘normal’ economic cycle, both credit spreads and equities would tend to benefit from a cyclical recovery, falls in unemployment, increases in corporate revenues and so on. This cycle appears to have a more anaemic growth outlook, however, constraining the potential for earnings recovery and potentially impacting equities.

For corporate bondholders, on the other hand, there are several reasons why anaemic growth could be positive for credit fundamentals. These reasons are linked to the increase in corporate sector savings, the modest level of capex and the fact that M&A activity is lighter than would normally be expected at this stage of the cycle. As a result, corporate balance sheets continue to improve regardless of the weak growth outlook. This would suggest that corporate bondholders are in a better position than shareholders relative to previous cycles.

Second, credit spread valuations remain attractive at almost 1.7% over government bonds. This is only marginally tighter than the 1.8% reached at the worst point of the post-dotcom period between 2001 and 2002. As that period was characterised by US recession, corporate balance sheet problems, the 9/11 attacks and the accounting crisis of WorldCom/Enron, markets today seem priced for some fairly bad news.

Thirdly, with central bank rates at zero (and the Bank of Japan recently cutting rates from 0.1pc to 0 - 0.1pc), money is flowing out the term structure into 10yr bonds, and down the credit structure into investment grade and high yield. We generally don’t invest on the basis of flows or demand, but respect the power that flows exert on markets.

The near term risks remain third quarter earnings – we are sceptical that growth was particularly strong— ongoing European stresses, and US macroeconomic data.

While the fund remains marginally overweight credit beta, we continue to hold back considerable cash, with the view to adding more risk should any of these considerations push out credit spreads.

We believe that, in order to continue to post top quartile long-term returns, investors in credit will need to look at adding ‘non-credit’ sources of risk, such as active currency risk including emerging market foreign exchange.

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