Quarterly Fund Update

Schroder ISF^ Emerging Markets Debt Absolute Return*

Fund Overview

The Schroder Emerging Markets Debt team manages global emerging market debt funds using a variety of instruments and techniques in an effort to enhance overall risk-adjusted returns. The funds aim to achieve high, long-term absolute returns while keeping volatility to a minimum. Specifically, the team aims to make positive returns in any 12 month period. The team manages 'absolute return' EMD* funds of over **US$7,931 million**** on behalf of private clients, institutional and retail investors worldwide.

* Emerging Market Debt is referred to as EMD throughout this document
** Source: Schroders dated 30 December 2011

Cumulative Gross Returns to 30 December 2011

US$ %	3 months	2011	1 year	2 years	5 years	10 years	Since inception annualised
Schroder ISF Emerging Markets Debt Absolute Return*	**-0.31**	**-1.21**	**-1.21**	**-0.27**	**21.49**	**104.07**	**7.72**
JPM EMBI+	5.25	9.20	9.20	22.11	47.84	200.55	11.13
JPM ELMI / ELMI+**	-1.00	-5.19	-5.19	0.19	24.87	103.35	7.10

†€uro Hedged %	3 months	2011	1 year	2 years	5 years	Since inception annualised
Schroder ISF Emerging Markets Debt Absolute Return†	**-0.28**	**-1.02**	**-1.02**	**-0.35**	**18.83**	**4.19**
JPM EMBI+	5.12	3.76	9.27	21.47	42.16	8.85
JPM ELMI / ELMI+**	-1.28	-5.83	-5.83	-1.70	18.11	5.64

^Sterling Hedged %	3 months	2011	1 year	2 years	5 years	Since inception annualised
Schroder ISF Emerging Markets Debt Absolute Return^	**-0.20**	**-1.51**	**-1.51**	**-0.80**	**14.34**	**3.36**
JPM EMBI+	5.39	9.78	9.78	23.21	54.92	9.75
JPM ELMI / ELMI+**	-0.87	-4.68	-4.68	1.09	30.81	6.71

Since January 2000 in US$	Fund	EMBI+	ELMI+ **
Annual Rate of Return %	**7.72**	11.13	7.10
Annual Volatility %	**6.04**	10.22	7.56
Sharpe Ratio	**0.90**	0.89	0.65
Sortino Ratio	**1.63**	1.06	0.73
Correlation	**1**	0.56	0.61
Positive Quarters %	**72.34**	72.34	70.21
Maximum Drawdown %	**-10.29**	-19.71	-19.93
Best Month %	**6.34**	8.52	5.03
Worst Month %	**-3.78**	-13.79	-8.73

Source: Schroders
* Schroder ISF EMD AR A Shares Net 31 January 2000 Daily NAV to NAV
** ELMI used until 31/01/02 (index discontinued)
† Euro Hedged Inception 30 September 2003
^ Sterling Hedged Inception 31 May 2005

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

Review

There were no major changes to the investment strategy during the quarter under review. The fund maintained its ultra-defensive positioning in all sectors (credit, currencies and duration). The fund's cash balance remained very high. As a result, the performance of Schroder ISF EMD Absolute Return remained broadly flat during the quarter.

Overall, during what was an extremely challenging 2011, the fund managed to achieve one of its key objectives: low volatility and capital preservation. While the absolute returns achieved have been disappointing, the fund is in a good position to pick up some very cheap assets, once the ongoing re-pricing runs its course (see below). In other words, both the recent widening in spreads and weakness in currencies have noticeably improved the medium-term return prospects for the fund.

After the sharp sell-off experienced in Q3, EM bonds (sovereign and corporates) have generally been in a consolidation phase during the quarter under review. Foreign exchange rate markets have remained weak. A number of currencies have even weakened to new lows against the US Dollar during the month of December. This was particularity the case for the Turkish Lira, the Polish Zloty, the Hungarian Forint and the Indian Rupee. The continued pressures on currencies led to various forms of interventions by a number of central banks and governments. As an example, there were direct spot interventions in Turkey and Poland, as well as a relaxation of measures previously designed to limit short-term capital inflows in Brazil and in India. All these interventions have so far failed to trigger a convincing rally in currencies. We believe this to be a worrying development, as the continued weakness in currencies is an early warning indicator of the deteriorating outlook for trade and economic activity in a number of EM countries. Equally worrying, is that the continued currency weakness amounts to further tightening in domestic liquidity conditions in a number of emerging countries. Foreign exchange accumulation by most EM central banks is experiencing a sharp slowdown and a number of countries are even now starting to lose reserves, a normal consequence of the recent acceleration in capital flight.

Therefore, while investors' attention has remained focused almost exclusively on the Eurozone's debt problems, economic and political developments in a number of EM countries also require heightened caution. The authoritarian and poor policies of the Hungarian government are being exposed yet again. Turkey's balance of payments problems are becoming hard to control. India's stalled reforms are negatively impacting domestic investment and the performance of financial assets. China's so called "fine tuning" measures have so far failed to convince that the country's previous credit policy mistakes could be corrected in an orderly manner. In this regard, the recent poor performance of China's domestic stock market is a worrying development.

Investment Outlook

Global

– Last quarter brought further evidence of the increasing inadequacy (or impotency) of leading policymakers in this ongoing global financial crisis. Successive Eurozone summits, the rapid expansion of the ECB's balance sheet, the US Federal Reserve's Operation Twist, China's fine tuning policy measures and the co-ordinated plan by major central banks to cut Dollar swap rates are amongst the initiatives that have done little to revive financial markets. By repeatedly attempting to reflate financial assets, policymakers have been accommodating unsustainable leverage in the financial system whilst avoiding painful but crucial pro-growth structural reforms. The global growth outlook remains poor.

– EM asset prices have cheapened somewhat this year but we believe that valuations have yet to reflect fully the following three key vulnerabilities:

– **(i)The money/debt spiral**: what started as a banking crisis in Western countries and then morphed into a public debt crisis could now turn into a monetary crisis, if the process of debt monetization is questioned. This sequence of events is well advanced in the West but appears to be in its early stages in China.

– (**ii)The unravelling global "carry trade"**: the avalanche of capital inflows which emerging economies had previously experienced has recently started to reverse. Of particular concern are the large net foreign liabilities in the banking systems of a number of EM countries. The recent co-ordinated actions by major central banks may provide cheaper Dollars to accommodate these liabilities but will not reduce them. A number of EM currencies could continue to weaken substantially.

– **(iii) Global macro-economic imbalances:** balance of payments crises in high deficit countries continue to brew. If history is any guide, rebalancing is unlikely to occur without a major shock to economic and trade activity. The broadening economic slowdown is a clear early warning of such a scenario.

– The good news is that as EM assets re-price and currencies weaken, policy changes will be imposed and some of the vulnerabilities above will be corrected. 2012 could thus bring compelling buying opportunities across a wide range of assets.

Asia

- The slowdown in Chinese economic growth, plainly forecasted in our recent China Country Reports, is gaining momentum, but this fact is still not changing widely-held investor opinions that the government will "engineer" a "soft landing" of 7-8% growth in 2012. Consensus forecasters, we believe, fail to understand the leveraged (i.e. credit-fuelled) nature of China's recent rise. As boom turns to bust, aggressive monetary easing measures will certainly be implemented but, in the absence of genuine structural reform, asset price stabilisation will likely prove elusive. Crucially, China's balance of payments position is now much weakened, a key factor which will contribute to continued tightening of domestic financial liquidity.
- Given this U-turn taking place in the Chinese economy and markets, it is only a matter of time before investors downgrade their expectations for the performance of other Asian assets. Negative fundamental developments are starting to accumulate outside China too, raising risks further: for instance, in India, promising reforms have been shelved, while in Indonesia, misdirected monetary policy risks market instability.
- High-return opportunities could appear in Asia in 2012 in a few areas: China-related credits in distress; Vietnam (after devaluation); and in countries that we continue to rate highly – Thailand or Philippines, for instance – after re-pricing.

Eastern Europe

- This region will continue to be the major casualty of the ongoing deleveraging of the European banking system. This withdrawal of capital is not only detrimental for domestic credit conditions but it equally moves most Emerging European countries closer to a full-blown balance of payments crisis. Hungary, Poland, Romania and Ukraine are particularly vulnerable. However, these countries have shown repeatedly in the past that, when under pressure, they can implement bold reforms.
- A vibrant and strong opposition to the current regime is emerging in Russia, which has the potential to improve the long-term reform outlook for the country. However, Russian financial assets could suffer in the short-term from escalating capital flight and from likely attempts by Putin to spend his way out of the brewing political crisis.

Latin America

- As the economic slowdown is continuing in Brazil, authorities are committing even more policy mistakes. With the prevailing fragile global climate, Brazilian assets could continue to suffer from a lack of structural reforms, eroding Central Bank credibility and the country's heavy reliance on Chinese demand for commodities.
- The deteriorating global environment is also exposing the poor monetary and fiscal management in Argentina and Venezuela. While Argentina's bond prices remain depressed, those of Venezuela have recently been supported by hopes that Chavez may exit the political scene. We do not expect such a scenario. As further re-pricing occurs, opportunities in this region will be explored mainly in Mexico, Chile and Colombia, where strong macro-economic fundamentals will prevail.

Middle East / Africa

- The UAE is one of the MENA countries with the lowest risk of political and social disorder. Good progress is being achieved to deal with the aftermath of the real estate crash in Dubai, where we have identified good corporate names. However, higher yields are required for us to consider building an exposure.
- The recent growth boom in Turkey has so far hidden the country's macro-economic imbalances. Now that growth is slowing, there is little that monetary policy can do to prevent a balance of payments crisis. South Africa exhibits less external imbalance, but the country's growth and policy prospects remain uninspiring.

Quantitative Analysis

- Our measure of global financial liquidity has recently experienced a modest recovery, a result of the policy initiatives highlighted above. However, our indicators also show that financial liquidity has not yet recovered to a level which would boost financial assets. In other words, liquidity is still broadly in a "*contractionary*" phase.
- Emerging countries have experienced more erosion in the Risk scores attributed by our Model. Eastern European countries, Turkey and Brazil have not yet seen any improvements in their "*Banking System External Liquidity*", and the gigantic global "carry trade", which these countries previously benefited from, could now unravel.

- The most noticeable development this quarter is that the average score of Asian countries has turned negative for the first time since the 1997 crisis. China is a key contributor to this deterioration but neighbouring countries are also affected. This is mainly the result of excessive levels of "*Hot Money*", deteriorating "*Competitiveness*" and a mature "*Credit Cycle*". In contrast, as highlighted repeatedly this year, the US Risk ranking has dramatically improved, suggesting that US Dollar strength could be persistent in 2012. US domestic credit conditions have stabilised and the country's balance of payments dynamics have improved.

Chart Analysis

- Trend, Momentum and Pattern Analysis all suggest the Dollar rally versus Emerging Market currencies will continue and may well accelerate with Indian, Turkish and Hungarian currencies particularly at risk. Long term Chart Analysis is less unequivocally negative for EM External Debt. However, a break to new lows could trigger more aggressive downward moves. Sovereign debt of Turkey, Russia and Ukraine remain the most vulnerable as does EM Dollar Corporate Debt.
- The technical outlook for local bond markets in Hungary, Turkey and India is negative, while in other local markets Momentum studies warn of potential weakness. In contrast, the multi decade trend of lower yields in Developed Markets is still intact.

Sentiment Analysis

- Long term Sentiment Analysis remains negative for the majority of EM assets. Our Analysis has become more negative for Asian currencies, which have moved from a phase of '*Blind Faith'* to '*Acknowledgement',* as market participants start to recognise the recent depreciation but have not yet positioned themselves accordingly.
- Our Model also shows that EM local and external debt remains in the '*Blind Faith'* phase, as investors' positions are at elevated levels and return expectations remain high despite recent price falls. Market surveys suggest that an overwhelming majority of market participants expect only a moderate slowdown in China, which is at odds with both our fundamental view and recent asset price movements. Our Sentiment Model remains positive on the US Dollar (and Cash as an asset class).

Abdallah Guezour / Geoff Blanning / Nick Brown / Guillermo Besaccia / Malcolm Melville / Margaret Nelson – December 2011

Asset Allocation as at 30 December 2011

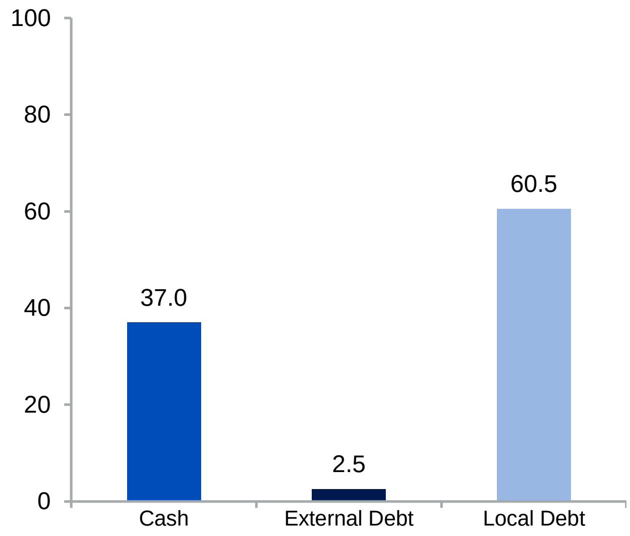
Holdings as at 30 December 2011 %

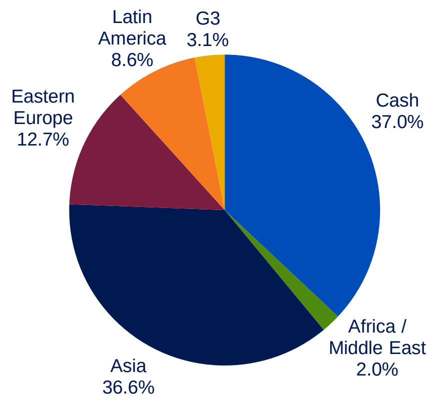
	Exposure	Duration
Mexico	0.7	1.2
China	0.4	2.7
Poland	1.3	0.5
External Debt	**2.5**	
Mexico†	7.9	0.9
China	6.3	0.2
Indonesia†	6.0	3.0
Korea†	3.8	2.2
Malaysia†	5.9	1.9
Singapore†	11.5	0.9
Taiwan†	0.7	0.3
Thailand†	2.0	1.3
Czech Republic†	7.4	1.2
Poland†	4.0	0.6
South Africa†	2.0	1.8
Japan	3.1	
Local Debt	**60.5**	
Cash	**37.0**	

Source: Schroders
^ Partially Hedged
† Fully Hedged

Performance Overview

Sector Allocation as at 30 December 2011 %





Fund Summary	%
Yield to Maturity	1.05
USD Exposure	89
EM Currency Exposure	7.7
Duration (years)	0.76
Average Credit Rating	AA-
Corporate Bonds	0

Fund information
As at 30 Dec 2011

Fund managers	Geoff Blanning, Abdallah Guezour, Nicholas Brown, Guillermo Besaccia
Managed fund since	31 December 1998
Launch date	29 August 1997
US$ size:	US$6,914 million
Annual Management Charge	1.50% (for A class shares)
Estimated Total Expense Ratio (TER)	Est. 2.00% (for A class shares)
Number of holdings in fund	68

Source: Schroders

Risk Warnings:

Investments in emerging markets are subject to market risk and, potentially, liquidity and currency exchange rate risk. Investments in debt securities are primarily subject to interest rate, credit and default risks 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. Investments in absolute return funds are primarily subject to interest rate, market, liquidity, credit and default risks and, potentially, to currency exchange rate risk.

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