

Schroders FundFocus



Schroder ISF* European Equity Yield

As the demand for income intensifies, fund manager Ian Kelly shares his thoughts on the future prospects for equity yield funds.

April 2012

Ian, after assuming management responsibility for the portfolio in December 2010, did you set about making any specific changes to the overall composition of the portfolio?

If I look back around 16 months to when I first took on the fund, I was fortunate that I inherited a portfolio of high-quality stocks from Sonja (Laud), who continues to manage our global equity yield portfolios.

The fundamental philosophy of the fund remains the same; both Sonja and I believe in dividends as a key driver of total stock returns, and as an indicator of an attractive investment. There have been no dramatic changes in composition but the fund has certainly not been static over the period, with 57% commonality between stock names in the portfolio just before I took over and those in the fund now.

What have you found most rewarding and/or challenging while managing the portfolio through 2011?

The most rewarding aspect of 2011 was obviously the fund performance. The fund outperformed its benchmark by 2.82%¹, despite the volatility in the market and, importantly, it has delivered that outperformance consistently throughout the year, rather than through a short period of very strong performance. The income style will tend to underperform in rapidly rising markets, so the first few months of 2012 have been challenging, but I do not believe in diluting the discipline of yield investing. So far, relative performance in 2012 has been pleasing.

Are there any stocks or areas that you are particularly interested in?

I am excited about the opportunity presented by UK insurer Admiral Group. This is a classic case of an over-loved and over-valued stock falling from grace, at which point, the market becomes

“With real interest rates tumbling, the hunt for yield is on the rise. In this environment, we would expect to see increasing demand for equity yield portfolios that are able to offer the attractive combination of sustainable dividends and real growth potential.”

too pessimistic. Investors often mistake great businesses for great investments, ignoring the importance of valuation. Admiral remains a great business, but was a poor investment at its peak of £17 – as the subsequent halving of the share price demonstrated. Now that the stock is trading at more attractive levels, supported by a dividend yield of 7%, our clients can benefit from the great business and management, with lower valuation risks.

So it is not all about finding the highest dividend paying stocks...

No, we never own a stock solely because of an attractive dividend. Although we look for companies that are able to generate higher-than-average yields, the sustainability and potential to grow those yields are of great importance.

We will also selectively consider stocks with low current dividends if they have high dividend growth potential. This growth could be because their industry is going through a cyclical low and we think it will recover, or because it has structurally high growth prospects. The counter-balance to this buying strategy is that we will sell stocks which have appreciated to a price where the dividend yield is too low, considering ‘through-cycle’ profitability and growth prospects.

How has this sell discipline impacted the fund?

During 2011, many ‘traditional’ yield stocks outperformed the market. Unilever is an example of this, outperforming the market by 27% over the year. This means that, despite continuing dividend growth, the available yield on these stocks has fallen; in the past 36 quarters, Unilever has only

had a lower dividend yield than today on three occasions. In combination with other valuation metrics, we took this to be an indicator that the market was ‘hiding’ in these safe stocks, and that despite these being great businesses, valuation risk was too high. We sold Unilever early in 2012 and reinvested in higher-yielding stocks, and stocks with greater dividend growth opportunities.

Which stocks are you attracted to, if the ‘traditional’ yield universe is becoming more expensive?

At the moment we are very interested in sectors with significant exposure to an economic recovery and global growth, but where we can find stocks with a sustainable dividend, which is already covered from current cash flows. An example of this is the preference shares of BMW, which are currently yielding 5.2% and provide exposure to growth in global affluence. They carry the same economic rights as the ordinary shares, except that they are non-voting, and trade at a 34% discount (as of 30th March 2012).

Another example is the building materials company CRH, which is profitable and currently yielding 4.1% despite 37% of its revenues coming from the depressed US infrastructure and construction market. US homebuilding has fallen from 2 million units annually in 2006 to an annualised 700,000 units in March 2012.

Since 1960, the US homebuilding cycle has troughed around 1 million units annually, and peaked around levels seen in 2006. There are 151 million more US citizens today than in 1960,



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and the US Census Bureau forecasts population growth of 3.1 million annually to 2020. Eventually, US construction and infrastructure spending will increase, and the earnings and dividend potential should rise accordingly. In the interim, we are being paid 4% annually to own a 'call option' on US construction.

...but you also own stocks which have very high dividend yields, which presumably have lower growth potential.

Yes, as well as stocks with strong dividend growth prospects, stocks with very high dividend yields can make great investments. The key questions are 'why is the dividend yield so high?' and 'what is the sustainable dividend capacity?' With ten-year government bond yields close to 2%, the market is not giving away stocks with 10% dividend yields; the implication from the yield is that the dividend will be cut. If the market assesses that the dividend is sustainable, even at a reduced level, then the stocks can re-rate strongly.

...and how do you go about selecting stocks to be included in the portfolio?

We initially use screens to filter stock ideas from a universe of over 1,300 stocks. We always focus on identifying superior fundamental characteristics – looking at, for example, dividends, cash flow and valuations – rather than price momentum or earnings revisions. Helpful though this process is in generating stock ideas, no screen will give 'the answer'. Rather, the process flags up ideas that I can then explore, in conjunction with our team of European analysts, who bring a great deal of experience and cross-sector expertise to the process.

Importantly, when determining our investment thesis, we ask ourselves 'where do we differ from the market?', and 'how will our investment thesis be crystallised?' Ultimately, we are looking to construct a portfolio of quality stocks with an enhanced risk/return profile that is able to generate sustainable dividends and attractive total returns.

Given the continued pressures on banks, including the increasingly stringent regulatory framework, are you still finding investment opportunities in the financials sector?

European bank valuations are still looking attractive, while the ECB's long-term refinancing

Why does dividend investing work?

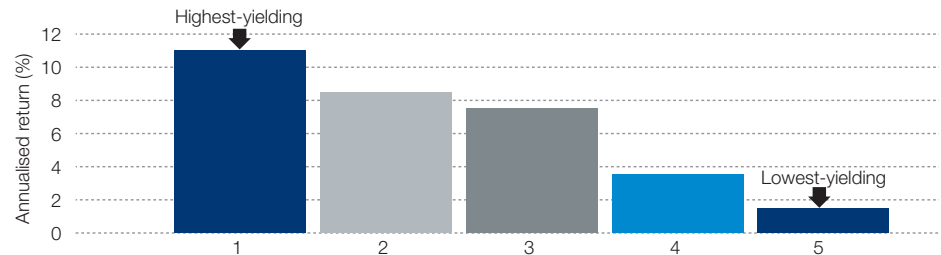
Dividends impose discipline upon profitable companies



High yielding stocks deliver superior long-term returns

Total returns are strongly influenced by dividend yields

European stock returns by quintile of dividend return, market cap weighed, 1989 to 2011



The chart above illustrates the total return of portfolios which are rebalanced every six months into stocks ranging from the highest (1) to the lowest (5) dividend yielding stocks in Europe. Note that trading costs are not considered. Source: Factset. Data taken from constituents of FTSE World Europe and S&P Europe as at 30 December.

operations removed most short-term funding risks. With so many moving parts it is difficult to make statements about the sector as a whole; it comes down to analysing external influences and balance sheets on a 'bank-by-bank' basis.

We are underweight the banking sector as a whole, but hold positions in select well-capitalised European banks that we think should generate growing income streams in the medium term. Our remaining financials exposure is through insurers, where the regulatory outlook is more favourable versus the banking sector. Insurers should also benefit from any uptick in bond yields in 2012.

What are the prospects for dividend yield strategies in 2012?

Robust corporate balance sheets are supportive for dividends in 2012. After a period of sustained deleveraging, companies have built up sizeable cash reserves, and increasingly inefficient capital structures are seeing a growing number of firms willing to initiate a dividend.

The cash-rich environment should also support dividend growth at a company level. We are already seeing more interest in yield strategies from investors. With government bonds trading on a 'P/E' of 50x (the inverse of the 2% yield), there will be a substantial risk to capital values if bond yields rise to historic normal levels. In this environment, the prospect of an income stream with some degree of inflation protection is certainly attractive to income-hungry investors.

Why invest in this fund?

- Superior income and growth potential
- Dividends as a buffer in weaker markets
- Element of inflation protection
- Income as an indicator of quality
- Diversification and ample liquidity

Fund Manager Biography

Ian is the fund manager of Schroder ISF European Equity Yield and the co-manager of the Schroder ISF European Dividend Maximiser.

Ian has had sole responsibility for the European Yield portfolios since December 2010. He joined Schroders in May 2007 as an analyst specialising in European insurance and automobiles. He is a Chartered Financial Analyst (CFA) charter holder.

He previously completed a PhD in Biophysics at Newcastle University and a Masters degree in Investment Management at Cass Business School, London.

Performance (EUR) to end of February 2012

	3 months	6 months	1 year	2 years p.a.	Gross yield (%)
Schroder ISF European Equity Yield	9.5	19.6	2.3	5.0	4.5
MSCI Europe TR Net	7.9	17.5	-1.5	2.9	3.7
Difference	1.6	2.1	3.8	2.1	
Quartile ranking	Q2	Q1	Q1	Q1	

Source: Morningstar. Fund performance data on 'A' Accumulation shares, bid-to-bid, net of fees. Yield source: Schroders as at 29 February 2012.

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