

# Schroder Australian Equity Fund

## Total return %

Schroder Australian Equity Fund (pre-fee)  
S&P / ASX 200 Accumulation Index  
Relative performance (pre-fee)

	1 mth	3 mths	1 yr	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Schroder Australian Equity Fund (pre-fee)	4.3	1.1	-3.9	15.2	1.3	8.6
S&P / ASX 200 Accumulation Index	5.1	0.1	-6.2	11.2	-1.7	6.5
Relative performance (pre-fee)	<b>-0.8</b>	<b>+1.0</b>	<b>+2.3</b>	<b>+4.0</b>	<b>+3.0</b>	<b>+2.1</b>

Inception Date: 03 Mar 1964, 47 years and 10 months.

Market cap	Portfolio <sup>1</sup>	Benchmark <sup>2</sup>
ASX 1 - 50	83.2%	83.2%
ASX 51 - 100	9.4%	9.8%
ASX 101 - 300	4.7%	7.0%
Non Index	1.1%	
Cash	1.7%	

Top ten holdings %	Portfolio <sup>1</sup>	Benchmark <sup>2</sup>
BHP Billiton Limited	13.3%	11.9%
National Australia Bank Limited	7.4%	5.2%
Commonwealth Bank of Australia	6.8%	7.9%
Westpac Banking Corporation	6.8%	6.3%
ANZ Banking Group	6.1%	5.6%
Woolworths Limited	5.3%	3.0%
Telstra Corporation Limited	4.2%	4.1%
Rio Tinto Limited	3.3%	3.0%
Brambles Limited	2.7%	1.1%
James Hardie Industries Se	2.6%	0.3%
<b>Total</b>	<b>58.5%</b>	<b>48.4%</b>

Characteristics	Portfolio <sup>1</sup>	Benchmark <sup>2</sup>
No. of stocks	54	200
Portfolio turnover* (1 yr)	13.8%	
Volatility (5yr standard deviation)	16.3%	16.3%
Tracking error (3yr historic)	3.7%	

1 The 'Portfolio' is the Schroder Australian Equity Fund

2 Benchmark is the S&P / ASX 200 Accumulation Index

Unless otherwise stated all figures are as at the end of January 2012  
Please note numbers may not total 100 due to rounding

\*Turnover =  $\frac{1}{2}(\text{Purchases} + \text{Sales} - \sum \text{Cashinflows} + \sum \text{Cashoutflows}) / \frac{1}{2}(\text{Market Value}(T_0) + \text{Market Value}(T_1) - \sum \text{Cashflows})$

Please refer to [www.schroders.com.au](http://www.schroders.com.au) for post-tax returns  
Past performance is not a reliable indicator of future performance

## Commentary

The S&P / ASX 200 Accumulation Index rose by 5.1%, while the Schroder Australian Equity Fund (pre-fee) rose by 4.3%, underperforming by 0.8% for the month.

January always heralds new beginnings and resolutions. But not this year, at least not for financial markets. It was far more like a cowardly, old world than a brave, new world, with markets dancing in the New Year to a familiar tune. A co-ordinated official injection of liquidity, this time A\$650bn of three year funds at an interest rate of 1.0% in Europe (with the loosening of bank collateral requirements and the promise of more liquidity injections this month), the confirmation of a further three years of a zero interest rate policy in the US, and the Chinese relaxing the reserve rate requirement for its banking system, again buoyed world markets as they were sprayed with official liquidity. The Australian equity market fully partook in this "risk on" financial party.

Indeed, the liquidity injection presaged the usual sequence of market reaction. Risk aversion falls. Equities rally, led by cyclical names and smaller resource stocks. Commodity prices rally and take the Australian dollar with it (industry assistance offered to Australian manufacturers – this time car and steel makers). The forced introduction of official liquidity into the European financial system prompts ratings agencies to review European sovereign ratings and determine – wait for it – there may be more risk than previously thought, and hence downgrades ensue. This is a movie that has been played several times since the GFC commenced in 2007. Whilst the early scenes usually evoke comforting memories, prompting market rallies as experienced through January, to date the ending is yet to be as pleasant. Further, and unlike the Star Wars series, successive rolls of this genre tend to be of increasingly shorter duration, as markets fatigue in the absence of structural reform.

Some of the consequences of living in a zero interest rate world are obvious, and not necessarily cause for joy for investors. Where have we come from? The IMF recently highlighted that G20 debt to GDP last year was 110% (and rising), from 80% in 2006. Where has quantitative easing got us to? Real US long term rates are now less than zero (versus the liberal definition of core inflation, ie ex food and energy) for the first time since the 1970's, and then it was a fleeting experience. Bonds have prospered, funded by equity holders and taxpayers. In turn, savers clearly lose, as do those less able to access cheap credit; the gini coefficient has risen from a high base in recent years as quantitative easing has taken hold in the western world. In turn, social unrest is likely to continue to increase; governments will continue to change, and the "Occupy Wall Street" movement is neither likely to disappear nor be the last (or most forceful) form of social protest as deleveraging proceeds. Hard assets and the Australian dollar, both proxies for Chinese industrial production, are likely to continue to benefit, although this is now more a sentiment than fundamental trade.

The capital needed to be raised by the European banking sector this year is clearly large. For context, the Australian banking sector has a market cap of US\$230bn and assets of US\$2,900bn. Those same numbers in Europe are US\$750bn and US\$33 trillion; the market is pricing European bank assets at 28 cents in the dollar of what's being paid for Australian bank assets. Part of this reflects fundamental risk; Deutsche Bank, for example, only has 2% of its assets in net tangible equity, and unlike Australian banks with loans representing 60% of the asset base, large securities holdings see loans amount to only 20% of the Deutsche Bank asset base. Not much scope for a repeat of the 70% write down in Greek debt here! Yet the Germans are, by a long way, acting the most rationally of the European nations currently, calling time and again for debts to be written down to a fair economic value and for fiscal disciplines to be put in place (even to the extent of now placing EC overseers into Greece).

Whilst it's hard to see Australian banks outperforming the market when the month of recapitalizing the European system comes later this year, in the meantime they continue to do much that is right for their investors. Deposit growth continues to overwhelm loan growth. ANZ has established a smart structure to allow the political detonator that is mortgage repricing to be undertaken outside of the RBA interest rate cycle, and the focus on productivity across the sector is accelerating. We continue to believe that any corporate, in any industry, which can make the price in their market and generate productivity improvements, will generate good returns for equity holders even in the face of a deleveraging environment and adverse demographic trends. The major banks in Australia fit these criteria.

### Fund objective

To outperform the S&P/ASX 200 Accumulation Index after fees over the medium to long term by investing in a broad range of companies from Australia and New Zealand.

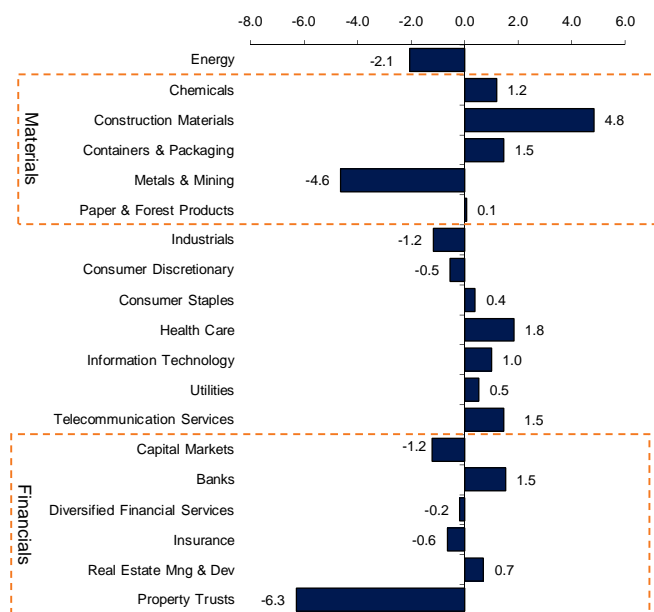
### Investment style

Schroders is a bottom-up, fundamental, active growth manager of Australian equities, with an emphasis on stocks that are able to grow shareholder value in the long term.

### Fund details

APIR code	SCH0002AU
Fund size (AUD)	\$1,284,028,354
Redemption unit price	7.3179
Fund inception date	March 1964
Buy / sell spread	0.30%/0.30%
Minimum investment	\$500,000
Distribution frequency	Normally twice yearly - June and Dec
Management costs (p.a.)	0.62%

### Sector exposure versus the benchmark %



Unless otherwise stated all figures are as at the end of January 2012  
Benchmark is the S&P / ASX 200 Accumulation Index

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Investment in the Schroder Australian Equity Fund ('the Fund') may be made on an application form in the Product Disclosure Statement dated 1 February 2011, available from the Manager, Schroder Investment Management Australia Limited (ABN 22 000 443 274 AFSL 226473) ("Schroders").

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### Commentary Continued

As recipients of aid, the steel makers in Australia are also a good case study of the "Dutch disease" at work, as high input prices, high currencies, and excess supply result in imports seeing selling prices pressured. Both Bluescope and Onesteel were spun out of BHP a decade ago. At that time, for a tonne of steel produced, the mining margin accruing to BHP of \$35 per tonne was approximately a quarter of the steel margin accruing to Bluescope (at approximately \$140 per tonne). Together, a tonne of steel generated almost \$200 per tonne of value for the commodity producer and processor. It was only in 2010 that for the first time the commodity producer took more of the cake than the processor. Today, whilst the combined \$ per tonne of value generated is little changed, more than all of this value accrues to the commodity producer! Major Chinese steel producers are also now reporting losses. Record levels of capacity expansions in the Pilbara, and elsewhere in the world, are scheduled for this year and next. Capitalizing current commodity prices defies common sense.

Nonetheless, the usual suspects in the ASX200 did well during the month given this "risk on" environment. Materials (+10.3%) was the best performing sector, and within it Paladin Energy (+34.3%), Lynas Corporation (+26.8%) and Perseus Mining (+19.6%) were among the best performers, unsurprisingly this was a drag on relative performance for the Portfolio. We see more value in BHP and RIO at the moment than we do in many industrial stocks, let alone financials and REITs, but high cost, short mine life producers and explorers continue to be priced for sustenance of current commodity prices, which we think unlikely.

Other strong performers in the month included some of 2011's laggards, with Leighton Holdings (+23.1%), Downer EDI (12.8%) and Boral (+12.2%), all performing well. A new broom sweeps clean, and the management travails of 2011 seem a long time ago now for Leighton. Better pricing of contracts, and recognition of the sins of the past through provisioning, along with fair multiples and a prospective revenue environment sees Leighton well placed. Downer EDI continues to find innovative ways to lose money amidst a strong revenue environment for its four business units, but with the NSW Government appearing to (rationally) assume the Reliance Rail equity from Downer and its financial partners, the worst may be past in newsflow for this long run underperformer, and performance may henceforth be reflective of operational capability rather than the M and A legacy that has beset 2011. Of course, operational capability can cut both ways; here's hoping for the best! Finally, Boral has been busy implementing LEAN manufacturing principles through the past two years, since Mark Selway assumed the MD role. The results of this operational improvement program are yet to clearly appear, however the focus on it and the clarity with which it is being applied is refreshing. As we have previously written to, however, the stock is currently trading at less than book value and its lowest point relative to the market in fifteen years, because all of the benefit of operational performance has been overwhelmed by a less than judicious acquisition agenda. Paying high prices for assets in turbulent markets is rarely a path to riches; the good news is that, out of firepower, Boral management is unlikely to repeat this destructive behavior anytime soon.

Of course, amidst the winners were losers. All of QBE (-11.5%), Transfield Services (-7.4%), Primary Health Care (-3.2%), Amcor (-2.4%) and Woolworths (-1.2%) underperformed through the month. In some cases, this reflected strong performance through the past year and the market reverting from defensive to more cyclical earning streams, rather than company specific factors – we would place Amcor and Woolworths firmly in this category. QBE, however, fell aggressively after a profit warning. QBE is geared, opaque, acquisitive, and lacks a credible comparator stock not just locally but globally. These are omnipresent risk factors. The equity price, however, now reflects these risks, with Net Tangible Asset multiple lower than at any point through the past decade.

### Portfolio outlook & strategy

We are now four years from the peak of the last cycle, with subsequent market turmoil morphing into economic turmoil and political turmoil. The presumed link between economic growth rates and market performance continues to be proven false. Last year, Chinese GDP growth came in at slightly more than double Australia's, which in turn was about the same multiple of US GDP growth. Yet equity market returns were the exact opposite; the US was the best performer, followed by Australia and then China. The longer run gives us similar outcomes. Hence, whilst we continue to think the risk to economic growth is firmly to the downside, with a starting point of high equity risk premiums, companies with an ability to make the price in their markets and management focused on improving productivity should continue to provide good returns.

The major themes affecting the Australian markets of too much debt, albeit concentrated in the financial and household sectors, aging demographics, and commodity prices continuing to trade at levels well above what we consider long term sustainable prices, all remain on foot. The Portfolio is positioned accordingly, with a bias to industrials with earnings exposure to economies where we believe upside to mid cycle exists more than can be said to be the case in Australia. Markets remain thirsty for what they perceive to be good news, and will rally when it is received, as occurred in January. That will continue to be the case, and we need to continue to be prepared for that likelihood with the Portfolio. Equally, it would be imprudent for us to ignore what we see as the base case of ongoing risks detailed above, which only become amplified the longer they remain unaddressed. It is this balancing act that has dominated the past year and will continue to dictate our assessment of not just future likely returns, but also risks, in the Portfolio.