



December 2011

Quarterly Report

Schroder Australian Smaller Companies Fund

Total return %

Schroder Australian Smaller Companies Fund (post-fee)

S&P/ASX Small Ordinaries Accumulation Index

Relative performance (post-fee)

	1 mth	3 mths	1 yr	2 yrs p.a.	3 yrs p.a.	Inception p.a.
Schroder Australian Smaller Companies Fund (post-fee)	-2.7	0.1	-15.7	-2.0	10.4	-4.9
S&P/ASX Small Ordinaries Accumulation Index	-4.3	-0.6	-21.4	-5.8	11.8	-10.2
Relative performance (post-fee)	+1.6	+0.7	+5.7	+3.8	-1.4	+5.3

Inception Date: 17 Dec 2007, 4 years and 0 months.

Market cap

	Portfolio ¹	Benchmark ²
ASX 1 - 50	0.0%	0.0%
ASX 51 - 100	4.0%	0.0%
ASX 101 - 300	62.9%	100.0%
Non Index	28.3%	
Cash	4.8%	

Top ten holdings %

	Portfolio ¹	Benchmark ²
DuluxGroup Limited	4.4%	1.2%
Fletcher Building Limited	3.5%	1.4%
Resolute Mining Limited	3.3%	0.7%
Adelaide Brighton Limited	3.2%	1.6%
Hastings Diversified Utilities Fund	3.2%	1.0%
Technology One Limited	3.2%	0.0%
SP AusNet	3.0%	1.5%
Blackmores Limited	2.8%	0.0%
Skilled Group Limited	2.8%	0.3%
Telecom Corporation of NZ	2.8%	1.0%
Total	32.2%	8.7%

Characteristics

	Portfolio ¹	Benchmark ²
No. of stocks	61	192
Portfolio turnover* (1 yr)	45.2%	
Volatility (3yr standard deviation)	16.5%	20.0%
Tracking error (3yr historic)	6.9%	

Please refer to www.schroders.com.au for post-tax returns
Past performance is not a reliable indicator of future performance

Commentary

The S&P/ASX Small Ordinaries Accumulation Index fell by 0.6%, while the Schroder Australian Smaller Companies Fund (post-fee) rose by 0.1%, outperforming by 0.7% for the quarter.

It has been our contention for some time that if you follow the chain of causal links that drive Australian mining exports, the pricing of Chinese assets through their stock market provides a useful leading indicator of Australian resource stock performance. As risk assets have rallied in response to the latest scheme to find a political solution to the European morass it has been interesting to see one of the markets that has failed to rally has been China. Given this relationship between the Chinese economy, the Chinese stock market and the fortunes of Australian commodity producers it was a surprise that Small Resources in the December quarter declined only 1.4% in the face of an 11% decline in Chinese equity prices. The fact that the Small Ords Accumulation Index decline in 2011 of 21.4% looks a lot closer to the 21.7% decline in the Chinese equity market than the 0% recorded by the S&P500 should reinforce to Australian small cap investors what the more significant economic influence on returns will likely be in 2012.

Staying away from resource related sectors was not an easy road either in 2011. In the fund commentary of March 2011 we discussed in some detail how we thought that the combination of higher domestic savings rates and the impact of the Internet was going to make life very difficult for non-food retail companies. However it wasn't until there was no longer any denying the reality that share prices truly began to price in what we believe is a structural change to the retail operating model in Australia. During December, when retail profit warnings seemed to come through on a daily basis, JB Hi-Fi fell (-25.7%), Billabong (-46.7%), Kathmandu (-21.2%), David Jones (-16.6%) and Harvey Norman (-12.3%).

Mining Services – for some, the profitless boom

On a recent trip to Perth we met a number of mining service companies who reminded us just how hard making money through the cycle is for these businesses – despite how easy it looks right now. We group the small cap mining services companies into four broad categories based on their business model:

1. Balance sheet rentals – companies that need X dollars of property, plant & equipment (PP&E) for each dollar of client revenue. No gear = no work.
2. People rentals – companies that provide manpower of various skill levels on a mark up basis. No people = no work.
3. True IP – companies that own a valuable intangible that clients are willing to pay to access.
4. The 'One and Twenty' crowd – mining services equivalent of hedge funds. Take their balance sheet, people, IP and project execution capability and package into an at risk proposition that can pay higher returns based on a share of performance.

Before we can jump into examining the business models and the exposure they provide to investors, we need to first understand the basics of the industry in which they operate. Our assumptions for the mining industry are as such:

1. It is very cyclical, with significant peak to trough levels of activity (regardless of trend) driven by commodity price volatility
2. It is very difficult in the short run for industry service providers to diversify away (high exit barriers due to specialised equipment or skills)
3. Because of these two factors in general operating leverage of mining service companies is high.

The category we will focus on for the purpose of this quarter's report will be the balance sheet rental companies.

1 The 'Portfolio' is the Schroder Australian Smaller Companies Fund

2 Benchmark is the S&P/ASX Small Ordinaries Accumulation Index

Unless otherwise stated all figures are as at the end of December 2011
Please note numbers may not total 100 due to rounding

*Turnover = $\frac{1}{2}(\text{Purchases} + \text{Sales} - \sum \text{Cashinflows} + \sum \text{Cashoutflows}) / \frac{1}{2}(\text{Market Value}(T0) + \text{Market Value}(T1) - \sum \text{Cashflows})$

Quarterly contributors %	Position *	Attribution
Hastings Diversified Utilities Fund	Overweight	0.57
Telecom Corporation of NZ	Overweight	0.57
DuluxGroup Limited	Overweight	0.47
Domino's Pizza Enterprises Limited	Overweight	0.45
Billabong International Limited	Underweight	0.40

Quarterly detractors %	Position *	Attribution
Medusa Mining Limited	Overweight	-0.77
Chorus Limited	Overweight	-0.58
Aurora Oil & Gas Limited	Underweight	-0.52
Hastie Group Limited	Overweight	-0.42
Fletcher Building Limited	Overweight	-0.38

* Portfolio weights versus benchmark are average weights over the quarter

Distribution details

	2009	2010	2011
Total CPU (i)	1.51	12.74	7.51
Capital gains (ii)	0.00	10.04	6.23
Discount capital gains	0.00	7.57	6.19
Non discount capital gains	0.00	2.47	0.04
Franking % (iii)	65.39	13.87	19.93

i) CPU: Cents Per Unit.

ii) Annual cash distribution represented by capital gains

iii) Franking for financial year ending 30 June. Franking Levels Per IFSA calculation being franking credits as % of cash distribution multiplied by (1-tax rate) divided by the tax rate.

Commentary continued

As will not be news to anyone, our investment philosophy pivots around investing in companies that can 'sustain excess returns on capital'. Sustainability to us means on a through-the-cycle basis, or in the long run. Not this year. Perhaps not even over the next three years, but structurally for as far forward as we can see. Cyclical industries are often the most interesting as above and below sustainable return conditions exist more often than mid cycle conditions – leading investors to over and under estimate the sustainable position as recency bias kicks in. The other observation would be that if an industry spends 80-90% of its time over or under mid cycle, the peak cycle returns need to be high enough to compensate the trough cycle returns for the through-the-cycle return to be an adequate number. The final point about cyclical companies is the matching of high operating leverage with appropriate financial leverage. Part of this is to not amplify the leverage to equity through a cycle, but the more important long run consideration is to ensure that the equity is not 'stopped out' if the below mid cycle conditions extend for a long period of time.

There is little doubt that providers of mining services in Australia are currently operating above mid cycle, and the near term revenue outlook suggests we are still in the upswing of this cycle. For balance sheet rental businesses however, what becomes obvious quickly is that the cash cost of funding growth is such that shareholders are required to fund rather than earn at this stage in the cycle. By using the aggregated financials of six asset heavy mining service companies (Ausdrill, McMahons, NRW Holdings, Emeco, Mermaid Marine and Boom Logistics) we can see the impact of market conditions upon the financial aspects of these business models.

Some observations over the aggregate financial position of these six companies over the past five years (F2006 – F2011):

- Over the five years, revenue has grown at 16.6% per annum, with a small cycle in F2009 and F2010 when revenue grew at 5% and declined 11% respectively,
- On average, these businesses require A\$0.70 of PP&E for every dollar of revenue, more than double the level of the average small industrial company. As such, the cash flow statements for these companies shows capital investments of 170% of their F2006 fixed assets to support the subsequent revenue growth. Investors should also note that actual capital expenditure (CAPEX) investment can be understated on the cash flow statements of these companies as chattel financed assets are recorded on the balance sheet but are not put through the cash flow statement due to current accounting standards. We estimate that this under represents CAPEX by between 15% and 20% over the past five years for these companies.
- The profit and loss statement (P&L) presents a reasonable outcome, with earnings (EBITDA) margins relatively stable between 20% and 22% over the period and a return on capital around 11%. However it is worth recalling that if we expect to make our appropriate through-the-cycle return, we need the above mid cycle returns to compensate for the cyclical lows we are likely to experience some time in the future. Given this is about as good as it gets, these returns in our view are not high enough to compensate shareholders for the volatility they are assuming here.
- The cash flow available to shareholders tells a different story. Because of the significant investment required to fund the revenue growth, pre M&A only 4.4% of the revenue has been available to shareholders as free cash. Management has chosen to reinvest more than 50% of this figure into acquisitions, leaving only 2.1% of revenue available to shareholders. Given this is exactly 1/10th of reported EBITDA margins, it becomes clear as to why using EBITDA multiples as passive minority investors is such a ludicrous concept. Indeed the only reason the cash available was this high was due to the years of slower growth that enabled cash to be released. We would be surprised if any of these companies release any free cash when funding revenue growth of 10% or more.
- The financing of these businesses has changed pre and post GFC. Net debt to equity as a group has declined from 50% in F2007 to 25% in F2011, and given the lack of free cash available to achieve this deleveraging it has been the shareholders that have funded the A\$1.1bn of equity issued by these six companies, or 1/3rd of their current market capitalisation.

Although we struggle to see the through-the-cycle merit of these businesses at current market values (1.5x book) due to what in our view are inadequate returns on capital for the volatility and cyclical nature of returns, and also struggle to understand why they are attractive investments in the short term due to their voracious appetite for cash in the growth phase, that is not to say that they have not been attractive stock market investments over the past five years. As a group, they have outperformed the Small Ords by some margin (although individual performance varies significantly) and this has allowed the companies to finance themselves with equity issued at strong valuations. Investor desire for exposure to revenue growth as a driver of valuation premium has meant that through the generosity of the capital market, these companies have turned theoretical overvaluation (in our view) into real money through equity issuance.

So if the balance sheet rental business is economically unappealing, through-the-cycle is the answer found in the other three categories of business model? In part yes, however these business models bring with them their own challenges where analysis extends into the increasingly subjective. Financial statement analysis can only take us so far with these companies, who rely far more on soft factors such as reputation and culture for their ongoing success. Without a hard asset safety net (albeit with Boom Logistics trading at a 50% discount to NTA, the net does have a fair bit of give), and without the same capital constraints to growth these non balance sheet driven businesses have a wider range of investment outcomes. Ironically, another way of looking at the balance sheet driven businesses is that without management getting the soft factors right, investors still get a poor outcome and have had to fund the hard assets along the way. The only way to unlock value in any business (hard or soft) is to have management who can deliver it to shareholders.

Fund objective

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

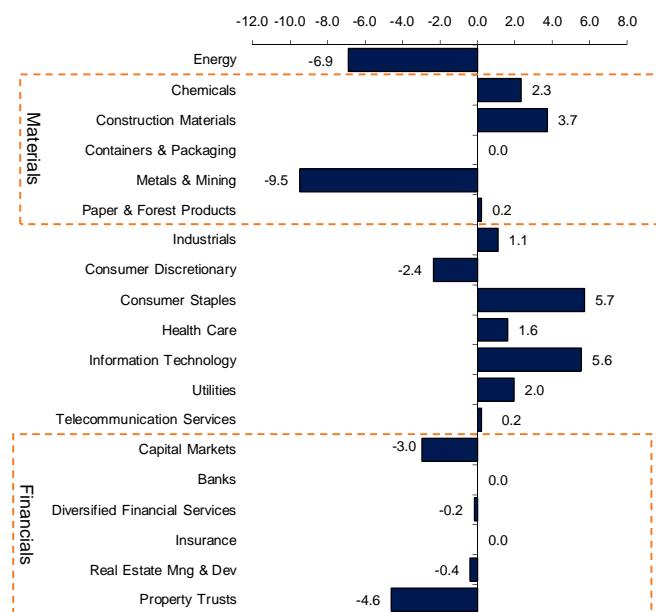
Investment style

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	SCH0036AU
Fund size (AUD)	\$31,817,173
Redemption unit price	0.5714
Fund inception date	December 2007
Buy / sell spread	0.60%/0.60%
Minimum investment	\$50,000
Distribution frequency	Normally twice yearly - June and Dec
Management costs (p.a.)	1.10% pa plus performance fee of 20.5% pa of net outperformance

Sector exposure versus the benchmark %



Unless otherwise stated all figures are as at the end of December 2011
Benchmark is the S&P/ASX Small Ordinaries Accumulation Index

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Investment in the Schroder Australian Smaller Companies 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

Building an understanding of the success factors for each business model beyond the balance sheet is both difficult and valuable. As we have said in the past, that is the definition of value added and for management and investors who can achieve this, the rewards should be commensurate.

Contributors

Hastings Diversified Utilities Fund (HDF.AX, +34.4%): We invested in HDF at around A\$1.65 in January 2011 based upon the thesis that: South East Water valued at below RAB, EPIC short term revenue locked in, EPIC medium term expansion potential and spare capacity, EPIC long term expansion potential and potential revenue from storage and HDF was a potential acquisition targets for APA. In December, APA offered HDF shareholders 0.326 APA shares and A\$0.50 in cash for the 79.3% of HDF they do not already own. This implied a A\$2.00 per share consideration based upon the prevailing APA share price and a 20.6% premium to the preceding 3 month VWAP of HDF share price. This is not a friendly deal, with HDF directors advising shareholders to reject the bid both on the grounds of the value attributed to HDF, and the form of consideration offered by APA.

Other contributors included Dulux group (o/w, +17.8%), Domino's Pizza Enterprises (o/w, +19.2%) and RCR Tomlinson (o/w, +19.6%).

Detractors

Fletcher Building (FBU.NZ, -20.8%): The downgrades in the housing related sectors continued in the December quarter, with Fletcher Building updating the market in October to the trading conditions in the September quarter. FBU highlighted "In Australia, the significant downturn in residential consents and continued weak approval levels in commercial construction" as a key driver of weaker than expected profit performance, and continues similar comments from other participants in exposed to domestic non-infrastructure construction activity in the past months. The share price continued to trade down on these downgrades in the December quarter.

Other detractors included Medusa Mining (o/w, -34.7%), Aurora Oil and Gas (u/w, +51.3%) and Hastie Group (o/w, -39.9%).

Outlook

Equity valuations by reference to P/E ratios have been apparently cheap against history for most of 2011 however context is important here. Firstly the history against which investors often compare (the last 10-20 years) looks to be quite different to the current economic and political environment. Secondly as shareholders in non-food retail stocks in 2011 would attest, a low P/E ratio struck off earnings that are unsustainably high is a false value signal, and it only takes a couple of downgrades to operating earnings combined with excess financial leverage for that cheap stock to have lost 50% plus of its market value.

Relative to large cap stocks (ASX100), the valuation equation for small companies today has modestly improved compared to the beginning of 2011 – due in large part to the 12% relative underperformance by small caps during the year. We are yet at a point where there is a compelling relative valuation case to be made for small companies and we continue to expect the benefits of investing in small companies to come from the businesses we own, rather than any stark valuation arbitrage. The risk to earnings in the short term is still elevated, and the Portfolio remains invested in those companies we believe are best positioned to sustain high returns on capital, with managements that can deliver true productivity gains and capital structures that eschew excessive financial leverage that serve to only amplify risk in an uncertain environment.