March 2013 Quarterly Report

Schroder Australian Equity Fund

Total return %	1 mth	3 mths	1 yr	3 yrs p.a.	5 yrs p.a.	10 yrs p.a.
Schroder Australian Equity Fund (pre-fee)	-2.5	8.6	23.5	7.9	7.0	13.0
S&P / ASX 200 Accumulation Index	-2.2	8.1	20.0	5.2	3.1	10.3
Relative performance (pre-fee)	**-0.3**	**+0.5**	**+3.5**	**+2.7**	**+3.9**	**+2.7**

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

Inception Date: 03 Mar 1964, 49 years and 0 months.

Market cap	Portfolio[1]	Benchmark[2]
ASX 1 - 50	89.3%	84.0%
ASX 51 - 100	6.6%	10.0%
ASX 101 - 300	1.2%	6.1%
Non Index	0.8%	
Cash	1.9%	

Top ten holdings %	Portfolio[1]	Benchmark[2]
BHP Billiton Ltd.	10.4%	8.7%
National Australia Bank Ltd.	8.0%	6.0%
Westpac Banking Corp.	6.5%	7.9%
Commonwealth Bank of Australia	6.0%	9.1%
ANZ Banking Group Ltd.	5.5%	6.5%
Woolworths Ltd.	5.4%	3.5%
Telstra Corp. Ltd.	4.6%	4.6%
Wesfarmers Ltd.	3.9%	3.9%
Brambles Ltd.	3.7%	1.1%
Rio Tinto Ltd.	3.7%	2.1%
Total	**57.7%**	**53.4%**

Characteristics	Portfolio[1]	Benchmark[2]
No. of stocks	49	200
Portfolio turnover* (1 yr)	15.1%	
Volatility (5yr standard deviation)	16.1%	15.9%
Tracking error (3yr historic)	2.2%	

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 March 2013
Please note numbers may not total 100 due to rounding

*Turnover = ½(Purchases + Sales - ∑Cashinflows + ∑Cashoutflows) / ½(Market Value(T0)+ Market Value(T1) - ∑Cashflows)

Commentary

The S&P / ASX 200 Accumulation Index rose by 8.1%, while the Schroder Australian Equity Fund (pre-fee) rose by 8.6%, outperforming by 0.5% for the quarter.

A change in physical seasons is noticeable as the days shorten and temperatures dial down. As autumn sets in, the equity market also cooled in Australia in March, with the first month of negative returns (-2.2%) since last winter. Given this burst of market performance had all been attributed to a QE inspired rerating, with earnings being no greater than had been anticipated through this time (and cashflows being lower than had been forecast), equity market volatility is unsurprising. If last year to the downside, and 2007 to the upside, saw multiples at extreme levels, we are now in that turgid mid ground, albeit with this headline level masking extremes at a sectoral level.

Our fundamental views haven't changed much. Six principles of this line of thought are;
• lower (global growth) for longer, driven by overcapacity and demographics;
• an ongoing need for deleveraging by the government, financial and household sectors, albeit deferred (but ultimately exacerbated) by political realities;
• there is no long term monetary solution to indebtedness; although this is now becoming an increasing craze for central bankers;
• in line with unemployment rates, the Australian economy is far above mid cycle whereas most other developed world economies are below;
• business plans extrapolating prior cycles are folly; and
• the two golden rules for corporate success in this low volume environment remain the ability to exert pricing power, and a productivity focus.

To the contrary, three thematics which have provoked us through the past year, and caused us to question our embedded beliefs, include;
• the political capital invested in bond holders being kept whole (and the consequent ongoing rally in sovereigns to unprecedented levels, and the knock on effect in equity markets), although Cyprus shook this tenet a little;
• the ongoing robustness of the Australian dollar in the face of falling commodity prices (albeit we think the correction in iron ore to date is mild relative to our long run assumption); and
• the readiness of corporates in the financial and property sectors to regear and add capacity, in the face of ongoing tumult in debt markets and broad based declines in demand, respectively.

Consistent with this last surprise, Financials are the star stocks in Australia through recent times. The major banks have added $100 billion in market capitalisation in the past year; we would be interested to see the logic behind an explanation as to how their sustainable earnings have increased at all, let alone by even close to the $10 billion required to justify this increase in market value, through this time. In a relative sense, if not quantum of value, the (domestically focused) general insurers have done a lot better than the banks, reflecting a perfect storm of pricing and investment market returns. After underperforming the market in the vast majority of years since listing, due to a high starting multiple, even AMP has outperformed through the past year. Directly and indirectly, listed money changers in Australia have all benefited from the liquidity boost global QE has given markets.

As with all market trends, fervour is rarely tempered, and the most leveraged prosper most. Just as in 2006 and 2007, payday lenders are enjoying dramatic outperformance; with bigger credit lines, at lower spreads, now being proffered by the major banks than at any time since the GFC. So much for "we are vigilant on credit standards".

Globally, Financials have not led the way. In fact, global Financials have underperformed the MSCI World Index through the past quarter. The larger outperformers in a global index have been Health Care and Consumer Staple stocks; domestically, Consumer Cyclicals have joined Financials in leading the way, whilst Materials, especially the Miners, have been sold.

The consumer cyclical rally is co-incident with broad economic indicators locally but we remain unconvinced either will prove durable. Employment continues to be strong, with the unemployment rate at 5.4%, and consumer confidence is at its highest levels in almost three years, translating into strong retail sales. Our concerns arise as we attempt to reconcile this with the labour shedding currently being undertaken by so many of our investee companies – the major miners, major banks, and most industrial stocks all have lower staff numbers than they had a year ago, and their productivity efforts are accelerating. Some State Governments have also aggressively shed staff through the past year.

Schroders

Quarterly contributors %	Position *	Attribution
National Australia Bank Ltd.	Overweight	0.25
News Corp.	Overweight	0.24
Primary Health Care Ltd.	Overweight	0.18
Alumina Ltd.	Overweight	0.17
Woolworths Ltd.	Overweight	0.15

Quarterly detractors %	Position *	Attribution
Rio Tinto Ltd.	Overweight	-0.54
BHP Billiton Ltd.	Overweight	-0.40
Incitec Pivot Ltd.	Overweight	-0.17
Cochlear Ltd.	Overweight	-0.14
Insurance Australia Group Ltd.	Underweight	-0.13

* Portfolio weights versus benchmark are average weights over the quarter

Distribution details for the financial year ended 30 June

	2010	2011	2012
Total CPU (i)	23.16	27.01	27.41
Capital gains (ii)	0.00	0.00	0.00
Discount capital gains	0.00	0.00	0.00
Non discount capital gains	0.00	0.00	0.00
Franking % (iii)	88.06	82.68	89.75
Growth component (iv)	13.65%	10.58%	-8.28%
Distribution component (v)	3.45%	3.81%	3.58%
Return (post-fee)	**17.10%**	**14.39%**	**-4.70%**
Benchmark (vi)	13.15%	11.73%	-6.71%

i) CPU: Cents Per Unit.

ii) Annual cash distribution represented by capital gains.

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

iv) Growth return is the price to price return excluding distributions.

v) Distribution return includes both income and realised capital gains where applicable.

(vi) Benchmark is the S&P / ASX 200 Accumulation Index

Commentary continued

Loan growth overall, but especially in the SME market, is low single digits; and business confidence is falling from below average levels, suggesting a reluctance to invest, which again does not appear consistent with the official jobs growth statistics. With like sales growth at anaemic levels, if positive at all for many specialty retailers, we continue our underweight position in retail and suspect the absence of near term earnings growth, and more importantly the longer term structural concerns pressuring revenue growth and costs, coupled with high levels of operating and financial leverage, may see much of this recent burst of outperformance ceded as the year progresses. The valuation argument for domestic cyclicals has been a seductive one, but is often mercurial when needed to be relied upon, as investors in mining stocks have discovered in recent times.

After spending the better part of the past decade cheering the “stronger for longer” line as commodity prices raced ahead, and production volumes and capacity expansion accelerated at an even faster rate, the mining sector has now decided to continue on a pro cyclical tack and decrease operating costs and capital expenditure aggressively as prices fall. Just as market prices have compounded increases in profits recorded by financials on the upswing, the contrary is now happening with resources to the downside; as profits are falling, multiples are compounding this to see the stocks dramatically underperform.

We still see some commodity prices – iron ore and copper especially – as materially above a mid cycle level, and hence expect further pressure to revenues for the major miners on this front. However, changing a CEO in order to reduce costs and capex tends to generate a strong reaction; we suspect both major stocks have a bias to surprise to the upside on their cost efforts, and that mining service companies will tend to continue to suffer collateral damage as they discover how little pricing power they really possess. There can be no question that our movement into the major miners has been premature, but we still believe they are significantly better placed to perform than any of their competitors with greater operating and financial leverage in a declining commodity price environment; and in the meantime current multiples for the major miners are so low that some scope for earnings slippage is able to be accommodated.

Within the resources universe, since our investment in Newcrest late last year it and many of its brethren in the gold equity stable have continued to be sold off aggressively. Ironically, if we had been told when we made that investment that through the ensuing year not one major economy would have produced a better than forecast fiscal outcome, and that Japan and the EC would not just join but attempt to usurp the US through the use of monetary policy to stimulate asset prices and demand, our confidence in seeing gold as a viable alternative store of value would have only increased.

Those providing services to miners also suffered during the period, with Leighton compounding sectoral concerns with the resignation of the Chairman and two independent directors following their expressed perception of a breakdown in relations with major shareholder Hochtief. As with other companies that have transitioned from “star” CEO’s in recent times, what has subsequently emerged would suggest that if “ignorance was bliss” for shareholders in Leighton for several years until 2011, reality has been painful ever since. This is a pattern also familiar to QBE shareholders since the 2012 transition of their previous CEO; and was the 2009 experience for ANZ shareholders. This repeated pattern is one reason why we continue to believe that a greater bias of incentive payments to (much) longer vesting periods, payable in shares, would benefit shareholders.

The irony in the Leighton case is that whether or not the independent directors had good grounds for their resignation, minority shareholders (and the incoming directors) will now benefit from their actions. The degearing process being followed by the management team at Leighton can only continue apace with this change in stewardship, which we see as critical for the share price to outperform. Our position in Leighton has not changed after the resignations; our assessment of likely returns has not changed, and our assessment of risk has fallen. With the stock underperforming nearly 10% over the last month, clearly the market did not share that view!

Contributors

National Australia Bank Limited (o/w, +23.4%) After a terrible operating and market performance through 2012, NAB rebounded through the first quarter. We continue to harbour significant strategic concerns with the group, which were not allayed with a first quarter strategic update; however these concerns do not justify the extent of the discount to its more highly rated peers.

News Corporation (o/w, +18.9%) News has enjoyed a great year of market performance, as the previous insatiable appetite to purchase assets, often at prices that delighted vendors, has been quashed through regulatory focus. The operational performance at News has long been at industry best levels; the absence of M&A has allowed some more focus on this attribute by investors.

Alumina Limited (o/w, +23.4 %) As with NAB, several years of chronic underperformance has created a base effect which has aided the more recent relative outperformance for Alumina. The stock continues to trade at little more than net tangible assets and trades a commodity which is linked to a commodity price which continues to trade below what we assess a long run sustainable price, largely due to Chinese capacity. A closure of capacity in the industry would give us comfort that our assumed mid cycle commodity prices may be more likely to be met.

Schroder Australian Equity Fund

Quarterly Report
March 2013

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.

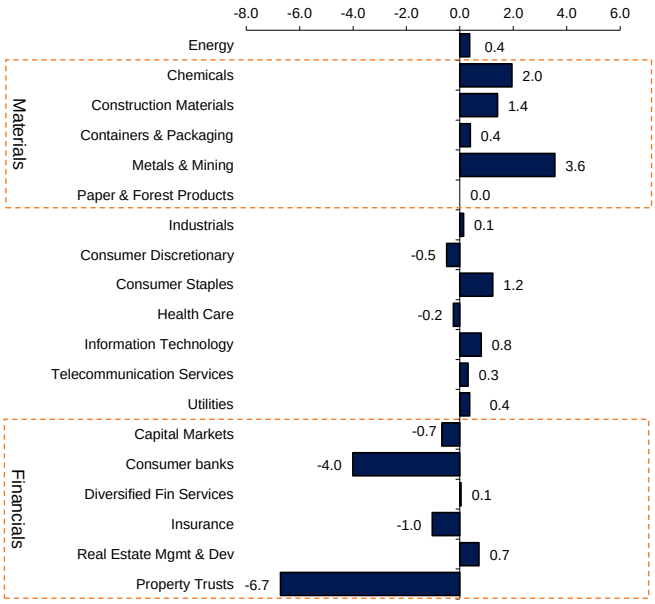
Investment style

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)	$1,607,215,295
Redemption unit price	$8.9488
Fund inception date	March 1964
Buy / sell spread	0.25%/0.25%
Minimum investment	$500,000
Distribution frequency	Normally twice yearly - June and Dec
Management costs (p.a.)	0.62%

Sector exposure versus the benchmark %



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Benchmark is the S&P / ASX 200 Accumulation Index

Commentary Continued

Detractors

Rio Tinto Limited (o/w, -12.1%) and BHP (o/w -10.3%) Fears of drops in levels of ongoing demand, especially from China, has seen the major miners underperform. The playbook is almost identical for each; rising prices through the past decade has seen increasing amounts of capacity added, and an absence of focus on operating returns as high spot prices were forecast into perpetuity. New CEO's have now been installed to aggressively improve operating and capital productivity, which even in the face of declining commodity prices leaves scope for large cashflow generation through to mid cycle.

Insurance Australia Group (u/w, +24.1%) Record operating profits reflect a strong pricing and investment return, and benign claims environment for general insurers. Unfortunately, the insurance cycle has been cyclical for several hundred years and we suspect it may remain so, in which case capitalising peak earnings may not ultimately prove a sound investment thesis.

Incitec Pivot Limited (o/w, -4.3%) A combination of lower DAP prices and higher currency, and less production from the newly commissioned Moranbah plant than had been forecast has seen IPL join many of its mining services peers in underperforming through the quarter. The operating leverage from the provision of ammonium nitrate has been relatively low through time, although IPL continues to have a high debt load relative to the cashflows it has generated, and ambitious capex plans.

Outlook

The six principles we spoke to in setting the scene for our market outlook at the beginning of this commentary are prima facie headwinds for both multiples and earnings. They ignore a critical issue; the management intent to generate good returns on investment even in the face of challenging conditions. As equity markets underperformed, these risks did not become larger; and hence we increasingly assumed more cyclical assets in the portfolio, albeit those which generally are exposed to offshore cycles and feature lower levels of financial leverage. Equally, through the sunshine rally the Australian market has just enjoyed, we have shed operating and financial leverage as those stocks have rallied most. The tide may ebb and flow, but monetary imbalances mean that good (and bad) management will increasingly be laid bare, and through a focus on productivity the better performers have laid a path to how equity holders can be well rewarded even in low growth environments.

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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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