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All I want for Christmas ...

by Andrew Fleming, Deputy Head of Australian Equities

Macro events continue to dominate markets, as much as any time in our memory. This will likely remain the case until underlying imbalances are corrected; any short term rallies, oft fuelled by a renewed bout of liquidity injection by central banks, will usually be unwound without accompanying structural reform. The US didn't undertake structural reform through QE1, QE2, and now the Twist; and despite record profit margins for non financial operating companies, unemployment at near 9% is stubbornly high, and equity markets continue to discount enormous risk premiums. Europe is now wrestling with the best remedy for the same malaise that caused the GFC and continues to weigh on the US; the weight of unproductive debt. The Germans, rightly in our view, remain resolutely in opposition to the use of further debt to remediate too much leverage; especially without structural reform, or "the new fiscal compact".

What policies would address this? Simply put, fiscal policy through time should aim for a balanced budget. In contrast to our forebears, confronted with building the infrastructure required to service future generations and/or rebuilding efforts after wars had destroyed social infrastructure, and our successors, who will be confronted with the looming pension and health care expense of baby boomers in retirement (which we have pretended don't exist, in not accounting for them), the past thirty years have been close to economic nirvana for the western world. And yet we leave this period with government debt to gdp ratios at record highs, and with little in the way of physical infrastructure and other social benefit (such as life expectancy or improved health) to reflect this high level of spend. The cost of this reckless abandonment of fiscal responsibility now needs to be borne by one of two parties; the lenders to governments, still needing to account for the loss of capital as these loans sour, or (future) taxpayers, left to pay the residual. The US model, adopted by the Irish, sees bondholders made good, and hence taxpayers bearing an undue cost; fortunately, Germany seems determined to ensure that Europe adopts a more rational and sustainable path, with the Greek model seeing private bond holders losing half their investment.

Language isn't helping. "Austerity" is now the term de jour used to explain a policy of spending more than you earn as a sovereign, just to a lesser extent than you did previously. Hardly Dickensian, although the bleak term conjures a spartan existence. Little wonder governments are changing and civil unrest is rising. When Warren Buffett asks the government to raise his taxes, Gini ratios are at all time highs everywhere in the world, and the evidence of the past decade calls into question the social value of many wholesale financial transactions, whilst the cost of those transactions has been socialised, it appears some ready avenues for increased government revenues through new, equitable, efficient and effective taxes are present.

All of this matters for Australian equity investors in two ways. November again highlighted that inherently unstable economic environments lead to unstable investment markets. As economic imbalances continue to be addressed, and we enter a period of lower GDP growth than we have experienced and prolonged deleveraging in the western world, volatility in markets is likely to continue. However, lower economic growth is likely in itself to have no bearing on the returns derived by equity investors. By way of illustration, this year, Chinese GDP growth has been a little more than double Australian GDP growth, which in turn is about double US GDP growth. And yet equity returns are exactly the opposite, with US returns bettering Australian, which in turn better Chinese. Over a long period of time, whilst Chinese GDP growth has been strong, equity returns from that market have underperformed developed markets. Lower GDP growth in developed markets through an extended period of deleveraging need not equate to poor equity returns; in fact, no evidence exists that it has in the past nor does intuition suggest that it should in the future.

Stocks performing best in a deleveraging environment, though, will differ from those that did best through the reverse. In this "new normal", we look for two qualities in preferred investee companies. Firstly, an ability to make the price in the market in which they operate. In most parts of the world, companies dominated by intellectual property, such as IT and Pharma, lead the list of price makers, whilst commodity producers are, through a cycle, at the other end of the spectrum. The Australian market features few price makers, and is dominated by price takers, when seen in this global context. The notable exception in Australia from the global norms is financial services, which tends to exhibit greater pricing power locally than is exerted by global peers. Secondly, the investee companies we expect to do best in a deleveraging world display a relentless focus on productivity. This is often a management response to faltering demand, rather than an initiative pursued with full



force whilst demand is still strong. Telstra has had this focus for several years; the banks are now starting to embrace it; whereas resource stocks are still forsaking any thoughts of productivity whilst ongoing high prices, translating to extremely high margins, continue to encourage a volume focus.

Within the Australian market, stocks such as James Hardie, Woolworths, Brambles and Amcor reflect both of these preferred characteristics.

James Hardie of course generates 90% of its earnings and value from its US operations, where it has a 90% market share in fibre cement. As annual housing starts in that market have dropped from more than 2million in 2006 through a fifty year low of 600,000 in more recent years, Hardies has continued to produce operating margins above 20%. We cannot think of another stock in the portfolio that could keep margins at anything like this level when a primary demand driver (in this case housing starts) is at less than half a sustainable level, which has only been achieved by James Hardie through an aggressive use of both pricing power and productivity initiatives.

Woolworths has seen the end of the Michael Luscombe era. Whilst plenty in the market are critical of his tenure, it is easy to forget that between 2007 and 2011 ebit grew 50% from \$2.1b to \$3.2b, a record the envy of many corporates through what was a period of great tumult. Whilst clearly its major competitor has improved its performance and now represents a far greater competitive threat than was the case at the beginning of CEO Luscombe's tenure in 2007, even in the most recent financial year the growth in ebit per square metre generated by Woolworths, was greater than that generated by the resurgent Coles. To continue to improve an organisation performing at a sustained and high level is often more of a management challenge than reinvigorating an ailing organisation.

Brambles, though, is a good case study of an organisation that is being reinvigorated, with high calibre appointments in the past several years to the most senior levels of management. Amcor is a more seasoned example but one where a new generation of management have materially improved performance. In Amcor's case, shareholders are also benefiting from a large acquisition made at the depths of the market gloom several years ago, as opposed to most mergers and acquisitions which are often pro cyclical and undertaken when asset prices are far higher, and hence expected returns to the acquirer become much lower. Finally, the operating results of all of James Hardie, Brambles and Amcor have not been assisted by the high Australian dollar, and yet are good examples of management creating strong shareholder returns even in the face of poor economic growth in their major markets, through focusing upon our two tenets of making the price and focusing upon productivity.

Portfolio outlook & strategy

This year, our Christmas list includes four simple wishes;

1. Fiscal policy targeting surpluses through a cycle, and being honest about how they are achieved in the face of lower nominal growth rates as the world deleverages;
2. Monetary policy not being seen as a panacea for confidence, in the absence of accompanying structural reform;
3. Management focusing upon creating competitive advantage and executing it through a focus upon price and productivity; and
4. Investors' understanding that growth is likely to be lower for an extended period; and that the relationship between this growth experience, and investment returns is likely to remain tenuous, at best.

Yes Virginia, there may be a Santa Claus, but we don't expect our four wishes to be fulfilled. We can but be comforted that our portfolio continues to be positioned 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, or with exposure to domestic industries where cyclical debasing has already occurred. Balancing these factors has dominated our thinking in constructing the portfolio through the past several years, and now reflects our assessment of future likely returns, which have of course increased as market prices have fallen, and these attendant risks in the portfolio.

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