

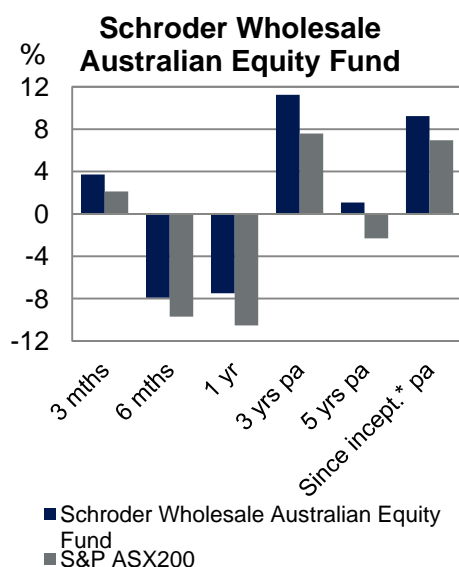
# Schroders Fund Focus

## Schroder Australian Equities



Martin Conlon, Head of Australian Equities, discusses how global events are impacting the Australian economy and Australian businesses in addition to his views on finding value and opportunity in the sharemarket.

### Performance to 31 December 2011 net of fees



Source: Schroders. \* Inception = July 2002

### The sovereign debt crisis in Europe is severely impacting investment markets around the world. How is it specifically affecting the Australian share market?

There's no doubt that the sovereign debt crisis is affecting Australia on a number of fronts. Firstly, on the simple issue of confidence. The inability of governments and policy makers to propose a viable path forward is sapping investor confidence and ensuring that wealth protection remains the dominant focus and risk aversion remains high. Secondly, capital flows are having a distortionary impact. As investors increasingly desert economies that are in trouble, capital is flowing aggressively into those that are perceived to be safe, including Australia. Australia continues to see massive inflows of capital as a result of our relatively low levels of government debt and interest rates that are higher than the rest of the world. This has led to an artificially high Australian dollar which is having a huge impact on the economy and the sharemarket.

### What is the biggest threat to the Australian economy?

There's not much doubt that the biggest threat to Australia is a sharp slowdown in China. To date, we have managed to evade most of the impacts of the global financial crisis courtesy of strong commodity prices and exceptional terms of trade. However, in the event that China's economy does slow it's going to significantly impact the cash flows from the commodity boom. That is, royalties will fall, commodity prices will fall and government revenues will fall sharply. While that will create some short term dislocation in areas of the stock market highly reliant on commodity prices, in the long run we believe it will be a good thing, in that Australia will become more competitive in a range of industries and not just dominant in one. A restoration of competitiveness is very important to the Australian economy in the medium term.

### In your opinion do you see valuations of Australian equities as cheap or expensive at the moment?

The question of valuation is always somewhat convoluted. Most observers would tell you that PE ratios are at the low end of historic ranges. While that is true on the surface the reason we are more cautious than some other players is that we believe the earnings base tends to be the dominant driver of valuations and not PE ratios alone. Earnings are currently elevated by historic standards although we are seeing some level of correction, particularly in areas such as retail and currency exposed businesses. So, while PE ratios for equities may appear relatively cheap, particularly against bonds, our concern is that on the earnings side of the equation there are significant adjustments still to come. The overall picture has us seeing stocks around fair value rather than outrageously cheap.

### Looking forward to 2012 which sectors do you believe will offer the best returns?

It's always very difficult to bucket returns in sectors, and we believe forward-looking returns are going to be far more stock specific than sector specific. We find significant divergence between those companies that believe what's going on in the world at present has a large element of

structural change, and those that prefer to convince themselves that factors driving business conditions are largely cyclical. The former companies are adjusting their businesses to cope with that new environment and typically have less debt than they have had over the last 20 years and are sizing their business for a level of demand that envisages a very slow demand growth environment and one where costs have to be kept under control. The other area we focus on is pricing power. Most industries in the world currently have too much capacity and that is eroding pricing power, particularly in commodity businesses. This makes it even more important to focus on businesses that have some control over their pricing and can control their destiny. We think that the combination of pricing power and less than aggressive leverage are going to be more important than sector thematic.

**Schroders has been underweight resource stocks for several years now. What needs to happen before you would consider taking an overweight position?**

We are always happy to take an overweight position when we think the value of a business is more than its current market value. Most importantly, in valuing that business we are always looking at sustainable earnings. In the case of resources stocks, we concentrate on whether valuation is reasonable given sustainable production and sustainable commodity prices. There are still a number of resource stocks we own and are happy to own because they fulfil those conditions, however, there are a lot of others we think are factoring in unrealistic commodity prices in the longer term. Our other concern surrounds an expectation by resource investors that the good fortune of controlling a mineral deposit should entail significant excess return in isolation, rather than as compensation for the risk of significant capital investment.

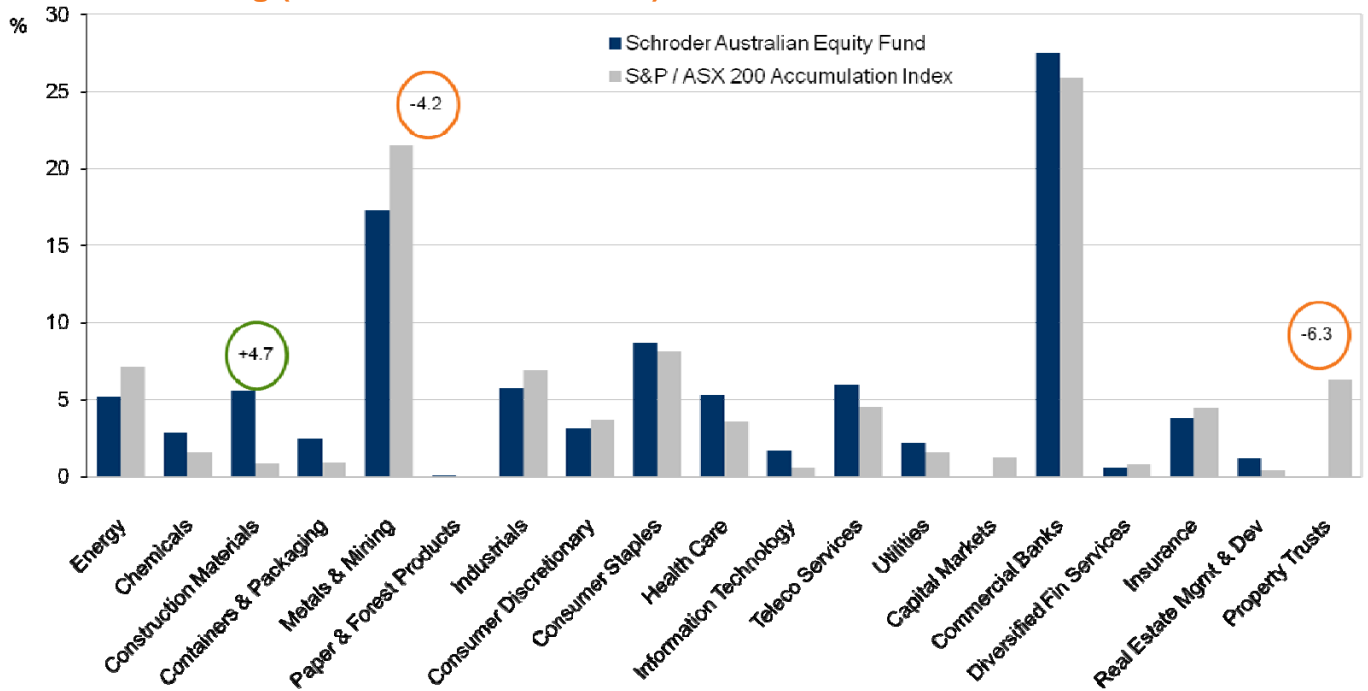
**During the December 2011 quarter what were the biggest stock positions you took in the portfolio and why?**

We continue to be focused on the longer term and don't alter the portfolio around significantly. We are looking for decent businesses that control their destiny and are sensibly run considering the relatively tough environment. Buying those qualities at cheap prices is the challenge. It happens sometimes and you've got to be prepared to move when those opportunities arise. Cochlear is a recent example. The recent product recall caused the stock price to react very aggressively on the downside. We look at events like this as transitory and expect that Cochlear will remain the dominant player in a good industry with a great business. For that reason we took a reasonable position in Cochlear while others were selling. Elsewhere in the portfolio we remain invested in companies that continue to fit this criteria including James Hardie, Brambles and Woolworths. These companies are not aggressively geared, have good pricing power and sensible management in a relatively tough environment.

**How is the Australian Equity portfolio currently positioned?**

Our positioning hasn't changed significantly over the last 12 months primarily because our outlook for the world hasn't changed much in this time. We are relatively cautious with the world facing issues that, in our view will take a long time to resolve. As a result our sector positioning changes relatively slowly. The caution on resources continues to dominate. In other areas like listed property we remain underweight for valuation reasons as we are cautious on paying too much for those cash flow streams. Positioning remains very stock specific rather than sector dominated and we hope to remain that way. We will always be opportunistic in taking positions in well run industrial companies where we can.

### Sector Positioning (as at 31 December 2012)



Source: Schroders

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