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# Australian equities: outlook 2009

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**Abundant and cheap capital of recent years has seen companies generating mediocre returns on this capital enjoy undeserved prosperity. A more discerning capital environment should direct capital towards those able to use it efficiently. Rather than overreacting to current balance sheet structures, investors should focus on the sustainability of a company's returns. In doing so, one could avoid the overarching generalisation that all companies with currently low gearing are good, and not all those with high gearing are bad.**

Waxing lyrical on the short-term direction, quantum and composition of equity market returns is not one of our favourite pastimes, as the odds of anticipating these variables to a more accurate degree than a dartboard are no better than average. We'll try and focus on observing the facts and not getting caught up in the tide of prevailing sentiment. Panic has rarely been a useful emotion for an investment manager.

## The landscape

Let's start by recapping on the now blatantly obvious:

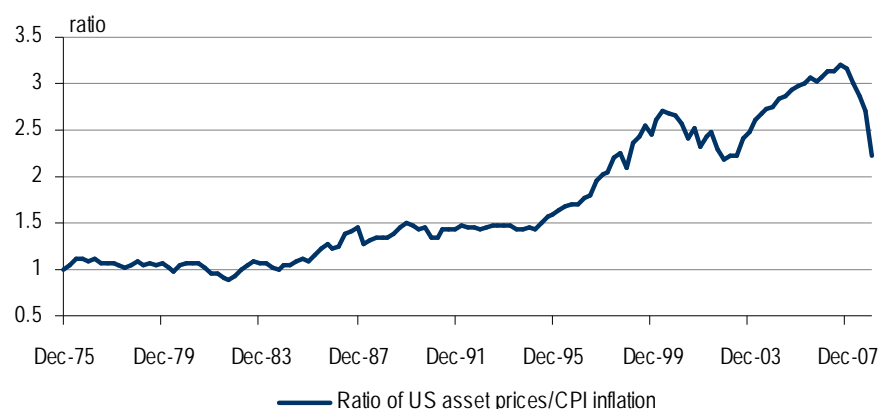
- The macroeconomic picture in the vast majority of major (and minor) economies globally is sharply weaker than a year ago, and still weakening in most. Inflation fears have disappeared and the deflationary impact of the credit crisis is keeping central bankers more than amply occupied.
- Unemployment is rising globally, as companies rush to support profits and adjust to lower demand and activity levels by shedding labour.
- Printing presses have been put into action as governments inject liquidity. Whilst many observers accused governments (particularly the US) of printing money in recent years, in reality, money supply growth was relatively subdued. This is now changing.
- The credit crisis is a big deal. Observers expecting emerging economies (primarily China), to sail on unperturbed have changed their minds (probably five or six times since) in typical economist fashion.
- Massive amounts of global wealth have been destroyed and risk aversion has escalated sharply. Asset prices have declined rapidly and consumer confidence has been shattered.

It is this single word, 'confidence', which is probably the most important in establishing the basis for more favourable market conditions, and its high level of unpredictability which makes forecasting recovery so difficult. There is little doubt that confidence will return over time, however, it is crucial that the recovery is based on sound fundamentals and business investment, rather than an expectation that a burst of consumption fuelled by government handouts or attempts to re-ignite house prices with first home owner grants. We seem to have learned few lessons from the US experience to date.

In our view, the confidence issue has its root in the expectations of consumers on the prices of assets and goods. The widespread use of the terms inflation and deflation and the lack of clarity in what these terms mean for the average consumer remain perplexing from our perspective. The nirvana which policy makers and investors seem to seek is not one that is readily available. A happy world in which the prices of 'assets', such as real estate, stocks and bonds rise in perpetuity, while the prices of the bricks, cement and steel used to build the real estate and drive the profits of the companies making up the economy are expected to remain relatively stable. This might happen in the Land of Oz, where the

Emerald City doesn't seem to need much maintenance and the yellow-brick roads don't have tolls, but unfortunately Dorothy has clicked the heels of the ruby slippers together and we're back in Kansas. The years in which western economies outsourced manufacturing to countries offering cheap labour and happily borrowed more money each year to keep the cycle of consumption and growth continuing have come to an end. More questions need to be asked of why an equation of no or very low population growth and ageing populations justify GDP growth targets of 4%+ and credit growth in the double digits. The equation doesn't seem overly balanced on my maths. This is not to say that the asset prices (and particularly equities) should move in line with CPI, as productivity gains etc. should enable investments to deliver better returns, but asset prices will not always be a rising line and goods prices a flat to falling line.

The chart below shows how asset prices have moved relative to CPI in the longer term for a developed economy such as the US. There have been extended periods in which the ratio has barely changed.



Source: Merrill Lynch December 2008

The good news is that asset price adjustments over the past year or so have made very substantial progress in moving these variables back in line. Expectations that rising asset prices will allow consumers to spend beyond their income indefinitely are long forgotten. Savings are rising rapidly, cash is king, debt is a dirty word and investors are hugely risk averse. So where do we go from here? I'll start with a brief list of positives and negatives.

Positives	Negatives
All the negatives raised in my opening passage are both known and factored into investor expectations	The dire economic news globally will have obvious impacts on businesses and consumers. Unemployment will rise, demand will suffer and company profits will fall
The process of recapitalisation of corporations and banks is well underway, particularly in Australia	The massive accumulation of financial leverage cannot be unwound quickly. Consumers must make a structural adjustment to spending, not just a cyclical one
Valuations of equity and debt (particularly the higher risk varieties) have moved to historically attractive levels on almost all measures	
Interest rate reductions are making the hoarding of cash increasingly unattractive. As return differentials between low risk and high risk assets continue to widen, incentives to assume risk will heighten	
Investors are now extremely risk averse, causing defensive assets to be extremely aggressively priced and risky assets pessimistically priced	
The re-emergence of Paul Volker and his ilk as part of the Obama administration is likely to see US monetary and fiscal policy more durably set than has been the case for the past decade.	

Overall, we would conclude that the scorecard is becoming skewed far more materially to the positive side. Prospective returns for all but the terminally irrational must necessarily look far more attractive than they did a year ago, but as bank deposits skyrocket and investors run for the security of gold bars, you wouldn't know it.

### The impact of financial leverage

The vastly dominant theme in stock selection over the 2008 year has been financial leverage. Almost all stocks perceived to have excessive leverage have been savaged, and the correlation of stock price performance with leverage has been extraordinarily high. In the midst of a financial crisis there is obviously some logic to these moves.

- The necessity to refinance debt has shifted the power dramatically towards banks. The fate of equity holders is increasingly in the hands of bankers. Not a situation in which we're comfortable given historic lending practices.
- As the multiple which investors are willing to pay for stocks contracts (and the risk premium expands), leveraged companies fare worse by definition. That is the nature of equity investing.

Cyclical stocks which had benefited from buoyant global growth and strong demand ran a close second. After extrapolating perpetually buoyant conditions, the scorched earth philosophy now prevails. Logic would dictate that any return of risk appetite should see stocks with financial leverage and/or more cyclical earnings fare best. As defensive and conservatively geared companies have trounced their leveraged counterparts in performance terms, there is little logic in a market recovery led by defensive stocks which are 10% or 20% off their all time high. Economic value is not created disproportionately by defensive companies, it is just created in a more smooth and comfortable fashion. As many cyclical and/or financially geared companies trade at historically low multiples of book value, earnings and most other valuation measures analysts could proffer, whilst defensive counterparts command valuations reserved for more optimistic market conditions, we have little doubt that rewards in the future are more likely to accrue to those prepared to take some risk.

### Productivity gain

In addition to assuming some risk while others are shedding it, we would urge investors to look at those sectors which can deliver future productivity gain and genuinely enhance economic growth. History has given us ample lessons that competitive differentiation and innovation are more likely routes to prosperity than seeking volume growth without it. The history of companies planning to strike it rich selling beer, software and most other products into the HUGE Chinese market is not one littered with success. Volume growth, GDP growth and population growth are often quoted, but generally illusory sources of wealth creation for investors. Sectors such as technology, healthcare and others, in which Australia can produce high quality, differentiated products which produce better returns per unit of capital than their global peers, should always be the first port of call for investors.

Let us look briefly at the positioning of major sectors and perhaps suggest a few stocks.

### Real Estate

In my view, real estate falls firmly into the category of sectors which have (in general) been delivering exceedingly mediocre cash returns on capital for investors for extended periods of time, yet continue to attract substantial new capital on the basis that investors expect ongoing capital gains regardless of the cashflow fundamentals. It is also a sector which has relied disproportionately on debt markets to fuel growth strategies, and one to which banks globally, remain significantly over-exposed. Valuers remain reluctant to acknowledge a changed environment, and 'worst case scenarios' of 200 basis point blow-outs in cap rates remain laughably low relative to what every other asset around has already experienced. If debt securities can be priced at 1000 basis points over swap, I'm not quite sure how 7% cap rates are a worst case scenario for a shopping centre. Add to this, the fact that even the lower geared REIT's have interest cover of 2-3 times (which explains why the moves in equity values look,

rather than are, quite dramatic), you can understand why we don't believe new capital should be deployed to this 'asset class'.

### Resources

Whilst the bubble has undoubtedly burst, resource stocks remain one of the more challenging longer term calls. Our cautious thesis over the past couple of years has been based on the view that commodity stocks overall would not generate significant excess returns in the longer term, particularly in areas where the commodity was not in short supply. Share prices earlier in 2008 reflected ludicrously high return expectations for both poor and good quality companies alike. This has changed very meaningfully in some stocks, and less so in others. In an area in which the quality and cost positioning of the resource base will always be important to the quantum of returns generated, we would suggest investors remain focused on buying companies with good quality, low cost assets. In times where gearing levels cause panic in these assets, they will generally represent good buying, as the assets will remain of good quality, and sensible buyers will want them. This situation arose recently in Rio Tinto, as the sensible withdrawal of BHP Billiton from the bid, caused panic on the Rio Tinto financial position, to a level where the stock, in our view, became markedly cheaper than that of the bidder (and probably still is). We will continue to concentrate on the level of earnings which we expect that assets to generate prior to worrying about the current balance between debt and equity in all the businesses we look at. The failure of many others to do this is the source of very significant opportunity at present.

### Banks

As the leveraged equity play on the underlying economic rate of the economy, the banking sector clearly faces cyclical headwinds through the next two years which will see profit growth at best muted. This cyclical pressure is magnified by the spectre of foreign banks withdrawing from Australian debt syndicates, seeing approximately A\$50b of debt needing to be adopted by new lenders or the equity market through the next few years. Further, after 14 years of returns on equity being 2% either side of 19% for the sector, and RoE changes driving equity prices for the banks through that time, the rise in tier 1 capital ratios to 8% is depressing RoE's and share prices. Beyond this cyclical maelstrom, however, the withdrawal of foreign banks has led to an even better industry structure, allowing pricing power to return to the market (with net interest margins improving for the sector in 2008 for the first time in more than a decade). We see little reason to believe the historical similarity in RoE's derived by the major Australian banks will differ in the future, and hence relatively favour those trading at closer to 1.2x nta (ANZ and NAB) over those trading at closer to 2.0x nta (CBA and Westpac).

### Defensive Industrials

Unsurprisingly, in an environment characterised by panic, defensive has been an attractive term. This has been the area of the most lucrative relative stock performance, and in our view, holds probably the least opportunity. Beer, packaging, telecommunications and food retail have moved from the mundane to the revered, as earnings security (rather than growth) takes precedence. We have no argument that many of these businesses have good quality, sustainable earnings, and in many cases, generate strong returns, however, the pricing (which in most cases sees multiples of earnings before interest and tax (EBIT), well above 10 times), have more than reflected this status. It is only in isolated instances (often debt induced), where opportunity can be found. Businesses such as Primary Healthcare still fall firmly into the defensive earning category, and undoubtedly fall into the strong organic return on capital category, yet debt concerns have overshadowed these attributes. As interest rates fall and earnings remain robust versus the general economy, the significant increased cashflows to equity holders which lower interest rates can provide should allow underperformance versus more lowly geared (but not higher quality) businesses, to reverse.

### Cyclical Industrials

The increasing dominance of earnings and share price momentum investment strategies has made life difficult for cyclical industrials. Investors with philosophies based on 1 or 2 year earnings results are heading for the exits, while those employing (price for earnings growth strategies) are faced with the conundrum of needing to sell stocks below zero as their valuation tools (not in my opinion!) fail to cope with less favourable conditions. In a similar vein to resource stocks, it is clear that the direction of earnings for many businesses in this category is undeniably negative. Share prices have moved rapidly

to reflect this anticipated decline. It is in this area which we believe the most fruitful opportunities exist for investors. The most important factor in taking on risk in this area is to distinguish between businesses facing a cyclical downturn in conditions with those facing structural decline. By way of example, we remain extremely reluctant to invest in businesses for which technology and productivity gain, are creating increasing headwinds. Newspapers and free to air television are examples of businesses which we would expect to be in structural decline. In contrast, we have no issue at all investing in businesses which generate earnings in a less stable manner, but for which no such structural issues are identifiable. Building materials and logistics are examples, and businesses such as James Hardie, Fletcher Building and Brambles are in the category which we see as having absolutely no concern on the viability of their business models as return on capital through cycles has always been strong. Businesses such as Computershare that are also embracing technology and economies of scale to both lower costs in their existing business and expand potential revenue to segments relatively un-penetrated by productivity gain are also attractive opportunities when other investors focus predominantly on short term earnings.

### Conclusion

We can only re-emphasise that our skill set does not extend to correct identification of the day in which markets 'form a bottom' and 'move into a more constructive upward phase'. These phrases are best left to chartists and market commentators, and will, in my humble opinion, continue to constitute a 'luck set' rather than a 'skill set'. I hope I'll have the good sense to retire prior to needing to consult the Ouija board for stock recommendations. The unfavourable cyclical conditions which now face the Australian and global economies, will most certainly result in challenging earnings conditions for a large number of companies. The length of time for which these unfavourable conditions persist is uncertain, but could well be of longer duration than most recessions (based purely on the fact that the upturn was similarly longer). This does not, however, justify starving good quality businesses of capital just because current conditions are unfavourable. I hope that investors will have the good sense to assess earnings and returns across the abyss, rather than extrapolating into the abyss, as failure to do this will most certainly extend the period and severity of economic pain.

The views and opinions contained herein are those of Martin Conlon, Head of Australian Equities at Schroders, and do not necessarily represent Schroder Investment Management Australia Limited's house view.

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